PCA Market Commentary

April 2020

Seeking Signs of Recovery

History as a Teacher

The global pandemic has engendered an unprecedented decline in markets, with the shift from record employment and economic growth to bear market levels in fewer than three weeks. Infections bloomed within interconnected societies that are woven into the fabric of commerce. We are more globally intertwined today, than at any prior point in human history.

Although we have faced environmental shocks that have disrupted the prevailing 'normal', the impact of such events were isolated on a geographic basis. In comparison, COVID-19 accelerated from a localized problem to global pandemic in roughly two months. In that time, we witnessed the shuttering of entire industries around the world.

Despite the market turmoil, we innately understand the resilience of communities, and are fully aware of our instinctive drive to adapt and overcome. Perhaps we've heartened by concerted efforts of governmental bodies, or by the deployment of resources, both intellectual and financial to stabilize the medical condition. We can see past chasm and believe that calm will return in the near horizon.

However, we can't predict how the virus will react to changes in environment, nor do we have a sense of when technology might provide a sustained solution. This is why the question of timing is so difficult to answer, even when we have past recessions to analyze. Key drivers of past market downturns were mostly of human creation, where the fragility of markets was mitigated after structural repairs.

Here is a brief summary of key shocks over that last few decades:

- **Risk Controls:** Long Term Capital was a case study that involved highly intelligent and regarded individuals that capitalized in perceived inefficiencies. These investors produced 43% and 41% returns annually in their first two years of operation, achieving such results by employing > 30x leverage on their capital base. LTCM's eventual failure nearly collapsed the world's financial system because the risks modeled by its investors fell well short of the spike in correlations of sovereign interest spreads. Contributing to the collapse was the opaqueness of their investment process, coupled with the lack of regulatory oversight.

- **Irrational Exuberance:** The technology bubble of late 1990's culminated with the decline of NASDAQ composite levels from 5,000 to 2,000. The bubble's creation found its genesis within humble beginnings in the 1970's and 1980's, when scientific researchers developed a communications protocol later named TCP/IP to manage the transfer of data packets to each other in the name of research. This eventually evolved into the internet. The public, with increasing exposure to the web, began to sense a change in how we lived. This was an evolutionary leap forward and pushed markets to new highs. However, the subsequent collapse was nearly guaranteed, due to irrational corporate spending coupled with unstainable investor expectations for profitability. The digital transformation could not violate basic tenets of economic viability and capital deployment.

- **Financial Integration:** The Global Financial Crisis found its roots within the subprime housing bubble, as mortgaged backed loans were re-engineered and repackaged for distribution to stakeholders both public and private. The inherent risks of these derivatives were in part diversified and disseminated. Counterparties across the globe looked upon these investments as being relatively safe, given assurances of the financial engineers that created the instruments and credit rating agencies charged with providing objective evaluations of their associated risk/performance profiles. The contagion spread from credit markets to the currency markets eventually forced a flight to liquidity across all asset classes. This precipitated a change in the risk structure of the banking system on a worldwide basis, requiring rescue plans from >100 sovereign nations.

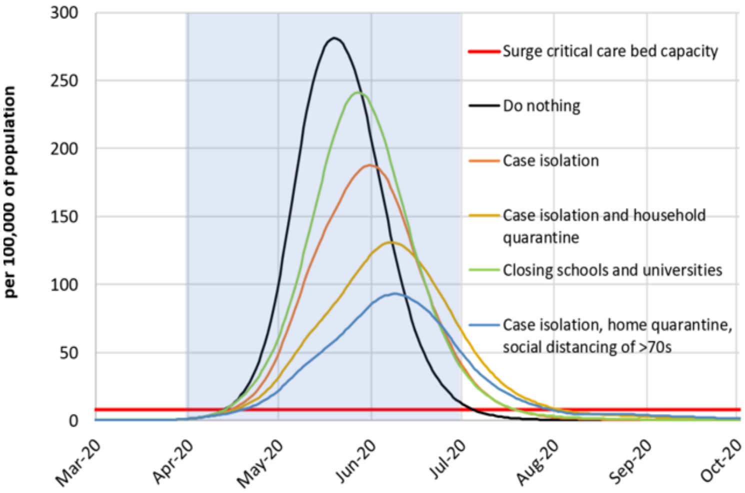
This Time, it Really *Is* Different

Unlike past events, the current pandemic crisis did not find its roots within the financial system itself. In recent years, global economies were in a reasonable state of uptrend, financial regulators have imposed tighter capital controls, and investors have generally stayed away from opaque financial instruments or esoteric investment processes. In fact, the current stimulus program that has been implemented within the US is not intended to repair unhealthy segments of our markets. Rather, the goal is to bring an already healthy financial system past the danger of economic collapse.

In its search for the prospect of a recovery, the markets are correctly focused upon two crucial elements: stabilization of the medical crisis and projection of attitudinal shifts within the population as the pandemic abates.

Investors have become highly data driven within the current analysis to glean insights on the medical picture. Many questions have centered on the efficacy of pre-existing treatments, pace of developing treatments, capacity utilization of hospitals, per capita count of health workers per geographic region, acceleration of ventilator delivery, slope of infectious growth, availability of testing, proper sampling techniques, etc. The mosaic painted by this data would eventually point towards a level of sustainable capacity within our healthcare system. In effect, we need to see evidence that we have given ourselves enough time to build population immunity, find a vaccine, or locate other forms of treatment.

For now, the most effective way of giving ourselves more time has come from social distancing policies. But as we adjust to the new normal, the latest research from the Imperial College London suggests that even a mitigation strategy that combines quarantining of the sick/old/exposed, along with school closures (light-blue line), would likely see an expansion of critically ill people that would exceed healthcare capacity (red-line). These conclusions are consistent within the US as well as the UK.



Source: Imperial College London

Based upon this study, and numerous others, we begin to understand why the most viable solution is to enact stricter social distancing policies, more consistently, and on a longer basis, to buy enough time to find a medical solution. In parallel we must develop a plan for sustained testing, tracking, and treating the infected. Time is the tip of the spear used to attack COVID-19. The alternate path of allowing a natural formation of population immunity might be shorter and simpler, but would come at an unacceptable human toll.

Monitoring The Markets

In our [webinar] last week, we discussed our investment team's outlook on markets, with particular focus upon the depth and duration of the current economic decline. While there is an unending stream of headlines and updates from news feeds, we tend to focus on several key factors derived from medical data, economic data, market data, and investor positioning.

	Key Metrics	Current View
Medical	Infection rates | Health capacity	Neutral/Negative
Economic	Production | Employment	Negative
Market	Valuation	Negative/Neutral
Risk appetite	Volatility | Spreads	Negative

At this juncture, the factors that deserve the heaviest consideration include medical and economic related. Both are tilted towards a negative outlook. Relative to medical indicators, we don't yet see a sustained leveling of the infectious growth rate, and the economic picture remains unclear since the vast majority of the production halts towards March-end have yet to be reported.

We will continue to provide weekly market updates. In the meantime, you can access our thought leadership pieces on our Insights page and by following us on LinkedIn.