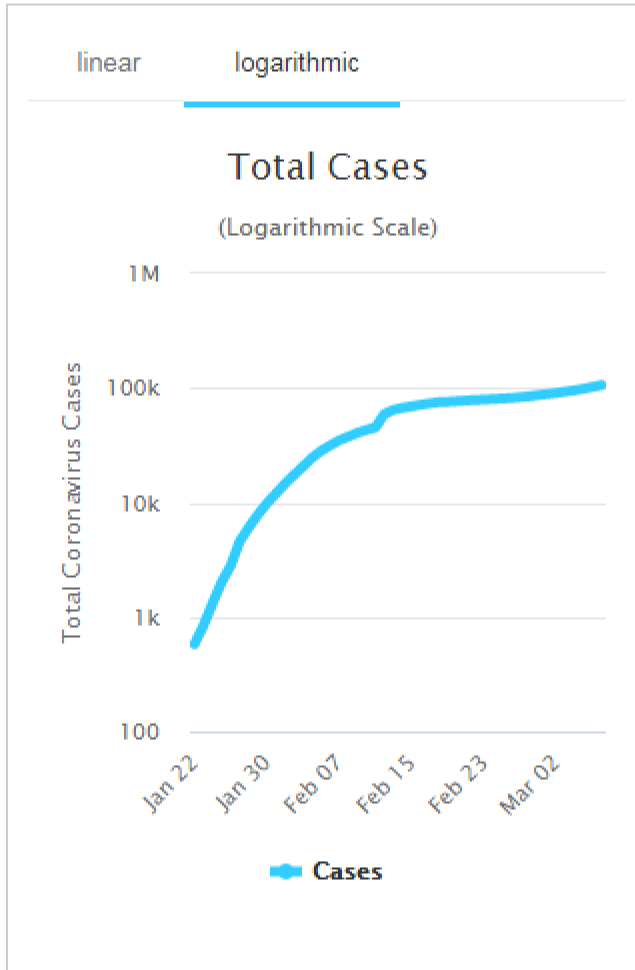
Coronavirus, Biden's Resurrection & Yields

"In capital markets, price is set by the most panicked seller at the end of a trading day. Value, which is determined by cash flows and assets, is not. In this environment, the chaos is so extreme, the panic selling so urgent, that there is almost no possibility that sellers are acting on superior information. Indeed, in situation after situation, it seems clear that fundamentals do not factor into their decision making at all."
– Seth Klarman

The 3 Coronavirus charts are as of today. From the front page of this weekend's WSJ:



Rush for Safety Sends Yields to New Low

Investors flock to buy Treasurys as stocks pare big declines late ...

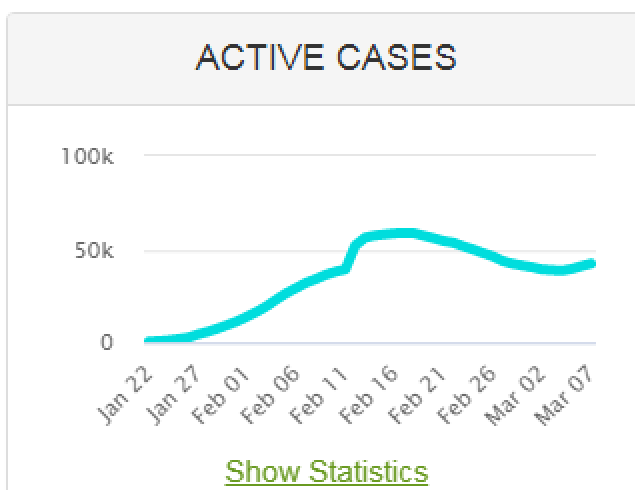
BY JULIA-AMBRA VERLAINE

Yields on U.S. government bonds fell to new lows and stocks dropped Friday after a better-than-expected jobs report failed to assuage growing investor fear over the global coronavirus.

