The Blitz:

Coronavirus Part 2

ABOUT THE AUTHOR

Michael J. Merlin
MMerlin@rockco.com | (404) 942-3060
Michael Merlin is the founder of Merlin Wealth Management at The Rockefeller Global Family Office. He and his team formulate wealth strategies to help clients achieve their specific objectives and provide advisory services including cash flow planning, retirement and estate planning, and philanthropic consulting.

They thought it would be worse than it turned out to be. In the years leading up to World War II, British planners estimated the effects a German bombing campaign would have on England. They figured that London would be flattened, 200,000 Brits would die in the first barrage, and millions would go insane. In *The Splendid and the Vile*, his gripping history of the period, Erik Larson quotes one military planner: "London for several days will be one vast raving bedlam. The hospitals will be stormed, traffic will cease, the homeless will shriek for help, the city will be a pandemonium."

But the worst-case projections did not come to pass. People generally did not lose their mind. Few called for surrender, and only a handful criticized the government. Social solidarity was not shredded—it was enhanced. In fact, government censors found that morale was actually highest in the most badly hit places. People felt they were achieving moral victory merely by staying alive. "Finding we can take it is a great relief to most of us," one woman wrote. "I think that each one of us was secretly afraid that he wouldn't be able to, that he would rush shrieking to shelter, that his nerve would give, that he would in some way collapse, so that this has been a pleasant surprise." A man wrote, "I would not be anywhere in the world but here, for a fortune."[1]

Britain during the Blitz has gone down in history as the exemplar of national resilience—a role model for any nation going through a hard and stressful time, whether a war, terror attack, or pandemic. How did the British do it? What can we learn? What exactly are national resilience and social solidarity made of, and how are they built?

If you want to list the factors that contributed to the country's indomitable resilience, start with a sense of ***agency***. Brits needed to feel that they were not helpless or passive, that the nation was taking positive action every second of every day. Churchill set a frenetic pace for his whole government, showering his aides with "Action This Day" memos. Londoners could look up and see Royal Air Force (RAF) pilots fighting on their behalf against German planes. Rooftop artillery units fired anti-aircraft guns throughout the nighttime raids. These guns had almost no chance of actually bringing down an enemy plane, but citizens wanted to see the folks on their side doing something, so the guns blazed. The second element of British resilience was intense ***social connection***. People were forced together every night in tightly packed group or family shelters. They sat shoulder to shoulder and lay in crowded bunks with heads touching heads. They coped with hardship together. Some of the shelters created little newspapers to record the personal news of those who slept there. Third, ***laughter***. Brits credit themselves, accurately, for being a comic people. During the war, every disaster was turned into an occasion for humor, dark or otherwise. A sign on one bombed-out London store read: This is nothing! You ought to see what the RAF have done to our Berlin branch! The fourth factor in British resilience was ***moral purpose***. Friedrich Nietzsche once remarked that "he who has a why to live for can endure any how." The Brits had a firm sense of the moral rightness of their cause, the unique evil Hitler represented, and the reason they had to endure all this. Finally, there was ***equality***. During moments of threat and crisis, people are intensely sensitive to inequality, to the feeling that some people are being treated better than everybody else. The government did what it could to foster an egalitarian spirit. Rationing was mostly equitable. The Queen was delighted when

Buckingham Palace was bombed, because she didn't want it to seem like she was being spared. One evening, Churchill was driving into the country when a major bombing campaign began to hit London. He had the car turn around so that the people could see their prime minister sharing the danger.

The lessons from Britain's experience during the Blitz are pretty clear. In national crises, a sort of social and psychological arms race takes place. The threat—whether bombings or a pandemic—ramps up fear, unpredictability, divisiveness, fatalism, and feelings of weakness and meaninglessness. Nations survive when they can ramp up countervailing emotions and mindsets. This happens when countries take actions, even if only symbolic ones, that make frightening situations feel more controllable and predictable. This happens when they foster social solidarity by paying extreme attention to fairness. This happens when they intensify social connection and create occasions for social bonding and shared work. Societies that build resilience do not hide behind a wall of happy talk or try to minimize the danger. Resilience does not come from mindless optimism, or from people telling one another to be calm amid the turmoil. Resilience is built when people confront a threat realistically and discover that they have the resources to cope with it together.

