

STRATEGIC INSIGHTS

Strategic Frontier Management

March 16, 2020

Fear Itself of Geoeconomic Panic

Let me assert my firm belief that *the only thing we have to fear is...fear itself*—nameless, unreasoning, unjustified terror, which paralyzes needed efforts to convert retreat into advance.

—President Roosevelt, Inaugural Address, March 1933

Just a month after the dawn of a new decade, fixation on the Wuhan Coronavirus, known as COVID-19, triggered a geoeconomic panic resulting in an unprecedented spike in global equity market volatility with corrections exceeding 20%. The *CoronaCrash* marked the end of a remarkable equity bull market beginning March 2009. Meanwhile, bond yields plunged to record lows with negative yielding global debt again exceeding \$14 trillion—how is it rational for an investor to assume duration risk, yet *pay* interest to lend your money? A fixed mortgage for 30 years is available at just 3.4%, albeit still a wide gap vs. Treasury yields.

This threat is not a financial crisis, but a *health security crisis* unlike any other crises—investor panic has been unprecedented given equity volatility, despite inevitable transitory economic consequences. US growth may decline for 2-4 months, but recession is unlikely, in our opinion. The game of recession probabilities is headline grabbing, but not very useful for real analysis. We focus instead on simple point-in-time forecasts, and when appropriate, convey uncertainty in a confidence interval. Equity and bond markets may have overreacted. Depending on the duration of quarantine restrictions, (15 days or longer), the transitory impact can be severe, but need to conditionally adapt so the cure doesn't make the problem worse with crushing economic and job losses. Relenting peak panic could provide tactical opportunity.

It pains us to revise forecasts so soon into the new year, but we must cut our forecasts of real growth (2.7% → 2.0%), earnings growth, and interest rates for YE2020. Other changes are reflected below, but we think 5-10% growth declines or over 12% unemployment forecast by some economists seem irrational, particularly in comparison to the -3.3% US GDP decline observed during the Global Financial Crisis (Sept/2008–May/2009). The Fed cut interest rates 2% since October for insurance against global risks from trade disputes and this pandemic, while Congress seeks \$1 trillion or more in stimulus spending. Global growth in 2020 could

be lower by at least 1% versus previous expectations, particularly among China, South Korea, and Europe. Japan and the Eurozone have struggled to maintain even 1% real growth recently, so measures including social distancing and foregoing unnecessary travel will probably tip Europe and Japan into recession, having less ability to do “whatever it takes”.

Economic Forecasts	2015	2016	2017	2018	2019	2020e	2021e
GDP Growth (Y/Y Real)	2.0	1.9	2.6	3.0	2.4	2.0	2.7
S&P500 Earnings Gr.	-1.1	0.5	11.8	22.7	0.6	3.0	10.2
CPI Inflation (Y/Y)	0.7	2.1	2.1	1.9	2.3	2.5	2.7
Unemployment	5.0	4.7	4.1	3.9	3.5	4.0	3.8
Fiscal Deficit (vs. GDP%)	-2.5	-3.1	-3.5	-4.5	-4.7	-6.0	-5.0
Fed Funds Target ¹	0.50	0.75	1.50	2.50	1.75	0.50	1.50
10y Treasury Notes	2.27	2.45	2.41	2.69	1.92	1.30	2.50
S&P 500 Target	2044	2239	2674	2507	3231	3300	3600

Operating Earnings	2021e	2020e	2019e	2018	2017	2016
IBES Consensus	193.73	172.90	162.98	161.93	132.00	118.10
Growth	12.0%	6.1%	0.6%	22.7%	11.8%	0.5%
Strategic Frontier	186.00	169.22	163.50	161.93		
Growth	9.9%	3.5%	1.0%	22.7%		
S&P 500 @18x SFM	3348.00	3046.01	2943.00	2914.74	2376.00	2125.80

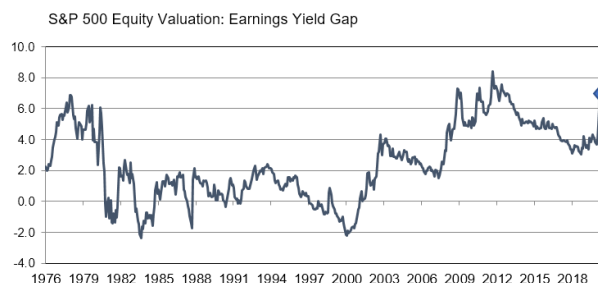
Source: Strategic Frontier Management (1. Top of range)

The US has built a strong economic foundation for growth with tax, trade, and regulatory reforms. We should expect decline in US employment for a month or two, but the US economy is not fragile, as some have suggested with stimulus achieved and expected. An inflection point in the pandemic should take hold before May given strong measures taken to limit further virus infection. Other developed countries are more fragile and unlikely to weather this crisis as well as the US.

