GKV Capital Management

Market Update

February 27, 2020

Coronavirus Impact

"Panic is highly contagious, especially in situations when nothing is known and everything is in flux." - Stephen King, Wizard and Glass

It appears that the efforts to contain the latest version of coronavirus (COVID-19) have not been successful. Despite the significant measures of putting whole cities under quarantine, the virus has been emerging in more countries around the globe. Many health experts now believe that a pandemic is inevitable despite the measures to contain it. According to the World Health Organization the number of confirmed cases globally is 81,209 as of yesterday, February 26th resulting in 2,718 deaths. Cases have now emerged in 37 countries. Here in the United States, we have seen very few isolated cases however it would be naïve to believe that we will be able to keep COVID-19 out.

From, a containment perspective, the problem with COVID-19 is that it just isn't very deadly. Many infected with the virus have typical influenza symptoms and recover. In fact, on the ill-fated Diamond Princess isolated off the coast of Japan, 14 Americans tested positive for COVID-19 despite feeling fine. Previous new diseases such as SARS or MERS are considerably more fatal making transmission less likely. Those infected end up in the hospital rather than causing further infection.

Certainly, containment of a new strain of coronavirus is desirable if possible. Governments have gone to great lengths to attempt to stop the spread of COVID-19 despite the fact that the health implications are not significantly greater than that of existing strains of influenza. Consider that from October 1st, 2019 to February 15th, 2020 in the U.S. alone the Center for Disease Control estimates that there have been between 280,000 and 500,000 people hospitalized due to the flu resulting in 16,000 to 41,000 deaths. If we can keep a new strain from spreading worldwide, we should but once it becomes apparent that containment is no longer possible, our goal needs shift away from causing a panic and undue economic damage.

Predictably there has been considerable attention paid to the prospect of a COVID-19 vaccine. Certainly, a company that comes up with a vaccine would be worth investing in. Any prospective vaccine will require testing to ensure its safety and then manufacture. The fastest reasonable timeline we have seen discussed is approximately six months before a vaccine could be ready and another 12 months would be required for testing before the vaccine could be ready for manufacture. A vaccine will come too late to stop a pandemic. Once the virus has spread a vaccine will no longer be able to eradicate the virus. Lastly, a vaccine for COVID-19 would be like other flu vaccines in effectiveness requiring an annual shot to combat

	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020E**	**2020 Revised**
S&P 500 EPS	$113.01	100.45	10626	$124.52	$151.60	$155.84	$173.45	$155.00
EPS y/y growth	*5%*	*-11%*	*6%*	*17%*	*22%*	*3%*	*11.3%*	*0%*
S&P 500 Index	2059	2044	2239	2673	2507	3231	**2979**	2979
Index y/y return	*11%*	*-1%*	*10%*	*19%*	*-6%*	*29%*	*-7.8%*	*-7.8%*
Trailing P/E	18.2x	20.3x	21.1x	21.5x	16.5x	20.7x	19.1x	19.2x
Forward P/E	**20.5x**	**19.2x**	**18.0x**	**17.6x**	**16.1x**	**18.6x**	**17.2x**	**19.2x**

Source: GKV Capital Management

the new coronavirus strain. In other words, the discussion and focus on a vaccine to end the crisis is a chimera.

We expect that a pandemic is very possible given the data. We do not believe that this represents a critical health crisis due to the comparable mortality rates to existing influenza. To be sure, influenza is bad- it kills many people, particularly with underlying respiratory complications but COVID-19 is not comparable to SARS or MERS. Unfortunately, it does appear that the response to the emergence of COVID-19 is creating a panic which will have substantial and lasting economic challenges.

