KARMIN CAPITAL

Four Questions

Based on client discussions over the last several weeks, we wanted to synthesize the four most common questions we have received and share our thoughts on each. The questions are: (1) Is the market correction over; (2) When will the economy recover; (3) How should I position my portfolio; and (4) How can I safely generate income from my investments?

1. Is the market correction over?

Unfortunately, it is impossible to predict the short-term trajectory of markets with any degree of confidence. At its nadir on March 23, the S&P 500 had declined 34% from its February 19 closing high.[1] With the recent rally off the March lows, the S&P 500 is now down about 22% from its high point. The economy will certainly struggle this month and next as small businesses face existential risks, most workers stay home (with many losing their jobs) and as the coronavirus takes a heavier toll on peoples' health and the nation's healthcare system. During March, we think markets went through the rapid process of pricing in an extremely weak second quarter for GDP and unemployment (perhaps -50% GDP on an annualized basis and an unemployment as high as 20%). Yet, however dire the current situation seems, markets are forward looking and have rallied due to increasing optimism that the worst-case scenario for the nation's health and economy have perhaps been avoided.

The key question remains, though, as to what will happen when states lift the current lockdown restrictions. There is still an incredible amount of uncertainty as to the path of the virus and its impact on the economy, let alone company earnings (which we expect to be down materially this year). Until investors have more clarity on the economic impact of Covid-19, we think it's too early to make the call that markets have already bottomed. It's possible that the virus scare may be ending from a health standpoint, but that the lingering damage to the economy is yet to unfold. We wish we could be bolder in making a market call – the only thing we are confident about is that volatility is likely to remain elevated in the near-term.

2. When will the economy recover?

In response to the extreme measures world government have enacted to slow the virus – effectively shutting down the global economy – monetary and fiscal support during this crisis has been unprecedented (see charts on following page).[2] In the U.S., the $2.2 trillion Congressional stimulus and Federal Reserve's proactive monetary policy (cutting policy rates to 0% and providing trillions of dollars to support credit markets and backstop bank loans) have provided the economy with emergency breathing room. Going forward, the most important factor for the economy's recovery will be getting the coronavirus outbreak under control. On this front, some recent news has been encouraging. The growth in new virus cases seems to have declined in epicenters such as New York, Italy and Spain. Unfortunately, the resumption of new cases in China this week after the government allowed much of its economy to open is a sign that we may have to live with the risk of coronavirus for the near-term future. A durable economic recovery will require confidence that the virus won't overwhelm the healthcare system again and that it is generally safe to return to normal daily activities, such as going to work. When the economy does eventually turn the corner, the trajectory of the recovery will depend on the severity of the downturn and the continued risk that Covid-19 poses to individuals and the broader healthcare system.

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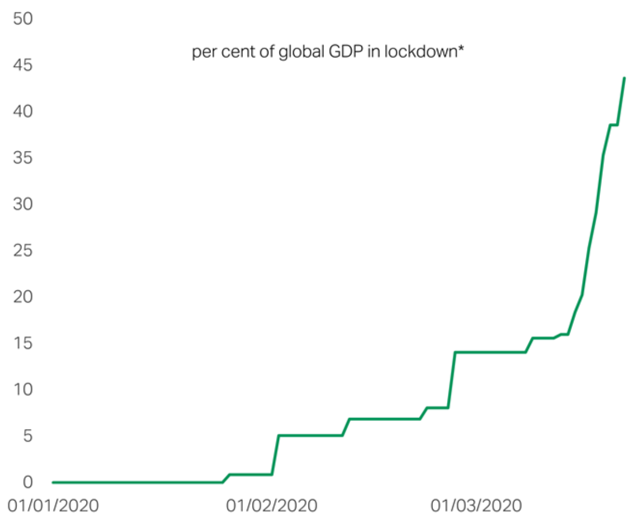

