LITMAN GREGORY ASSET MANAGEMENT

Our Changing Thoughts on the Coronavirus Impact

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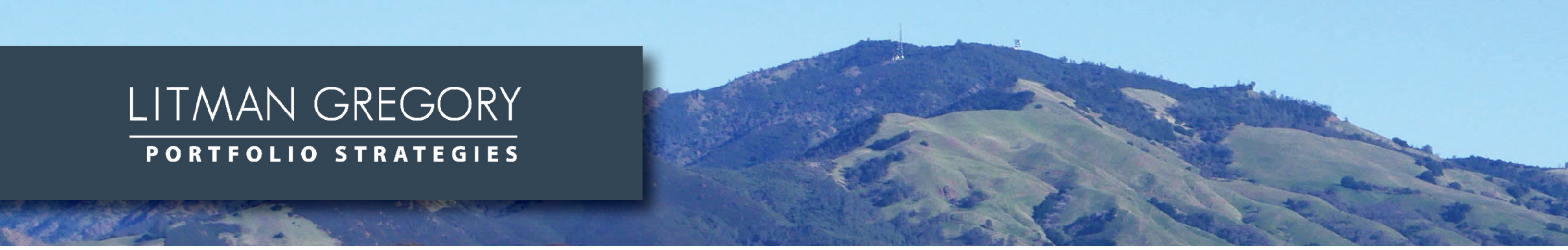

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Things are changing rapidly in this environment. We're digesting and analyzing new information and trying to share it before it gets stale so it can help inform your client conversations. A week or so ago we would have said that the current crisis caused by the coronavirus was different from the 2008 financial crisis. That is still the case. However, based on the continued spread of COVID-19 and the more and more aggressive action being taken to contain it, it is becoming clear the economic impact is going to be very severe. We would now say this could be as bad, in magnitude, as 2008. This is leading us to re-evaluate at what level we would add more back to U.S. stocks. Given we think the downside from here may be greater than we once thought, we are considering revising our next buy point down to provide a greater margin of safety.

The External Shock Finally Came

Any investment manager with humility, a historical perspective, and common sense has to acknowledge there could be an external shock to the system at any time. Litman Gregory has mentioned this many times, we just didn't know what it would be or when it would happen, and we didn't think anyone could predict it. The coronavirus is clearly such a shock. In December 2019, no one predicted a virus would emerge to set off a worldwide health crisis and threaten the global economy.

We continue to think this current economic crisis caused by the coronavirus differs from the 2008 financial crisis across several dimensions. So far, it has not caused the same level of existential fear of a complete freezing up or collapse of the entire financial system. It seems that political actors and monetary authorities have learned key lessons in terms of understanding the necessary response. There appears to be a willingness to "do whatever it takes" to maintain markets and support the real economy.

The Likelihood of a Severe Recession

We are always hesitant to put a probability on a recession, but it's currently our near-term base case. (We had already been assuming the U.S. would have a recession at some point within our five-year base case macro scenario.) Some economists and investors think we're already in one, starting in March. And it is hard to argue with them. The biggest impact is likely to come in the second quarter. In a severe global or U.S. recession scenario, a 45% to 50% decline in stocks is very plausible. So, there could be more downside. There is also no law of physics that says the market can't drop more than 50%, especially given our view that U.S. stocks were overvalued to begin with. But such severe drawdowns will not be permanent losses of capital unless an investor locks them in.

Fiscal and Monetary Stimulus to the Rescue?

Much of the ultimate shorter-term impact now seems dependent on the fiscal policy response and magnitude. The Republicans, Democrats, and the Trump administration seem to be mostly on the same page: They need to "go big and go fast." And the Federal Reserve appears ready to do anything it can to support the fiscal side and pump liquidity into markets. The Federal Reserve has dropped interest rates to just above 0% to maintain liquidity in markets. They have again restarted massive, apparently unlimited Treasury and mortgage-backed security asset purchases (QE). And they have launched several other programs and tools (similar to the 2008 financial crisis and then some) to provide funding to businesses and the credit markets. Lower interest rates, QE, and unlimited liquidity can't stop a virus, but at least the Fed (and other global central banks) are committed to keeping the financial system's plumbing flowing.

But the devil is in the details as to the amount, speed, and near-term effectiveness on the fiscal side. Still, bigger fiscal stimulus (upwards of $2 trillion as we write this) seems inevitable in the United States, and Europe as well, despite the political disfunction and polarization that has plagued us these past five to 10 years.

The Known Unknown: A Resolution to the Health Crisis

On the medical side, we don't know when we will see daily COVID-19 infection rates flatten out or start to decline in the United States and Europe. The trajectory has worsened over the past week (albeit with possible glimmers of a positive trend emerging in Italy) and the aggressiveness of the government response to slow the spread has increased substantially. The longer shelter-in-place orders and lockdowns stay in effect across the country, the greater the negative economic consequences will be.

The Glass Half Full Point of View

Hopefully, the scenario that played out in China repeats in other parts of the world (assuming the outbreak does not re-emerge in China or gets "imported" now that the country is returning to work and citizens are coming home from abroad). After the coronavirus first spread in China, the markets began looking for signs that the number of daily new cases (or the growth rate of new cases) was flattening out or starting to decline. When that happened in China, markets rallied. Now it seems like Italy is the next case for this. Or if it happens sooner in the United States, that would be incredibly positive news. But as many have commented, it appears the United States is a couple of weeks "behind" Italy in terms of the timeline of virus spread and the policy/societal response.

When virus news turns positive, it seems reasonable that markets will rally from wherever they are at the time. There is still a good chance that there will be a sharper or quicker rebound from the recession (a so-called V-shape recovery). The recession may still prove short-lived (only one or two quarters). We believe markets will most likely turn up strongly prior to the end of any recession, as is the case historically. Massive well-targeted, effective fiscal policy could change sentiment. We are seeing that in the markets today (3/24/20). But we have little confidence predicting the short-term direction of the market. We'll continue to keep you informed as our thinking evolves with new information and market reactions.

—Litman Gregory Investment Team