Life would be tragic if it weren't funny

— Stephen Hawking 1942-2018

First let us say that this is a very tragic time. The unnecessary loss of any life is most unfortunate, and we send our very best wishes to everyone. If someone in your family is ill, we hope for a speedy recovery. If you are safe, we hope you stay safe. We yearn for a time when life returns to some semblance of normalcy.

We can't help but ponder what that normalcy will look like? Some behavioral changes brought about by the recommended physical distancing are likely to remain imbedded in our behavior long after the corona virus has ceased keeping us "safer at home." (If you are pressed for time, consider reading the bold only.)

Are we going to return to the Western tradition of shaking hands, or hugging and kissing our friends? Perhaps an Eastern bow will replace handshaking as we should be cognizant that hand-shaking does help spread infectious diseases. What other changes are likely to remain following the defeat of Covid-19, the disease caused by the coronavirus?

It is important to acknowledge the remarkable policy changes that have been implemented to help reduce the impact of the virus. The Fed, acting in emergency mode, cut interest rates twice. Interest rates were cut to just above zero, the same levels that eventually helped the U.S. recover from the Great Recession. While near-zero interest rates have their own unintended economic consequences, the Fed wasted no time in acting.

Other monetary policy decisions were made, and learning from the mistakes of 2008-09, the Fed did not wait for financial stresses to exacerbate. They have acted quickly and decisively to help reduce the potential problems in the financial system. Funds have been made available to corporate borrowers, and liquidity has been rushed into the system to prevent the shock of slowing economic activity from having greater repercussions.

The Fed's quick and dramatic actions were driven, in part, by problems that began to crop up in credit markets. Lower quality borrowers found it almost impossible to refinance their debts. Even investment grade companies found fund-raising difficult. **While initially a healthcare crisis, it quickly became clear that, if left unchecked, this**

could easily become another credit crisis. Even the mortgage bond market found itself struggling as liquidity and buyers dried up almost instantaneously. **The Fed's actions have provided much-needed support to a market that was struggling with the speed and depth of the changes that were occurring in the economy.**

While it took a little longer, Congress has passed three bills to provide a fiscal policy response to help offset the dire economic outlook. Most important is the CARES act, the Coronavirus Aid, Relief, and Economic Security Act. This bill provides substantial financial assistance to businesses and individuals who find incomes greatly reduced by following the recommended policies of providing appropriate physical distancing. **The total amount of aid available is in excess of $2 trillion, perhaps as much as 10% of U.S. annual GDP.**

A $2 trillion aid package is the largest stimulus package ever passed, eclipsing the rescue packages of the Great Recession. Even so, it may not be enough, and some people expect a fourth fiscal program to help offset the expected economic slowdown. Further, the President is talking about an infrastructure program to help provide jobs, although it is unclear how quickly such a program can be initiated when people need to pay their rent and mortgages now.

While the impact on the economy of the disease will be quite dire, it is important to remember that "necessity is the mother of invention." **American ingenuity is the best in the world, and the American capitalist society provides the opportunities for those gifted scientists to come up with anti-virals and vaccines to keep us safe from the virus in the years to come.**

Our best scientific minds are already working on three necessary fronts. First there must be more testing. Nations like South Korea tested its citizens aggressively. That is the only way to determine how widespread the disease is. There were recent announcements that one pharmaceutical company was working on a test that could be purchased at your local drug store, and would provide results in minutes, much like a pregnancy test. **Not only do we need to know who is infected, but we need to know who has antibodies and immunity, and is safe to return to work. Testing must expand dramatically,** and we are on the cusp of seeing a quantum leap in testing (which unfortunately, will lead to a quantum leap in the number of cases).