At year-end, we observed stable growth in retail sales, housing, employment, and construction likely reinforced by investment and net exports, driven by trade deals. Improving household confidence and interest in buying a home (NAHB) coincides with mortgage rates bottoming out. Residential construction still should increase in 2020, as inventory hovers near an extraordinary low level. Housing demand and higher prices still support rising starts. Our 2020 thesis should just be deferred a quarter or two with some catch-up in the second half.

Equity valuations have improved, yet global bond valuations stretched further versus 2.3% inflation. With the S&P500 index trading well below 2500, Price/Forward Earnings fell below 14X as interest rates plunged. It is easier to react to corrections with

confidence as a value investor than anticipate a correction in eventual reversion to equilibrium. High S&P 500 operating profit margin over 11% bolsters earnings, even if revenue growth struggles. Price/Book has declined toward 2.5x, as last seen in 2015. Also, a tax-advantaged compelling 2.7% dividend yield with at least 80% of companies exceeding Treasury yields. Equity markets tend to overshoot fair value, but government bonds yielding < 1% are even more overvalued versus 2.3% inflation. US equities are more compelling given interest rates plunging, energy costs declining, rising government stimulus, hoarding pulling forward demand, and improving valuations.



Source: Strategic Frontier Management

We don't anticipate unemployment rising much above 5% or a material recession, but financial and economic collateral damage will depend on the duration of imposed quarantines and testing effectiveness to identify those infected, rather than quarantining everyone with a fever or cough at the height of common flu season. Fiscal and monetary policy stimulus often bolsters sentiment, although monetary stimulus has become less effective after years of manipulating interest rates with little consumer demand or investment to pull forward anymore. Eventual normalization of central bank intervention will not be easily resolved, and could trigger a global financing crisis, but that is for another day.

We expected improving trade flows due to the *New US Order in Global Trade*, but this pandemic has exposed unsustainable trade dependencies on China from critical pharmaceuticals to electronic components. So, we don't expect China's supply lines to fully recover as other governments surely seek to reduce dependency on strategic imports. In other words, China's delayed response to COVID-19 will have severe consequences for strategic exports after exposing uncomfortable dependencies. Our future theme of adaptive robotics has caused a shift to greater onshoring already underway. China's trade surplus should deteriorate further, driving potential growth toward 4% by 2025—the consequences of *COVID-19: Made in China* accelerated this decline.

Business may defer strategic decisions until confidence improves, but we don't expect sustained economic decline given *perceived transitional nature of this health*

crisis. Those with a longer horizon should seek this opportunity to lock in low financing rates for investment or to buy a home. Net exports and government spending should rise as consumption moderates—such bulwark should preclude a prolonged growth decline in the US.

The WHO's use of "pandemic" to describe this crisis solicited fear of indiscriminate illness or impartial death, but mortality rates have depended on geography and resistance of one's immune system. Fear can overwhelm markets, as evident in soaring equity, commodity, and currency volatility. It will take time to restore economic and investor confidence, but hoarding (excess demand), lower interest rates, declining energy costs, and adapting business practices can at least partially offset supply chain disruption and lagging leisure + travel (i.e., airlines, hotels, restaurants, entertainment, etc.).

The S&P500 drawdown exceeded 40% through March 2009 under a severe unrelenting credit crunch, as earnings declined 86%. This crisis is transitional, thus much different in its economic impact, and requiring a different playbook for investors. We should expect slower growth, but a prolonged recession is unlikely as a material share of activity is simply deferred, not lost as it was lost due to a broad financial crisis. Income lost will be partially offset by government stimulus and lower interest rates. The economic impact should also be of shorter duration with little financial liquidity concern given a now strong banking system. Thus, an equity correction exceeding much more than 15% seems an overreaction, thereby providing a tactical asset allocation opportunity, as suggested in [Equities from Mars, Bonds from Venus](#). We expect peak market panic to abate before mid-April.

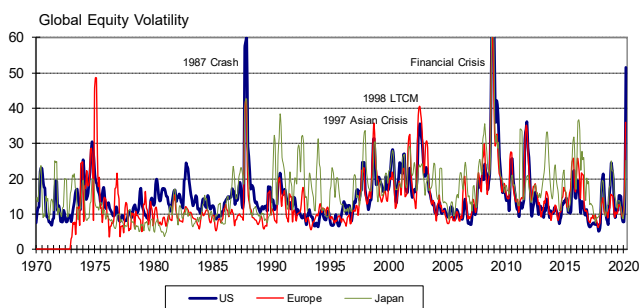
Our tactical global equity forecasts are only more compelling with even lower interest rates and improving valuations. Investors with a longer time horizon than programed algorithms triggered by stop-loss trading limits can take tactical advantage of such opportunities, as we've discussed. The US still enjoys better economic growth due to tax and regulatory reforms that have boosted potential growth, as earnings growth benefits from still high (11%) S&P500 profit margins. With the narrowing gap in interest rates globally, support for the US dollar has diminished. The likelihood of negative bond returns only increases with even lower real bond yields and stimulus efforts likely to boost inflation further.