When I began researching the Blitz, my sense was that Americans today have it much easier than the Brits did then, despite the ravages of the coronavirus pandemic. We don't have to deal with bombs ripping into citizens' bedrooms every night. But in some ways, COVID-19 is on par with the Blitz. Like the bombing campaign, the virus induces cascades of fear—the fear of possible death, the fear of the random extinction of our neighbors and loved ones, the fear of job loss and economic collapse, the fear that our future may be altered in unknowable ways. And then, most challenging of all, there is the question of national morale. In 1940, Britain faced a uniquely evil foe. Building a sense of moral purpose was relatively easy. Today, the world is threatened by a virus. The moral story we tell has to be less about the evil we face and more about the solidarity we are building with one another. The story we tell has to be about how we took this disease and turned it into an occasion to become a better society.

I truly believe that in the midst of this pandemic, Americans will once again find a common purpose and a resolve to persevere. I am not the most religious person, but I do think that God shows up at times, and that this may be one of them. I think that perhaps we as a people had gotten too divided, too selfish, too focused on our differences rather than our common goals, and too distracted by all the noise that fills our world. I think that this COVID-19 pandemic is an opportunity for us to press the "reset" button. To recognize that more binds us than divides us as a people, to remind us that the most important things are our family and our health- not how many likes we get on Instagram. And, finally, to strive for the next great era in American history to be defined by collaboration, accomplishment, and a desire to lift each other up; rather than conflict, gridlock, and relishing in tearing each other down. I often say when solving a problem that we should seek the "win-win," not the "win-lose." I believe the last decade in American history could easily be defined as a "win-lose." As many people (maybe more) feel like the opportunities and progress of the last decade passed them by, as those who feel that they are better off. Perhaps confronting a common enemy, this virus, will remind us of the time in history when we were united as a people and we can once again return to being the America that Ronald Reagan described as the "shining city upon a hill, whose beacon light guides freedom-loving people everywhere."

The Two Big Questions: Economic Shock-and-Awe and A COVID-19 Battle Plan

In our last piece, published on March 18th, we called for a more aggressive fiscal policy response from the U.S. Congress, to match the Federal Reserve's "nothing is off the table" response on the monetary policy side. On Friday, March 27th, President Trump signed the CARES Act into law, creating the largest single stimulus package in U.S. history, topping $2 trillion. From an economic recovery perspective, we believe that the most important aspect of the CARES Act is that nearly 50% of the package consists of direct funds for households and small businesses. That includes $300 billion in direct cash handouts and nearly $400 billion in small business assistance in the form of loan forgiveness.[2] Specifically, for keeping workers on their payrolls during the current

COVID-19 emergency, small businesses receive forgiveness for loans used toward payroll costs, mortgage interest, rent and utilities.[3]

As small businesses employ one-half of the private sector workforce, the passage of the CARES Act is important in ensuring that critical economic relationships are not disrupted by months of low activity and therefore may recover more quickly when the pandemic is over. The CARES Act has provided a lifeline to small businesses, and subsequently many U.S. workers, so they can stay afloat financially through the current crisis. It is important to note that the economic relief provided to households to ***replace*** lost wages and profits will be used to fund essential spending that would be captured in GDP regardless (in the absence of delinquencies and defaults). As a result, we do not expect the CARES Act to boost US GDP in the near term. Consumer spending is not simply a function of wages, but also confidence and expectations.

As we've discussed before, we felt that there were two main questions to answer as this crisis unfolded: The first, was "would the federal government step up and provide the necessary economic relief to help businesses survive?" Now we can say that we see the magnitude of the response and, both fiscal and monetary authorities have indicated that more can and will be done if necessary. In addition, markets saw the long-awaited fiscal response as a positive, sparking an 18% rebound from the lows reached on March 23rd through the quarter end, March 31st. More on the markets and economy below.

The second question was, "can we flatten the curve in the United States, and how long will it take?" This is now the predominant question and will be what, in our opinion, drives market sentiment over the next several weeks. Much has been written and debated about this topic. While it is clear that the longer the economy stays shutdown during this period of self-quarantine the harder it will be for business, consumers and workers to recover quickly, it is also equally as important to ensure that we have truly created a safe environment for people to return to work and that we have a containment plan to reduce the possibility of a recurrence after shelter-in-place orders are lifted.

