"Will Early 2020 Showers Bring Late 2020 Flowers?"

Neuberger Berman Long Short Team | April 15, 2020

Spring is in the air – the cherry blossoms are blooming and the birds are chirping. And while it's harder to appreciate this change in season given "WFH" (work from home *or* weekend from home) and the health crisis surrounding us, the market cheered last week's apparent COVID-19 "curve-flattening" and further monetary policy responses with the best S&P 500 Index ("S&P 500") performance week since 1938! The Federal Reserve's ("Fed") ongoing financial "bazookas" outweighed some very ugly economic data this time around. However, the epic battle of "stimulus versus economic activity" has only just begun.

Over the last several months, everything has moved at warp speed – from the spread of the pandemic to the historic slowdown in economic output to the downdraft (and subsequent bounce) in capital markets to the fiscal and monetary responses from global governments. The combined speed and magnitude of a global interconnected economy is simply breathtaking. Now the market debate has transitioned to the timing of the economy's re-opening and the nature of the earnings recovery. Wall Street folks try to answer these recovery questions through letters such as "V" vs. "U" vs. "W" vs. the "Nike swoosh".

In our view, the path of the disease remains critical to the overall economic outlook. As such, it is up to our public and private leaders to instill confidence regarding (i) the progress of a potential vaccine and therapeutic treatments for COVID-19, (ii) the progress of testing (especially important will be testing capacity around the asymptomatic population), and (iii) the preparation for a potential "second wave" of COVID-19, to name just a few initiatives. Steps such as these – anchored in credible and consistent data – could help provide the public with a greater feeling of safety, which many require for any return to normalcy. And, generally, the quicker people feel safe, the quicker the potential for any rebound in our view.

With that as a backdrop, here is what we are currently thinking, monitoring, and questioning:

- **The power of science, innovation, grit, and ingenuity.** Generally, leaders rise in difficult times and the public and private sector's innovation and resilience has been truly inspiring. Perhaps most importantly, there are already over 70 vaccine candidates in development (at various stages) according to the World Health Organization. But other positive examples include Virgin Galactic and NASA partnering to produce oxygen hoods for coronavirus patients, Tesla and Medtronic working together on ventilators, Hanesbrands converting factories to produce masks, and technology companies such as Google and Facebook attempting to help the government track the COVID-19 spread. Importantly, data – and the appropriate use of it – will likely be key to the re-opening of society. And of course, to those essential workers on the "front lines", words can't express our gratitude and admiration, as they help make daily activity possible.

- **Fiscal and monetary intervention.** The global cavalry has not run out of ammunition just yet! This past week the Fed took even more unprecedented action to support the flow of high yield and investment grade credit. Specifically, the Fed announced a Primary Market Corporate Credit Facility, a Secondary Market Corporate Credit Facility, a Main Street expanded loan facility, and a Term Asset-Backed Securities Loan Facility. Amazingly, with these programs and others, the Fed balance sheet has increased by over 50% to $6 trillion from $4 trillion in the past few weeks alone. At this point, with over $7.5 trillion in total monetary and fiscal stimulus, the U.S. is up to 35% stimulus as a percentage of U.S. GDP; globally, stimulus dollars exceed $15 trillion, representing over 18% of global GDP[1]!

[1] Source: Cornerstone Macro.

- **Equity market volatility.** One of the many fallouts of the coronavirus pandemic has been the unprecedented speed of large equity market moves – both down and up. Are we in a bear market? Are we in a new bull market? Are we in both?! After the S&P 500 peaked on February 19th, it proceeded to fall 34% over 23 trading days. The markets then reversed course at an even greater speed, with the S&P 500 gaining 25% in 13 trading days! Another way of looking at this extreme period is that the S&P 500's absolute average percentage change in March was 5%, which surpassed the previous high set during the Great Depression.

- **Credit market volatility.** During the first quarter of 2020, high yield experienced its second worst drawdown of all time with high yield spreads reaching a peak of almost 1,300 basis points. This spread widening was reminiscent of prior peaks in February 2016 and October 2002 – albeit below December 2008's peak of 1,900 basis points. The sell-off in credit was felt throughout fixed income markets as investment grade bonds experienced their worst March on record. However, similar to the equity markets, high yield has already started to reverse course – in large part due to last week's aforementioned Fed announcement. Specifically, the reaction in the credit market to that news was immediate, with the iShares Corporate High Yield Bond ETF jumping 6.5% on a single day!

- **1H'20 corporate earnings volatility...** This week marks the beginning of the Q1'20 earnings season in earnest and it appears to be our first chance to see what a "shutdown" does to corporate earnings across sectors. Sentiment already skews skittish as evidenced by extremely negative earnings revisions – the magnitude of which was last seen in Q4 '08. One investor we know went so far as to ask, "If I don't have any expectations, is it possible to be disappointed?" Ultimately, whether investors focus on 2020 earnings estimates, liquidity availability, or simply a path to recovery (or an improvement in trends) will likely vary by sector and company.

- **…so buckle up because the details will matter.** At the start of earnings season, the average S&P 500 stock is implying an earnings day move of 13.3%, the highest on record[2]! Thus, with the "wildcard" earnings season approaching, it's imperative to recognize our companies' underlying business models, exposures and valuations. Details within sectors are also important – and may be as disparate as understanding a *consumer* company's merchandise mix, geographic profile or supply chain efficacy, to a *utility's* end customer demand and regulatory framework; all could result in meaningful differences in earnings sensitivities (and subsequently stock price reaction).

