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Coronavirus and US elections

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<u>Coronavirus</u>

Since we are investors who are responsible for managing risk and uncertainty, and are not expert epidemiologists, our view of the coronavirus outbreak has been centered around the calendar, based on various lags between infection, symptoms, testing, diagnosis, and prognosis. In particular, asymptomatic incubation periods appear to be as high as two weeks. Based on this, we believed that the second and third weeks of February would be key for gauging severity, especially as data fidelity becomes higher based on the following:

1. Alleviation of test kit shortages in China, as case counts may have been limited by capacity constraints;
2. Enough time having passed to begin gauging trajectories abroad, providing international data comparisons against Chinese official data (of which many have, rightly or wrongly, been skeptical);
3. First wave of economic data, helping to gauge initial economic impulses from the virus and consequent shutdowns of cities, trade, and travel;
4. Enough time having passed to account for asymptomatic incubation periods and healthcare constraints.

We have started seeing initial positive signs out of Hubei Province, the origin of the outbreak, with case counts sequentially declining since February 4, when the market bottomed. However, a revision to diagnostic standards has retroactively raised the level of case counts, despite the deceleration in the pace of increase. The extent of quarantines and lockdowns is very material, however, with about half a billion Chinese people living in a state of quasi-martial law. This is likely to induce a powerful negative impulse on Chinese and global growth, and likely stimulus against it to meet the Party's economic targets.

Perhaps more concerning is the contagion (no pun intended) to the rest of the world. Air travel to China is basically completely shut down for weeks more, and trade barometers suggest a meaningful slowdown there as well. And most importantly, the international spread of the virus is the biggest threat, since the length of prevalence abroad is the primary differentiator between a regime in which this is a short-term shock with a sharp rebound, or a more durable shock that takes ample time and stimulus for recovery.

Thus far in this cycle, the negative shocks to the global economy have primarily been driven by tightening. Fiscal and monetary tightening in Europe helped ignite the 2012 slowdown.

The coronavirus is a shock to both supply and demand, however. And to an extent, it somewhat resembles the dynamics of the breakdown in structured products in 2008.

The first confirmed coronavirus case on the African continent was confirmed today in Egypt. South Asia and sub-Saharan Africa present particularly concerning dynamics, given their healthcare infrastructure is weaker, population densities are very high, and the lag between infection and diagnosis is likely materially higher than in East Asia, Europe, and North America. This suggests we may see more regional outbreaks to come, especially because the political and healthcare infrastructures required for the type of screening and quarantining that China has implemented doesn't exist in these regions.

Perhaps most concerning is the wave of updated expert opinions, which have started to turn quite pessimistic. For example, today, Marc Lipsitch, a professor of epidemiology at Harvard T.H. Chan School of Public Health, said, "I think it is likely we'll see a global pandemic. If a pandemic happens, 40% to 70% of people worldwide are likely to be infected in the coming year."

The dynamic around asymptomatic incubation and infection are especially of concern to epidemiologists and researchers. As Lipsitch said, "What proportion of (those infections) will be symptomatic, I can't give a good number." Suspected asymptomatic cases are presently excluded from China's official case counts.

Regarding markets, we believe that the inflection reached in early February, on the back of a deceleration of Wuhan cases, combined with the decline in government bond yields (which now discount a Fed cut and a half this year, for example), has led to expectations of a V-shaped rebound from the coronavirus's impact. Given the uncertainties, especially about international transmission, we think this may be misguided, or at least challenged at some point.

Going into the long weekend and into the next phase of the "window" in which higher-fidelity data can present itself internationally, with the S&P at all-time highs, we believe it is prudent to begin hedging again. We are keeping an eye on key technical levels in government bonds, as well, which are close to breaking out of consolidation patterns to the upside. We continue to believe that the underlying economic backdrop has positive momentum, and ultimately likely reasserts itself. But for the time being, we think markets have become too complacent about the risks of a V-shaped recovery not materializing as soon or as strongly as markets seem to expect.

US elections

In recent weeks, Bernie Sanders has broken away as the front-runner for the Democratic Party nomination for the 2020 Presidential elections. After strong showings in Iowa and New Hampshire, he is now projected to win Nevada, is closing in on Joe Biden in South Carolina, and even tops polls in Texas (where he's only two points behind President Trump in general election polling).

At the same time, Mike Bloomberg has strongly bounced in the polls, as well, on the back of unprecedented personal expenditures, including staffer wages that are often almost double the rates in other campaigns. He has employed an investment in social media to success, with strong attacks against President Trump in Twitter videos and memes. The primary bear case for Bernie Sanders at this point is if Bloomberg's success is sufficient to bring about a contested convention, at which point the introduction of unpledged superdelegates is likely to hurt Sanders's chances.

We think the market may be reading too much into early primary results, which are in states with low minority populations (precisely who Bernie Sanders needs to turn out, in order to win). We also think that the market's initial response to a Sanders nomination would be quite bearish. And Sanders appears to be quite competitive with President Trump in a variety of states, including swing states.

