TJT CAPITAL GROUP

On Our Radar – April 2020

In light of the ongoing coronavirus (COVID-19) situation, we hope that you and your families are well and are staying safe. Given the unprecedented nature of recent events and the shock that the virus has had on the economy, markets, and peoples' lives, March 2020 will not soon be forgotten as the coronavirus wreaked havoc on the healthcare system, the economy, and the markets.

Given the devastating impact of COVID-19, we want to provide some context that we believe is critical to understand where we go from here.

In April 2015, Bill Gates gave a TED Talk and said, "If anything kills over 10 million people in the next few decades, it's most likely to be a highly infectious virus rather than a war." Not missiles but microbes. Unfortunately, he was prescient when he said "We're not ready for the next epidemic."

On January 14, 2020, the World Health Organization (WHO) tweeted "the Chinese authorities have found no clear evidence of human-to-human transmission of the novel coronavirus identified in Wuhan China." In late January, Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases and a member of President Trump's coronavirus task force, said "The American people should not be worried or frightened by this. It's a very, very low risk to the United States."

Furthermore, on January 28, 2020, the Director of the Centers for Disease Control and Prevention (CDC) sent an email stating the "health risk from 2019-nCoV to the general American public is low."

Clearly that was not the case, and, as a result, we were not prepared and are fighting this from behind. That said, the full weight of the U.S. government is behind solving this crisis.

The first order of business is to slow the spread of the virus and reduce the stress on the healthcare system. In an evolving crisis, focusing on mistakes is usually counterproductive, however, the lack of proper testing was a critical, and in some cases, fatal error. Because of our inability to test, we had no idea who was infected and who was not. As a result, Governors of many states have ordered nonessential businesses to close, which is causing unemployment to skyrocket and sales to evaporate. That "medicine" is having a devastating impact throughout the economy.

A Series of Delays

Adding to the chaos has been inconsistent messaging at best, which has led to a lack of trust and confidence in what we are being told. Politics aside, in early March President Trump said "Anybody that wants a test (for the coronavirus) can get a test." Within hours, that was refuted by medical professionals on the front lines. On March 30, 2020, the CDC sent an email stating "While supplies of these tests are increasing, it may be difficult to find someplace to get tested."

It is also clear that the delay by Congress in approving the $2 trillion coronavirus bill was a factor in pressuring the markets. When the country was suffering, people were dying, and businesses were being forced to shut down, Congress took additional time to ensure that pet projects and lobbyists got a piece of the $2 trillion pie. New York Governor Andrew Cuomo (D), who is at the epicenter of the outbreak in the U.S. said: "This is an extraordinary time for this nation…this was the time to put politics and put partisanship aside." They did not.

Hospitals were running out of critical supplies, but the Kennedy Center for the Performing Arts got $25 million with a phone call.

Interest Rates (Monetary Policy)

After taking every opportunity to say the Federal Reserve will be there to "provide insurance against ongoing risks," and seemingly responding to every tweet by President Trump over the past 15 months, when it mattered most, when a real issue came up, they were nowhere to be found.

The Federal Reserve initiated an emergency 50 basis points (0.50%) interest rate cut on March 3, 2020. That was a warning. The last time the Fed had conducted an emergency interest rate cut of that magnitude was during the Lehman Brothers crisis in 2008. Obviously, the Fed does not do that when times are good.

In addition, the Fed cut by 100 basis points (1.00%) on March 16, 2020. However, the Fed failed to understand that it was not about the cost of money, it was about the availability of money, and liquidity was drying up fast. It was reported that a large investment company with over $500 billion in assets could not borrow money.

When market liquidity dries up, if you cannot sell what you want to, you sell what you can. There were a lot of leveraged players and leveraged products that were forced to unwind positions in very illiquid markets. The Fed finally got the message when one of the largest investment-grade bond Exchange Traded Fund (ETF) declined by more than 20 percent in less than 2 weeks.

As a result, the Fed announced an unprecedented number of programs designed to support the flow of credit in the economy and stabilize the markets and the financial system. The Federal Open Market Committee (FOMC) announced the following:

- Exchange Stabilization Fund (ESF)
- Term Asset-Backed Securities Loan Facility (TALF)
- Money Market Mutual Fund Liquidity Facility (MMLF)
- Commercial Paper Funding Facility (CPFF)

And "expects to announce soon the establishment of a Main Street Business Lending Program."

The Fed statement said "Aggressive efforts must be taken across the public and private sectors to limit the losses to jobs and incomes and to promote swift recovery once the disruptions abate."

On March 26, 2020, Fed Chairman Jerome Powell appeared on the NBC Today show. When asked if there was any limit to the amount of money the Fed is willing to put into the economy, he said "Essentially the answer to your question is No." When asked if the Fed was prepared to spend an unprecedented amount, he responded, "We certainly are."

The Fed's balance sheet has increased by more than $1 trillion since March 4, 2020, to $5.25 trillion, and it will not stop growing anytime soon. So, while the cavalry arrived late, they are here, and more reinforcements are on the way.