Short-term Realty, Longer-term Opportunity

There is one simple idea that has worked to bend the curve or extinguish the COVID-19 threat of spreading, namely social distancing. Those who feel sick, including those with a common cold or flu, need to be isolated for up to two weeks. China finally locked down Huanan province on January 22nd, and by mid-March China was on the road to recovery. At least 80% of infected patients realize mild or no flu symptoms, and 98% completely

recover—just 2.5% of infected patients required intensive care or a ventilator. Given 3% of 2% implies a very small segment of the population is at mortal risk.

Financial markets often overreact to unknown risks, including strong transitory measures required to slow the spread of COVID-19, and may limit global growth. The US has limited America's infection rate by virtue of geography and early policy decisions, including limiting inbound passengers from China. Ramping US testing availability, after a notable delay, can minimize individuals' time spent in self-quarantine or isolation, thereby limiting the economic impact. Years of planning and investment on business continuity, as a great number already work remotely, minimize the workplace disruption that distancing requires. Necessary corporate precautions increase operating costs (inflation), thus limit profits. New security concerns increase health security hardening and homesteading (i.e., home entertainment, home improvement, and protection).



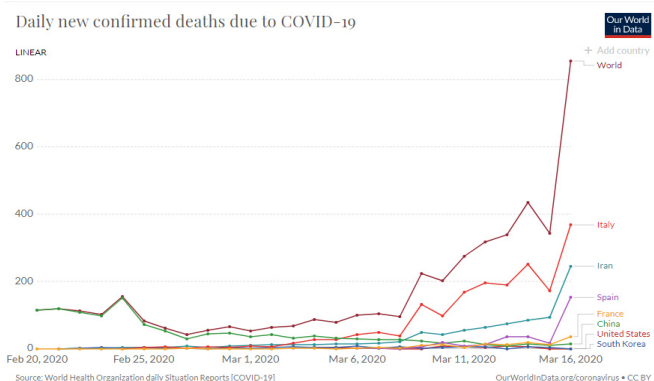
While prudence dictates isolating the most vulnerable and contagious, more comprehensive and available testing is needed. Caution is better than regret given health concerns. The CDC's failure to provide adequate testing capacity was appalling, but the Administration is pulling out the stops to get ahead of it now. Public-private partnerships accelerated its response, including approving a novel COVID-19 test by Roche in record time to roll-out quickly with retailers such as Wal*Mart supporting drive-up testing. Another milestone was the speed in approving vaccine trials for Moderna by March 15th after the FDA relaxed regulations. Chloroquine, available since the 1950s for malaria, demonstrated curative COVID-19 efficacy in China. So, lessons learned in this crisis provide long-term benefits to health security and responding to future threats. We wouldn't dismiss ingenuity when the private sector is unbridled.

We must not be dismissive of this pandemic even if mortality of COVID-19 remains just a fraction of annual common flu in the US. This threat is not unprecedented considering SARS, Avian Flu, Swine Flu, MERS, Ebola, and Zika epidemics—there will be another pandemic in the future, but we should be better prepared. COVID-19 spread quickly due to lack containment in China, but the global mortality rate has been lower than other

pandemics, ranging from 0.1-0.8%. In contrast, other viruses resulted in much higher infected mortality, including MERS (1/3rd), SARS (15%), and Spanish Flu (10%). Tragically, 6599 people have perished globally from COVID-19, mostly in China (3218), Italy (1809), Spain (152), and Iran (853).

The Centers for Disease Control and Prevention (CDC) observed at least 15 million illnesses during the 2019-2020 flu season in the US, including 140,000 requiring hospitalization and 8,200 deaths already. This is consistent with 9–45 million common flu illnesses annually resulting in 140,000–810,000 hospitalizations and 12,000–61,000 deaths since 2010 (ref: CDC). With 69 deaths and 3774 infected in the US through March 15th (ref: WHO), coronavirus is less deadly than the common flu with a population mortality rate of 0.1%.

