Rockefeller Asset Management
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Monthly Market Review

April 1, 2020

The Great Lockdown

Sudden collapse in aggregate demand; tsunami of stimulus to the rescue

Vladimir Lenin once said, “There are decades where nothing happens; and there are weeks where decades happen.” Well, the last few weeks sure felt like the latter. The U.S. job market swung from the best shape in five decades to the fastest pace of losses in a span of a few weeks as a result of COVID-19 induced behavioral changes and lockdowns. The one-two punch of COVID-19 spreading worldwide and the Saudi-Russia price war over crude oil triggered an avalanche of indiscriminate selling in practically every asset class, including U.S. Treasuries. Leveraged funds were unloading what they could to meet margin calls, and if not for the Fed’s unprecedented market interventions, many could have collapsed. The S&P 500 Index experienced its fastest ever drawdown of 34% from its peak of 3,386 on February 19th to the closing price of 2,237 on March 23rd. This decline was about in line with the 35% average maximum drawdown in the seven prior recession-induced bear markets since 1959. The Index then mounted a spirited rally that surged as much as 18% at one point, driven by of the passage of the massive fiscal stimulus bill and quarter-end pension fund rebalancing.

In the fixed income market, yields at the long end of U.S. Treasuries reached record lows, but there was quite a bit of dislocation in the corporate and muni bond markets. As a sign of the elevated volatility, one investment-grade corporate bond ETF had swung from a 5% discount to a 5% premium to its net asset value in a matter of a few days. Similarly, one national muni bond ETF also traded off to as much as a 5.8% discount to its net asset value before snapping back to a premium. With the Fed actively injecting liquidity into these markets, price discovery had returned to a more normal state by month-end. In the commodity complex, gold shined as a safe haven while base metal prices unsurprisingly dropped on economic weakness. Crude oil prices collapsed to 18-year lows as gasoline and jet fuel consumption plunged on lockdowns and trip cancellations. On the currency front, the greenback at one point surged to three-years highs, but the Fed managed to bring it down by opening up currency swap lines with many foreign central banks. In short, March 2020 was one for the record books, and the market may just be at the beginning of a choppy bottoming phase. Time will heal all wounds, but patience is required.

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The Spanish Flu

Here is a paragraph from my report in March 2018: *"Nestled in the southwest corner of Kansas and midway between New York and San Francisco, Haskell County was a typical mid-western farm community dotted with sod houses and livestock at the turn of the last century. In late January 1918, local physician and drugstore owner Dr. Loring Miner noticed an unusual development – one after another, many of the county's 1,720 residents were suddenly struck with a debilitating flu, which then morphed into pneumonia and, in some cases, death. Dr. Miner thought the flu was so dangerous that he wrote to the U.S. Public Health Service and the warning was published in the agency's weekly Public Health Reports. Little did he know at the time that Haskell County was ground zero for one of the deadliest pandemics in human history."* At the time of that writing, I had no idea that something akin to the Spanish Flu would sweep across the globe just two years later.

The influenza spread 300 miles northeast to Camp Funston, where soldiers were trained and transported to Europe during the Great War. The virus crossed the Atlantic Ocean with American soldiers and afflicted troops on both sides of the Western Front, but neither side divulged the damage for fear of giving the opponent an edge. The flu finally made the headlines after King Alfonso XIII of Spain fell gravely ill in May 1918. It gave the wrong impression that Spain was the origin of the influenza and popularized the moniker "the Spanish Flu."

In the U.S., the flu came in three waves. The initial wave in the spring of 1918 was viewed as a typical seasonal flu. The outbreak dissipated in the summer heat but made a deadly return in the fall. By the end of September, more than 14,000 soldiers at Massachusetts' Camp Devens came down with the flu and 757 of them died for a case fatality rate of 5.4%. In New York City, businesses were asked to stagger opening and closing hours in order to reduce subway crowding during rush hour. Churches and theaters were ordered to have people sit in every other seat, with every other row left vacant. New Yorkers who were caught spitting were rounded up and fined one dollar each. Some municipalities even made wearing face masks compulsory. The aggressive social distancing and quarantine efforts finally paid off and the daily death count started to move down in November. The deadly flu mounted one more attack in the first quarter of 1919, but a better prepared public was able to keep the fatality rate at less than half of the second wave's peak rate.

By the time the Spanish Flu made its exit in December 1920, it had infected about 500 million people – about a quarter of the world's population at the time – and killed an estimated 50 million people. The healthcare system was never overwhelmed as there was no treatment for those infected and their own immune systems were the only line of defense. Unlike today's COVID-19 outbreak that inflicts high mortality rates among the elderly, the Spanish Flu was also deadly with the younger population as it often triggered the so-called cytokine storm – an overreaction of one's own immune system that wound up killing the patient.