On Friday, Rockefeller Capital CEO Greg Fleming hosted a call with Vivek Ramaswamy the founder and CEO of the pharmaceutical company Roivant Sciences. Of the many interesting suggestions Vivek had for addressing the current crisis, one particularly interesting idea was that the government should be implementing national antibody testing just as aggressively as they are pushing for more widespread and rapid virus testing. Vivek said that it is assumed that millions of Americans are immune to COVID-19 and could be confirmed by testing in a matter of weeks. In fact, he stated that there is already an antibody test available for $25, so that every American could receive one for the total cost of $7 billion. A very small proportion of the $2 trillion aid package just passed by Congress. Once Americans were deemed immune, they could be given immediate clearance to return to work, hence allowing the economy to slowly restart.[4]

In my view, suggestions like Vivek's are not just about flattening the curve. They are about ***crushing*** it. It is becoming evident to many, including me, that we are at war. In a physical conflict, would we allow our enemy to beat on us, even kill us, while we sheltered in place in our homes? We would not. Would our military leaders sit back while our enemy went on offense, just ordering a duck-and-cover defense? I think not. What could be worse, too, is that by just trying to flatten the curve, we are also elongating our economic pain which will impact a much larger portion of our population, not just the smaller percentage that could potentially get fatally sick from COVID-19.

Dr. Harvey Fineberg, president of the Gordon and Betty Moore Foundation, and past president of the U.S. National Academy of Medicine, wrote an editorial published Wednesday (April 1st) in the New England Journal of Medicine. Fineberg believes, "We're thinking too defensively about what we should and could do against the coronavirus." "If it is a war, and I believe that's a proper metaphor, then we should fight it like a war. That means we should fight to win- to vanquish the foe- not to let it persist and hassle us for an indefinite period."

In the editorial, Fineberg outlines six steps the country should take to accomplish this goal:[5]

1) President Trump should appoint a commander in charge of the coronavirus response. This person is not a "coordinator," but rather someone who has the authority to mobilize civilian and military assets needed. Each governor should also appoint a commander with similar authority at the state level. A unified command structure with a person in charge who can help guide and make strategic choices will help us execute successfully.
2) America needs to carry out millions of diagnostic tests in the next two weeks. Testing is our form of intelligence in the military sense.
3) Healthcare workers should have access to ample supplies of personal protective equipment. We wouldn't send soldiers into battle without ballistic vests; health workers on the front lines of this war deserve no less.
4) The population should be divided into five groups. Those infected with COVID-19; those presumed to be infected based on symptoms but who initially test negative; those exposed to someone with COVID-19; those who are not known to have been exposed to or infected with COVID-19; and those who recovered from COVID-19. The latter group would, in theory, be immune and after confirming with antibody testing, could be released back to work. This would be a game-changer in restarting parts of the economy more quickly and safely. In Germany, researchers already started a large study to find out how many people in the country are immune to COVID-19, which could allow officials to issue "immunity passes" to allow people to return to work.
5) Intense efforts should be made to "mobilize the public." Give all citizens the tools to keep themselves and those around them safe (an example given in the editorial is for the Postal Service to deliver a mask and hand sanitizer to every American household).
6) Researchers should continue fundamental research to learn as much as they can about the virus and how to treat it. Real time experience will be critical so as we start to reopen different parts of the country, we can see what strategies work, and employ those more widely throughout the states and cities.[6]

Of course, there are many real challenges and roadblocks to implementing what it would take to "crush the curve." Many are out of our control as citizens, but one thing that is directly in our purview is our willingness to alter our lifestyles for the sake of our fellow Americans. It is quite possible that in order to crush our enemy, we will have to maintain temperature checkpoints at schools, airports and other locations. We may be asked to wear masks or other face coverings well into the fall and winter months. While those are inconveniences that we did not have to deal with just a few short months ago, they may be the difference in this crisis ending with an economy we can all return to, or one that could take years to recover.

A Third Big Question?

The potential for lifestyle changes lasting well into the back half of the year (if not longer), brings up a potential third big question: will there be an economic cost from the psychological impact of this crisis?

In China, where the COVID-19 outbreak is reported to be largely under control, many are still hesitant to return to their old lives. As fears about safety linger, many are still nervous about leaving their homes and going to public places, such as restaurants and theaters. Aside from this, many have become more cautious with their discretionary purchases, after having experienced the financial pressure caused by the country's economy effectively being frozen for two months. The challenge that Chinese policy makers are facing to jump-start consumption will serve as a cautionary roadmap for governments around the world that hope for a quick recovery once lockdowns are lifted.

