NAPATREE
CAPITAL

Commentary | March 15, 2020

Coronavirus Crash. What Now? What Next?

First and foremost, we have tried to speak with as many clients as possible the past two weeks; if you need to speak to us directly about your account, please call or email. We are in uncharted territory as the world grapples with the coronavirus. We will attempt to provide our scenario for what we feel has been extreme panic and how to best move forward.

We haven't faced a pandemic this widespread in modern history, and perhaps it has taken time for everyone to fully understand that. But here's the constant through all this mayhem: basic human behavior does **not** change. During times of extreme uncertainty, the market tends to discount a lot of "bad stuff". We as humans are not immune to the emotional aspect of investing, but history shows that panicking during such periods is never warranted. We all have different needs and goals for our assets; hopefully Napatree Capital has set you on a course to navigate these turbulent times and maintain a longer-term focus.

Extreme Selling

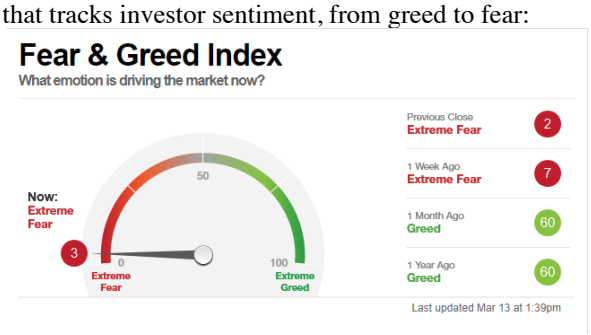
In mid-January we sent out a note titled "A Time to Play Defense" in which we outlined reasons why we thought stocks could face some trouble in the coming month. We also reduced exposure to equities across most client accounts. In no way could we have foreseen this type of sell off.

The level of selling in the stock market is nearly unprecedented. On Wednesday and Thursday of this past week, stocks gave up more than 16% in value. That has only occurred one other time in history: Black Monday, October 1987. If an investor held through that turmoil, she was rewarded as stocks returned between 25-30% a year later.

Another measure we follow is investors' level of fear, which is quantifiable. When fear is highest, the market tends to rally in the following weeks and months. Fear is scientifically measured in part by the volatility index, or "Vix." As fear rises, so does the Vix. Typically, a reading of 50 is considered extreme. On Thursday, the Vix registered a reading of 76, a level of anxiety not seen since the 2008 financial crisis. Does that mean the market is telling us we are about to go through a similar period? Possibly, but there is a silver lining.

There have been nine other periods with similar levels of fear, all occurring during either 1987 or 2008. A year after each of these instances the market was up by an average of 18%. During some periods there was additional pain, but each time the market was higher 12 months later.

We also monitor a CNN index that tracks investor sentiment, from greed to fear:



Not only is 3 an extreme, but the gauge moved very quickly from greed to extreme fear, in just a month. Another illustration of the severe nature of this correction. We are being quite technical here, but hopefully the message is clear. The level of panic is dramatic by all measures. We know you feel it because nobody is immune, including us. But history shows that during heightened panic, in general it is not a good time to sell stocks. *(Unless you have short term needs – everyone has a different situation.)*

Saudi/Russian Oil Dispute

Adding injury to insult, the Saudi Arabian government decided to **increase** oil production because the Russians refused to accept a global reduction in the output of oil. The Saudis are tactically weakening oil prices to force the Russians to agree to a cut. The economies of both countries rely heavily on revenue from oil production; as a result, all of the publicly traded energy stocks have gotten pummeled. It is likely a needed corrective for those smaller companies whose balance sheets are weak and have high debt loads, but if this situation is not remedied soon, it could have a ripple effect on our economy.

We don't have any special insight, but we suspect that neither country could allow this dynamic to continue for too long. It is not in either of their best interests, especially as demand for oil slows due to an almost complete halt of travel globally. Still, we remain concerned.