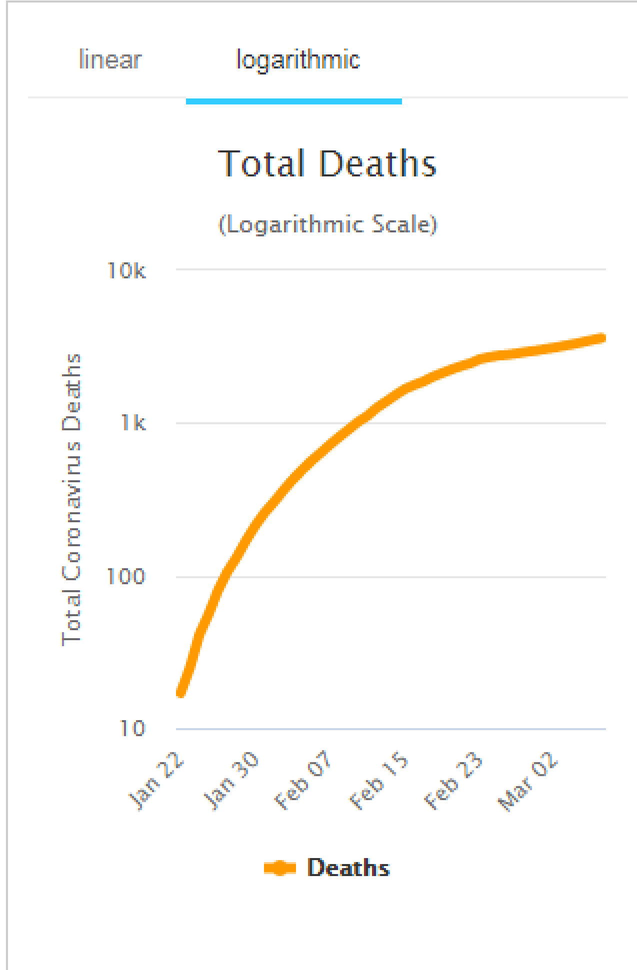
The yield on the benchmark 10-year Treasury note, a key reference rate for borrowing costs throughout the economy, fell for a 12th consecutive session to close at an all-time low of 0.709%. This was fueled not only by investors rushing to safer assets but by commercial banks hedging against balance-sheet risks in anticipation that more consumers will look to refinance mortgages ...

... the Dow Jones Industrial Average ... did post a slight gain for the week, a period marked by violent swings as investors gauged the progression of the coronavirus and a surprise rate cut of a half-percentage point by the Federal Reserve.

The Dow ended Friday down 1%, at 25864.78, paring what at one point earlier in the day had been a drop of more than 800 points. ... A sharp drop in the price of oil hit energy stocks, while investors also punished bank shares.



... Many investors already expect the Fed to cut its short-term benchmark rate again by its March 17-18 meeting at the latest.



Virus Risks Darken Outlook For U.S., World Economies

BY ERIC MORATH

Financial markets and economic forecasters are warning of rising risks for the U.S. and global economy, which were improving before the novel coronavirus spread from China around the world.

A buoyant U.S. job market had fueled strong consumer spending and cushioned the economy through choppy waters created by the trade war with China, a manufacturing contraction and weakening momentum abroad. But markets flashed warning signals this past week showing investors see dangers ahead, particularly in the bond market, with Treasury yields tumbling to historic lows, and in commodities, with crude prices on Friday logging their worst day since the financial crisis.

The U.S. labor market remains a bulwark, with employers adding a robust headcount of 273,000 last month, the Labor Department said Friday. But that will be tested as the virus spreads and governments try to contain it. China and Japan, the world's second- and third-largest economies, are already flirting with recession from the coronavirus shock. ...

"The good news is the U.S. has a lot of momentum heading into this," said Diane Swonk, chief economist at accounting and advisory firm Grant Thornton. She expects the economy to slow sharply in the first half of 2020 but avoid a recession. "The risk is this mutates into a more vicious cycle."

Ms. Swonk projects U.S. economic growth to cool to a 0.5% annual pace in the first half—a marked slowdown from last year's 2.3% expansion, which itself marked an easing from a more robust 2018. She expects layoffs at restaurants, hotels and airlines, and for the unemployment rate to edge up from a half-century low.

The widening impact of the spreading virus, including into financial markets, caused Oxford Economics economists to cut their global economic growth forecast further to 2% in 2020. "The effects of financial market weakness and the disruption to daily life around the world will trigger lower consumer spending and investment on top of the disruptions to the global supply chain," said Ben May, Oxford's director of global macro research, in a note to clients.

The Organization for Economic Cooperation and Development said this past week its "best case" scenario would be for global economic growth to slow by a half-percentage point this year due to the epidemic. ...

Before the market volatility, the U.S. economy was on a solid footing. In February, unemployment returned to a 50 year low (@ 3.5%) and wages rose, the Labor Department said. Other recent readings showed layoffs at historic lows, steady consumer spending, low inflation and rising household income.

Then came the coronavirus. While the extent of economic harm isn't yet clear—with damage contingent on how long it lasts, how widely it spreads and how people respond—initial signs are already showing up.

Business activity by service providers contracted in February for the first time since October 2013, private data firm IHS Markit said Wednesday. Surveyed firms reported declining client demand and new business from abroad. The University of Michigan's gauge of consumer sentiment rose for all of February, but a fifth of respondents in the survey's closing days raised concerns about the coronavirus. The Institute for Supply Management said manufacturing activity cooled in February, as coronavirus effects rattled supply chains. ...

Crude prices notched the largest one-day decline since the recession on Friday after Saudi Arabia and Russia failed to agree on whether to reduce global supply in the face of the virus's effect on demand. Lower oil and gasoline prices could be a boon for U.S. consumers, though plunging prices could hurt parts of Texas and the Midwest where the local economies are increasingly tied to energy production. Policy makers in the U.S. and abroad took steps this past week to blunt the impact, including an emergency half-percentage- point rate cut by the Federal Reserve and rate cuts in Canada and Australia.

