

PALOS

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Weekly Commentary

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Macro View

By *Hubert Marleau*

Glussavedur: Watch the Storm from Your Window Stay Calm, Be Patient, Carry On Great Buying Opportunities Begin with Fear

Submitted March 8, 2020

This week the daily changes of the S&P 500 look like a roller coaster: Monday +4.6%, Tuesday -2.8%, Wednesday +4.2%, Thursday -3.4% and Friday -1.7%. Meanwhile, the bond market achieved nirvana, gold holders are buying “Chateau en Espagne” and the Russians destroyed the oil cartel. Despite the scary aura and the turmoil, the S&P 500 ended the week flat.

Uncertainties make us fearful sellers when hope is shattered, while the repricing of risk is making us greedy dip buyers when hope rises from the ashes. From here on, it’s guesswork because we have an unprecedented situation. It’s a kind of risk that I’m not trained for. It’s something that has not been seen before and therefore no experience for us to draw on. I can’t put a statistical model in place because exogenous shocks for markets that originate outside the economic and financial systems make it impossible. Then, the best idea is to stay balanced if one is not sure, overweight in safe havens if fearful and overweight in cyclicals if daring. Every market metric that I follow conclusively points to a bottom and a reversal. Unfortunately, the severity, spread and duration of the coronavirus outbreak has created havoc. No one knows how deadly and widespread it will prove to be or how long it will take to be resolved and how well we are going to recover from it. Accordingly, metrics that are usually reliable to gauge markets during normal cycles are currently compromised, creating uncertainties that investors hate.

Macro View cont.

By Hubert Marleau

The best thing that I can do is to draw a scenario that may help explain what we as investors are confronted with. We need to have an idea as to whether health agencies can contain the disease, governments can install fiscal measures and whether central banks have the power to counter the economic fallout. Our current strategy is to trade out of expensive stocks into cheap ones that have exceptional value under an overall barbell position that is underweighted in gold but overweight in defensive names. In the end, market panics don't last for a very long time. History shows that they can recover so fast and so strongly that if you happen to be out of town, you'll miss it. It's better to watch the storm from your window and carry on.

My Take on the State of the Coronavirus Situation: Based on My Readings

systematic risks generated by globalization. The dynamics of charging ahead with worldwide interdependence in fields like supply chains, infrastructure, ecology, climate change, trade and geopolitical issues means that people have never been as interconnected as they are in this new brave world. Edward Lorenz, the founder of "chaos theory" demonstrated that a butterfly flapping its wings in Brazil could cause a tornado in Texas. Thus, we shouldn't be surprised that the emergence of a coronavirus infection in Wuhan can produce a contagion that is spreading all over the world. Because there are only six degrees of separation between a person in NYC and one in Wuhan and major airport hubs have turned the world into a community, a worldwide pandemic is possible. So far, the coronavirus has infected 100,000 people and killed 3000 innocent souls across 79 countries. It's changing the way we live and conduct our daily lives.

In this connection, the market decided to make its feelings known. Stock operators, bond players and commodity speculators are demanding remedial actions from the authorities to find a cure for the disease, define methods to contain its spreads and limit its effect on the economy. The market wants the authorities to prevent a spiral. When none are in sight, the market downticks and when there is a ray of hope it upticks.

Macro View cont.

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What the market is worried about is the possibility of getting an unwelcome political and social episode of protectionism, xenophobia, conspiracy theories, nationalism, inequality and economic consequences which could clearly bring disruptions like worker quarantines, closure of factories, shrinking business and commercial conflicts. It would slow growth for sure and probably cause a contraction. In this connection, the probability of a recession priced across asset classes varies from 60% to 25%. Meanwhile, Goldman's US GDP tracking model points to a sub-1% growth for Q1. What is fascinating is that until then data on the economy was showing strength. The ISM surveys were good, the employment reports were strong. As a matter of fact, the Atlanta Fed High Frequency Model is still tracking +3.0 GDP growth for Q1. Unfortunately, the reality is in the perception. And it's anxiously and broadly bad. Even without the knowledge of hard numbers, we know that we are in a slowdown. Moreover, we know that should the butterfly effect create a global pandemic outbreak, the cost in economic output could be as large as \$2.5 trillion. That would be enough to descend into a "Lord of the Flies" state of depravity and "Primal Fear" with "Panic in the Streets". In my judgement, these dire forecasts are not going to happen.

Acknowledging, the potential seriousness of the problem, it has become the guiding credo of the G-7 finance chiefs and central bankers and government officials do whatever it takes to support the financial system by taming the forbidden forces of Covid-14 through ingenuity, effort and economic might to keep the wheels of commerce rolling. The G-7 communique did not contain any specifics but was clear that they were willing to cooperate on timely and effective measures-- health care, monetary and fiscal.

The Fed drew first blood. It surprisingly broadsided short positions of pessimistic speculators with a massive 50bps rate cut. All the major central banks have pitched in with their own monetary medicine. Bank of Japan conducted unscheduled repo operations in a bid to send a message to the public, the Australian Central Bank cut interest rates by 25bps, the Bank of Canada added another booster shot with a 50bps rate cut, the Bank of Korea introduce targeted monetary measures, the BOE, ECB and SNB made declarations that they would further ease their monetary stance. The BIS, the central bank for all central banks, is setting up chat boxes with important central banks to monitor the situation. Lower interest rates will ease the financing of receivables and inventories; but it cannot quickly fix the global supply shock nor protect the many sectors of the service economy. Think about this one, there is no chance that there will be a 25bs rate cut by the Fed at the next FOMC meeting on March 18—but there is a 60% chance for a 50bps cut and 40% for a 75 bps. Eric Rosengren, the president of the Boston Fed, gave credence that the Fed could buy a wider array of assets---SPY?

