"March Madness"

Neuberger Berman Long Short Team | March 2020

As we continue to navigate these extremely volatile markets, our goal is to provide our latest perspectives and offer additional color on what we are thinking about in this ever-changing backdrop. As you are aware, it is our fundamental belief to communicate in good times and to OVER communicate during the tougher times.

Simply said, these are unprecedented times. Unprecedented in terms of the speed of the market moves, unprecedented in terms of understanding appropriate social behavior, and unprecedented in terms of the uncertainty around the duration, scale and scope of economic disruption. And to state the obvious, the entire situation is quite unsettling. In our view, COVID-19 is a "rogue wave" that is both dangerous and unexpected, having come from directions other than the prevailing winds. It is the very definition of an exogenous shock. We don't believe any of us have dealt with this degree of global pandemic. The numbers of cases will continue to increase (especially with testing ramping up) and it will potentially get worse before it gets better. While no-one precisely knows, medical professionals suggest the number of cases may peak in forty five days. Importantly, let's not forget there have been thirteen epidemics since 1970 and not one has stood against the collective power of humankind. We do not anticipate this will be any different.

Now before jumping into various topics that our team is discussing, we thought it best to hit upon the most popular question we've been receiving: "Which is worse – 2008 or now?" And for better or worse, our team is certainly old enough to remember both. In 2008, we were genuinely scared that the structure of the entire financial system was in dire straits. The "world" seemed to be coming to an end. The economy was left for dead and all but forgotten. And of course, that's saying nothing about our beloved firm Neuberger Berman, and our front row seats of the crisis (Neuberger Berman having been owned by Lehman Brothers at the time). With regards to today's environment, while there are clearly elements of "nesting" and demand destruction, we sit in the camp that it is all a matter of *duration*. How long will this last and how much will it *temporarily* paralyze us? If one was to look around the world, you would see that some other earlier virus-afflicted countries – far less great than ours – are already on the mend. In China for instance, various retail stores and restaurants are re-opening, manufacturing plants are repowering, and life is slowly returning to normal. In our opinion, it won't take but a little bit of good news (e.g., medical break-through?) or very low-mortality rates to meaningful settle the gravest of fears and concerns. And we are certain that the equity market will *bottom* well before the public hysteria *peaks*.

With that as a backdrop – and recognizing there are a myriad of "ifs" for investors to ponder – here is what we are currently thinking, monitoring, and questioning:

- **Equity market volatility**: The fear and uncertainty – both economic and health-related – show up in the minute-by-minute swings in the market. During the week of March 9th, the daily moves (using closing day values) ranged from -9.5% to +9.3% in one of the most turbulent weeks for equities since the Global Financial Crisis. In fact, month to date through March 18th, the market hadn't had a single day close with a return of less than 1%! And while we've often noted that drawdowns in today's market structure would come fast and furious, we were notably surprised by the fact that the S&P 500 Index ("S&P 500") recorded its quickest bear market *ever* (i.e.., 20% sell-off from peak), reaching this mark in just 15 trading days (excludes 1987's single day 20%+ decline). According to JPMorgan, this is twice as fast as the 1929 crash (30 trading days) and the 1998 Russian financial crisis (31 trading days).

- **Credit market volatility**: As investors who believe that to understand risk, you have to have an interconnected view of equities and fixed income, we are closely monitoring the functioning of the credit markets. High yield spreads have continued to widen and are hovering around 1000 bps, levels that are reminiscent of prior peaks in February 2016 and October 2002 – albeit below December 2008's peak of over 1900 bps. Similar to the equity market volatility story, four of the five largest daily widenings in history occurred in the past few weeks. Interestingly, return opportunities become even greater at these spread levels with historical precedents showing positive subsequent returns over 1, 2, 3 and 5 year periods. (Source: JPMorgan)

- **Election volatility:** These days, election volatility seems just as erratic as financial market volatility. Just one month ago it was a low 40% likelihood of a Democratic presidential victory and now the markets are pricing in a 56% probability. And while the topic has been pushed off the front pages of the newspapers, we believe it's important to highlight that former Vice President Biden now has a nearly 90% probability of winning the Democratic party nomination – with recent key victories in future battleground states such as Florida, Arizona, and Michigan to name just a few. All of this has implications for the markets – and certainly particular sectors – especially relative to what could have been a "Bernie policy agenda" for up to 8 years.