The Fed has signaled it could cut rates further, but officials also have called for more government stimulus measures. Boston Fed President Eric Rosengren said Friday that a stronger fiscal-policy response is the "obvious alternative" to constrained monetary policy in the current low-rate environment. ...

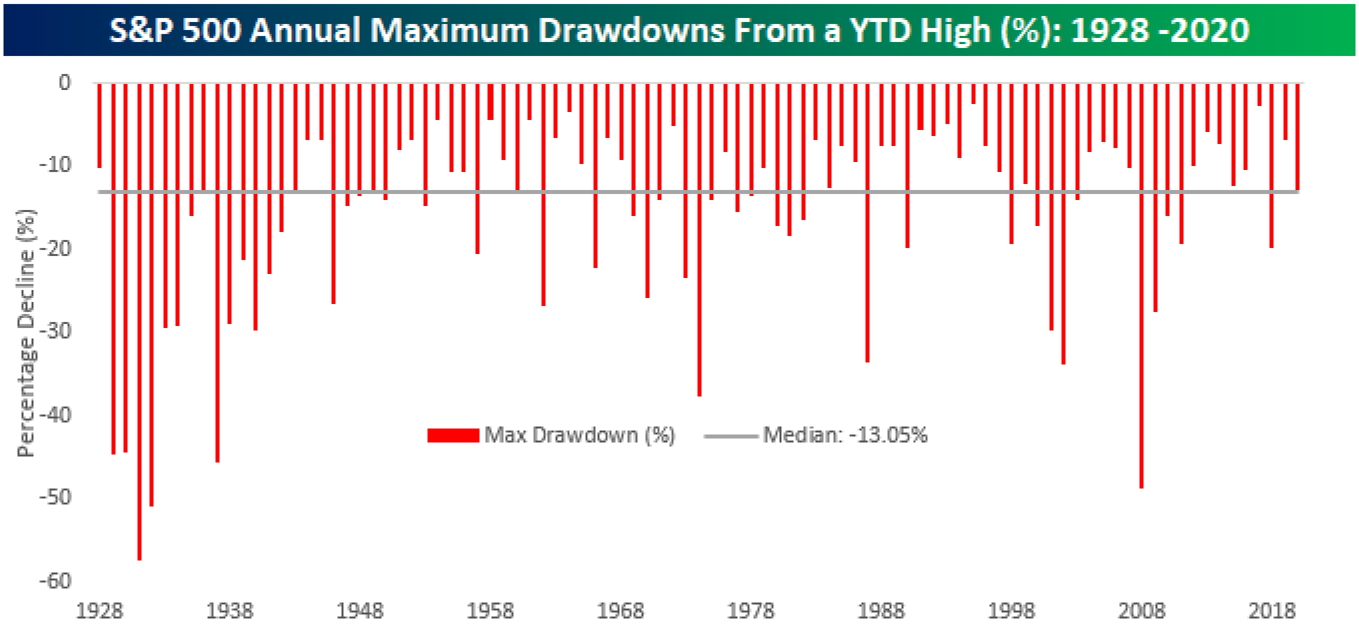
From Bespoke:

A "Run of the Mill" Drawdown

Fri, Mar 6, 2020

If you're like us, you've heard a lot of people reference the recent equity declines as a sign that the market is pricing in some sort of Armageddon in the US economy. While comments like that make for great soundbites, a little perspective is in order. Since the S&P 500's high on February 19th, the S&P 500 is down 12.8%. In the chart below, we show the S&P 500's annual maximum drawdown by year going back to 1928. In the entire history of the index, the median maximum drawdown from a YTD high is 13.05%. In other words, this year's decline is actually less than normal. Perhaps due to the fact that we have only seen one larger-than-average drawdown in the last eight years is why this one feels so bad.

The fact that the current decline has only been inline with the historical norm raises a number of questions. For example, if the market has already priced in the worst-case scenario, going out and adding some equity exposure would be a no brainer. However, if we're only in the midst of a 'normal' drawdown in the equity market as the coronavirus outbreak threatens to put the economy into a recession, one could argue that things for the stock market could get worse before they get better, especially when we know that the market can be prone to over-reaction in both directions. The fact is that nobody knows right now how this entire outbreak will play out. If it really is a black swan, the market definitely has further to fall and now would present a great opportunity to sell more equities. However, if it proves to be temporary and after a quarter or two resolves itself and the economy gets back on the path it was on at the start of the year, then the magnitude of the current decline is probably appropriate. As they say, that's what makes a market!