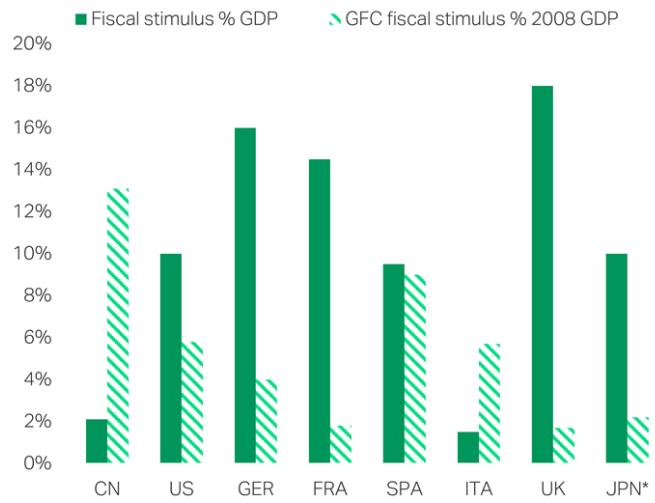

If the U.S. economy loses 20-30 million jobs and countless small businesses are forced to shut permanently, a "V" shaped or fast recovery is unlikely. It will take time to repair the economic damage. Further, until there is widespread antibody testing available to see how many Americans have immunity to Covid-19, we think it is unlikely that states will entirely relax social distancing guidelines or that most people will feel comfortable returning to their normal commutes and work routines. While there is some hope that the coronavirus entirely dissipates in the coming months, the scientific consensus seems to be that we will be stuck with smaller-scale recurrences until an effective vaccine becomes available or so called "herd immunity" is achieved in the broader population. Economic activity will most certainly see substantial resumption after the current wave of infections moderate, but the recovery will be uneven. For instance, until immunity is widespread, we think many social, recreational and leisure activities – such as dining out, travel and tourism, attending sports game – will be slow to recover. It's possible that for many activities, consumers will alter their behavior for years.

3. How should I position my portfolio?

We have received many questions on whether it makes sense to be buyers or sellers amidst this downturn. If you have a short-term investment horizon (several months to a year), trouble coping with heightened volatility, or know you will need a certain amount of cash in the near-term, we suggest de-risking your portfolio. In this case, we would advise selling firms that have weaker balance sheets, heightened sensitivity to the global economy or whose valuations were predicated on substantial sales growth that is no longer achievable. Holding firms that financed their operations or growth with debt is usually ok, but in this downturn there is a low, but real, probability that many firms see sales plummet more than 50%, putting pressure on their ability to meet interest payments. Companies exposed to the global economy tend to be in cyclical industries such as energy, materials and consumer discretionary categories. Many of these companies are oversold but the timing for their recovery is uncertain. Finally, owning growth stocks tends to be a good long-term strategy, but firms whose valuations implied 20% or more annual sales growth are likely to disappoint in the coming year.

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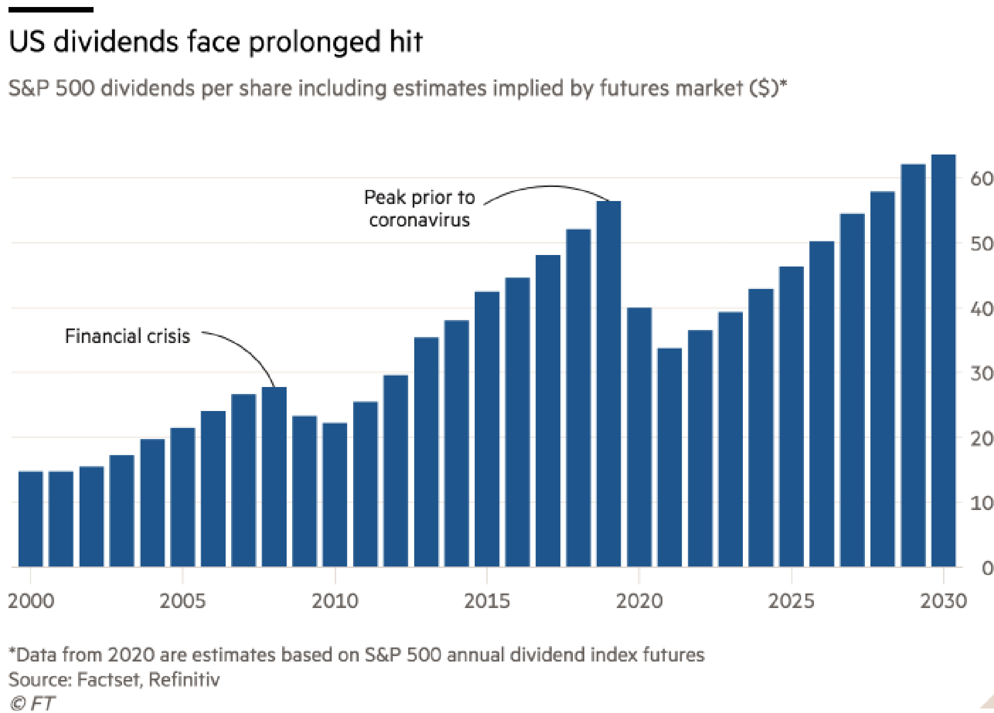
If you have a longer-term horizon (beyond one year), we suggest keeping your investments mostly intact, with perhaps some re-allocation of capital to firms with less business sensitivity to the current downturn and from firms with weaker balance sheets to those with stronger ones (i.e., higher ratio of cash to debt). Biopharma, utilities, consumer staples and some large cap tech firms are areas we'd be looking to add on weakness. Companies in these sectors may go down with the market but given their operating resilience to the slowing economy and generally reasonable valuations, we think they will behave more defensively. Investors can probably achieve the highest returns right now in small cap stocks that have suffered extreme price dislocations, but if the economy deteriorates more than anticipated these stocks also carry the highest risk and volatility. For now, we think there are sufficient opportunities in larger, more resilient firms to generally avoid new investments in small caps. Large cap company return profiles may not be the same, but neither is the risk; and managing risk at the moment should be of paramount importance to every investor.