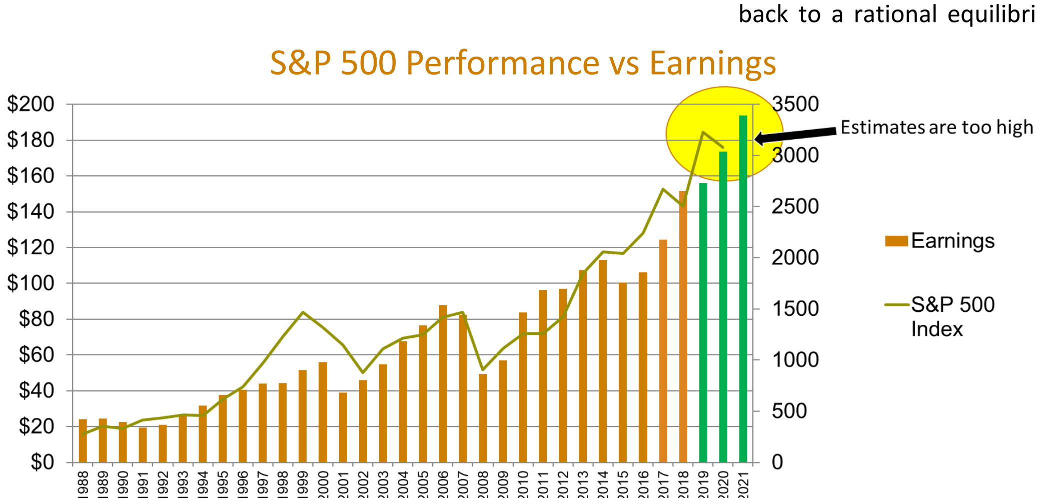
If our assumptions listed above come to pass and COVID-19 does continue to spread, the response by governments, the media and general population will have an increasing negative effect on economic growth and may push the U.S. and the rest of the world into recession. We suspect that by the late spring the urgent crisis around COVID-19 will have subsided but the damage to corporate earnings for 2020 and even 2021 will have been done. For the markets, the fear of COVID-19 is worse than the virus itself.

Despite a strong performance for stocks in 2019 (the S&P 500 gained 29%) corporate earnings growth was meager at 2.8%. In hindsight, the strong performance in 2019 was due to the terrible market performance in 2018 (down 6.2% for the S&P 500) coupled with the fact that a recession that many expected in the fourth quarter of 2018 never materialized. Additionally, some of the strong 2019 stock market performance was in response to an improving global economic outlook which was expected to increase earnings for 2020 and beyond. At the first of the year, earnings estimates for the S&P 500 were $175.52 representing 11% growth over 2019 and $193.90 in 2021 representing 12% growth. The U.S. stock markets ended last week at all time highs with a price to earnings ratio of nearly 19x the 2020 earnings estimate. The historic average since 1988 is 17.8x making the market somewhat expensive or optimistic regarding the forecast earnings outlook.

With the dramatic response to COVID-19, we must now anticipate that there will be material impact to these estimates. Companies including Apple, Microsoft, Procter and Gamble, Starbucks and even Lululemon have said that the coronavirus will impact their first quarter sales and earnings. To be prudent, we must anticipate that more fallout is likely to occur before we are beyond this crisis. It is possible that the concerns regarding COVID-19 dissipate quickly, but we find that unlikely based on global responses so far.

Taking a guess as to what the impact on earnings might be, we think it's reasonable to cut the 2020 earnings estimate to a level in-line with 2019, representing zero earnings growth at $156 on the S&P 500. Assigning a 18x multiple results in a target of 2,790 on the S&P 500 which is 6% lower than where we closed today (after losing 12% from the record high of 3,386 that was recorded just last week). We view this as a more positive outlook and it could be too optimistic. It is impossible to tell just how panicked the response will be at this point. If borders are closed, travel canceled, supply chains disrupted and purchases postponed, we could easily go into a recession. It could be mild, or it could be significant. It's impossible to tell.

In our view, we need to accept that the virus is out in the world and a response that causes economic losses is counterproductive, but we fear it will take some time to come around to that line of thinking. As is often the case in any crisis, the pendulum of sentiment swings too far one way before coming back to a rational equilibrium. This crisis will pass and there will be a buying opportunity. There are too many risks and unknowns to have any positive conviction just yet. We have been steadily reducing our clients' exposure to equities and raising cash. We will continue to take a conservative approach to protect the significant gains of 2019.



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