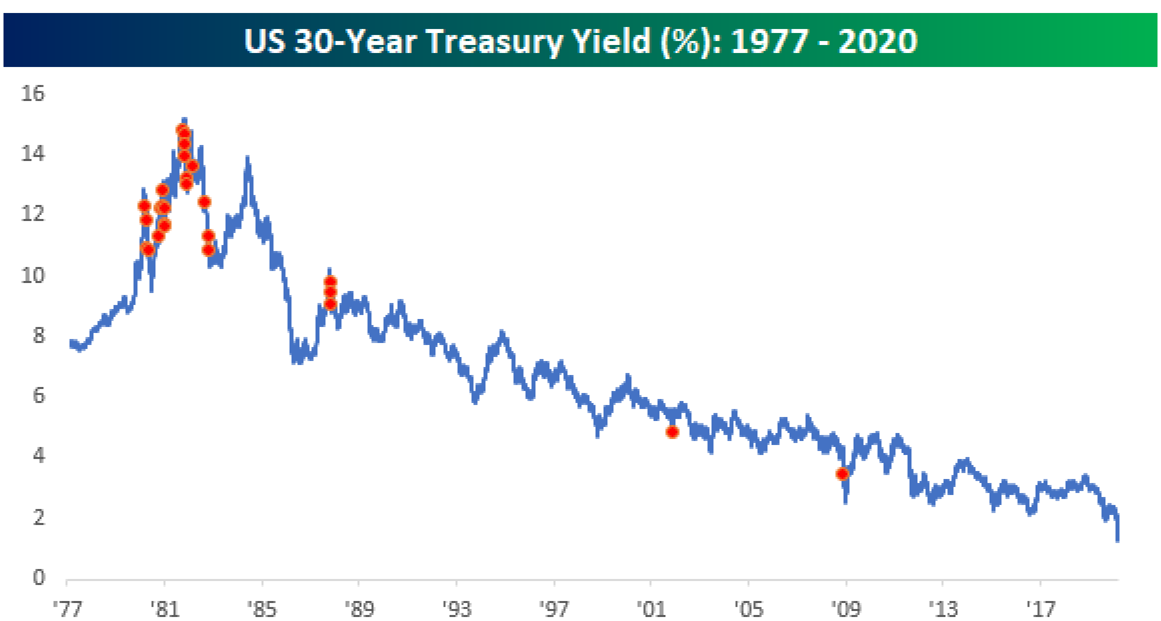


Long-Term Treasuries Go Haywire

Fri, Mar 6, 2020

Take a good luck at today's moves in long-term US Treasury yields, because chances are you won't see moves of this magnitude again soon. Let's start with the yield on the 30-year US Treasury. Today's decline of 29 basis points in the yield will go down as the largest one-day decline in the yield on the 30-year since 2009. For some perspective, there have only been 25 other days since 1977 where the yield saw a larger one day decline.

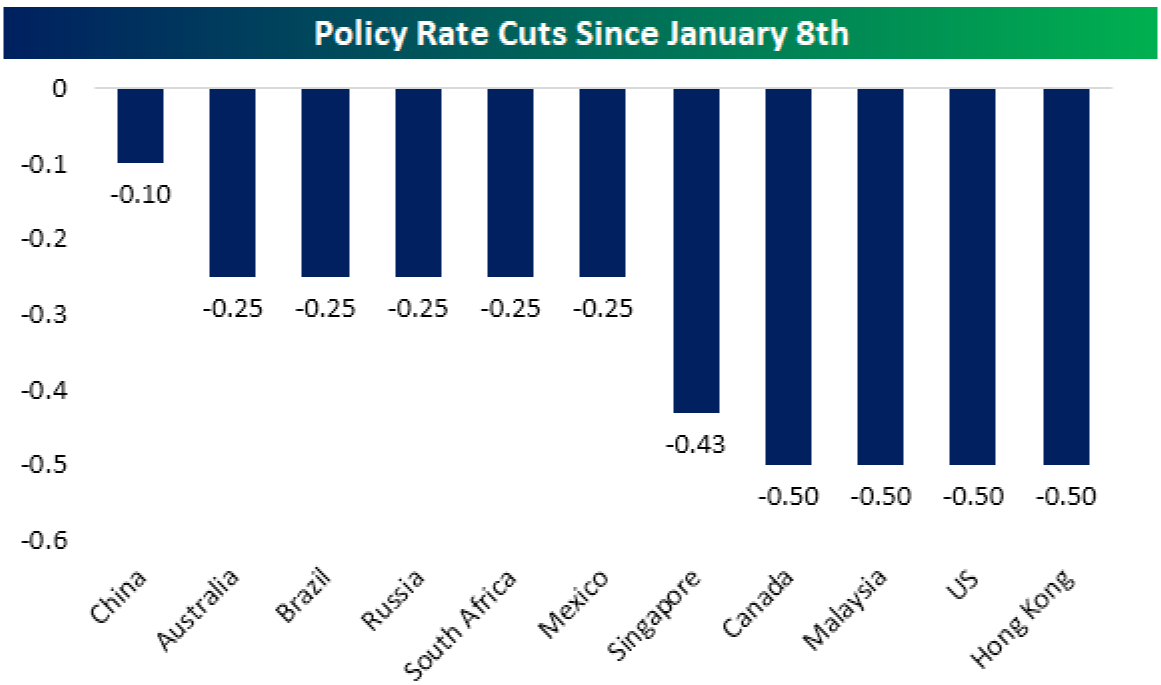
That doesn't even tell the whole story, though. As shown in the chart below, every other time the yield saw a sharper one-day decline, the actual yield of the 30-year was much higher, and in most other cases it was much, much higher.