Source: Bloomberg

Equity Markets Indices[1]	02/28/20 Price	03/31/20 Price	MTD Change	YTD Change
MSCI All Country World	513	442	-13.7%	-21.7%
S&P 500	2954	2585	-12.5%	-20.0%
MSCI EAFE	1810	1560	-13.8%	-23.4%
Russell 2000®[2]	1476	1153	-21.9%	-30.9%
NASDAQ	8567	7700	-10.1%	-14.2%
TOPIX	1511	1403	-7.1%	-18.5%
KOSPI	1987	1755	-11.7%	-20.2%
Emerging Markets	1006	849	-15.6%	-23.9%
Fixed Income				
2-Year US Treasury Note	0.92%	0.25%	-67	-132
10-Year US Treasury Note	1.15%	0.67%	-48	-125
BarCap US Agg Corp Sprd	1.22%	2.72%	150	179
BarCap US Corp HY Sprd	5.00%	8.80%	380	544
Currencies				
Chinese Renminbi (CNY/S)	6.99	7.08	1.3%	1.7%
Brazilian Real (Real)	4.47	5.21	16.4%	29.2%
British Pound ($/GBP)	1.28	1.24	3.3%	6.8%
Euro ($/Euro)	1.10	1.10	-0.1%	1.6%
Japanese Yen (Yen/$)	107.89	107.54	-0.3%	-1.0%
Korean Won (KRW/$) U.S.	1214.50	1218.55	0.3%	5.4%
Dollar Index (DXY)	98.13	99.05	0.9%	2.8%
Commodities				
Gold	1586	1577	-0.5%	3.9%
Oil	44.8	20.5	-54.2%	-66.5%
Natural Gas, Henry Hub	1.68	1.64	-2.6%	-25.1%
Copper (cents/lb) CRB	255	223	-12.5%	-20.3%
Index	159	122	-23.6%	-34.4%
Baltic Dry Index	535	626	17.0%	-42.6%

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The economy did not shut down and the stock market held up quite well in 1918 in spite of the pandemic and a seven-month recession that started in August. The Dow Jones Industrial Average was roughly flat during the second and third waves of the pandemic in the U.S., and took off like a rocket as the third wave was winding down. It may have more to do with the Great War ending in November 1918. Nevertheless, the country was quite resilient in the face of adversity and the Roaring Twenties were waiting around the corner.

The Great Lockdown

100 years after the Spanish Flu faded from the world stage, mankind was once again under siege from a highly infectious and virulent virus. The crisis is further compounded by asymptomatic transmission which makes it difficult to contain the outbreak. Wuhan, Iran, Lombardi and Madrid showed that the healthcare system can be overwhelmed with medical personnel and first responders put in mortal danger. At the time of this writing, numerous countries including New Zealand, Australia, Malaysia, India, South Africa, Nigeria, much of Europe, the U.K., Brazil, Argentina, Colombia and parts of the U.S. are under varying degrees of lockdowns. Many nations, including China, which is supposedly on the path to normalization, have also closed their borders.

With nearly 3 billion people around the world under lockdown, the global economy is experiencing an unprecedented collapse that exceeds all prior crises in both speed and scale. As a case in point, during the week ending March 21st, there were 3.28 million Americans filing for unemployment benefits, which was nearly five times the previous record high of 665,000 during the final week of March 2009. Even China, which boasts a centrally- managed economy that can supposedly withstand shocks, has seen a record high unemployment rate and rising bankruptcies. Their vaunted export engine has also been hit with order cancellations; about the only bright spot is their export of face masks, personal protective equipment and ventilators.

The Great Rescue

Desperate times call for desperate measures. In response to the waterfall like equity sell-offs, seizing up of credit markets, and the collapse in aggregate demand, policymakers around the globe quickly kicked into high gear in rolling out unprecedented monetary and fiscal stimulus. The Federal Reserve has cut the Fed funds rate to zero and promised to inject unlimited liquidity into the financial system, starting with $75 billion per day of asset purchases that include investment grade corporate and muni bonds. The Fed also alleviated the U.S. dollar shortage in overseas markets by opening up dollar swap lines with 14 foreign central banks to allow them to swap their currencies for the greenback. On the fiscal front, Congress put aside partisan bickering and passed the $2.1 trillion Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), which is the largest-ever stimulus package at 10% of the U.S. GDP. The crisis also compelled the usually tight-fisted German government to pledge €750 billion of fiscal stimulus. All told, global policymakers have cut interest rates more than 65 times since the start of the year and pledged more than $5 trillion of fiscal stimulus. Some pegged the combined monetary and fiscal stimulus at $12 trillion, a ginormous 14% of the $86 trillion global GDP.