- **Corporate behavior**: Previously we discussed the limited visibility and the "fluid" nature of corporate decision-making. And the conversation has quickly shifted from global supply chains (just a few weeks ago) to ensuring the safety and soundness of employees, customers and society at large. Unfortunately, there is no "business as usual", and with each passing day we see more announcements of store closings, hour reductions, business strategy modifications, and employee arrangements. Many companies are (appropriately in our view) withdrawing financial guidance and re-focusing capital toward internal initiatives. Interestingly, flexibility by company varies greatly as past decisions pertaining to capital structure and capital allocation come home to roost. Lastly, we'd argue that there are companies today that will emerge with even stronger competitive moats as they capitalize on some macro dynamics that could accelerate secular change (e.g., changing consumer behavior).

- **Fiscal and monetary intervention – here comes the global cavalry**: The Fed and the U.S. administration are now taking this seriously and are all in on providing the necessary liquidity and fiscal support. The 2008 playbook is being revisited and while the devil is always in the details, everything is likely on the table, including a $1+ trillion fiscal stimulus package, social safety net funding, small business loans, and support for various industries (e.g., airlines, hotels, etc.) to name a few. And let's not forget the rest of the world! The central banks of China, Japan, England and Korea have already announced accommodative moves and just yesterday Christine Lagarde, President of the European Central Bank, announced a EU750bn pandemic asset program; she went on to say that there is "no limits to our commitment to the euro" and "we are determined to use the full potential of our tools, within our mandate." Lastly, we've even started to see shorting bans re-emerge and discussions over government equity stakes. It's all very fluid…expect more to come from the U.S. and around the world.

- **Balance sheets really matter**: In times of economic stress, all eyes move to concerns around solvency and liquidity…whether you are a corporation or an individual. For this discussion, we focus on the former. Those with "fortress" balance sheets will be able to weather the storm while levered entities could need to find solutions…quickly (again, the devil is in the details). The market has seemingly recognized this point to a degree as well and is likely part of the reason that small cap stocks (Russell 2000 Index) have underperformed their larger cap peers (S&P 500) in this recent drawdown by over 10%! As one relevant data point, according to Credit Suisse, the Russell 2000 Index net debt to EBITDA has recently been in the 3.5-4.0x range while the S&P 500 closer to the 1.5-2.0x range. Be mindful of leverage.

- **Investment process and investment details matter**: In our view, active engagement and advice matter more than ever. It's important for clients to understand their asset allocations. It's important for investors to know their companies and their management teams. And it's important to ensure risk management is "working" as expected – know your factors, know your exposures, and know your liquidity profile.

- **Market timing vs. investing**: This is a repeat bullet for us. We truly believe that guessing market direction in the short term is a random walk. We do know starting points matter and time served in the market cures all ailments. And over time, we believe there is going to be tremendous opportunities for wealth creation in an attractive risk-adjusted manner.

- **And lastly…it's not all bad out there**: Channel checks indicate China and Hong Kong ramping up, the U.S. consumer found a new "fiscal stimulus" in the form of lower energy prices, interest rates remain low (with a steepening yield curve), and companies around the world are working hard to find treatments and vaccines. If – and it's a big "if" – the COVID-19's risk can be "ring-fenced" (both from a health and economic perspective), there will likely be significant pent up demand.

So what are we doing? Once again, our team of experienced investors is staying disciplined and true to our investment process – analyzing company fundamentals, monitoring the credit markets, and testing and re-testing individual investment theses. We are all at our "work from home" desks (with a few extra family members lingering nearby), working hard, and monitoring the environment closely.

In closing, and most importantly, please be safe. And please be smart. Our thoughts and prayers are with you, your families and all the healthcare professionals that are on the front lines working tirelessly to return this great country in SHORT-ORDER to its wonderful, full and lasting potential.