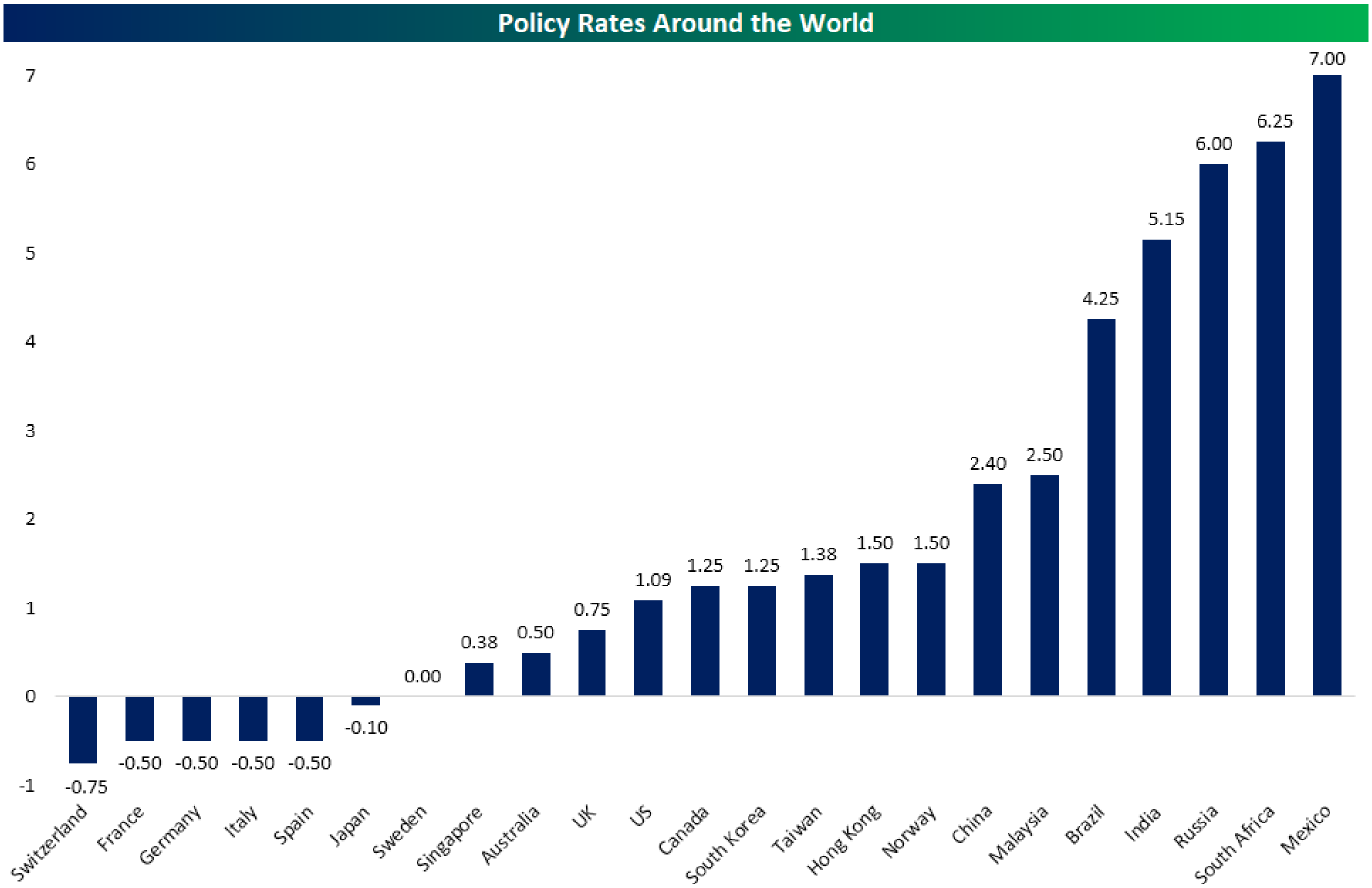
Central Banks Trim Around The Globe

Thu, Mar 5, 2020

In the wake of the coronavirus sparking growth concerns around the globe, central banks have stepped up to the plate through cutting rates. The chart below shows the countries ... that have cut their policy rates since our January 8th report, the day after the WHO identified Covid-19. Yesterday, the Bank of Canada cut its policy rate from 1.75% down to 1.25%; joining the Central Bank of Malaysia, the Fed, and subsequently Hong Kong in cutting rates by 50 bps. Singapore has come down slightly less by 43 bps. Australia, Brazil, Russia, South Africa, and Mexico have also cut rates by a quarter-point. Despite being patient zero and perhaps the country most affected by the virus, China has cut rates by just 10 bps; the least of any of the countries that have cut rates.



