KARMIN CAPITAL

Raising a Caution Flag

A little more a year ago, most U.S. citizens and investors dismissed the scenes of Chinese provincial lockdowns and Italian hospitals overflowing with Covid patients as a healthcare crisis that surely couldn't happen here. Reality turned out to be much worse than our worst expectations. In recent weeks, global Covid trends have become increasingly concerning. Investors, for now, seem to be largely overlooking these risks, which has given us unease that history may be rhyming, if not repeating. Considering the high degree of economic optimism currently priced into markets, investors need to make sure that their portfolios and psyche are prepared for the possible volatility that could result from markets adjusting to decelerating near-term growth expectations.

We want to note at the outset that the concerns we have are all near-term in nature and that we expect the economy to recover and grow in the coming quarters and years. Low interest rates – even in light of the recent move higher in longer-term yields – along with significant federal deficit spending and pent-up consumer demand are providing a powerful tailwind for the equity markets.

Still, we want to prepare you for the possibility that the recovery could face some Covid-related obstacles that cause investors to reassess their outlooks. Because positioning has shifted so rapidly over the last six months (for instance, investors have sold down bonds, driving yields higher, and have favored value stocks over growth) any changing sentiment regarding the economic outlook has the potential to cause sharp reversals of these recent trends. We think the best antidote to volatility is a diversified, long-term investing approach focused on high quality firms trading at reasonable valuations – and should any sector specific or market-wide sell-off occur, we would look to add to our holdings that fit these criteria.

Over the past few weeks, authorities have implemented lockdowns in parts of France, Italy, Germany, Poland, Hungary, Bulgaria and Bosnia.[1] Other European countries are reportedly close to instituting mobility restrictions. Brazil is facing a health system collapse with ICU occupancy rates above 90% in much of the country, and its reported daily death count has surpassed 3,000 (this despite a harsh first wave of Covid last year).[2] The culprit seems to be Covid-19 variants caused by virus mutations, such as the U.K. B.1.1.7 variant and Brazilian P.1. variant.[3] If you are not familiar with these developments you can learn much more from the news and scientific publications than from us, but the gist is that the new Covid-19 variants are proving, in some cases, to be more virulent and harmful than the original strain. And, though the data is limited, some of the new variants may be resistant to current vaccines and naturally occurring antibodies from prior infections.

In the U.S., the rollout of vaccinations has actually been a relative success compared to most Western countries. As of March 23, about 27% of the U.S. population has received 1 dose and over 14% of the population is fully vaccinated.[4] Despite the increased pace of vaccinations (now about 3m per day) and a sizeable portion of the population that has already recovered from Covid, we are still averaging more than 50,000 new daily cases over the last week which is more than the baseline prior to last fall's surge.[5] The Northeast and upper Midwest have the most alarming case growth trends, which has already caused New Jersey to pause its reopening plans. While the healthcare system remains stable, with hospitalizations just under 40,000 nationally, that is again higher than levels preceding the fall surge.[6] In Europe and developing countries, the situation is far worse on a per capita basis.[7] Other than Israel, the world still a long way from herd immunity.[8]

If vaccines are rolling out and many people have already recovered from Covid, why do these trends matter? First, each new emerging variant poses a risk of reducing the efficacy of current vaccines. For instance, the current mRNA vaccines are less effective against the South African Covid variant B.1.351.[9] Fortunately, scientists are optimistic they can adapt the mRNA vaccines to new variants, but this process takes time. A best-case scenario would be that scientists develop a "universal" Covid vaccine that offers protection from all potential variants, but there is no guarantee of success. Secondly, while most viruses mutate to become more benign over time, as harming the host hinders viral propagation, the rising number of global cases increases the risk of some mutation emerging that is materially more dangerous and virulent. Furthermore, mutations might evade naturally occurring antibodies and memory T-cells from those who have recovered from prior Covid cases. The world is in a race against time to vaccinate. Some countries are not running at all and many more need to be running faster.

Nevertheless, we are not in the doom and gloom camp. Based on our best understanding of the current science, we think that a combination of natural immunity and vaccinations, along with the tendency of viruses to become less harmful as they evolve, should result in either herd immunity or Covid-19 eventually becoming another class of the less harmful coronaviruses that cause the common cold.

As investors, the key issue question is: what's priced into markets? The environments in which investors can make or lose lots of money are those where a broad consensus emerges or reverses. It pays to be early and on the right side of each shift.

