PALOS

The Palos - Mitchell Report

February 3, 2020

By William Mitchell, CIM

Portfolio Manager

There is an old saying on Wall Street (or Bay Street) that states 'markets are driven by fear and greed'.

Fear and the Coronavirus

By now you've surely heard of the Coronavirus and as expected, social media and frightful headlines have stoked fears of a global pandemic. In the coming days and weeks, we are sure to be inundated with news about the virus spreading around the globe, a running assessment of the mortality rate, and measures being taken to safeguard the public. Announced last week, over a dozen major airlines have cancelled routes to mainland China and travel within several regions in the country have been restricted or halted. This morning we received confirmation that globally, over 17,000 cases have been reported with 362 deaths. We should expect further sensationalistic headlines, and this will certainly add to our fears.

Two things happen when markets get nervous. The first is the tendency for buyers to postpone their plans to buy. This is based on the simple logic that prices might get cheaper; so why buy now? Simple economic theory dictates that lower demand and higher supply should send prices lower. Today we saw the first day of trading in China as Chinese exchanges were closed last week for the Lunar New Year. The Shanghai Index saw its worst day in years as the benchmark declined 7.7%.

The second is based on *'instinct for survival'*. Some investors will panic and sell with the belief that a sustained pandemic will negatively affect the economy and asset prices will fall. While at first glance, *'selling the news'* may seem like a prudent course of action, it's surely not the correct one. We live in a complex world where uncertainty is omnipresent and from time to time, we should expect the unexpected. When we get bad news, the first reaction should be to reduce risk and patiently wait for opportunities.

By William Mitchell, B Comm., CIM
Portfolio Manager

How this affects the economy

Before jumping to the conclusion that we should lock ourselves in our homes and sell our investments, we should look at the facts. This is not our first epidemic. According to the World Health Organization, seasonal flu kills an estimated 400,000 people every year and over the past century, we've managed to survive Spanish Flu, AIDS, SARS, H1N1, MERS, Ebola, and Zika. While all of these crises were resolved in due time, in the short term there were consequences for the economy.

Global trade continues to expand. International commerce continues to grow in importance and the supply chain that industry depends on is elaborately intertwined. Any sustained disruption to the network should in theory, negatively impact economies. Also keep in mind, the global supply chain is much more dependent on China today than in it was in 2003 (when we had SARS).

The economy also relies on the consumer. With social media playing a crucial role in the distribution of information, negative news headlines could potentially inflame fears which in turn, could harm consumer confidence. This would obviously have an impact on discretionary spending and would negatively affect airlines, hotels, restaurants, cruise lines, casinos and resorts. Materials companies may also feel some pain as the potential for a drop in consumer demand, supply chain/inventory disruptions and even shuttered factories, would lower demand for commodities (i.e. copper, energy).

Whether legitimate or imaginary, fear is a powerful emotion and it's important to note that when fear spreads in financial markets, they usually go down much quicker than they go up. Case in point; on Monday we saw the largest one-day decline since October and while we've rallied over the past few days, markets remain nervous. Acknowledging that capital protection is a primary objective, it follows that in the short term, taking a defensive approach is warranted.

In the Palos-Mitchell Alpha Fund, which is actively managed, we locked in some profits on January 24th by selling positions in Starbucks and Restaurant Brands Int'l, for reasons that should be obvious (i.e. these establishments are gathering places). Several other holdings were tactically reduced in order to raise cash and we've sold some options to reduce exposure. On Friday alone, the fund went from fully invested to around 12% cash. This reduces risk and generates cash, which can be put to work when opportunities arise.

By William Mitchell, B Comm., CIM

Portfolio Manager

A bit of common sense

History has taught us that drawdowns are an inevitable part of investing. Unexpected events like the Coronavirus outbreak, that materialize out of nowhere, can cause portfolios to lose value in the short term. However, we should remember that until we receive more credible data on contagion, mortality rates, containment and a potential vaccine, economic fundamentals will be disregarded and the *'fear trade'* will rule. While no one can predict with any accuracy as to what lies ahead, history teaches us that similar to previous experiences, this crisis will resolve itself in due course. While negatively impacting the economy and shaking investor confidence in the short term, this should remain irrelevant to the long-term investor. Opportunities to buy good companies at discounted prices is what awaits the patient investor.

The best example to use as a comparable for the Coronavirus is SARS. The SARS crisis began in January of 2003, peaked in March/April, and ran until early June before its culmination. Looking back at the performance of global equities over the twelve months of 2003, we found the following (see the table below). While markets around the world saw declines over the pandemic's peak, all markets rallied in the second half and were solidly in the green by year end. Will the Coronavirus play out the same way as SARS? While early reports point to a fatality rate lower than MERS/SAR, only time will. The bottom line is this; raising cash and lowering risk is the best approach to protecting capital and realizing long term success.

INDEX	1 month	2 month	3 month	6 month	9 month	Full year
S&P 500 (USA)	**-5.9%**	**-7.5%**	**-6.7%**	**7.2%**	**7.2%**	**22.3%**
TSX (Canada)	**-2.5%**	**-2.7%**	**-5.9%**	**3.6%**	**10.1%**	**22.0%**
STOXX (Europe)	**-9.7%**	**-13.5%**	**-15.7%**	**-3.0%**	**-1.1%**	**9.6%**
Nikkei 225 (Japan)	**-2.8%**	**-2.5%**	**-7.0%**	**5.8%**	**19.1%**	**24.5%**
Hang Senk (Hong Kong)	**-1.1%**	**-2.6%**	**-7.8%**	**2.3%**	**19.9%**	**34.3%**

(source: Bloomberg)

"The Art of Investing"

Palos is a boutique investment management firm based in Montreal and Toronto.

Our mission is to continuously earn our clients' trust by growing, sustaining, and protecting their wealth over many generations.

We invest our clients' money as we do our own.

Our interests are aligned with yours.

William Mitchell, CIM

I am a portfolio manager at Palos Wealth Management based in Montreal, Quebec, Canada. My experience in the investment industry is extensive, having spent more than thirty years analyzing, trading and investing in global financial markets.

At Palos, we are driven by our values. We believe in the principles of honesty, integrity and transparency. We subscribe to a strong work ethic and we have a passion for investing. The pursuit of excellence is our motivating force. We take our fiduciary duty to heart and we always act in the best interests of our clients.

If you have any questions about investing, our services, or becoming a client of Palos Wealth Management, please contact me at:

William Mitchell | Portfolio Manager
Palos Wealth Management Inc., 1 Place Ville-Marie, Suite 1670, Montreal, QC Canada H3B 2B6

(514) 307-0467

wmitchell@palos.ca

Disclaimer: