Signal or Noise?

Coronavirus Part 1

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.

We have just commemorated the centenary of the Great Flu Pandemic of 1918, which lasted only a few months but claimed 50 million to 100 million lives worldwide, including 675,000 in the United States.[i] That pandemic remains a benchmark, and many commentators have rushed to compare it to the current coronavirus outbreak. What's most striking about these comparisons, though, is not the similarities between the two episodes, but the distance that medicine has traveled in the intervening century. Whatever happens next, it won't be a second 1918.

That year, as pandemic influenza ravaged communities as diverse as California and Kolkata, no one knew what was killing them. Theories abounded. Some suggested it was a misalignment of the planets. (That's what gave us the name influenza, from the Italian word for "influence.") Others believed the cause was tainted Russian oats, or volcanic eruptions. Microbiologists focused on a bacterium they had discovered decades earlier in the lungs of influenza victims and called it Bacillus influenza. But they had merely recognized a bacterium that invades lungs already weakened from influenza. Not until 1933 did two British scientists demonstrate that the cause must be a new class of disease, which today we call viruses.[ii] Finally, in 1940, the newly invented electron microscope took a picture of the influenza virus, and for the first time in history we could not only name, but also see, the culprit.[iii]

The contrast with the coronavirus, which causes the disease COVID-19, could not be greater. From the very start of the outbreak, scientists suspected a virus. Within two weeks, they had identified it as a coronavirus sequenced its genome and discovered that the most likely animal hosts were bats. This information, which was published by a Chinese team, was instantly shared across the scientific community, allowing research labs around the world to begin the long and complicated process of understanding the virus, and finding a vaccine and a cure. We may not have beaten the enemy yet, but we certainly know a great deal about him.

Unfortunately, the advantages we have today scientifically to handle a pandemic like the one we face, is little solace to the American public. While our incredible biotechnology community will most definitely find a treatment and a vaccine for COVID-19, the practical portion of the playbook to combat this infection is very uncomfortable for us. Part of what makes us feel connected as a community is personal contact- social gatherings, going out to dinner, shaking hands, high fiving, hugging and (*gasp*) even a peck on the cheek with a dear friend. Yet, social distancing has been proven to be one of the most effective tools to combat the spread of any virus, and therefore we are forced to abandon these warm and fuzzies. Other tools like washing hands frequently, coughing or sneezing into a tissue or into the crook of your elbow, and staying home if we are feeling under the weather, should be instinctive but we know for many they are not. In fact, we are implored annually by the healthcare community to practice such social distancing and personal hygiene practices during flu season, yet we still have millions of cases and tens of thousands of deaths from the flu each year in the U.S., and there is a proven vaccine for that virus!

These challenges along with additional uncertainties with the U.S. response to the outbreak, seem to portend that there will have to be further action taken at the state and federal government levels to ensure containment of the spread of the virus. In the last week, the U.S. seems to be moving faster and in the right direction with the declaration of a state of emergency- opening up $50B to be used to help states prepare their healthcare systems for an increased volume of patients; approving new testing and computers to bring results to patience and caregivers quicker; closing schools, cancelling sporting events and other large gatherings; and approving an $100B+ stimulus measure that will provide (among other things) two weeks of paid sick leave, three months of paid family and medical leave, enhanced unemployment benefits, and free virus testing including those who lack insurance.[iv]

Yet these measures seem to be dealing with today's reality, rather than looking ahead at the trajectory of the outbreak and where it will be in a week or a month from now. Paraphrasing from Dr. Fauci's comments at yesterday's press conference, if you think what we are doing today is overkill, it's probably right or even a little less than what would be ideal, since the true measure of the situation is always on a lag. With that in mind, it would not be surprising (and perhaps welcome) to see even tighter measures put into place to attempt and strangle this virus sooner and more effectively. Testing kits need to be more readily available and the addition of drive-thru testing is a great start. We most likely need to lock down cities similar to what occurred in China and South Korea- a move that directly correlated to the flattening out of the number of new cases of the disease in both of those countries. Lastly, the fiscal response, in my view, has been underwhelming to say the least. Vague commitments to enhanced leave, sick days and unemployment benefits are an insufficient response to a serious economic threat like this virus presents. While it is clear to us that these economic impacts will be temporary in nature, there is no reason to not use all our available fiscal tools to assist American families and businesses now, rather than wait for the painful effects from the impending slowdown to take hold and then stepping in to sooth the already wounded.