The psychological impact for the COVID-19 crisis is unique and likely much more profound than prior crises, and it has triggered both health anxiety and financial anxiety at elevated levels. The pandemic has left millions without jobs, sent billions into isolation, and forced nearly everyone on earth to grapple with the feeling that they or those they love are suddenly vulnerable. The sense of insecurity and uncertainty will likely have lasting impact on consumer confidence and spending habits.

Thus, the economic rebound in Q3 may not be as swift as some economists have forecasted. Models for GDP growth should take into account the potential lasting impact of the pandemic on consumer psychology. Policymakers need to be prepared to continue injecting fiscal stimulus long after the pandemic is over, to ensure at least a U-shaped economic recovery at this point.

What does the Market Expect?

Just as in 2009, it's likely that markets will rebound before the economy turns the corner. But should we brace for more downside from here before that occurs?

Companies will begin reporting Q1 earnings in a few weeks, and it would be hard to expect (or believe) company management teams to offer any guidance for earning for the remainder of the year. Thus, we can only make assumption that we are trying to assess the valuation of the market or any of our underlying company's stocks. Credit spreads in fixed income tell us the market expects further downgrades to credit ratings. As the number of Americans infected with COVID-19 continues to rise, markets are likely to be rattled. We expect volatility to be high for a while.

Bear markets rarely end without retesting the low, so in our view, lower equity prices are possible in the near term. The cause of this bear market may offer some solace for us, believe it or not. As devastating as the virus has become, its effect on financial markets may be less than if the distress was caused by internal market dynamics. Investment firm Goldman Sachs notes that event-driven bear markets are typically shorter in duration (9 months, on average) and recover more quickly (15 months, on average) than bear markets caused by either structural or cyclical circumstances.[7]

Merlin Wealth Management Outlook and COVID-19 Playbook

A steady deterioration in the performance of active equity managers as markets locked up this past month is spurring mutual fund holders into yet another mass exodus. About $68 billion has been yanked from stock-picking funds globally in the past four weeks as passive benchmarks widened their advantage during the rout.[8] Actively managed mutual funds have trailed the main indexes by 1.3% in March, according to Bernstein Research. Peers in Europe were 3.3% behind.[9]

One of our guiding principles at Merlin Wealth Management is that it is impossible to produce superior performance unless you do something different than the majority. MWM continues to work every day to live up to this standard. We are constantly challenging ourselves to look at the world, the market, and our portfolio companies in different ways. We are deploying the latest technology, including artificial intelligence, to assist us in tracking key metrics within our company's earnings reports, investor meetings, quarterly and annual reports. All of this in an effort to maintain our discipline, and our core belief that the ownership of great businesses over long periods of time is the most effective way to achieve maximum risk-adjusted returns.

We can proudly say, that even within this unprecedented crisis, our investment discipline and our decision-making process are working. I won't reiterate the cash-raising, hedging and other reasons why we have outperformed our respective benchmarks year-to-date, but I do want to address a lingering question that we are continuing to be asked by clients and colleagues.[10] As we've outlined above, it is possible that things will get worse in the markets before they get better. If that's the case, do we have a more aggressive plan to maintain our current edge over the benchmarks?

Every Friday in our Investment Committee Meeting, we review our proprietary valuation methodology as well as our stress testing scenarios. Admittedly, before February, we did not stress test for anything close to a global pandemic! Our stress testing scenarios include comparisons to the Great Recession, the Dot Com Bubble bursting, and other prior shocks to the market. We compare the back-tested results of how our current portfolio allocations would fare under such conditions, in addition to scenarios where we employed additional hedging or other defensive measures. Moreover, we are constantly adjusting our valuation methodology, assessing how many exogenous risk factors we see in the market, how many standard deviations the market has moved away from its mean (either above or below) and then adjusting the cash in our strategies accordingly. Currently, we are holding between 12%-15% cash in our equity portfolios based on our stress-testing and risk screens.

