KARMIN CAPITAL

Market Update March 9, 2020

As you get up this morning, global stocks markets are down in excess of 5% because of two primary reasons:

- The coronavirus, or Covid-19, continues to grow rapidly causing large sections of the global population to go into quarantine or to stop daily activities. As a result, economic growth is coming to a halt.
- OPEC (the Organization of Petroleum Exporting Countries) and Russia entered both a price and a supply war this past weekend. Consequently, this morning oil prices are down about 20% after being down more than 30% at one point while you were asleep. This is the biggest one-day price drop since the 1991 Gulf War.

These factors have caused interest rates to collapse. This morning the 30-year Treasury is down 0.40% to yield 0.87% and the 10-year Treasury is down 0.30% yielding 0.45%. Fears of deflation are rampant.

The last time U.S. interest rates dropped this much in such a short period of time was back on October 19, 1987 when the S&P 500 fell almost 23% on that day alone. You may remember that day. You may also remember the Gulf War; you may remember the Tech Crash of 2000; the Enron accounting scandal of 2000; the 2008 financial crisis; or even the alleged break-up of the European Monetary union in 2012.

They were all painful, but we survived just as we will this current market. The one horrendous event I left out above is the one that is more applicable to today's environment: the 9/11 terrorist attacks.

Following 9/11, travel collapsed and the economy suffered a demand shock, caused by consumers and businesses holding back on spending. After 9/11, the S&P 500 fell roughly 30% vs about 18% so far from recent highs. One notable difference was that valuations were much higher in 2001 with the S&P 500 price to earnings ratio close to 25x back then versus 17x today.

In addition, interest rates were far higher as well, with the 10-Year Treasury yielding 5.0% vs 0.30% today. Lower rates are generally supportive of higher equity valuations, as the value of future cash flows discounted to the present are greater in a low rate regime. Despite the horrific attacks on 9/11, the economy eventually recovered from a mild recession and life returned to normal for most people.

At some point, this virus will be over (whether that is in weeks, months or longer nobody can be certain) and there will be pent up consumer and business demand to make up for delayed travel, purchases and investments. Most companies (and we hope most people) should come out ok on the other side of this. We are more concerned about firms with lots of debt and a high proportion of fixed costs (such as the some of the airlines and shale producers). We would expect the stocks of these companies to be more impacted by this virus than those with healthy balance sheets and room in their cost structure to protect near term margins.

The longer-term economic consequence of Covid-19 is likely to be an acceleration of the deglobalization trend that began with the Trump administration. We think many companies will reconsider the location of their supply chains over the long-term. Rather than opening up a new manufacturing plant in China, U.S. companies may choose domestic locations or countries with stronger alliances. We think there is likely to be a political push to re-shore critical infrastructure back to North America. This trend may be a long-term

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headwind for cyclical firms that have benefitted from globalization, but it is unlikely to have a material impact on most companies we invest in.

Our positions within the energy sector are probably our biggest investment concerns right now. Energy demand is likely to fall significantly at least through the first half of this year while global supply increases due to the OPEC and Russia price and market share fight. This is a toxic combination and the near-term is likely to be painful for many companies in the sector whether that is integrated oil and gas producers (like Chevron) or midstream firms (like Enterprise Products Partners). With prices at risk of falling to perhaps $20 per barrel, many shale producers are likely facing an existential threat. This morning, Exxon Mobil is trading about 12% lower than Friday's close.

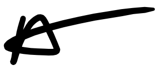
The companies we own are largely large cap firms with stable balance sheets that should be able to whether the temporary headwinds and still pay out their dividends. We are more concerned for smaller oil and gas firms whose debt burdens are significantly higher and for whom a 50% + drop in oil and gas prices puts them at risk of not being able to meet interest payments and going into default. Right now, most expectations are for U.S. energy production to remain flat in 2020 (vs prior expectations of robust growth). If production significantly contracts that would present a near-term challenge for even the best midstream operators. We are following the evolving situation closely and at this time do not recommend major changes to portfolio allocations.

With Treasury yields plummeting, the signal from markets is that investors are flocking to safety and expect a recession and deflation. When the economy eventually recovers, low rates and likely increased fiscal and monetary stimulus should be advantageous for stocks. Additionally, if the presidential election ends up being between President Trump and Joe Biden, investors no longer need to price in a Sanders presidency which is one of the market's larger risk factors.

If you have excess cash that you would like to deploy with a long-term time horizon, there are numerous opportunities to invest in high quality companies whose stock prices have significantly over-reacted to the Covid-19 spread and may further react to declines in energy prices. However, we expect volatility to remain elevated until the virus spread plateaus.

Please reach out with any concern or questions.

Sincerely,



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Citations and Disclosures

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