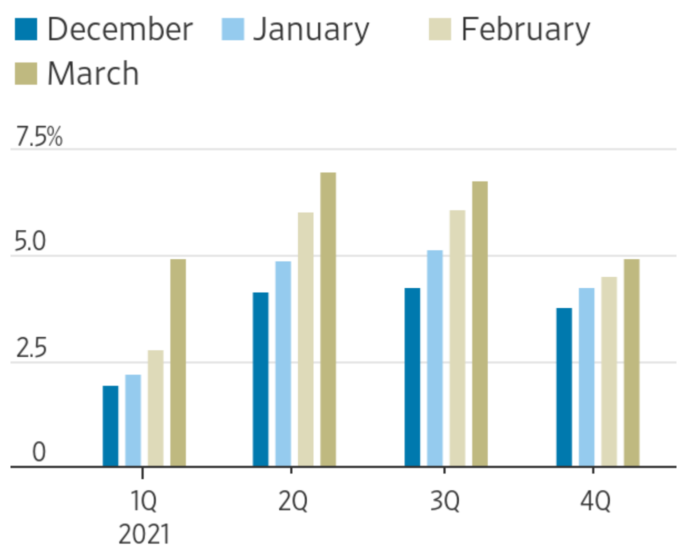
Since news of Pfizer's vaccine efficacy became public last November, investors who have positioned their portfolios to benefit from stronger economic growth have done incredibly well. Right now, a strengthening economy is still the predominant investment theme – and, in fact, growth forecasts continue to rise (see the adjacent graphic).[10] This has catalyzed a historic selloff in bonds, an increase in inflation expectations, a surge in commodity prices and a dramatic rotation from growth stocks to value and small cap firms whose business models tend to be more levered to an improving economy.

We are not suggesting these growth forecasts will prove wrong, only that markets are not priced for any bumps along the road to get there. Shifting economic expectations due to Covid setbacks would likely result in bonds rallying (driving yields down), commodity prices falling (due to lower anticipated demand) and investors shifting out of value and cyclical stocks and back into both defensive stocks (such as utilities) and growth firms (whose valuations would benefit from falling interest rates and the perceived scarcity value of growth in a potential lower growth environment). Basically, if expectations become more pessimistic, last year's market leaders would likely return to their leadership status.

Sooner Boom

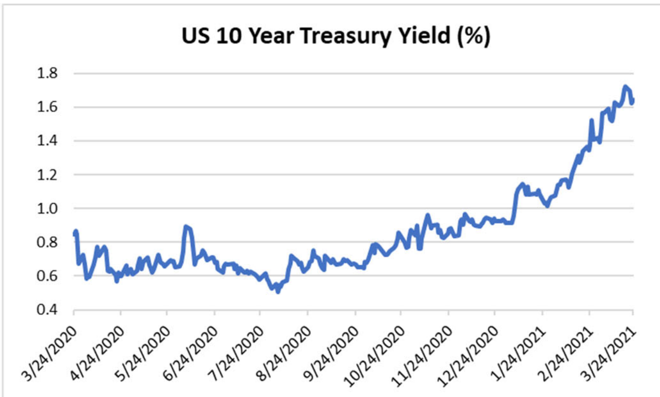
Economists raised their first-quarter growth projections in March

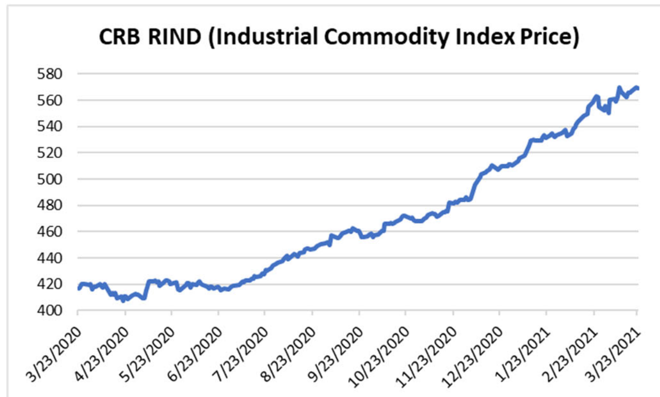
Mean estimates of real gross domestic product growth by survey month