Economic Impact

The economy had been on solid footing prior to the coronavirus spread. As recently as two weeks ago the Department of Labor reported that the economy had created **more** jobs than expected. In the short term, though, there is little doubt that this pandemic will hurt the economy. Besides travel and leisure, many small businesses – hair salons, restaurants, coffee shops – will feel some pain as quarantining continues. We believe the stock market has discounted much of this. How bad could it be? It's very difficult to say.

Ok, so, where is the good news?

Silver Linings

Government Response

On Friday afternoon, the administration announced a number of constructive measures to assist with testing for the virus and support the economy, working directly with major US corporations. While this has been a bit slow the markets welcomed it and we do expect continued fiscal programs in the coming week. Small and medium sized businesses will require assistance, i.e. guarantee paid time off for employees who need to be quarantined. We fully expect a package that provides a lifeline to the airline and travel industries as well.

Maybe this pandemic will lead to some unity – finally – in Washington. There hasn't been a more critical time since the 2008 financial crisis for our politicians to roll up their sleeves and do what is best for the American people, regardless of political affiliation.

Health Measures

Last week, the Swiss pharmaceutical firm Roche received FDA Emergency Use Authorization for the first commercial test to detect the coronavirus. This will allow high volume testing and significantly increase testing capacity. One of the issues with dealing with the virus has been the lack of widespread testing. This is a major positive.

We wouldn't be surprised to see similar news from other drug companies. Gilead Sciences, for example, is in the trial phase for a coronavirus drug. Results are not expected until late April, but if the company publishes positive interim data, that would be significant in calming fears, and markets too.

Finally, there seems to be two very different trajectories for the virus for the United States. If we look at South Korea as a model, that country went into immediate emergency mode with wide-ranging measures to protect the citizenry, with excellent results to date. Italy and most of Europe, however, seemed to have been behind and those countries are suffering greatly as a result, both from a health and economic perspective. The following illustration from Johns Hopkins helps convey the message:

You've probably heard the term "flattening the curve" …now you see it graphically and hopefully understand its significance.

<u>The Economy</u>

While it is nearly impossible to predict the economic ramifications of the coronavirus, there is one indisputable fact: the U.S. economy was still growing prior to the outbreak. Are we due for a recession? Probably. But recessions can be shallow and quick.

Low interest rates – the lowest ever, in fact – should provide a tailwind to the economy. Housing is a major component of personal consumption (think appliances, furniture, home renovation). Last Monday mortgage applications increased by 56% from the prior week – 78% of that increase are folks looking to refinance at lower rates. The remainder were applications for home purchases, up nearly 6% from the previous week.

We think the major banking franchises will benefit from this level of mortgage activity, and the added liquidity from refinancing should help consumer spending, which is 70% of our gross domestic product.

Banks, however, could face some temporary strain as businesses draw on their credit lines to support cash flow. Hopefully, this will be temporary.

Lower oil prices will also provide direct savings to consumers, although a decreased level of travel will offset that.

In summary, we think that with increased quarantines and more widespread testing, the weakness may only last a few months and possibly "push out" demand to second half of the year.

If you've read nothing else, read this…

We have absolutely no way of knowing what the future will bring as the world continues to cope with the coronavirus, but we have all been through markets like this before. It will pass. There is a high level of uncertainty, and it is warranted. Investing is not an all or nothing game; it is a long, drawn out process of peaks and valleys. It tests our will and taps into the rawest of human emotions. We believe volatility will continue and markets may trend lower, but the worst may be behind us.

For those of you who take distributions from your portfolios, we have raised cash – generally between six- and twelve-months' worth of distributions – so we do not have to sell securities at inopportune times.
Please call us if you are uncomfortable, fearful, or panicked. Is this time different? Absolutely. But the human emotions that govern our behavior never change.

On a different note, we all have a responsibility to each other. Wash your hands, stay away from crowded places, and take measures to limit any chance of spreading the virus.

Be well.

Jeff