March 31, 2020

LOOKING ACROSS THE VALLEY

In the few weeks since we last wrote about the coronavirus situation and its impact on the stock and bond markets, a lot has changed. The stock market dropped firmly into bear market territory. Bond yields and even gold prices have been whipsawed around, indicating that at times the only thing some investors seem to be comfortable holding is cash. Around the world, infections continue to grow, while three-quarters of Americans and one-fifth of all humans have been ordered to stay at home. As investors, our primary concern is how much impact the virus will ultimately have on our economy, not just for the next few weeks, but for the long term. This perspective will inform where we deploy our clients' capital. Consequently, in this *Investment Strategy Update*, we reassess what we know and don't know about the virus, the economic impact of the attempts to combat its spread, and the changes we foresee to consumer and business behavior.

The Spread of the Novel Coronavirus

The coronavirus infection was classified as a pandemic by the World Health Organization on March 11. It is essentially everywhere, and the only question anyone has is how best to manage its spread. There is no known treatment, and there is no vaccine, but fortunately most people will experience mild or no symptoms. Throughout this experience, the best guidance has remained consistent: wash hands regularly and thoroughly with soap and water, avoid touching the eyes, nose, and mouth, and practice social distancing. The latter particularly appears to have worked in China, where the authoritarian government imposed strict quarantines on the major outbreak centers. South Korea's government was able to identify carriers and test extensively early on, which allowed that nation to get a handle on the spread.

It remains to be seen whether the U.S. response, which has been decentralized – as is the American tendency (and perhaps the Constitutional necessity) – will be as effective. We are also not certain about the populace's willingness to comply with self-quarantine orders for a long period of time. As residents of the Bay Area, we can say that car traffic, foot traffic, and ridership on public transit were all well down before the order officially came from County authorities to shelter in place. We hope that is a sign that Americans generally have taken this threat seriously.

The goal of the Centers for Disease Control has been to "flatten the curve," a phrase that will undoubtedly become a permanent part of the American cultural lexicon. In other words, accept that the novel coronavirus will eventually infect a large part of our population, but slow its spread so that the healthcare system can handle the flow of patients and provide the best possible care. Some would argue that if its spread is inevitable anyway, and if there is no treatment, what's the point in all the social distancing? Just let it run its course and let society develop herd immunity. That line of reasoning ignores a key concern, that if the virus is allowed to spread unchecked, the peak number of cases serious enough to require hospitalization would overwhelm the healthcare system. While our healthcare system has three times as many critical care beds per capita as Italy, and ten times as many as China, many victims would receive inadequate or no care and would die unnecessarily. This policy is one no politician wanting to be reelected is willing to pursue.

The Impact on the Economy

Therefore, flattening the curve is the approach the U.S. has been taking to date. It will, however, have a significant negative economic impact. Economists are only beginning to throw around estimates, but when one considers that many Americans now find themselves spending a meaningful period of time in isolation being economically unproductive, one can assume the impact will be large. Again, based on our firm's Bay Area view, non-essential, discretionary activity has come to a screeching halt. Most Wall Street economists are currently expecting a second quarter decline in GDP well into the double digits before rebounding later in the year.

More than two-thirds of Americans have less than $1,000 in savings, so they could certainly not last long without a paycheck. But they *were* working. America's unemployment rate was near a 50-year low before this virus arrived, and formerly discouraged workers were re-entering the labor force. That's a good thing. However, last week's jump in initial unemployment claims to more than 3 million also indicates how the current/coming recession is very much self-inflicted. Fear caused many people to self-isolate, but for the most part, governments ordered it. As a result, government support is critical.

The stimulus package signed into law last Friday is impressive, sending much needed relief to both the working middle class and the unemployed. But temporary financial support is not enough. The government also needs to continue to provide practical, realistic guidance on social isolation policy. As politicians on both sides have now made clear, we can't shut down the economy forever. At some point, the lower-risk population can and should go back to work, while the more vulnerable continue to shelter in place. Then, the key question will be what the economy looks like after we return to "normal." If we do revert to something close to what we had before, there should be a lot of pent-up demand for everything (except maybe toilet paper), including discretionary items. But will there be long-term behavioral changes that will ultimately be reflected in stocks? We believe so, as noted below.

Investment Implications

This bear market was the quickest in history to reach both a 20% drop and 30% drop from the top. Yes, including 2008, 2000, 1987, and 1929. The sloppiness of the stock activity has led to a flight to quality, and particularly the highest quality. Even gold and U.S. government debt were sold at times in the race to generate cash. The violence of the bear market has also been shocking. Our team can't remember a time when there were so many days in quick succession where the market moved down, or up, more than 5% or even 10%, and we've never seen so many days in a short period where more than 90% of stocks traded down.

