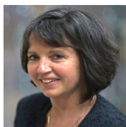
COVID19:
The Good, the Bad, and the Ugly



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"Market Meteorologist says Winter is Just Beginning"
"Tech Stocks Being Taken to the Woodshed"
"WHO Says Outbreak has Potential to Become Pandemic"
"Handwashing Seen as Better Virus Defense than Sanitizer"
"Coronavirus Fallout Spreads to Manufacturers in the US"

These are just a few of many headlines appearing in the business news today, February 27, 2020. It is no wonder that global markets are in full-on panic mode and have now corrected almost 10%, giving back the gains of the last four months.

As long-term investors who rely on stock selection rather than on market timing, what do we make of this? Is it time to go to cash and wait until the indiscriminate market sell-off is over? Or is this massive fear trade already overdone? We are the first to admit that we don't know, nor does anyone else. However, there is already much that we do know that can help us start to think about how to position ourselves in the new Corona World Order.

COVID19: WHAT WE KNOW SO FAR

There seems no need to repeat here all of the readily available facts and figures on the progression of the COVID19 Coronavirus. Rather we prefer focus on information we think is perhaps not yet well incorporated into the "common wisdom." The caveat here is that the information flow is so substantial and incessant that our thinking today may be outdated or challenged tomorrow. With that in mind, here goes the Good, the Bad and the Ugly, but in reverse order:

The **Ugly**

Some have pointed to the thousands deaths from seasonal flu as being a much bigger concern than Coronavirus, and therefore as a reason not to panic since we do not panic about flu. Others have used the SARS and MERS virus trajectories as a buy-the-dip justification. When compared to seasonal flu, the estimated infection

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rate, "R0", of Coronavirus appears to be 2-3 (people infected per person with illness), versus 1.3 for the flu, so about TWICE as infectious, *from what we know now*. Also, based on deaths per confirmed cases, the mortality rate appears to be much higher, at around 2% versus 0.1% for the flu. Comparing flu deaths to COVID deaths is premature at this point, since flu seems endemic, affecting about 1bn people each year, versus Coronovirus, which appears novel and in the early stages of spread. However, if not contained and if no effective preventive measures or vaccination are found soon, COVID would theoretically infect 2Bn people in one year compared to 1Bn for the flu (twice as infectious), and kill 40 million (2%). The Yokohama cruise ship is an empirical test tube for the virus. From (presumably) one infected passenger, about 17% (621) of the ~3,700 people on board have so far tested positive for the virus, and 2 have died so far. Diagnosed Korean cases have gone from 50 to 1,500 in one week. Comparing this to SARS and using SARS-based analysis of potential market impact, is clearly no longer valid at this point; SARS only sickened 8,000–10,000 people total. COVID is likely over 100,000 today, and is likely in its early exponential growth stage.

COVID mortality disproportionately targets the old and sick at this point, which is less disruptive to the world economy. But the potential impact on global GDP from supply chain disruptions, transport disruptions, and significant tourism and travel disruptions, are massive, even if the virus is brought under control within 6 months. In a pandemic scenario where the virus spreads globally and is not contained for at least 6 months, a global recession seems unavoidable.

The **Bad**

Markets hate unexpected bad news, but when the bad news is quantifiable, investors assess impact, react accordingly, and move on. What causes panic and significant and persistent market drawdowns is uncertainty. The lack of reliable and/or complete information creates a void to be filled with worst case scenarios and, worse, fabrications and conspiracy theories, that lead to indiscriminate selling. Market attention has so far been focused on China in terms of contagion, supply chain disruption, and global economic impact. However, the great uncertainty is in how far and wide the virus will spread outside of China and how other countries' economies will be impacted. The Korean virus experience so far plays into the worst case scenario, where observable exponential growth of 50 to 1,500 cases in one week is being attributed by some to a sect spreading the virus intentionally, a clear conspiracy theory. Italy's shutdown of the Lombardy region is driving rumors that reporting of new cases is being suppressed in France. Today a new case in San Francisco that is not traceable to China or contact with infected individuals contradicts President Trump's insistence that the virus has been contained and is unlikely to spread.

Arguably, China is better placed than most to move beyond the virus, as evidenced by the country's ability to quarantine tens of millions of people, to force shutdowns of vast swaths of the economy to prevent contagion, and to build hospitals with thousands of new beds in *days* to house and treat the newly infected. It is difficult to imagine the same draconian, but reasonably effective, policies to be possible anywhere else in the world. Therefore, it is quite likely that the bad news of contagion will continue to trickle out and undermine the Pavlovian buy-the-dip strategy that has served investors so well for the duration of the very long bull market we have experienced. The preponderance of indexed and ETF strategies will only exacerbate the correlation of asset selling, flipping markets from greed into persistent fear. It does seem that any investments that have benefited from overexuberance in the recent rally will be the most vulnerable to selling pressure. Investors wanting to protect gains from the last decade will likely add to the selling pressure.

The **Good**

With that very negative backdrop, how can anything be "Good" in this scenario? As we've stated above, markets hate uncertainty above all else. In this era of ubiquitous information, fake news and facts mingle, but empirical evidence does get a disproportionate hearing by investors since real money is at stake. The fact that China appears to at least be *managing* the virus (with draconian measures), meaning that it is *manageable*, is a positive piece of information. Also, China's virus research innovation over the past decade and front row experience with COVID may lead to informed treatment recommendations for the rest of the world. For example, the lethality of COVID seems to come from an excessive immune response that results in

organ shutdown. Early treatments in China using high dose steroids may have contributed to high death rates by over-treating the immune response but clearing the way for fatal bacterial infections. Updated treatment regimens of low-dose steroids may result in better mortality statistics.

The low number of child and young adult cases and deaths, and the mild symptoms for most who are infected, may signal a much higher R0 than 2-3. However, this may also mean that the COVD19 resembles other less lethal forms of Coronavirus that may have been circulating in the population much more broadly than previously thought, imparting partial immunity to large swaths of the population. In any case, it is quite likely that a fast, reliable test kit is forthcoming that will allow scientists and statisticians to better understand how infectious and lethal the virus actually is, which removes some uncertainty and allows the markets to quantify scenarios and move on.

WHAT NOW?

So we are back to our original question, what to do? Past experience tells us that it is never good to join a panicked, indiscriminate selling response. However, it does appear quite likely that the COVID19 virus will trigger at least a short-term global recession and disrupt global supply chains for an extended period of time. This means that we do need to look at economic sensitivity, leverage, and asset-light business models that rely on global supply chains, as areas that seem most vulnerable to a sudden recessionary scenario. Our portfolio construction and stock selection have always focused on a variety of business model drivers, with equal emphasis placed on valuation, growth, quality, capital deployment and persistence. So while we do own recession-vulnerable business models that require revisiting, we also feel confident that our investments overall reflect solid long-term fundamentals that should be rewarded once the market moves to a more discriminating phase of evaluating winners and losers in a less uncertain market backdrop.

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