The failure to contain the virus quickly within Huanan China was irresponsible, but China and South Korea's infection rates and deaths flattened out in a few weeks. This provided the world an effective action plan. Global exposure to SARS was limited in 2002-03 because migrants didn't travel abroad, but China's *Belt and Road Initiative* and Chinese New Year unleashed undetected COVID-19 more quickly in China and to surrounding regions including Asia, Middle East, and Africa. In the chart below, China and South Korea have rolled over, but now Italy, Spain, and Iran still have a problem.



America's per capita mortality rates for 327 million residents are low relative to other countries. Low US infection rates will climb as testing increases, but per capita mortality should remain a fraction of Europe and China. Efforts to contain COVID-19 may also limit common flu infections, thereby related deaths this year. Only 1-3% of those with respiratory symptoms have tested positive for COVID-19 and the observed mortality rate is probably overstated given many contracting the virus are asymptomatic or have negligible symptoms that go unreported. The bottom line is that US infection rates are low, as are consequences of infection, unless your immune system is compromised by age or illness.

Mortality outcomes have been a function of differences in health care systems. This failure is at least partly a

public policy consequence of universal socialized health care. The Servizio Sanitario Nazionale (SSN) of Italy has long suffered from ongoing health worker shortage and declining number of hospitals with price controls setting below market rates for providing “free” health care to all. A natural experiment emerged in how overwhelmed healthcare systems respond to capacity limits. Why did South Korea manage COVID-19 better as Italy rationed its health care?

Scientific progress has enhanced our ability to eradicate infectious diseases by advancing pharmaceuticals, vaccinations, and public health practices, but viruses are still hard to cure and too easy to catch. Globalization encourages free movement across borders enabling pandemics. Fiscal stimulus would be most effective targeted to mitigate infection, including vaccine research and development, discovery of curative virus solutions, innovative testing, and finding the source of COVID-19.

We expect panic to peak before mid-April, then subside in the US—markets may discount the trend earlier. Economic growth will be affected differently in each country with the US likely to be least impacted by limiting immigration from the source of COVID-19 in China and by virtue of shoring up new trade agreements that bolster net exports. Global trade will slow adversely impacting those with trade surpluses, particularly China, Japan, and South Korea. As in Aesop’s fable about the boy who cried wolf too often, we can be dismissive of real threats after too many false alarms, media hype, and central banks that take action too quickly to moderate volatility.

The Sum of All Transitory Fears

The WHO-declared pandemic caused by the COVID-19 coronavirus from Wuhan, China is a global health crisis with geoeconomic consequences. We must not dismiss the threat posed by COVID-19, but know that separation and a transitional loss of economic activity are needed to minimize the global impact of the virus—the sooner we can bend the curve of infection, the faster we can restore growth and prosperity.

Government efforts to slow the spreading infection will limit US activity and have a transitory adverse impact on growth, but the sort sustained decline should rebound, including a catch-up period over the summer—we still expect 2020 growth to exceed 2.0% with improving net exports and government spending even with a severe economic dip between March - May. Time will eventually extinguish the virus with increased social distancing.

We also are pragmatic about how quickly we adapt to threats, even if investor behavior too often exaggerates uncertainty, resulting in overshooting. US equity valuations materially improved, but bond valuations are more stretched than ever. Global bond valuations remain extended due to market manipulation, and negative real bond yields seem peculiar given economic conditions. S&P 500 volatility (VIX > 80) has soared, rivaling the 2008 peak for transitional managed economic impact.

Social distancing can slow the spread of the virus, but what is the optimal lockdown period without causing excessive economic collateral damage if quarantines of a few weeks turns into a few months. Fear itself may not be the only issue for capital markets, yet it should not drive such an extreme overshooting of fair value or risk collateral economic damage beyond what is necessary. This creates opportunities for tactical asset allocation and rebalancing.

Understanding the source of COVID-19, as well as why countries in Southern Europe (Italy, France, Spain) and the Middle East (Iraq, Iran), appear to be suffering higher mortality rates will be an important learning exercise. The pandemic exposed various vulnerabilities, so it should fast track needed research and development that hardens global health care systems and prepares us for more serious future biologic threats.

This inconvenient transitory economic disruption is likely a small price to pay to resolve the threat more quickly, but quarantines should not extend beyond what it needed to minimize health risk. The viral contagion appears to be low risk for most individuals, as evident in the low US mortality rate, but risk of US economic recession is rising with quarantines and measures to limit personal engagement. Declining business activity and deferred investment with a stronger US dollar can be at least partially offset by lower financing costs and reduced energy prices with stronger net exports and stockpiling consumption. Europe and Japan were still flirting with recession before this global health crisis, so the likelihood of tipping into recession increased. China’s march toward 4% potential growth should accelerate as its trade surplus narrows and strategic dependencies of critical products were exposed. Yet, we hope and expect the US should be trending back toward its 2.7% potential growth with unemployment near 4% again by Fall.

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