A Perfect Storm

March 25th, 2020

From Greed to Fear in a month time

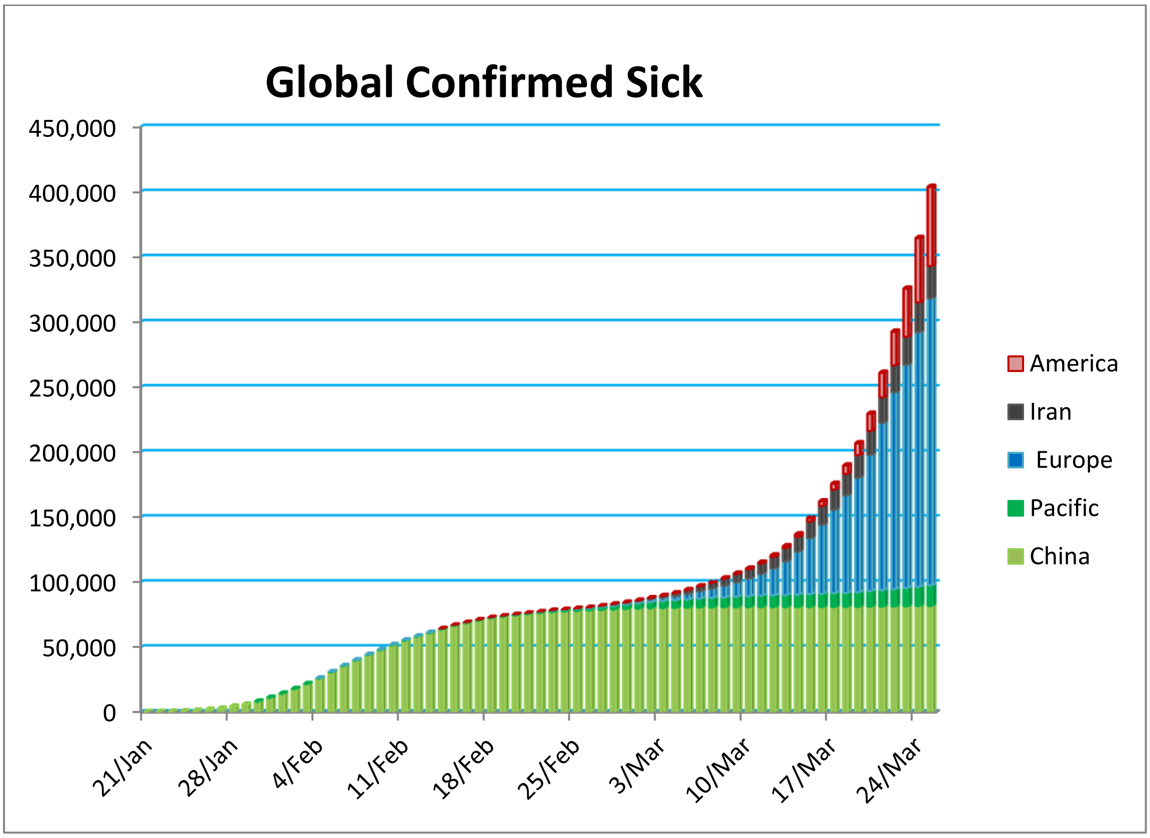
Corona Pandemic: the Virus spread is accelerating and Governments are lagging.

Economy: the Corona Pandemic, Trade War, Oil War, and Brexit are leading to a Recession.

Financial Markets: from Overvaluation a deep dive into Corona losses.

Introduction
End of January I recommended strongly to sell equities because of the Corona crisis. When to come back in the stock market? This is my second investment letter, with updated insights.

Corona
The pandemic is hitting hard. China seems over their epidemic, the Rest of the World sees the beginning in rapidly rising numbers of confirmed sick people, the deaths lag three weeks.



Source: WHO, JK

The only experience in modern history that had the potential to disrupt the global economy like this, was the Spanish Flu pandemic of 1918. But the world was a much different place then. The economy was not interconnected like it is today and travel was limited. People still rode horses, and air travel had not yet arrived. So, epidemiologists, governments, central banks and economists around the globe have to steer through a pandemic for the very first time.

