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I n v e s t m e n t   P e r s p e c t i v e

STEMMING THE TIDE

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As the year began, the U.S. economic expansion seemed poised to continue, with calming trade tensions and three Fed rate cuts propelling stocks to record levels. Then, in late February, news of a surge in coronavirus cases outside of China slammed into investors like a rogue wave. Fears that the virus could spread globally, tipping many economies into recession, pierced the market's tranquility.

A different bear

Oaktree Capital's Howard Marks once wrote that in the real world, things tend to fluctuate between "pretty good" and "not so hot." But in the world of investing, perception often swings between "flawless" and "hopeless." Until recently, the macro outlook appeared quite favorable. Valuations were elevated but it was difficult to envision an imminent threat to the bull.

However, after investors began to grasp the myriad threats from such a contagious and lethal virus, sentiment quickly shifted, with a cascading effect on risk assets. The S&P 500 dropped by 20% in just 16 trading days — the quickest descent into bear territory on record; the index was down 34% at the March 23rd close. Outside of cash and U.S. Treasuries, there were few places to hide. Corporate and municipal bond yields spiked, commodities and real estate funds plunged.

The current environment differs meaningfully from the 2000-02 and 2007-09 experiences. Those prior bear markets coincided with recessions that stemmed from bursting asset bubbles. Imbalances had built up over several years, valuations became extremely stretched, and excessive leverage added fuel to the fire.

Shot across the bow

But the catalyst for a recession or market correction is not always foreseeable; indeed, as just observed, one can literally appear out of thin air. The coronavirus and COVID-19, the disease it spawns, represent an exogenous shock, a threat from the outside. We are at war with an invisible enemy whose impact is all too visible today. And policymakers face challenges that are more complex than those associated with the *dot.com* and *Great Financial Crisis* episodes.

For this is first and foremost a global health crisis that rapidly mutated into an economic one. The world's response to the coronavirus threat has led to unprecedented social and financial disruption. In the United States, our mitigation efforts — widespread business closures, bans on gatherings, shelter-in-place orders — prompted much economic activity to ground to a halt. New claims for unemployment insurance exceeded 15 million over the first three weeks of the shutdown.

Like a large-scale military conflict, massive resources need to be quickly marshalled and deployed. And the parties involved need to work collectively to counter the threats. This two-front war requires substantial progress on the medical end before the economy can reopen. In the meantime, many households and businesses will need financial lifelines to bridge the downturn.

Printing press the weapon

To help contain mounting economic and financial-market fallout, the Federal Reserve has adopted a sweeping series of measures to support credit markets and the broader economy. The actions have been swift and *extraordinary*. In addition to lowering policy rates to near zero, the bank has established programs to ensure credit flows to corporations as well as state and local governments. The Fed has also embarked on another round of *quantitative easing,* signaling it will buy unlimited amounts of Treasuries and mortgage-backed securities to keep borrowing costs low. This effort will also facilitate the implementation of massive fiscal stimulus.

The central bank intends to ensure that the country only faces a science crunch, not a credit crunch. As Chairman Jerome Powell stated on April 9th with the unveiling of a $2.3 trillion set of initiatives, "Our country's highest priority must be to address this public health crisis, providing care for the ill and limiting the further spread of the virus. The Fed's role is to provide as much relief and stability as we can during this period of constrained economic activity, and our actions today will help ensure that the eventual recovery is as vigorous as possible."

Don't just lend — spend

Encouragingly, the administration and Congress hammered out a $2 trillion financial aid package. The *Coronavirus Aid, Relief, and Economic Security* (CARES) *Act* will provide $600 billion to individuals in the form of direct cash payments and enhanced unemployment benefits; $500 billion to large corporations, primarily loans; $350 billion of loans/grants to small businesses; $340 billion to state and local governments, largely to help fund their COVID-19 response; and $100 billion to hospitals.

It is critical that this assistance quickly makes its way to the intended beneficiaries. Logistical roadblocks abound: State agencies have been overwhelmed by unemployment insurance claims; banks are struggling to process small business loan applications; and the IRS must determine how to expeditiously deliver the $1,200 cash grants. Rent is due.

The private sector will likely require additional aid in the months ahead, particularly if the reopening process is delayed. Many households currently have no income and little-to-no savings. Likewise, many affected businesses are not generating any revenue. Now, more than ever, elected officials must shelve partisan differences and continue to provide financial support to set the stage for a recovery. The Federal Reserve can only lend, it cannot spend.

Crush the curve

There have been encouraging signs that the curve is flattening in hard-hit areas such as Italy and Spain. The United States now leads the world in coronavirus cases, but social distancing measures should soon slow the spread. The immediate challenge: Many hospitals are overwhelmed while testing kits, personal protective equipment, and ventilators remain in short supply. The private sector has rallied to help fill the void, as it did during the second world war.

Clearly, the economy cannot begin recovering until businesses resume operations and workers are rehired. How might that play out? The American Enterprise Institute (AEI) recently issued "A Road Map to Reopening" authored by former FDA Commissioner Scott Gottlieb, among others. The plan offers a four-stage approach to combat the virus and ease societal disruptions, allowing the economy to restart:

Phase I:	Slow the spread
Phase II:	Reopen, state by state
Phase III:	Establish protection then lift all restrictions
Phase IV:	Rebuild readiness for the next pandemic

The authors suggest specific milestones to progress through each phase. Obviously, the nation is still struggling to contain the spread (Phase I). A community could relax social distancing curbs (Phase II) once disease transmission has slowed measurably and healthcare systems have the capacity to safely manage the outbreak and care for the sick. To do so, providers must be able to diagnose, treat, and isolate COVID-19 cases and their contacts. For a return to something resembling "normal" (Phase III), a therapeutic to mitigate the spread and reduce serious outcomes or a vaccine to prevent the virus needs to be available. These would be game changers.

We'll get through this

Significant human and financial capital — public and private, domestic and foreign — is being expended to improve screening, develop therapies to treat the ill, and vaccines to prevent the virus. We will defeat the coronavirus; it is just a matter of time. For many, the next few months will prove very difficult. Nevertheless, if the government provides sufficient support through this challenging period, a decent economic recovery should ensue.

While much of the country shelters in place, economic headlines will remain bleak. Corporate profits will also come under significant pressure and CEOs will struggle to provide any definitive guidance. However, for investors, the primary focus should not be on next quarter's results. Kanawha values stocks based on estimates of their long-term stream of future cash flows. As long as a given company's earnings power has not been permanently impaired, we are inclined to hold it — even if near-term results may be messy.

Meanwhile, the Federal Reserve has declared all-hands-on-deck. The Bernanke Fed's aggressive response to the 2007-09 financial crisis was portrayed as a helicopter dropping money. The Powell Fed's initiatives would be more aptly likened to a B-52, carpet bombing the country with liquidity. With an unparalleled amount of fiscal and monetary stimulus in place, investors should not be surprised if stocks begin to look through the valley towards recovery on the other side. As a leading economic indicator, stock prices are always forward looking.

— Christopher J. Singleton, CFA, Managing Director

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