Valuation

Due to the forced shutdown of numerous non-essential businesses in a number of states, many companies are suspending revenue and earnings guidance. Nevertheless, investors should realize that earnings could decline dramatically in 2020.

Economic Cycle

The forced shutdown of non-essential businesses along with shelter-in-place orders by several states virtually guarantees an economic recession. The duration will be a function of how long it takes to get people back-to-work.

Sentiment

Investor sentiment is a contrary indicator, and given that there are more bears than bulls, we view that as a positive. History suggests that when so many are bearish, they have already reduced their equity exposure.

In fact that salutation was seen in December 2018, February 2016, and December 2011, which corresponded closely with lows in the U.S. equity market averages.

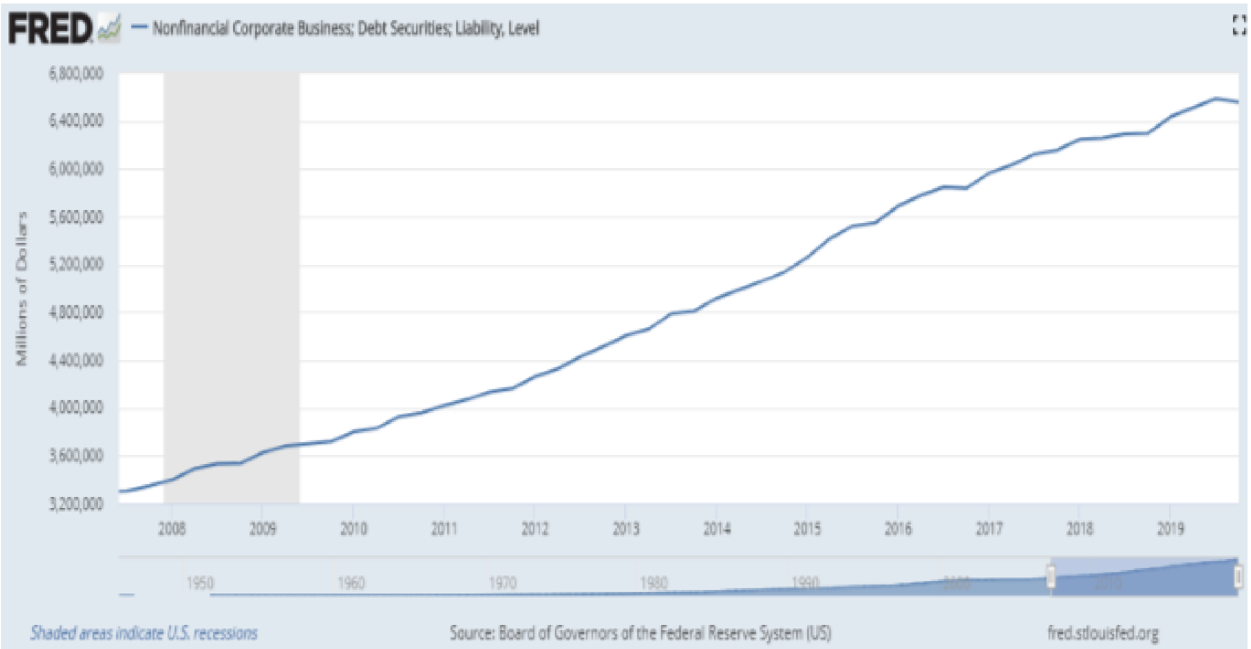
Technical Factors

The technical factors in the U.S. equity market broke down across the board as relentless selling took place. While technical damage of that nature will take time to repair, know that technical market bounces from extreme oversold conditions are the rule, not the exception.

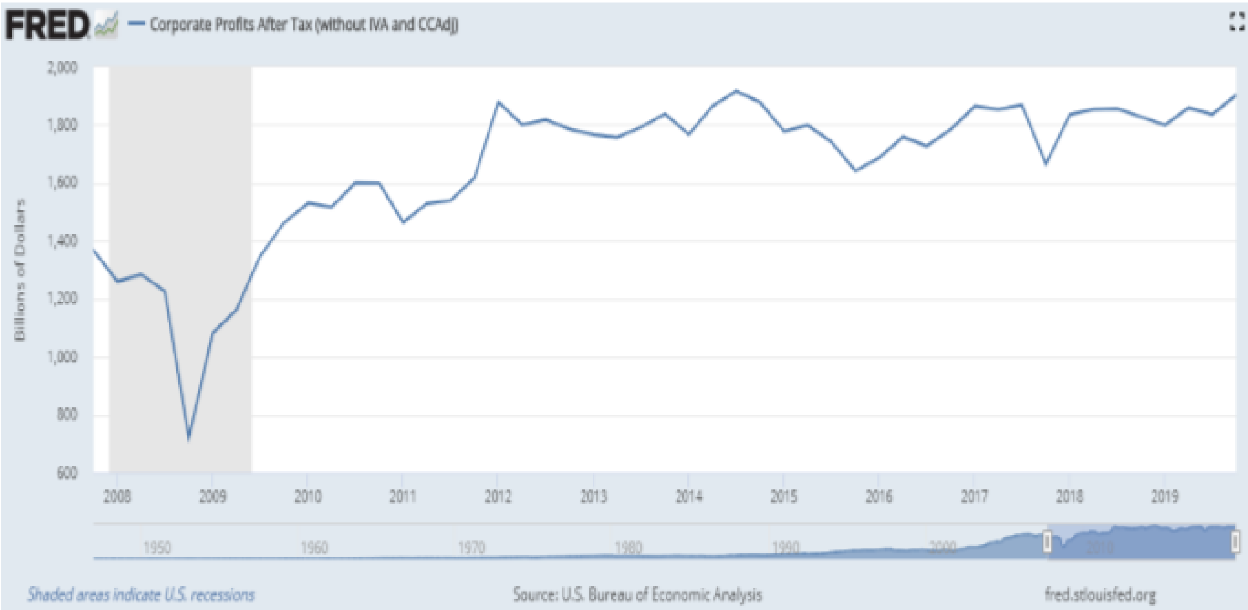
The percentage of stocks trading below their respective 50-day moving averages fell to roughly 1 percent.