Looking further ahead, we are more contrarian about a President Sanders's impact on the corporate picture. To the extent he's able to enact parts of his platform, the government deficit increase would feed directly into other sectors of the economy (Godley's sectoral balances equation). The extent to which these deficits help profits comes down to whether they are spent or saved, and whether they induce capex or not. Throughout this cycle, the focus on stimulating the higher-ends of the income ladder have done poorly, as inequality is high and inflation is low. These bouts of stimulus end up being saved by low-MPC actors, and the lack of aggregate demand increase has incentivized corporates to prioritize shareholder return over fixed investment.

We believe that a Sanders-style stimulus would be a strong dissaving impulse (higher-MPC cohorts would benefit the most, and many of them would gain access to credit they would otherwise not have), and induce corporates to invest to capture that demand. Using the Kalecki-Levy profits equation, this axiomatically would be quite bullish for pretax corporate profits growth. The extent to which taxes and multiples make this difficult is less clear, although a President Sanders would likely also have a Fed in yield curve control (YCC) mode, buffeting multiples. And we don't expect as much traction on tax hikes, as we do on

$15/hour minimum wage, a Medicare public option, and a mini-Green New Deal. These are all speculative views at present, but our conclusion is that the markets are not sufficiently discounting Sanders odds, nor are they likely to appreciate the potentially stimulative impulse of his policies on corporate profits growth, until much later. We look forward to taking advantage of these different opportunities, and aim to time them properly and with risk management and portfolio construction that allows our portfolios to remain robust across disparate environments.

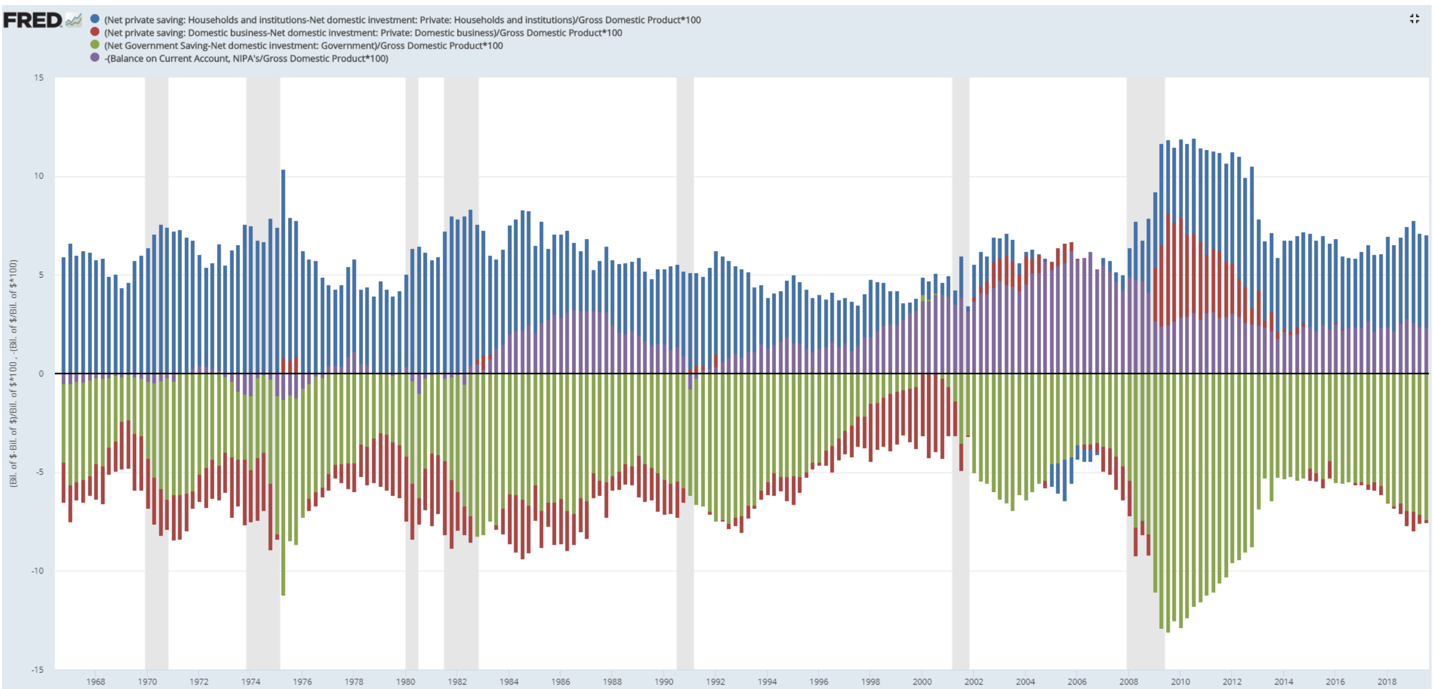

Chart 1. *Godley sectoral balances. Source: FRED.*

Term	Reference
(+) Investment	NIPA Table 5.1 (Line 21 - Line 13)
(+) Dividends	NIPA Table 1.12 (Line 16)
(-) Household Saving	NIPA Table 5.1 (Line 8)
(-) Government Saving	NIPA Table 5.1 (Line 10)
(-) ROW Saving	NIPA Table 4.1 (Negative Line 29)
(-) Statistical Discrepancy	NIPA Table 5.1 (Line 42)
(=) Corporate Profits	NIPA Table 1.12 (Line 15)

Chart 2. *Kalecki-Levy profits equation. Source: Philosophical Economics.*