- **Longer-term corporate earnings trajectory.** Since 1935 there have been 13 recessions. On average, it has taken 2½ years to regain the prior peak in trailing 12-month EPS, with the fastest in two quarters, the slowest in seventeen.[3] We prefer to take "the under" versus the average recovery given the catalyst for this recession, the awe-inspiring response from global policymakers, and our confidence in human ingenuity.

- **The capital markets have been open (selectively)…** Even at the height of capital market turbulence, it is important to note that best-in-class companies could still access capital. This is testament to the strength of these businesses and the credibility of the management teams. Specifically, investment grade issuances in March included offerings from the likes of Deere, Home Depot, Intel, Nike, Pepsi, Procter & Gamble, and United Parcel Service. Perhaps even more interesting, *quality* leisure companies operating in the eye of the COVID-19 storm – such as travel company Booking.com, restaurant company Yum! Brands, and hotel company Marriott – were also able to complete financings to strengthen their respective balance sheets.

- **…but there will likely also be disruption.** Unfortunately, there will likely also be limited time off for restructuring advisors as various business models were not made for an "essential" economy. We believe the high yield market is currently pricing in a high single digit percent default rate. And if we turn to the consumer sector as just one

[2] Source: Goldman Sachs.
[3] Source: Credit Suisse.

example, the last few weeks alone have seen press reports pertaining to financial restructuring considerations from department stores (e.g., J.C. Penney, Macy's, Neiman Marcus) to restaurants (e.g., Chuck E. Cheese) to movie theaters (e.g., AMC Entertainment) among others.

- **Re-start details to consider.** Whether it is polarizing policy differences between "red" and "blue" states, the waxing and waning of COVID-19 "hot spots", the tremendous government support programs in the system, the changing consumer behavior, or the timing around human psychology, there are a myriad of factors that seemingly indicate that the rebound will likely take longer than the "drop-off" period. For instance, JPMorgan's CEO Jamie Dimon recently estimated that given the recently enacted fiscal stimulus, 30-40% of people getting unemployment will be temporarily earning more than when they were previously working; one may subsequently ask, in contrast to the Great Depression, could we have a *temporary* labor shortage (for up to four months?) within the context of unprecedented unemployment levels? Nonetheless, we firmly believe it is not a question of "if" we recover, rather a question of "when."

While many of the above represent near and medium factors to consider, we thought it was equally important to highlight our early thinking on how the *longer-term* future could look different than the past.

- **Accelerating the pace of secular change.** While numerous businesses are struggling, the "forced" change of consumer behavior (e.g., "stay at home") does benefit certain models. For instance, select technology and data-centric models are seeing the "pull forward" of demand for their total addressable markets. One consumer-centric company highlighted that they reached adoption rates in the past four weeks that they had not expected to reach for at least another two years! Furthermore, in times of change, where discretionary capital expenditures are being curtailed, we quickly learn which projects are truly "mission critical"; this provides the opportunity to uncover businesses, such as those levered to cloud service adoption rates, which have exciting long-term value creation ahead.

- **Larger government role.** As discussed above, the sheer magnitude of the government's involvement for this pandemic is jaw-dropping. It is equally impressive *and* scary. The subsequent questions are – where does it stop? Where do we draw the line? How much will taxes have to increase? Moreover, with central banks aggressively subduing financial shocks, pundits will likely question whether America is truly operating in a "free market" economy. Finally, other public-related issues that have been brought to light – or heightened – from this pandemic include the need for greater health care capacity, proper incentives for healthcare professionals and other essential workers on the front lines, and greater solutions for income inequality. We fully expect to be hearing much more on these topics.

- **Future corporate returns on capital could be lower, but also safer.** Corporations may utilize this backdrop to revisit their capital structure and capital allocation frameworks. With regard to the former, "less is more", particularly as it pertains to financial leverage. It also seems rational to believe that entities will likely divert more capital to ensuring greater reliability for their business models; one such example includes shifting portions of global supply chains to more local production, in turn prioritizing reliability and access over cost. Ultimately, the cost of doing business may be increasing with scale players likely having an advantage.

- **Humans vs. the machines.** After years of success from quantitative investment approaches with sophisticated computer algorithms, we would expect the tide to shift back to the power of human capital. After all, when we increasingly use terms such as "unprecedented," historical patterns break down, and playbooks get torn up. As a result, we believe there will be no substitution for active management led by human judgment, proven processes, and deep analytical rigor.

- **Behavioral investment considerations.** Two exogenous shocks in the past dozen years is reinforcing the notion that protecting and growing principal – in that order – is critical to long-term success. As such, we would expect

risk-taking attitudes to remain exceptionally moderate. We also believe the role of sound financial advice should become increasingly valuable. It may be important to strike the proper balance between playing offense (where we risk losing money) and playing defense (where we risk missing opportunities). History tends to suggest that risk assets tend to perform especially well when skepticism is greatest.

So what are we doing? The same thing as always – process, process, and process. Our team of experienced investors are staying disciplined, focused, and true to our investment approach – analyzing company fundamentals, monitoring the credit markets, and testing and re-testing individual investment theses. And if the facts change – on a macro or a micro level – we stand ready and able to adapt.

And on a personal level, please continue to be safe and smart. Our thoughts and prayers remain with you, your families and all the healthcare professionals and essential workers that are working tirelessly every day to return this great country in short-order to its wonderful, full and lasting potential. These are the folks that deserve the Presidential Medals of Freedom.

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For more information on COVID-19, please refer to the Center for Disease Control and Prevention at cdc.gov

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

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