Outlook

We face some very difficult challenges ahead. In addition to "flattening the curve" to slow down the spread of the virus, companies have to service an enormous amount of debt outstanding. The combination of low-interest rates and a seemingly insatiable demand for debt encouraged companies to leverage balance sheets. With cash flows under serious pressure, to say the least, companies will be cutting back on non-essentials including headcount, marketing, and capital spending.



This shock to the system is occurring as corporate after-tax profits have not meaningfully grown since 2014, as seen in the following chart. Earnings per share have grown, however, due to many corporations buying back their stock as they were one of the biggest equity buyers since 2009. That dynamic is not expected to be repeated anytime soon.



There is an old adage that the markets stop panicking when officials start panicking. Well, officials are panicking.

The coronavirus outbreak has caused unprecedented disruption to everyday life. It is overwhelming the healthcare system and devastating businesses, markets, schools, and families. The lack of information, misinformation, delays, and uncertainty have led to extreme policy decisions.

The lack of adequate testing for the coronavirus has put us in a position of needing to shut down significant portions of the economy. The CDC's initial tests were flawed, and the government did not lift restrictions on outside lab testing until March 3, 2020. Now we are trying to play catch-up at a time when states are issuing "stay-at-home" orders and "social distancing" is the new catch-phrase in order to prevent community spread.

However, Taiwan, a country that is roughly 100 miles from mainland China, learned not to rely on China for virus information – or the World Health Organization for that matter- as a result of the 2002 Severe Acute Respiratory Syndrome (SARS) outbreak. Taiwan's rapid response to address the coronavirus stemmed the potential outbreak without draconian measures. As of a few days ago, Taiwan had roughly 300 cases with 5 deaths.

Recently when asked by lawmakers whether the U.S. should be testing the way other countries are doing it, Dr. Fauci said "Yes, but we are not. It's a failing. Let's admit it."

It appears that President Trump was trying to be an optimist in mid-March when he originally said we have "15 days to slow the spread," then threw out Easter (April 12th) as a possible target, and now it's "30 days to slow the spread." While perhaps well-intentioned, continuing to push the timeline back is causing confidence to erode.

In addition, just as the U.S. and global economy were coming to a standstill, an oil price war between Saudi Arabia and Russia broke out. Saudi Arabia flooded the markets with oil just as demand collapsed. The price of a barrel of West Texas Intermediate oil was $63 at year-end. It closed at $20.48, falling 67 percent in three months.

While markets experienced panic-selling as the economy shut down, the Fed has vowed to support the economy and markets with asset purchases "in the amounts needed." Moreover, Congress is likely to approve additional stimulus packages in the weeks ahead. Nevertheless, economic and earnings reports will be grim over the next month or two, although equity markets may have already discounted a number of these realities, and a significant amount of "de-leveraging" has likely taken place.

After extreme panic-type selling, a market bounce is generally the rule not the exception, but you never know from what level. Policymakers' extraordinary support has helped stabilize risk, but lasting market stability and declining volatility hinges on slowing the number of cases.

However, in the middle of difficulty lies opportunity. While the markets have experienced indiscriminate selling, a number of companies and industries seem to be well-positioned to come out ahead. These are companies with products or services that are necessities. For example, a large cloud computing company has seen a 775 percent increase in traffic. The need for more capacity, more servers, more laptops to work remotely whether for school or business is causing a spike in business. Telemedicine, biotech, video conferencing, and medical diagnostics are but a few of the potential winners.

On the other hand, the cruise industry and a number of department stores, for example, are not a necessity. And the oil price war is likely to last for some time. Therefore, while the trading algorithms are going to continue to keep market volatility on the high side, there will be opportunities for the companies considered necessities, while those in the non-necessity category struggle for survival.

Bill Gates finished his 2015 talk by saying "we can build a really good response system. We have the benefit of all the science and technology [we need]…We just haven't had the will to do so yet."

It is safe to say things will change as a result of this crisis, and that is where the opportunities can be found. (4.2.20)

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