The Federal Reserve Bank certainly took a page from this book on Sunday evening, when they cut interest rates to near zero and announced $700B in quantitative easing.[v] While this was clearly a bazooka approach, it is also quite clear that such aggressive monetary policies are aimed at ensuring proper functioning of the financial markets, in light of what will likely be an unprecedented drop in demand and a rise in unemployment. These moves are not designed to address the human effects that this crisis will create. Beyond the public health policies that we outlined above, we feel that the public and the financial markets would respond favorably to a more aggressive stimulus such as a payroll tax cut, support for affected industries and de facto "business interruption insurance" for small businesses in exchange for not laying off workers during the crisis.

Turning to financial markets, we have experienced a historic decline in the markets over a 2-week period of time. The S&P 500 Index is down -26% for the year, and close to 30% from its all-time high.[vi] The recent gyrations in the market, where we continue to break record single day moves up and down, signal that investors are uncertain as to whether policy responses are going to be sufficient to contain the coronavirus outbreak, and therefore are also uncertain as to whether markets are pricing in sufficient risk for the economic impact the virus will have on individual companies.

While our equity portfolios are not immune to such large and abrupt market moves, we are happy to see them continue to perform better than benchmarks by roughly 500 to 900 basis points in a difficult environment this year.[vii]

Yesterday's almost 3,000 point decline in the Dow Jones Industrial Average felt both like a signal that the market feels as we do, that policies will have to become more stringent in the near term, possibly causing deeper economic consequences for American businesses, as well as the first signs of true fear and capitulation in this cycle.[viii] Three factors tend to cause market drops like we've seen in the last two weeks: recessions, bursting of valuation or credit bubbles, and external shocks. The COVID-19 epidemic seems to fall in the category of an external shock and, therefore, more likely a sentiment-driven decline, but the unprecedented actions taken globally to fight the pandemic could cause a recession at some point in the near term as well. Further, with markets in the U.S. having just finished a historic 11-year bull market, some claim that we are also resetting from a valuation high as well (although no one I've seen refers to the recent prices as a bubble).

While no one can predict how far the market will fall, we do know that certain valuation measures and investor sentiment are tipping on extremes. The Put/Call Ratio (a measure of investor sentiment) is showing extreme bearishness, at a level not seen since the Financial Crisis.[ix] Stocks are also as cheap in relation to bonds as they have been in over 8 years. Further, with the 10-year treasury yield holding well below 1.00%, over 93% of S&P 500 companies are now paying a yield higher than the 10-year. That is a record.[x] Lastly, a word about market timing. We have received a few inquiries about "going to cash." While this sounds soothing in a market that is inflicting such daily pain, I am always reminded of the ever famous statistic that by missing the 10 best market days in now a 20 year cycle (1998-2019), an investor reduced his return by almost 50%, as measured by the S&P 500 Index.[xi]

The truth is, none of us know what the market direction will be in a week, or a month. The daily swings of sentiment are out of any one person's control. What can be controlled is action, discipline and mindset. Several items should help strengthen our resolve during this time period. First, your overall asset allocation includes significant weightings to cash and fixed income. These asset classes have not provided huge returns due to the low interest rate environment, but they provide a crucial level of liquidity and non-correlation to the equity market. Second, we methodically and purposefully raised cash in all our equity strategies back in September 2019. We've increased that cash in recent days and are also contemplating a hedge to protect against another potential leg down in the market. Lastly, for those who depend on income from their portfolios, our methodology of setting aside at least 3 years of cash flow in fixed income and/or cash is designed specifically to handle tough times like this. We should have ample runway within that bond and cash allocation to pull years' worth of monthly payments without having to rely on the equity portion of the portfolio at such a disadvantageous time.