China locked down cities and activities at the center of the outbreak, over 60 million people stayed at home. Currently, China is reopening business and factories. In other countries the Corona epidemic will probably last twice as long as China, because these rigid policies are difficult to implement elsewhere. At an early stage the markets underestimated the massive virus outbreak in Europe and the US, including the corresponding economic consequences.

Europe was not successful in containing Corona infections. Europe is a cocktail of 28 countries, with open borders, different policies, and different limits on social behavior. In the US, sign are gloomy. President Trump repeatedly minimized the epidemic threat, thus slowing down an adequate response. The US healthcare system seems not effective to handle a virus outbreak. Many people uninsured and the hospital capacity ratio per population is low. Fear is valid because of the uncertainties. Business is drying up as people are in quarantine, sick or dying. And above all, a vaccine will not be available before 2021 for the wider population.

Sadly, this year I expect Corona at least as deadly as influenza or can kill ten times more people. The difference lies in the realized slowdown of exponential growth in infections. If countries can flatten this epidemic, hospitals operate in *Code Red*, meaning medical shortages in everything. Otherwise it can be *Code Black*, the worst case where doctors have to choose which patient to cure and whom doesn’t get healthcare treatment.

Age of confirmed patient	***Code Red* death ratio**
up to 59 year	below 1%
60 – 79 year	circa 4%
80 year and older	20%

Source: WHO and China, 72.000 cases.

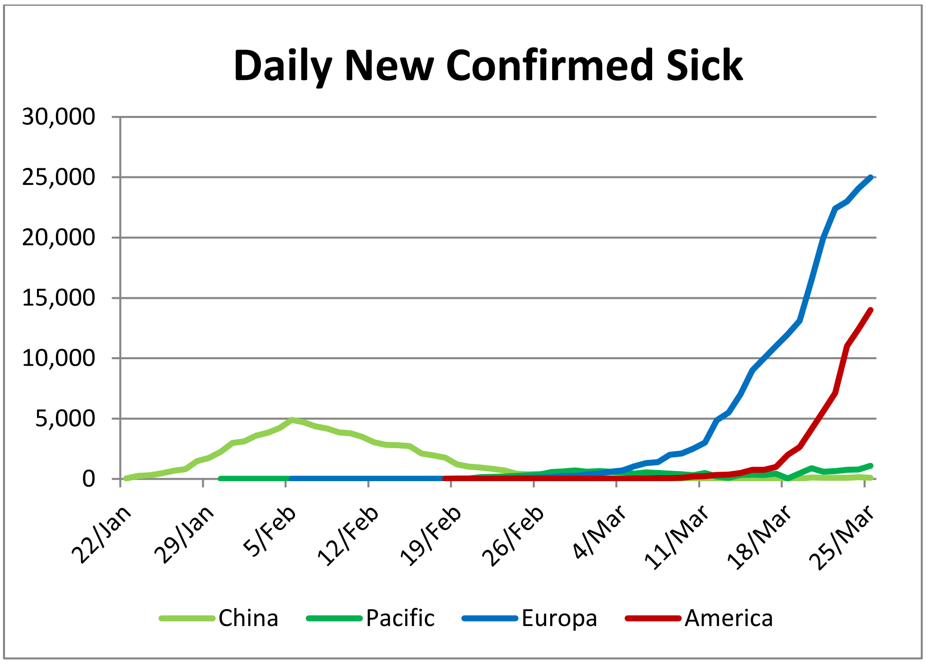
In Hubei, the epicenter of the Chinese outbreak, 1 out of 1.000 people got sick, and of the confirmed sick people 4% died. Unfortunately, Italy has both numbers higher.

In the Netherlands, with 17 million inhabitants, I wanted to be more hopeful. After an initial lax attitude by the Dutch government, the stricter approach to combat Corona is appropriate and will save lives.