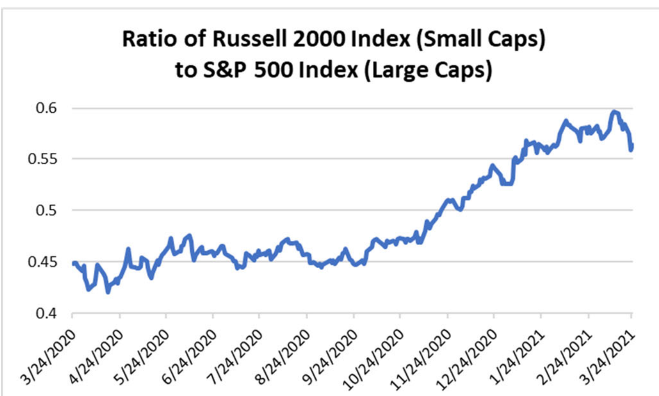


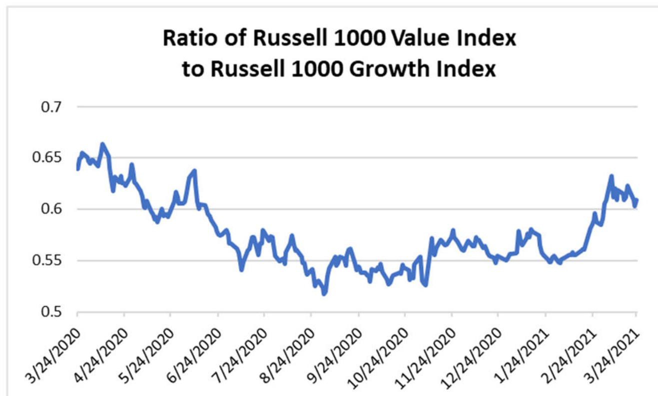
Source: Wall Street Journal Economic Forecasting Survey

Even if Covid has a challenging third wave, we doubt there is the political will at most state and local levels to implement stringent lockdown policies. Even more, we doubt there would be widespread compliance like last spring. We get the sense that most people are eager to return to their pre-pandemic routines. Still, if Covid trends deteriorate in the coming weeks and months, even without mandated stay at home and distancing policies we think part of the population will choose to exercise extra precautions. Such behavior spread across the entire country – and globe for that matter – will have the effect of slowing down the recovery. That creates the risk of an investment environment where actual economic data and company operational performance do not live up to elevated expectations. If this happens, we expect the trends depicted in the below charts to reverse (note that Pfizer released its clinical vaccine data in early November, which is when small cap stocks began materially outperforming large caps and value stocks began outperforming relative to growth).[11]









To reiterate, a harsh third Covid wave and economic deceleration is not our base case forecast. However, we think it is a risk that investors need to take seriously. The mistake most investors made last year was not taking seriously enough the warning signs coming from China and Europe. We would rather raise the caution flag and be wrong than not bring up the possibility of further Covid risks materializing.

The best way to prepare for any risks is to have some diversification in your portfolio. If you are significantly overweight value and cyclical firms, consider adding growth exposure (which has sold off over the last month) to position for an environment where growth firms again take market leadership. Conversely, if you are significantly overweight growth stocks, consider adding some value and cyclical exposure on any weakness as those firms will likely outperform if the economic recovery maintains its footing. If you have no fixed income exposure, bonds would likely perform well if we are faced with increasing economic uncertainty. As we wrote a few weeks ago, we should expect the unexpected. The best way to structure a portfolio with the unexpected in mind is (1) to make sure your equities exposure is aligned with your risk tolerance and (2) for the stocks you do own to be high-quality firms across multiple industries that are trading at compelling valuations, which do not reflect overly optimistic investor expectations. That way, any economic or operational setbacks should hopefully provide cushion against substantial price declines.

As always, please let us know if you would like to discuss your portfolio allocation or any investment ideas. We hope you and your families are doing well and that this spring proves to be far better than the last.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[1] NPR, *New Lockdowns In Europe As COVID-19 Cases Soar* (March 20, 2021).
[2] NPR, *Brazil Is Looking Like The Worst Place On Earth For COVID-19* (March 23, 2021).
[3] U.S. Center for Disease Control and Prevention, *Science Brief: Emerging SARS-CoV-2 Variants* (Jan. 28, 2021).
[4] Our World in Data (March 23, 2021).
[5] The New York Times (March 23, 2021); Bloomberg LP (March 23, 2021).
[6] The New York Times (March 23, 2021); Bloomberg LP (March 23, 2021).
[7] Financial Times (March 23, 2021).
[8] nature, *Five reasons why COVID herd immunity is probably impossible* (March 23, 2021).
[9] Reuters, *Pfizer says South African variant could significantly reduce protective antibodies* (Feb 17, 2021).
[10] Wall Street Journal, *Economy Revs Up as Americans Increase Spending on Flights, Lodging, Dining Out* (March 19, 2021).
[11] Bloomberg LP (March 24, 2021).

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