COHO PARTNERS, LTD.
Economic Commentary

First Quarter 2020

"As with a crumbling sandpile, it would be unintelligent to attribute the collapse of a fragile bridge to the last truck that crossed it and even more foolish to try to predict in advance which truck might bring it down."

-- ***Nassim Taleb***

"You don't make the timeline, the virus does"

-- Dr. Anthony Fauci

INTRODUCTION:

We at Coho Partners are hoping that all of our clients, friends and associates are doing well and following all guidelines during quarantines caused by Covid-19. The human element of the impact of the virus is incalculable and is accentuated by the financial and emotional toll from the immediate cessation for many of the life we knew only weeks ago.

We are optimistic that the next few weeks will exhibit a flattening of the infectious curve and combine with the warmer weather to cause the virus to recede. With many of the countries that contracted the virus early and applied aggressive isolation, we are seeing good progress. Even the hardest hit areas in Italy, Spain and France are exhibiting a deceleration in the growth of new coronavirus cases. Still, as Dr. Fauci observed, the virus will have its own timeline. It is our job to each do all we can from the bottom up to help our friends and neighbors and we will collectively get through this pandemic.

This commentary will be very different in structure and focus almost exclusively on our best understanding of the overall domestic impact on our macro economy and the aggressive response of our government and administration. We will avoid much of our usual discussions of sectors of the economy as the data is old and irrelevant to where we are now and prospectively. We will also do our best to frame our thoughts around how we emerge from this and some of the impacts that may be with us for a longer period of time.

OVERVIEW:

The U.S. economy along with that of most of the world is undergoing a massive and ferocious global downturn that appears to be the deepest since World War II. We have focused much of our recent commentaries on how, though still solid, the U.S. economy was clearly weakening and vulnerable. Traumatic, exogenous events occur more often than we recall but the ones we tend to most remember are the accelerants to bear markets and recessions. Covid-19 will likely be the defining event of this generation.

With the entire global market in turmoil, there is a growing fear that we may be again entering a systemic financial meltdown such as 2008 which itself nearly moved the global economy into a depression. One of the challenges facing the optimism of a v-shaped economic recovery from Covid-19 is that this is not only a virus shutdown that we are facing. It is also a global recession, credit event and oil shock all rolled into one. Recessions that are accompanied by financial crises are usually deeper with slower recoveries than typical business cycle recessions. Weakening balance sheets and widespread personal and corporate defaults inflict severe damage on economic activity. This is exactly what the Federal Reserve is attempting to minimize. We will address these issues first before discussing the profound impact on employment and the consumer.

Following the typical prescription in Keynesian economics, the policy solution to any business cycle slowdown has been for governments to intercede and offset any vacuum in demand with increased fiscal and monetary stimulus. This, along with the secular shift from an industrial to a service-based economy, has smoothed the business cycle making for shorter and less frequent downturns. Economist Hyman Minsky simplistically referred to a potential outcome from this as, "stability breeds instability" as these policies have increasingly raised the confidence of businesses and households. In turn, this has encouraged the behavior in our economy of carrying much larger debt loads and smaller cash cushions feeling the government could and would restrain the downside shocks to the economy**.**

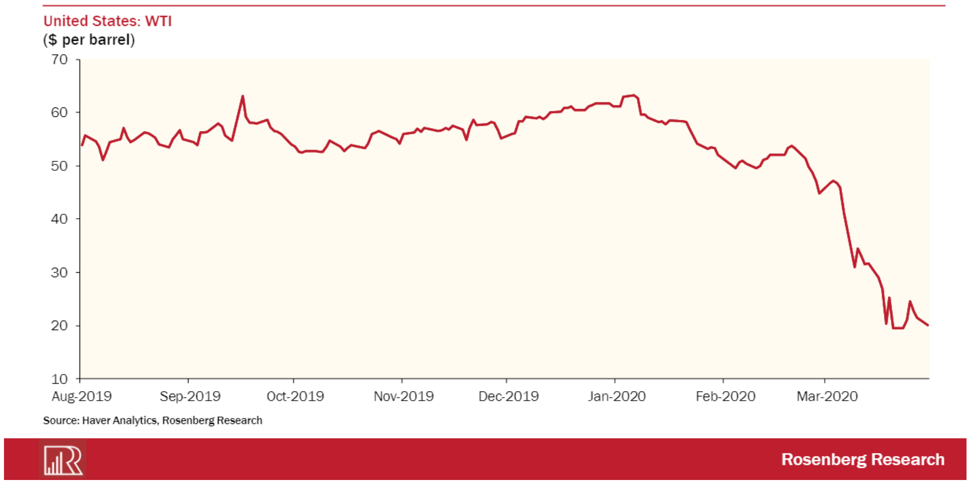
Though the day of reckoning was eventually coming, the coronavirus is immediately threatening the Achilles heel of the U.S. economy: highly leveraged corporations. With the longest economic expansion in history stretching into an 11th year and interest rates also near historically low levels, business debt ballooned and exceeded that of household debt for the first time in almost 30 years. The borrowing has increasingly been centered in riskier companies with fewer financial resources to withstand a typical recession much less a virus-driven shutdown. A potential wave of defaults would intensify the economic impact of the contagion and has been the leading concern of Federal reserve Chairman Jay Powell since 4Q 2018 when he dramatically reversed course on prior attempts to raise interest rates. It is the second-level impact of contracting cash flows on debt-service capacity that can reverberate throughout the economy and the markets.