As business owners, many of you have faced tough times. Whether those were company specific or related to the macroeconomic environment, your goal was to push through and even capitalize on opportunities if you were able. At no point during those challenging periods was someone walking past your office, scrap yard, construction site or warehouse with a sign telling you the daily price of your business. At those moments, that is not your concern because you are not selling. The same holds true for our ownership of great businesses within your equity portfolios. Now is not the time to sell. Now is the time to assess how capable our companies are to handle the crisis at hand and know that on the other side of this, their businesses will once again return to prominence. When properly setting expectations and timeframe, these are the most important lessons.

Disclosures

These materials were prepared by Rockefeller Capital Management ("Rockefeller") solely for informational purposes only and do not constitute an offer to sell or a solicitation of an offer to buy interests in any Rockefeller Capital Management investment vehicle or product. The information contained herein are the views of Michael Merlin and the Merlin Wealth Management Group; and is based on information obtained from public sources. Rockefeller assumes no responsibility for independent verification of such information, and we have assumed and relied upon the accuracy and completeness of such obtained information for purposes of this document. Neither we nor any of our affiliates or agents make any representation or warranty, expressed or implied, in relation to the accuracy, fairness, reasonableness or completeness of the information, and expressly disclaim any and all liability to any such information or any errors or omissions therein to the fullest extent permitted by law.

Although the information provided is carefully reviewed, Rockefeller cannot be held responsible for any direct or incidental loss resulting from applying any of the information provided. Past performance is no guarantee of future results and no investment strategy can guarantee profit or protection against losses. The information contained herein is considered proprietary and confidential to Rockefeller. This presentation may not be copied, reproduced or distributed without Rockefeller's prior written consent and is not valid without a consultation with a representative of Rockefeller.

These materials are based on financial, economic, market and other conditions prevailing as of the date of these materials and are subject to change. Certain information contained in these materials may constitute "forward-looking statements" and/or may be obtained from, or based on, third party sources that Rockefeller believes to be reliable. No representations or warranties are made as to the accuracy or completeness of such statements, and actual events or results may differ materially from those reflected or contemplated. Opinions and analysis offered constitute Rockefeller's judgment and are subject to change without notice. The materials should not be construed, as investment, accounting, tax or legal advice. Please consult your legal and tax advisors when considering this information.

These materials shall not be considered a solicitation or offering for any investment product or service to any person in any jurisdiction where such solicitation or offer would be unlawful. By accepting these materials, the recipient agrees to be bound by the foregoing limitations.

Rockefeller Capital Management is the marketing name for Rockefeller Capital Management L.P. and its affiliates. Rockefeller Financial LLC is a broker-dealer and investment adviser dually registered with the U.S. Securities and Exchange Commission (SEC). Member Financial Industry Regulatory Authority (FINRA); Securities Investor Protection Corporation (SIPC). The registrations and memberships above in no way imply that the SEC has endorsed the entities, products or services discussed herein. Additional information is available upon request.

Products and services may be provided by various affiliates of Rockefeller Capital Management.

---

[i] Centers for Disease Control and Prevention website, Pandemic Influenza, 1918 Pandemic (H1N1 virus)
[ii] The Atlantic, The Coronavirus Is No 1918 Pandemic, March 3, 2020
[iii] The Atlantic, The Coronavirus Is No 1918 Pandemic, March 3, 2020
[iv] New York Times, 3/15/2020
[v] The Washington Post, 3/15/2020
[vi] Bloomberg, 03/16/2020
[vii] Merlin Wealth Management at Rockefeller Capital Management- Managed Account Reference Portfolios YTD Performance Through 03/16/2020
[viii] Google Finance, 3/16/2020
[ix] Bloomberg, 03/13/2020
[x] Bloomberg, 03/13/2020
[xi] Bloomberg, 12/31/2019