Corona	**Infected**	**Sick**	**Death**	**Possibility**	**Former possibility**
China only	100 (travelers)	50	1	X	X
Code Red	500.000	250.000	2.500	**60%**	40%
Code Black	3.000.000	1.500.000	30.000	**40%**	60%

We will overcome the pandemic, the virus isn't some permanent, structural crisis.

Economy
The deaths are a tragedy, the confirmed sick are a bell weather for economic damage. The abrupt slowdown is visible already and will be lasting until summer. Few are able to put a number on the damage caused to the global economy, since the pandemic is unraveling so quickly. Analysts are unable to update their forecast models to keep up with the news cycle.



Source: WHO, JK

China witnessed an unprecedented economic drop over a combined January & February 2020:
- industrial production declined by 13 per cent over the first two months;
- retail sales fell by 20 per cent, the first decline on record;
- fixed asset investment (real estate, infrastructure, machinery) collapsed by 24 per cent.

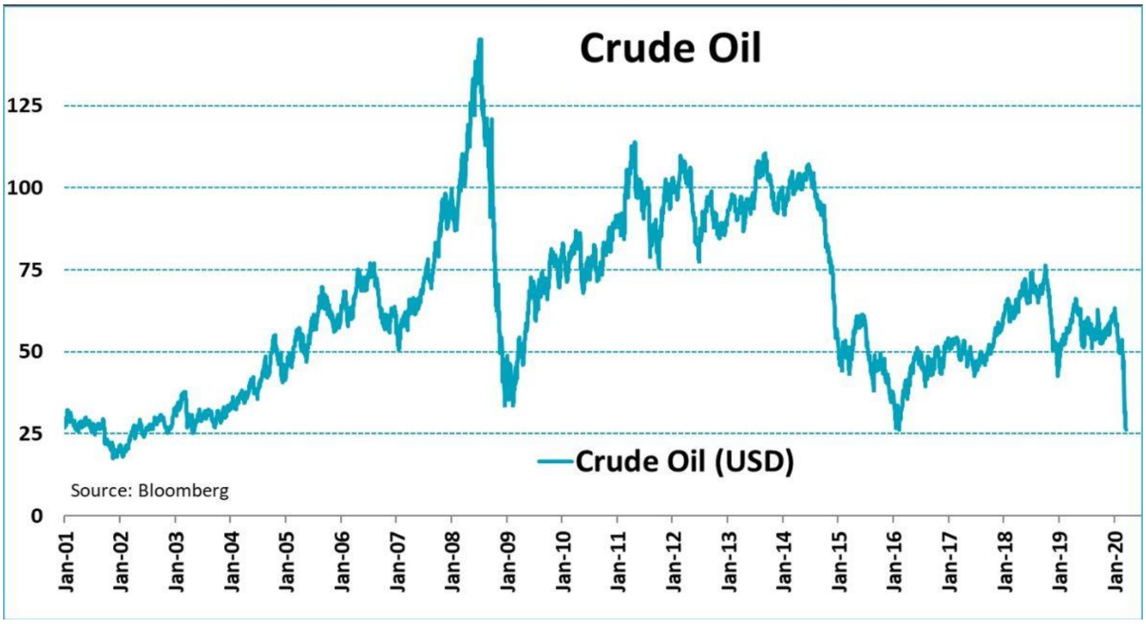
Assume that in GDP half of these items is deferred, the other half is lost forever. Chinese GDP in 1Q could be around zero, for the total year 4% or less.

The global disruption causes permanent losses. After the Trade War, American and European companies have now an additional stimulus to resource production from China closer to home. When reshaping the supply chain, other Asian exporters get hurt also. Japan holds on to start the Olympic Games as planned, an uncomfortable contest between public health and economic interest.

Globally, the health of small businesses is a concern. They have limited cash reserves, less access to credit, and are at risk of default much sooner than larger firms. Many of these small businesses are not publicly traded but impact a substantial number of jobs. Throughout the world this makes uncertain consumers save more and spend less.