The Great Tug of War

Investors are facing a quandary between two strong forces: the biggest public health and economic crisis in decades, and the most aggressive monetary and fiscal stimulus in modern history. The former led to a 34% drawdown in the S&P 500 Index in a little over four weeks, and the latter has generated some optimism that led to the subsequent 18% rebound in late March. We suspect the initial shock-and-awe of both forces have been absorbed, and the market is likely to enter a bottoming, or base building phase where investors get to assess potential winners and losers rather than making wholesale risk-on or risk-off bets.

On the negative side, the deep economic decline is only starting and could trigger a wave of defaults and other financial contagions in the coming months and quarters, causing the equity market to retest its recent lows. Some may argue that, given the scale of the potential GDP decline, the 34% drawdown may not be deep enough in comparison to the 57% and the 49% maximum drawdowns during the Great Financial Crisis and the dot-com bubble implosion, respectively. We still don't know when the current lockdown will be lifted, what the "new norm" will be post-lockdown, and if there will be additional waves of outbreak later in the year. Many publicly traded firms will be focused on solvency and liquidity rather than profitability. While the fiscal stimulus is indeed massive, it could be poorly administered by bureaucrats, similar to how they mishandled the country's pandemic preparedness. Then there is the oil price collapse, which will likely trigger defaults among not only energy companies, but also sovereign debt issuers.

On the positive side, this deep recession is likely to be over by the third quarter, as GDP is measured on a sequential basis, prompting investors to start anticipating the second half 2020 recovery. Publicly-traded companies will get a free pass for missing first half results, and investors will instead focus on their second half recovery and 2021 earnings potential. On the pandemic front, Italy appears to have "bent the curve" and the rest of Europe will follow. While COVID-19 will not be eradicated in the near future, a better prepared populace practicing social distancing and proper hygiene will be able to deal with additional outbreaks. After all, there were no lockdowns during the Spanish Flu and people somehow persevered. Indeed, countries like Sweden and Iceland have chosen to protect the vulnerable while keeping businesses open. If they can successfully bend the curve without dramatic stress on their healthcare systems, they could serve as a role model for the rest of the world. Lastly, Congress is already talking about the next phase of fiscal stimulus should things take a turn for the worse; politicians are most generous in spending other people's money during an election year.

This tug of war between these potential drivers is likely to keep the market range bound at best in the near-term. We are sailing in uncharted waters and policymakers, business executives, and investors will all need to conduct multiple scenario analyses and make adjustments as needed. As we move beyond the immediate crisis mode, there will be some deep soul searching on multiple issues – business efficiency vs. resilience, global vs. local sourcing, role of debt and share repurchase, shareholder capitalism vs. stakeholders, etc. In time, investors will also question the side effects of bloated central bank balance sheets and elevated national debt. All these issues will impact future corporate profitability, market multiples, and secular growth potential.

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A Race Against Time

Ultimately, the most important catalysts are on the scientific front with the development of effective treatments for and vaccines against COVID-19. There are already several trials underway for various treatments. Importantly, the National Institute of Health had started a Phase 1 clinical trial of Moderna Inc.'s vaccine in mid-March, and the data on its safety and immunogenicity could be available by mid-May. Pfizer is working with Germany's BioNTech to start a vaccine trial in late April. Johnson & Johnson announced that it plans to begin human trials of its vaccine by September at the latest. The company will take the risk of manufacturing the vaccine concurrently so that it would be available on a not-for-profit basis as soon as it is approved.

While the vaccine may not be available for another year at the minimum, our sentiment and spirit will soar on the news of a successful trial. The confirmation of an effective vaccine will enable investors to start discounting a return to normalcy, and potentially save some companies from bankruptcy. It will let us once again plan for what used to be ordinary activities. I long to take my friends and family out for a hearty meal at a neighborhood restaurant where we can toast to each other's good health. I will stay up late and visit crowded nightclubs where my daughter, her all-girl band and other struggling young musicians perform for the love of music rather than money. I promise to spend more there but will avoid getting intoxicated. I may even consider booking a cruise trip. On Easter Sunday 2021, I hope to be standing in front of Leonardo da Vinci's timeless masterpiece, The Last Supper, at the Convent of Santa Maria delle Grazie in Milan. Since its completion in 1498, the mural has silently observed the Italian Plague of 1629-31 that claimed possibly one million lives. It has survived vandals during the Napoleonic Wars and Allied bombing in August 1943 that destroyed much of the convent. The COVID-19 outbreak, while heart wrenching and economically devastating at the moment, will turn out to be just another bump in the road of human history. Mankind is ingenious and resilient, and in time, COVID-19 will be largely eradicated just like polio, measles, and the Spanish Flu.

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