Macro View cont.

By Hubert Marleau

Meanwhile, pressure on governments is mounting to pass stimulating fiscal measures. China fiscal support will exceed 2% of GDP, after already having announced corporate tax cuts and emergency spendings. The U.S. The House of Representatives approved a \$8bn coronavirus response bill that is both comprehensive and affordable for the general population. Additionally, Prime Minister Trudeau and Finance Minister Morneau said that they were prepared to help and that the Government of Canada has the fiscal capacity to do so. Internationally, the World Bank and the International Finance Corporation are moving quickly with an initial package of up to \$12bn for countries needing crisis financing.

Luckily, markets have historically been quick to recover from pandemic threats. The science of Epidemiology has made big strides over the years and public health organizations are manned with trained officials and technicians.

Past records show that public centers, volunteers and various public centers do come to the rescue under the supervision of the local, national and international health organizations. Additionally, the private sector also gets into the act. For example, Tim Horton has stopped the recirculation of used cups, the Fed is quarantining cash received from Asia, businesses are reducing density by opening secondary locations and many companies are encouraging their employees to be safe and work from their home. On this last point, Bloomberg reported that “42 million Americans, 29% of the U.S. workforce, are able to work from home.” And, yes the U.S. phone service giants like AT&T and Verizon have the broadband power to accommodate, with a few glitches at peak moments.

In the end, everybody will get into the act of fighting pandemics like they fight wildfires.

Remdesivir, a Gilead product, has some potential. It’s not a vaccine, but it has been safely administered on multiple occasions and could save infected patients. I spotted an article by Bram de Haas in Seeking Alpha that made the point that it’s application can be miraculous in that it looks as if it works against all coronavirus.

There is hope for a drug and a vaccine. Unfortunately it will take time, especially for the vaccine. A lot of capital has been poured into biotechnology companies which have been flowing it in medical innovation in the last few years. One of them, Moderna Inc., announced on Feb24 that it had shipped vials containing a first batch of

Macro View cont.

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coronavirus vaccine to the National Institute of Allergy and Infectious Diseases. Clinical trials involving about 20 to 25 healthy volunteers are expected in April. Bloomberg's Robert Langreth reported on Friday that on February 6, the deadly coronavirus arrived by courier and was delivered to a secret location on the University of North Carolina. A team of elite scientists got down to work and haven't stopped since. Their mission is to come up with a drug to treat the pathogen. A lot of others are racing to find solutions and are on the case--the University of Maryland School of Medicine, the Vanderbilt University School of Medicine, Gillings School of Global Public Health. Additionally, the government is working with Regeneron Pharmaceuticals, Gilead Sciences, Johnson & Johnson to create new drugs or identify existing ones in the hope of quickly finding something that can slow down the scourge. Rick Bright, director of the U.S. The Biomedical Advanced Research and Development Authority said: "there are hundreds and hundreds of new technologies. Our job is to comb through those as quickly as possible." Ralph Baric, veteran researcher and lab leader sits at the center of the action to make sure that the overall effort gets as many ideas as possible under the goal of a program to find broad-based inhibitors that work against everything in the virus family.

Looking at the 11 Sectors of the S&P 500 by the Numbers:

Name	Index Weight	10-Yr Annualized Total Return	Current Dividend Yield	P/E	P/B	P/S	Comment	Dependency
S&P 500 INFO TECH INDEX	24.6%	17.59%	1.5%	23.81	6.73	4.61	Growth	Future
S&P 500 HEALTH CARE IDX	14.7%	13.55%	2.0%	19.18	3.94	1.61	Growth	Age
S&P 500 FINANCIALS INDEX	11.5%	10.37%	2.9%	10.69	1.15	1.81	Neutral	Interest Rates
S&P 500 COMM SVC	10.6%	10.10%	1.5%	19.40	3.00	2.73	Growth	Innovation
S&P 500 CONS DISCRET IDX	9.8%	16.03%	1.6%	21.98	7.08	1.53	Growth	Inequality
S&P 500 INDUSTRIALS IDX	8.6%	11.83%	2.4%	16.01	4.32	1.52	Cyclical	Exports
S&P 500 CONS STAPLES IDX	7.8%	11.03%	3.0%	20.23	5.86	1.49	Defensive	Population
S&P 500 ENERGY INDEX	2.9%	0.74%	7.1%	12.60	0.97	0.68	Cyclical	Gas & Oil
S&P 500 UTILITIES INDEX	3.8%	12.06%	3.3%	17.01	2.23	2.74	Defensive	Bond Yields
S&P 500 REAL ESTATE IDX	3.2%	10.62%	3.4%	45.05	3.59	6.65	Defensive	Population
S&P 500 MATERIALS INDEX	2.5%	7.98%	2.7%	17.19	2.06	1.51	Cyclical	Global

Source: Bloomberg

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