Central Bank measures do help the commercial banks with lending more money to enterprises to overcome liquidity problems. Besides, banks have a healthier balance sheet then 2008/9, I foresee not a credit crunch like the world experienced during the Great Financial Crisis. And the Pandemic Emergency Purchase Programme (PEPP) from the ECB is huge. This year they buy an extra EUR 750 bln bonds in the market. Thus, European governments benefit from cheap finance for their announced EUR 250 bln emergency package to relief companies and workers. The US will top this, they announced an astonishing USD 2.000 bln relief bill.

To make things worse after Brexit and the Trade War, came the **Oil War** along! Both the Russians and the Saudis fear rising production of US shale oil. With the advent of a global slowdown in economic activity due to Corona fears, the Russians and Saudis have staged what may be a coordinated effort to force oil prices lower. The US may lose some production for a short time as some players may indeed be forced into bankruptcy. Global oil majors may have to cut their dividend.



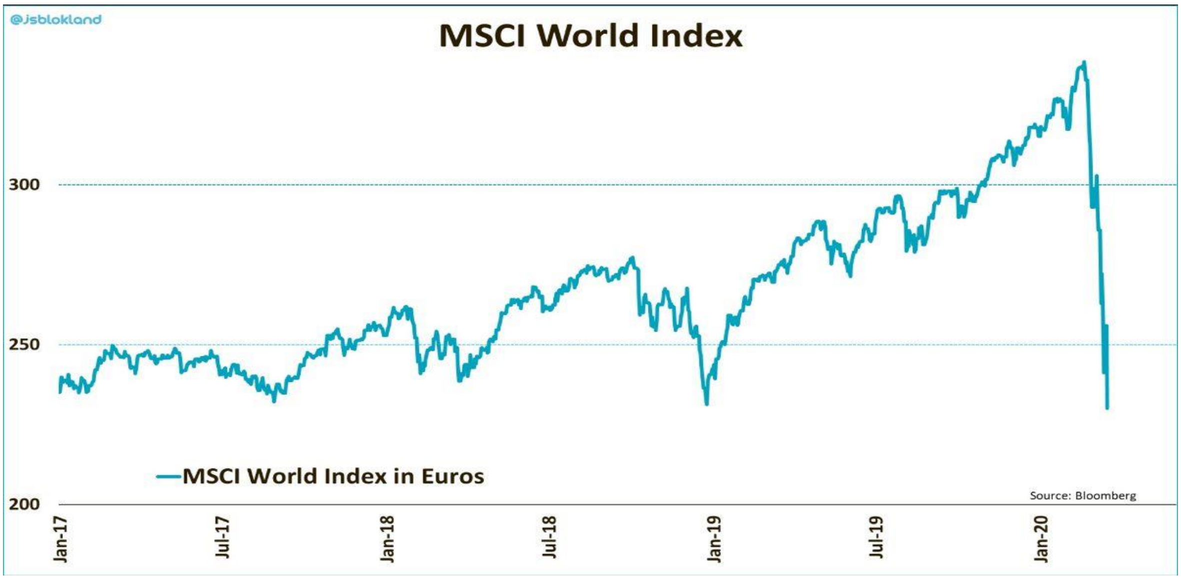
Source: Robeco

To conclude, the global economy is facing three hefty setbacks: supply disruption, lack of demand and lack of funding (partially mitigated by government and central banks). A global recession is on its way. Companies will lose revenues and profits, consumers will lose jobs, governments will gain debt. For global GDP forecasts over 2020, my outlook grew more negative, because every continent and country is infected by Corona measures:

Corona area	Duration	Form	Change in Global GDP	Possibility	Former possibility
China only	3 months	V	-0,1%	X	X
Epidemic	6 months	U	-0,5%	**25%**	40%
Pandemic	9 months	L	-1,5%	**75%**	60%

However, this is not like a major war where all the factories get destroyed.
We will overcome the recession, in 2021 production will probably be at pre-Corona levels.

Financial Markets
In four weeks time the stocks markets lost about 33% in value, and volatility quadrupled!



Source: Robeco

We experienced a major shift in sentiment, *from greed to fear*, because:
1. nobody knows how long the Corona pandemic will last or how severe it will be;
2. at the start of 2020, stocks were trading at historically high valuations;
3. the health crisis will trigger an overdue recession in the next months;
4. the financial shock causes negative Wealth Effect and Loss of Confidence.