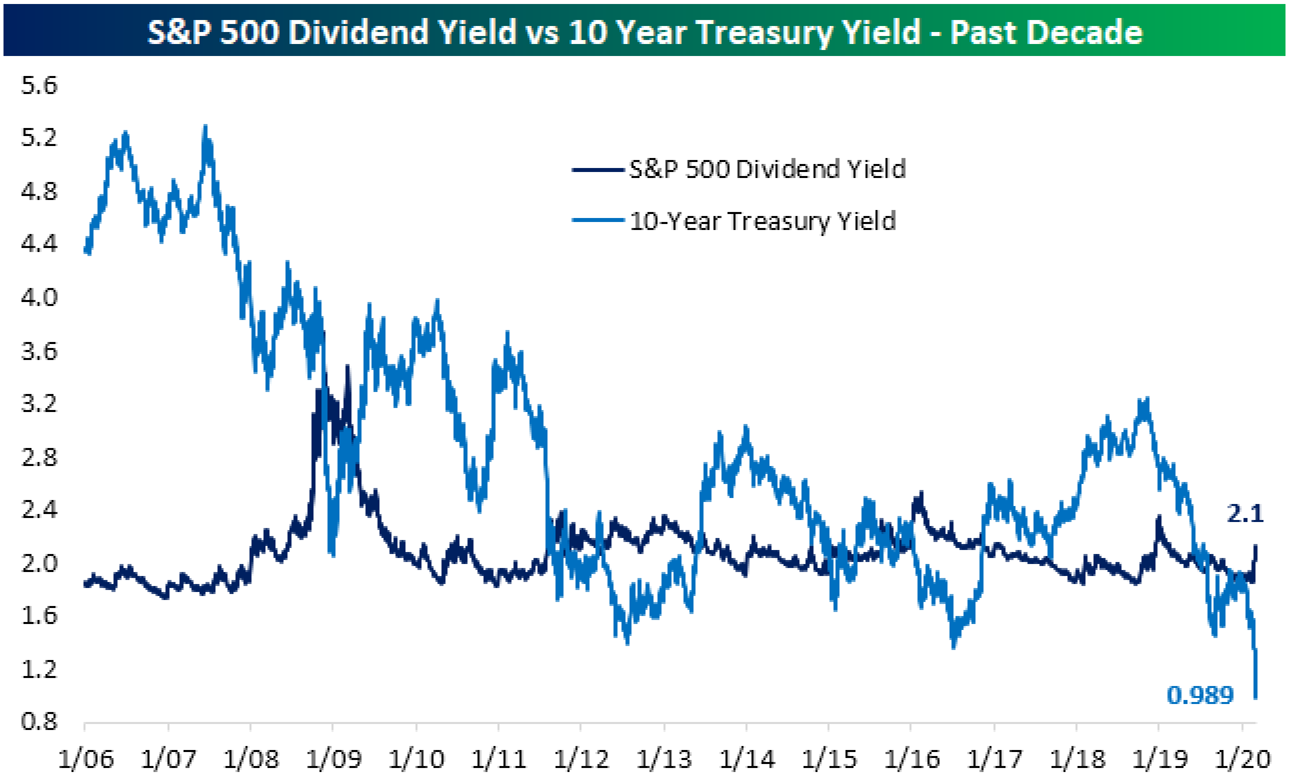
Even though it cut rates by 25 bps, Mexico still has the highest policy rate at 7% followed by South Africa (6.25%) and Russia (6%). While recent cuts have not sent any additional country's policy rate into negative territory, the ECB countries, Japan, and Switzerland all have negative rates at the moment. As for the US, the effective Fed Funds rate is now at 1.09% which leaves it on the lower end of the range of policy rates which stand at 1.75% on average (median: 1.25%).