As for cash and fixed income, every investor has a different risk profile, objective and time horizon. We are happy to have discussions to go over allocation and recommendations. Generally speaking, the higher the risk profile you have and the longer the time horizon, the more we recommend having invested in stocks.

4. How can I safely generate income from my investments?

This might be the most common question we receive. Unfortunately, there is no panacea. Dividends will decline this year with falling revenues. Companies simply must conserve cash as their sales plummet but expenses remain constant. Already there have been many announced dividend cuts from companies across all industries. Per the below Financial Times graphic,[3] investors don't expect S&P 500 dividends to recover to 2019 levels until 2028.



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Many companies we own will weather this storm without needing to resort to cutting payouts, but some (including a number of energy firms) will be forced to slash distributions in order to conserve cash. Going forward, the experience of seeing quarterly (and perhaps annual) revenues fall off a cliff is likely to result in more conservative cash management for many companies. We expect balance sheets to become stronger, but dividend payouts to take a hit. The companies with the safest dividends are likely ones with already lower than average yields, whose balance sheets are strong and whose payouts are conservative relative to cash flows and earnings. These companies may not offer the most enticing dividends, but they are the most likely to maintain and grow them over time. Nonetheless, one should prepare for lower dividend and interest income.

Other Thoughts

We wanted to share additional thoughts on markets and the economy that as of now are not as formulated as we usually like, but we think are important to consider:

- The U.S. has a long history of emerging from crises; we don't think this time will be different.
- Many behaviors are likely to be altered for generations:
  - Improved hygiene hopefully will lead to less severe seasonal flu and cold outbreaks.
  - Will people be as comfortable dining out, flying in crowded planes, living in crowded cities, commuting on crowded trains/busses or attending packed sports stadiums?
  - The anti-vaccination movement is likely over, now that the entire world is clamoring for an effective Covid-19 vaccination.
- Even though credit will remain cheap, will companies be as comfortable taking on as much debt? We think the answer is no and that firms with currently strong balance sheets are at a competitive advantage to peers with funding challenges.
- Big firms, particularly big tech firms, are likely to get bigger. Scale is an advantage in a downturn. The greatest risk to large tech firms has been antitrust action. The "FAANG" companies and Microsoft have been exemplary corporate citizens during this health crisis and are providing critical business and consumer services without which everyday life would be far more difficult. Antitrust does not appear to be as pressing a political issue for now.
  - Employees who worked at smaller firms – whether in tech or other parts of the economy – whose compensation was highly dependent on stock options (currently worth much less than a few months ago), may now see the attractiveness of working at more mature firms who largely compensate employees in cash. Large firms might have regained the advantage in hiring talent from midsized businesses and startups or acquiring them at lower valuations than previously.

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- The biotech industry, which has been much maligned by politicians over drug pricing, should emerge more popular out of this crisis, as the only way back to normal will be from biotech innovations.

- De-globalization will gain momentum as the U.S. and other countries see the importance of having critical supply chains located at home or in allied countries. Global distrust – particularly of the West to China – is likely to rise.

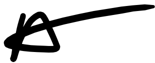
- The current contraction in demand is likely to have near-term deflationary pressures and may lead to falling interest rates; but longer-term, the massive global fiscal spending packages may lead to higher interest rates and inflation.

- Now that we have begun a tremendous fiscal and monetary expansion, ending such programs will be quite hard and unpopular. Today's policies were enacted to end a deflationary bust, but if the pandemic does end in coming weeks or months, the Federal Reserve may get more inflation than anticipated and portfolios need to prepare for this.

- States entered this crisis with poor finances and underfunded pensions and are now in worse shape. The two ways out are higher taxes or curtailing benefit payouts. We think expected recipients of state or union benefits may need to readjust their expectations downwards, as higher taxes in the aftermath of this economic downturn are likely to face broad resistance.

- Life will eventually get back to normal, as will markets and the world will be better prepared for a future pandemic or natural disaster.

Sincerely,



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Citations and Disclosures

[1] Bloomberg (April 7, 2020). All data citations herein are sourced from Bloomberg unless otherwise noted.
[2] TS Lombard (April 6, 2020).
[3] Financial Times, *US shareholders brace for nine-year squeeze on dividends* (April 6, 2020).

Investing involves risks, including the possible loss of principal and fluctuation of value. Past performance is no guarantee of future results.

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