While this time is extremely uncomfortable to live through, the stock market is a predictive mechanism, so at least a violent pullback implies an attempt to reflect economic and consequent earnings damage as quickly as possible. Some observers are starting to believe we saw the bottom in stocks on March 23rd. We respect that technical thesis, but are concerned that news flow could still overwhelm it. Without a firm grasp on the length of the impact of the virus on the economy, the market is still only guessing. This pandemic is unlike any prior experience for most Americans, and it is bound to impact how we live, work, and spend money in the future. The stocks BTR eventually buys, therefore, will in some cases be different from what we would have envisioned prior to the bear market.

One important lesson we believe many companies, including our own, are learning is that working from home is, in fact, possible. For years, BTR had not found it worthwhile to pursue an extensive work-from-home scenario, because we believe there is value in having the group together in one place. Our contingency plan, meanwhile, was designed to address a situation where our office was unavailable, wherein we would congregate at an offsite location. This proved impossible when congregating itself was banned.

Over the weekend prior to the shelter at home order, we arranged for portfolio managers to securely access all of their office applications from their home computers. We cannot be the only organization to discover how beneficial such an arrangement can be. As the large cohort of younger workers who are more desirous of flexible schedules comes to dominate the workforce, remote work will undoubtedly become more common. This shift has implications for commercial office space. We believe that whatever the perceived square footage need was before the pandemic of 2020, it is now measurably lower, and office rents will reflect that for the long term. Similarly, the software that allows for remote work is daily proving its value to ever more workers, so the companies that create that software will benefit. We remain interested in such software stocks, but as always, their valuations will remain a focus for us.

The travel and hospitality sector has been the most obvious loser. The question now is whether travel, for leisure or business, will ever snap back to 2019 levels. Should this pandemic take more than a few months to burn itself out, we are inclined to think such a reversion unlikely anytime soon. While there is undoubtedly some pent-up demand, we believe many consumers will think twice about taking that cruise, flying to that particular country, or visiting that very crowded city/bar/restaurant. Even for business travelers, conferences or simple face-to-face meetings may not seem all that necessary after an experience like this.

The forced isolation caused by the pandemic has resulted in a clear distinction between what we would call the “stay at home” and “leave the house” themes. Not only bars and restaurants, but sporting and theatrical events have also been impacted. If one is not allowed to leave home, at least one has lots of in-home entertainment options. Streaming video content has probably never been more appreciated, and the number of offerings has been expanding. Movies that used to show exclusively in theaters for months first, may now go to streaming much earlier. While live events will resume and movie theaters will reopen, the demand for premium experiences at home will probably remain elevated.

This stay-at-home theme has implications not only for the content providers, but also the telecommunications service providers. Where would we be without high-speed Internet connections and robust wireless data plans? How many people are deciding that their Internet connection and their data plans are actually not as robust as they’d like? For that matter, how many people currently being forced to work from home as well as educate their kids at home are realizing that their PCs, tablets, and wireless devices have finally gotten too old, or are insufficient in number? Whatever demand for computing devices has been forgone due to store closings could well come back strongly when this is all over.

Home improvement retail would also seem a logical beneficiary of the stay-at-home theme. A lot of people are spending a lot more time at home than they usually do. They are undoubtedly noticing some things they'd like to change about the place. If they don't have the skills to take care of these projects themselves, perhaps they will get a contractor out sooner rather than later. The fact that interest rates have dropped may result in less concern about drawing down the home equity line of credit, even if the demand for refinancing has resulted in mortgage rates that are not any lower than they were last year. Also, if the family road trip or cruise has been cancelled, the money that would have been spent on vacation may be redeployed.

Speaking of borrowing, the finance sector is one of the areas of greatest concern in this environment. Our banks were very well-capitalized going into this experience, but if tens of millions of borrowers are forced to default on their car, credit card, and home loans, it will be a different story. For now, we believe the stimulus bill and the backstops put in place by the Federal Reserve will be sufficient to prevent bank failures. As long as this safety net works as intended, we are comfortable with our financial holdings.

Finally, no discussion of the coronavirus can be complete without addressing the impact on the healthcare system. Any news that indicates a company is making progress on a test, a vaccine, or a treatment for coronavirus is reflected positively in the stock. Companies that provide equipment, supplies, and services were doing very well, and should continue to do well in this environment and in the future. Perhaps most importantly, under the changed circumstances, with the government desperate for both a treatment and ultimately a vaccine, it will be less inclined to pursue complaints about pharmaceutical pricing.

Conclusion

There is no doubt, this period is a mess. Aside from the fear that the words "virus" and "pandemic" engender, every member of a free society who is currently under some form of lockdown will start going stir crazy at some point. And for many with school-aged children now at home, that point may come sooner. Our focus on your behalf is to make the best decisions we can with the information at hand. With news coming fast, expect us to move slowly. We are not going to attempt to be heroes. We are going to attempt to make prudent purchases at a time when stocks seem to reflect all the bad news yet to come. As regards your health, stay safe and be well. As regards your portfolio, stay calm, and note that ***required minimum distributions for traditional IRAs have been waived for 2020***. This is a new experience for us all, but eventually it will pass.