During the **Corona crisis** the services sector has had a clear and direct hit: airlines, transport, tourism, hotels, restaurants have seen their revenues more than half (and profits evaporate). A second order effect is visible in discretionary goods, advertising, temping, automobiles, airplanes, steel, banks (non-performing loans) and insurance (increased cost of Corona patients and deaths). Also chemical-, pharma-, tech- and industrial companies are hurt by the supply disruption, and suffer from soft demand as well. Beneficiaries are supermarkets, selective online retailers, telecom.

In comparison to the **2008/9 crisis** banks are much better capitalized, this sector is punished too harsh in my opinion. In comparison with the **2001 bubble**, tech is currently not more overvalued than the rest of the market. I understand why the tech-monopolists are expensive, and their business is scalable, so they can adapt to a low growth environment. If those last two recessions are an indicator, we have about a -50% drop for the S&P 500.

Another way to estimate stock market losses, is adding up three adjustments:
-15% from overvaluation (on a diversified set of valuation ratios);
-15% real economic damage (on average one year no profit or dividend in the DCF models);
-15% to undervaluation: fear, margin sells, insurers and pension funds face obligatory (regulatory) selling, leveraged companies have to sell assets.

To conclude, 45% to 50% downside is warranted. And I projected it would come in four waves, in accordance with the epicenter of the pandemic: from China, via the Pacific and Europe to the US.

For the global equity scenarios, only one option remains in my opinion:

Corona area	Duration	MSCI World	Possibility	Former possibility
China only	3 months	-1%	X	X
Epidemic	6 months	-15%	X	40%
Pandemic	9 months	-45%	**100%**	60%

Frankly, I am surprised by the speed of the equity crash. And who not? These Corona crashes are of historical magnitude! Three one-day losses rank in the all time top ten, amidst the worst days of the 1987 and 2008 bear markets. Often those large downward moves are followed the next day by a *Dead cat bounce*. Investors who neglect the medium term are *buying the dips*. Or day traders and speculators feel the *Fear Of Missing Out*, and they buy to follow the herd in hopes for higher.

Even when all equities seem cheap, I am reluctant to buy the dips yet. Reported company results over 2019 and estimates over 2020 are worthless. During the Corona crisis every estimate will be downgraded. The pandemic is accelerating at the expense of GDP, sales, profits, and some dividends. We know the scale of downgrades only when the crisis is over. Currently the outlook is worsening almost by the day. I expect a last 10-15% downside for equities in the fourth wave, when the virus is taking over the US.

Central Banks & Governments took adequate actions to prevent a further economic fall out of the Corona pandemic. With the US Treasury rate at zero and negative interest rates by the ECB, safe government bonds have reached their most expensive levels ever. Expect negative return for coming years. How to proceed in the investment portfolio then?

Risk management helps to get grip on emotions in turbulent times. **Scenario analysis** helps in understanding the current environment and the next possible developments. Try to follow a defined scenario-path, with limits on exposures and be ready to change plans when the facts differ from expectations. Risk reduction is done via diversification; across geographic markets, sectors, duration and asset types, including having sufficient liquidity.

I know it is impossible to time the bottom of the market. During this Corona panic all assets are sold - including gold, bitcoins and safe credits - there seems no bottom. Cheap assets can become even cheaper, volatility remains high. Currently, risk-return seems asymmetric and attractive, in that long term upside is larger than near term downside. I see some sector rotation and individual stocks reacting on specific company news. As if panic is replaced by fundamental analysis. Step (back) in the market incrementally, with several small orders.

For a sustained recovery in equity markets, we need signals that the virus outbreak is peaking, just in the case of China. Wait for the light at the end of the tunnel! Jeroen Blokland (Robeco) noted: Keep in mind however, that markets will try to anticipate this inflection point well in advance.

We will overcome the market crash. I expect this summer to lay the seeds for a beautiful equity portfolio. And leave it grow for a decade, till the next perfect storm.

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