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Second, we will see progress developing anti-virals and other medications that can help those that are stricken. Some anti-virals are far along in the testing process, and it is certainly possible that existing therapies may be successful in helping infected people overcome the disease. **We have sufficient confidence in our scientific capabilities to believe that an anti-viral can be found.** This will not only be critical for those who are stricken, but it will also allow us to medicate our healthcare professionals to prevent transmission of the disease to those on the front lines of care-giving. **It would not surprise us if one or several anti-viral medications are available before the end of this year, hopefully sooner.**

Third, we need to see work on a vaccine to prevent the coronavirus from returning seasonally. While we remain confident in our capabilities, we recognize that a vaccine may be the most difficult task to overcome. One large pharmaceutical company recently said it was initiating testing on a potential vaccine that could be available before the year is out. That would be very welcome news. The reality is that we have been unable to develop a vaccine for the HIV virus, and it might be the case that success on a vaccine eludes us. Still, as with AIDS, anti-virals have prevented the worst outcomes for most patients, and perhaps even gene therapies will be utilized to beat the coronavirus.

With work on tests, anti-virals, and vaccines underway, it is also important to recognize that the U.S. was woefully ill-prepared for a pandemic. The shortages of personal protective equipment (PPE) and ventilators will cost us lives. **Like the strategic petroleum reserve that can provide oil in the event of an embargo or other geopolitical event, we must have a stockpile of equipment available to beat the next deadly illness.** After all, this is not the first coronavirus we have faced. There have been others, none quite so widespread, but some far more deadly. This will most certainly not be our last coronavirus. **The U.S. will need to spend on a strategic reserve of pandemic readiness equipment so that shortages are not as rampant, and more lives can be saved. This is just one way that the world will change as we look past the immediacy of physical distancing.**

What other behaviors will change, and are there investable themes that will emerge from the current pandemic? Many of us have been asked to work from home. For our firm, as I write this, we are in the middle of our fourth week at home, and looking at the end of April suggests at least another four weeks to go, perhaps longer. We are very pleased to report that all of our systems are available, and our work has been remarkably productive, despite our physical absence from the office. **If we can work successfully from home, do we need as large of an office? Will some businesses decide that working from home becomes the new normal? Has the demand for office space peaked?** What will happen to the unrentable square footage that used to be a requirement for business operations?

Perhaps even more interesting from an investment perspective is who makes the software that enables us to work virtually? From my dining room table, I can access all of our software and files as if I were in my office. These software providers are likely to see their businesses continue to expand as more and more firms embrace the ability of workers to work remotely. **Whether the reason to work remotely is because we are in times of stress, or simply to reduce traffic and rent and parking expenses, the fact remains that following this virus outbreak, people are likely to work remotely more often**.

As more people work from home, it is important to consider whether the benefits of living in a big city are worth the risks. The big, global cities like New York, Seattle, and Miami are places where the number of infections has increased dramatically. Big cities seem susceptible to the spread of disease because more people live in a smaller space, and are less able to maintain safe physical distancing. **Will the move to work from home also drive people away from big crowded cities?** Many rural counties have no cases of Covid-19, (at least not yet,) . Will smaller cities become more popular, and will the rush to live downtown in an artist's loft be reconsidered?

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The end of globalization? Nearly four years ago the British voted to leave the European Union, a process dubbed Brexit. This was the beginning of the end of globalization. The election of Donald Trump represented another blow to those who supported global trade. While economists generally believe that global trade is a net positive to society, it is certainly the case that there are both winners and losers. Workers in America's rust belt who saw their jobs transferred overseas were some of the more visible losers. They voiced their frustration with a vote for a President who had never held any public office, but who heard their pain.

The coronavirus may be yet another stake in the heart of globalization. Many companies relied on parts and supplies from China. Donald Trump upset those supply chains by placing tariffs on goods imported from China. Many businesses felt it necessary to secure supply chains by shifting away from Chinese suppliers. China earned that coveted position in supply chains by having been the low-cost producer, so moving supply chains to Mexico or Vietnam or India may suggest higher pricing. Yet that may be a necessity to prevent being captive to a supply chain from China that increases political risk.

Now with China being the epicenter of the virus outbreak, will more supply chains be shifted away from China? Will Chinese goods be considered tainted by WalMart shoppers, even as the price of goods remains attractive?

Will people travel as frequently in the post-virus era? Suddenly that trip to see the Terra Cotta Soldiers seems somewhat less enticing. Will even simple journeys to a family wedding be viewed as having an increased risk?

Will airlines be able to sell that dreaded middle-seat? (I personally hope not…) **How long will it take for air travel to return to normal?** Following September 11, 2001, when planes were used as weapons of terrorism, it took about three years for passenger counts to reach the previous peak. Will it take three years for people to be as willing to travel as they were in 2019?