In addition to this part of our investment discipline, which is designed to help us manage through market environments like this one, here are some other thoughts that play into our "coronavirus investing rules:"

1) **Maintaining a long-term time horizon is paramount**: Every investment decision we make is from the perspective not of tomorrow but at least five years from now.
2) **Every company we invest in during this time should either be robust or 'antifragile'**: Robust means we believe the business survives the crisis, while antifragile means it benefits. This doesn't mean these businesses won't be impacted by the crisis. In fact, we are counting on the some of these companies being impacted. That is what will create the opportunity to buy them, because most investors will be focusing on the next six months while we're focusing on the next six years.
3) **Position sizing**: Recessions are only events in hindsight; in real time they are processes. We are in the early innings of a recession. This time, its duration is not going to be determined by economic rhythms but by a virus. We are coming to this chapter with cash reserves that we intend to put to work. But since we don't know how long this will last, we'll diversify across time by employing a micro-focused investment strategy. So, instead of building a position in one or two scoops, we've reduced our initial purchases to "micro-doses"- 0.25% to 1%. We'll continue to build positions over time, allowing ourselves several "bites at the apple." For example, and as you have seen in your portfolios, we continue to add to Microsoft but in small increments. Our goal is to maximize the buying power of our cash but at the same time to put it to work.
4) **Accept imperfection**: We are aiming not for perfection but for rational, thoughtful, analytical decisions based on the information we have at hand, and in the spirit of our proven investment discipline. We accept that in hindsight our decisions may be seen as imperfect. We are always our worst critic- "we could've sold more before the markets fell;" "we should've bought more at the recent low." We accept that in a vacuum any and all of our decisions can be second-guessed, but we never stop moving forward.
5) **Hedging**: We attempt to buy insurance (hedging) when it is cheap and hope a hurricane doesn't come. Keep in mind, however, that for us risk is not volatility, but permanent loss of capital. We almost don't care what this market thinks about our stocks in the short run- unless we want to add to them.

All this being said, Merlin Wealth Management Equity Strategies continue to outperform their respective benchmarks.[11] You may recall that this was roughly the same positive spread we reported to you three weeks ago when we penned our first coronavirus piece.

Tactical Insight: An Opportunity in Municipal Bonds

The 60-consecutive-week streak of inflows into municipal bond mutual funds ended in early March, as panicked investors rushed to raise cash. The muni market is dominated by retail investors who often move in unison, specifically, buying when prices are rising and selling when prices are falling. As redemption-driven sales by muni fund managers pushed bond prices lower, the forced selling created a negative feedback loop. Retail investors withdrew record amounts from muni mutual funds in March, with $14 billion in outflows last week and $12 billion the week before.[12]

As the Fed announced last week that it will begin to purchase short-dated municipal bonds in the primary and secondary markets, confidence was restored. Yields on 1-

year AAA munis climbed from 0.47% on March 9th to 2.83% on March 23rd before falling to 1.05% on March 31st. We were fortunate to pick up some high-quality bonds in the March 23rd time frame, and still believe short-term munis are very cheap compared to Treasuries, despite the epic rally that ensued last week. As a reference point, 12-month Treasuries were yielding 0.15% on March 31st. Hence, we will continue to look for high quality munis on the short-end of the yield curve, as we expect that this illiquidity-driven dislocation will normalize fairly quickly.[13]

Making the Best of a Bad Situation

While none of us have enjoyed watching our assets fall in value over the last month, we believe it can be prudent to consider whether this presents opportunities to make adjustments to financial and estate plans that may add value for your family over the longer term. With that in mind, we are also including a piece written by the Rockefeller Global Family Office that details some ideas one could consider in this regard. As always, your Merlin Wealth Management family is here to guide and advise you during this time and are happy to engage in a conversation about how these strategies could be applied to your specific planning objectives.

---

1 How to Survive the Blitz, by David Brooks. The Atlantic 3/29/2020
2 CRFB- Committee for a Responsible Federal Budget
3 SBE- Small Business & Entrepreneurship Council
4 Live Meeting, Rockefeller Capital Management, 4/3/2020.
5 Ten Weeks to Crush the Curve, by Harvey V. Fineberg, M.D., Ph.D.. The New England Journal of Medi
6 Instead of just flattening the COVID-19 curve, can we 'crush' it?, by Rachel Rettner. Live Science, 4/3/2020
7 Wall Street Journal, 3/27/2020
8 Active Managers Stumble Right When They Were Supposed to Shine Bloomberg, 3/26/20

[9] Active Managers Stumble Right When They Were Supposed to Shine Bloomberg, 3/26/20
[10] Past Performance is no guarantee of future results
[11] Past Performance is no guarantee of future results
[12] Monthly Market Perspectives, Rockefeller Global Family Office, 3/31/2020
[13] Monthly Market Perspectives, Rockefeller Global Family Office, 3/31/2020