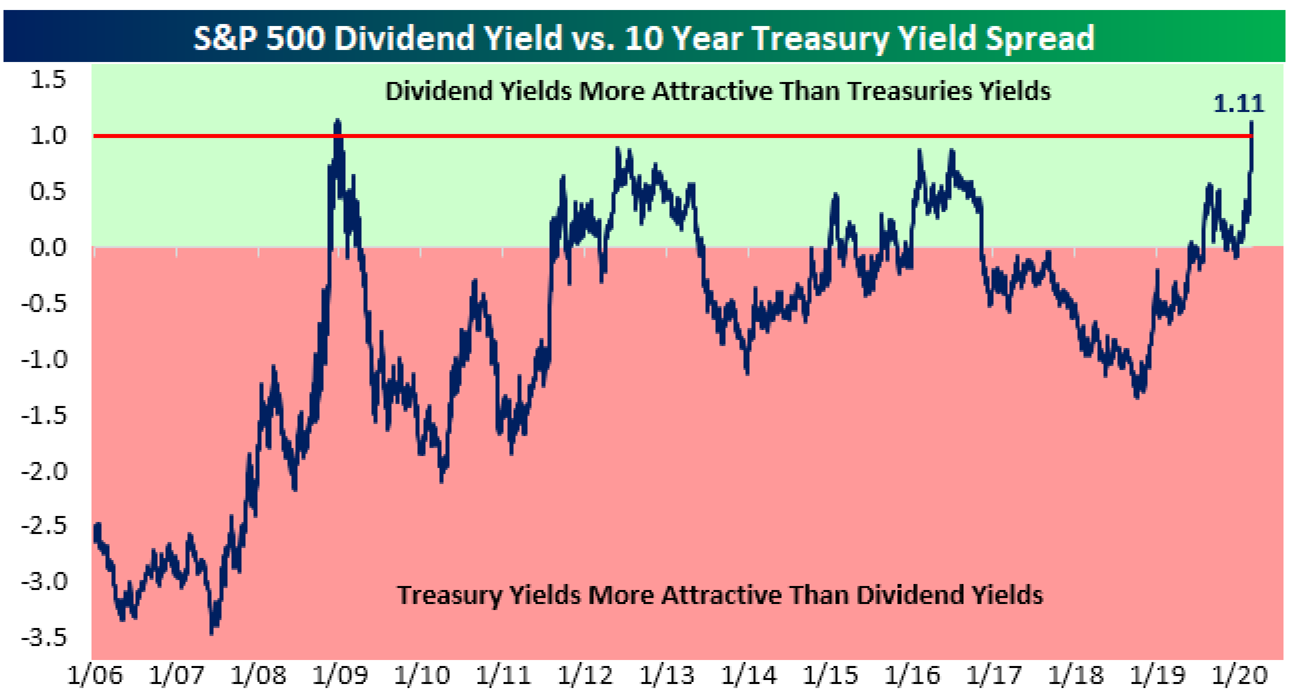
S&P 500 Dividend Yield Now 100+ Basis Points Higher Than 10-Year Treasury Yield

Tue, Mar 3, 2020

The yield on the 10-Year Treasury tipped below 1% today for the first time ever as the Fed cut rates by 50 bps. That is a record low yield for the 10 Year. Meanwhile, the past few days have seen the S&P 500's dividend yield rise to some of its highest levels in over a year. This leaves the S&P's dividend yield at 2.1% today. That means holding the various levels of risk and other factors constant, stocks are yielding over 1% more than the 10-Year yield. That sharp divergence in yields is shown in the chart below.



Since the mid-2000s, the spread between the S&P's dividend yield and the 10-year yield has only moved above one on one other occasion, and that was near the depths of the Financial Crisis in December 2008.



From Global Investment Strategy's Weekly Report dated Mar. 5th:

Stay Overweight Stocks

... The shift towards even looser monetary policy in the US and elsewhere has increased the probability that stocks will rip higher, perhaps even entering a full-fledged bubble like they did in 1998 after the Fed cut rates in the wake of Long-Term Capital Management‘s implosion.

A Manageable Problem

While a 1918 Spanish flu-type scenario cannot be ruled out, it is unlikely. For one thing, most people died from secondary bacterial pneumonia back then. The virus damaged the lungs and bronchial tubes of its victims, permitting common bacteria to infect the lungs. This problem can now be readily treated with antibiotics.

Moreover, as China’s experience demonstrates, it is possible to contain the coronavirus. China has recorded just 42 new cases outside of Hubei since February 26. The number of cases in Hubei has also plunged. In fact, the government has already closed one of its makeshift hospitals built to house COVID-19 patients.

One might argue that other countries will not be able to implement the same draconian measures that China was willing to take. We are sympathetic to this view, but would note that Singapore and Hong Kong have also been able to stem the outbreak without imposing mass quarantines.

In fact, it is worth noting that the number of new cases outside of China fell from 2,410 on March 3rd to 2,160 on March 4th. While one day does not make a trend, it is an encouraging development.

What’s The Current Fatality Rate?

A simple calculation of the number of COVID-19 deaths divided by the number of confirmed cases implies that the current fatality rate is around 3%. However, this figure is probably overstated because the denominator excludes people with mild symptoms who were never tested.

The outbreak on the Diamond Princess cruise liner offers a potentially important natural experiment. Of the 705 people on board who have contracted the virus, only six have died. All six were over the age of 70. This is actually a fairly low fatality rate, considering that those on board were probably exposed to concentrated viral loads, and in some cases, had their treatment delayed.

Admittedly, not everyone on board has fully recovered. Thus, more deaths could still occur. Nevertheless, the cruise ship’s saga does suggest that the true fatality rate from COVID-19 may be less than 1%, with most of the deaths confined to the elderly and those with pre-existing respiratory conditions.