How about cruise ships? Do you have any desire to spend a week seeing the beaches of the Caribbean with 3,000 closely contained strangers? Cruise ships have established a reputation of being floating Petri dishes. **How long will it take for**

people to be willing to cruise again? This year will clearly be a disaster for cruise ship profitability. Next year they will offer incredibly good deals to try to fill ships. "Spend a week in Mexico for $99!" If they are able to fill berths, they will do so with very poor margins, or perhaps even modest losses. After the ships are used as hospital overflow suites, what will it cost to return the ship to be attractive vacation choices? Will profitability return to cruise ships in 2022? **Is it possible that the cruise industry never returns to its past glory?**

The end of malls? Admittedly, malls have been on the decline for years. While malls were once seen as a social gathering place, a place where seniors could walk and teens could congregate, they have long since passed their peak popularity. Now that all non-essential shopping has been curtailed, many more people will continue to use delivery services even after the "safer at home" orders have been lifted. Sure, some items are very difficult to buy on-line, but **once we have survived without malls for a couple of months, it does not seem likely that we will fully return to our old habits. Malls will be repurposed with some becoming distribution centers for large on-line retailers, others will become offices, and maybe some will become apartment buildings.** The U.S. has always had more shopping square footage per person than other countries, but that is changing and the malls have likely passed their peak. **The migration away from malls is likely to accelerate.**

Bigger deficits across the world. We mentioned earlier that the policy response from both the Fed and Congress has been quick and robust. The response from other central bankers has also been keenly focused on reducing the potential risks. While it is harder for Europe to create a pan-European fiscal policy because there is no structure for European central bankers to run deficits, individual governments across the continent have provided fiscal responses for their economies. Japan and other economies across the globe have also created policies to offset the coming economic shortfalls.

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What about deficits? Following the passage of Trump's tax cuts, budget deficits were projected to be in excess of $1 trillion per year for as far as the eye can see. (The CBO provides 10 years of estimates.) With the economy in freefall, there is no chance that actual deficits will be even close to budgetary estimates. **Deficits will expand as they always do in the face of recession. Add to that the additional $2 trillion of fiscal policy spending, and the budget deficit will be far greater than $3 trillion this fiscal year.** The largest previous budget deficit was $1.4 trillion in 2009, so this year's deficit is likely to be at least twice as bad as the previous nadir. **What are the economic ramifications of**

huge deficits? And large deficits will not just be an American issue, but will be the new normal across the globe.

Will enormous deficits lead to inflation? Will supply chain changes lead to inflation? **Will we see a new round of inflation, or worse, stagflation, before the end of this decade?**

As if the world were not struggling enough, the Russians and the Saudi's have embarked on an oil price war. **The Saudis, recognizing the inherent economic weakness, have sought to lower oil production to help protect prices. The Russians have refused to cooperate. Rather than reach a compromise, they both have increased production, flooding the market with unneeded oil. From $63 in January, the price of oil has plummeted to $20 now, and estimates suggest lower prices could be likely.**

Without being too much of a conspiracy theorist, **it does seem as though the oil price war was expected to do great harm to U.S. domestic oil producers**. While many shale formations can be profitable with oil prices near $40, virtually none are profitable with $20 oil. Are the Saudis and the Russians trying to put many U.S. oil producers out of business so as to protect their long-term franchise. After all, the U.S. has become the world's largest producer, and why not kick a competitor when they are already down? Energy companies are unable to borrow new funds, and bankruptcies in the oil patch have already started. This just adds to the problems we are facing.

There are so many unknowns, and that is what makes this viral episode so difficult to manage. Earlier health threats such as SARS and MERS and Ebola were thought to have the potential to be massively disruptive to economic output, but those previous events proved to be well contained. Fears of worst case turned out to be unfounded. Markets quickly rebounded, and the economy never shut down. Using history as a guide proved to be a poor road map this time around.

Estimates for the economic impact of the virus are horrific**. Recent estimates from Goldman Sachs suggest that US GDP will be –3.8% for the full year of 2020, worse than 2009.** They estimate that Europe will see a full year down –9%. Global growth will be negative for this year as well.

The first statistics indicating the economic impact of the virus showed that initial unemployment claims for people freshly laid off were +3.3 million for the third week of March. The last week of March was even worse, generating more than 6.6 million new unemployment claims. The previous number had been 282k, and the highest reading during the Great Recession was 665k. St. Louis Fed President James Bullard suggested that unemployment could exceed 30% in the coming months. While formulas have changed over time, **the worst reading for unemployment during the great depression was about 25%.**

With the coming economic news looking so poor, how could it possibly be a good time to buy stocks?

Certainly there are some businesses that will struggle to recover, and may never regain their pre-virus peaks. For many other businesses, their competitive position will not change once the worst of the virus passes. There are still only two real manufacturers of cell phones, or two stores to purchase home improvement supplies. We mentioned that the software companies that support doing business remotely and storing data on the cloud are likely to see their businesses strengthen. Several of those companies are already seeing their stocks outperform.

Companies that provide medical care on the phone are likely to see their business remain strong. Further, **companies who have planned for a rainy day and have strong balance sheets and low debt levels are likely to survive this crisis, and may thrive as business returns to normalcy**. Some companies will generate new anti-virals and perhaps even vaccines. Others will help to resupply our much needed stockpiles of medical equipment and supplies. **There are absolutely themes to consider and companies to invest in.** What doesn't kill you makes you stronger, **and the survivors are worthy of some investment even before the worst of the healthcare crisis is over.**

American ingenuity is boundless, and will help us overcome this virus and future outbreaks. The path to health will not be without its bumps, and far too many of our loved ones will be lost. Still, this is not the end of humanity, and it is not the end of growth, and it is not the end for stock investors. With a long-term perspective, the outlook could be quite bright indeed.

While we don't know how long this recession will last, we do not believe it will be as long as other very severe recessions. The Great Recession lasted about 18 months. This one is likely to be much shorter. While we have never full-stopped our economy and do not know precisely how long it will take to restart, **we do know that there will be enormous pent-up demand. We are all yearning to have dinner with a friend and get out of the house.** We want a return to normalcy, even as the new normal will be different. C**hina is restarting its factories three months after the first cases were identified in late December. Apple and Starbucks are re-opening stores in China. At some point this virus-driven recession will end.**

Consider that the S&P peaked on February 19th at 3,386. At the close of business on March 31st, the S&P was at 2,585. Let's say, hypothetically, that it takes three years for the market to reach its old high. That would suggest the market would need to gain about 9.4% per year (hypothetically). Add the roughly 2.5% dividend yield, and a 3-year break-even could approximate a nearly 12% compound rate of return. Perhaps we are too optimistic. Perhaps it takes five years to reach the previous peak. That would represent hypothetical appreciation of 5.6% per year. Add back the dividend and the return could approximate 8% per year compounded for the next five years.

Can markets go lower first? Absolutely. The economic news will get worse before it gets better. We are not certain that investors are ready to see Great Depression-like economic reports. It is impossible to know what earnings estimates are going to be. Companies are pulling guidance and estimates faster than shoppers are pulling toilet paper off store shelves.

What we do know, however, is that the market tends to bottom before the economic news bottoms. In 2009, the market found its footing in early March while the recession did not end until June of the same year. The market will likely again

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bottom this time before the economic news bottoms.

America's longest economic expansion has ended. It certainly was good while it lasted. It ran from July of 2009 through February of 2020. A new expansion will begin following this virus-induced recession.

The new normal will be different from the old normal. Some behavioral changes mandated by the "safer at home" policies will linger. **As prudent and active investors, we are working to determine what opportunities will present themselves as the new cycle starts, and how we can best take advantage of those opportunities for you.**

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While we are not working from our office, everyone at L&S is working tirelessly to make sure that we continue to meet your needs. This has been a very trying time, something that none of us could have foreseen a few short weeks ago. Please do not hesitate to contact us if you would like to hear our thoughts regarding markets or the progress being made to beat this unfortunate illness. We are available to discuss your portfolio, and welcome your questions and concerns. Stay well, stay safe, and stay sane.

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