Two Virus Strains

The other piece of good news has to do with the virus itself. A recent study conducted by researchers at Peking University’s *School of Life Sciences* and the *Institut Pasteur* of Shanghai has revealed that the virus has evolved into two major strains, designated L and S.

Strain L is the more pervasive and aggressive of the two, but has become less common since early January.

This is not surprising. Viruses that quickly leave people bedridden will spread less rapidly than those that produce milder symptoms. This suggests that the fatality rate from the virus could trend lower.

Joementum

The other market-relevant development this week was Joe Biden's better-than-expected performance in the South Carolina primary on Saturday and the Super Tuesday states.

Betting markets are now giving Biden a 76% chance of becoming the Democratic nominee, up from 7% on February 11. Unlike in 1918 when the Bolsheviks consolidated power, Bernie "I don't mind people calling me a communist" Sanders no longer has much of a path to becoming America's first socialist leader.

As president, Joe Biden would likely take a more conciliatory stance towards trade issues with China. That said, if the Democrats manage to capture the Senate, Biden would probably be willing to sign into law a bill that reversed at least part of Trump's corporate tax cuts.

On balance, the impact on markets would probably not be huge regardless of who wins the election. This suggests that US political risk could fade over the coming months. That is bullish for stocks. (We concur that Biden's rise from the ashes is bullish for stocks. However, on December 18, 2019 my Father wrote a Quest Opportunity Fund member and HCM client "I am growing increasingly concerned about the Macroeconomic, and Geopolitical risks, especially with 3 (S&P 500, NASDAQ, and Dow) of the 4 primary domestic indexes at all time highs. While I expect Trump to lose in November, provided that neither Sanders or Warren are the Democratic nominee, the betting markets consider the election a tossup, and that both Sanders and Warren have a significant chance at the nomination. BCA Research, which we frequently share, gives the edge to Trump. Four more years of Trump, or a Sanders or Warren Presidency, would likely be a disaster. The continued rise of Populism around the world is a major concern." We share this view, even though the betting markets now give Trump the edge, with Predict It at 53%.)

Investment Conclusions

Investors should overweight global equities over both a 3-month and 12-month horizon. Bond yields will rise modestly from current levels. While the Fed is highly likely to cut rates a further 25 basis points later this month, we doubt that rates will stay as low for as long as markets currently anticipate.

US yields will increase more than yields abroad, which should take some pressure off the dollar. Nevertheless, as a countercyclical currency, the greenback will likely trade lower over the remainder of the year as global growth begins to reaccelerate.

The combination of stronger growth and a weaker dollar will lift commodity prices, while also giving cyclical stocks and financials a boost. Cyclicals and financials are overrepresented in non-US indices, which implies that international stocks will outperform their US peers.

Our thoughts

"... the true investor *welcomes* volatility." – Warren Buffett

TSC - a Bank holding company, was placed on our Watch List on January 3, 2020. While it qualified as an IVE System pick, the Insider Buying was dated, with 5 insiders buying between 7/19-8/30/19 @ 19.37-21.15. In addition, the consensus analyst Target Price @ 26.8, 5 Buys and 1 Hold, was only 3% above the current price @ 25.96.

With another Insider Buy signal, 3 from 2/11-28/20 @ 20.4-22.45, TSC's return potential was now 39%, based on an unchanged Target Price, with 4 analysts rating it a Buy and 1 a Hold (down from a Buy) since it reported earnings on 1/29. None of the analysts had changed their Earnings estimates for the next 2 quarters. On 3/4 we bought for 6 clients @ 19.32.

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
03/06/2020	1	Getz James F		15,000
03/03/2020	1	Riddle Timothy		2,000
02/28/2020	1	Riddle Timothy		3,000
02/24/2020	1	Fetterolf Brian		2,000
02/18/2020	1	Riddle Timothy		4,747
02/11/2020	1	Demas David J		1,000
08/30/2019	1	Getz James F		12,500
08/29/2019	1	Getz James F		7,390
08/28/2019	1	Getz James F		12,500
08/27/2019	1	Getz James F		12,500
08/21/2019	1	Demas David J		1,000
08/07/2019	1	Riddle Timothy		3,838
08/06/2019	1	Riddle Timothy		1,162
07/29/2019	1	Bonvenuto David L		4,500
07/24/2019	1	Fetterolf Brian		
07/19/2019	1	Dolan James J		5,000

The "I" in our IVA System for stocks stands for Insider Buying, which tends to get rarer as stocks climb during a Bull Market. For example, InsiderInsights Weekly Insider Tables of Feb. 22 showed only 1 stock with 3 or more insiders buying over the past week. On the 29th, that number had climbed to 22, and was up to 40 yesterday. Of those 40, 4 were new signals on stocks our clients already own, 1 was on a stock already on our Buy/Watch List, and just 1 was a new stock that also met our Value, and Analyst criteria.