The Fed is now trying to cushion the economy and the corporate sector from the blow of the coronavirus by cutting interest rates and pumping money into the financial system. According to Bloomberg, there are about $1.3 trillion of high-yield bonds outstanding, up from $786 billion a decade ago. The investment-grade credit market has more than doubled to $6 trillion in the same period with almost 51% of that market now rated BBB up from only 30% as recently as 2009. This area is now at increased risk of being downgraded to junk status by the rating agencies which then precludes many investors from being able to hold that debt. This vacuum of buyers would in turn raise the cost of capital and threaten the ability for these companies to fund their operations.

Janet Yellen, the former Federal Reserve chairwoman chimed in at the end of March in a conversation with the Wall Street Journal saying, "Non-financial corporations entered this crisis with enormous debt loads, and that is a vulnerability. They had borrowed excessively" and they did it not so much for productive purposes like investment, but for buying back stock and paying dividends to shareholders.

The corporate borrowing binge "creates risk to the economy. And I'm afraid we'll see that in spades in the coming months, because it may trigger a wave of corporate defaults. Even where a company avoids default, highly indebted firms usually cut back a lot on investment and hiring, and that will make the recovery more difficult," the former central banker said.

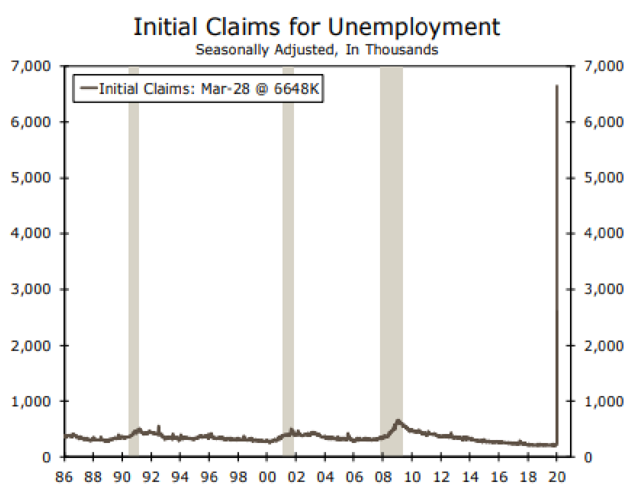
The virus also hit at a time of a global oil price war as Saudi Arabia announced a plan boost output to 12.3M barrels per day (bpd) from 9.7M bpd. With Russia not cooperating with OPEC in efforts to reduce production to stabilize prices in the face of the COVID virus, Saudi decided to play a game of chicken with Russia and potentially also deliver a major body blow to the growing U.S. shale industry. This over supply is now confronting a record demand plunge of 12 million barrels per day leading to an over 60% collapse in the price of oil (see chart on following page). Normally such a price war might benefit the U.S. consumer at the pump but this impact is overwhelmed by the economic damage of the shutdown.



While the energy sector is the smallest in decades as a component of the S&P 500, it has far greater influence over the U.S. economy. The U.S. oil and gas industry contributes about 8% to overall GDP and accounts for over 10.3 million jobs. Growth of the shale industry has been a huge boon to overall economic growth in the last decade. This is now at a cyclical risk.

ECONOMIC IMPACT:

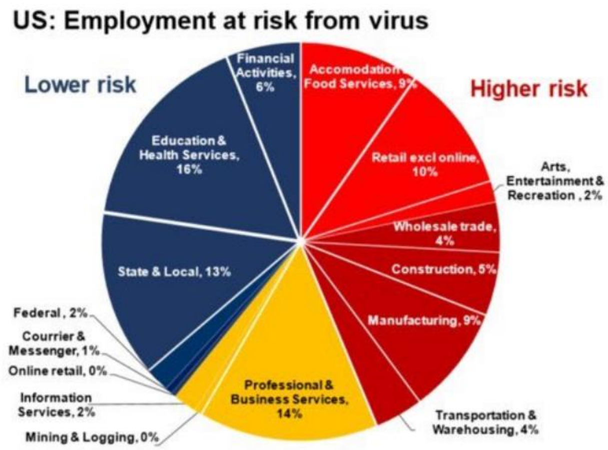
While some of the estimates from Wall Street firms for the cataclysmic impacts on growth and unemployment represent such a wide dispersion as to be less helpful, we need to start with a baseline. Initial jobless claims are the most contemporaneous data point for what is happening now. For the week ended March 20 they soared to a record 3.307MM or around 2% of the total workforce. This is almost a five-fold multiple of the record peak reached during the financial crisis of 665K in March of 2009. For the week ended March 27, jobless claims then doubled again to over 6.648MM bringing the two-week total to almost 10MM (see chart below from Wells Fargo).



It is estimated that with a total labor force that approximates 164MM, every 1.6MM increase in jobless claims equates to roughly a 1% increase in unemployment. The nearly 10MM that have already filed for claims in the past two weeks would likely bring the current unemployment rate in early April to around 10%.

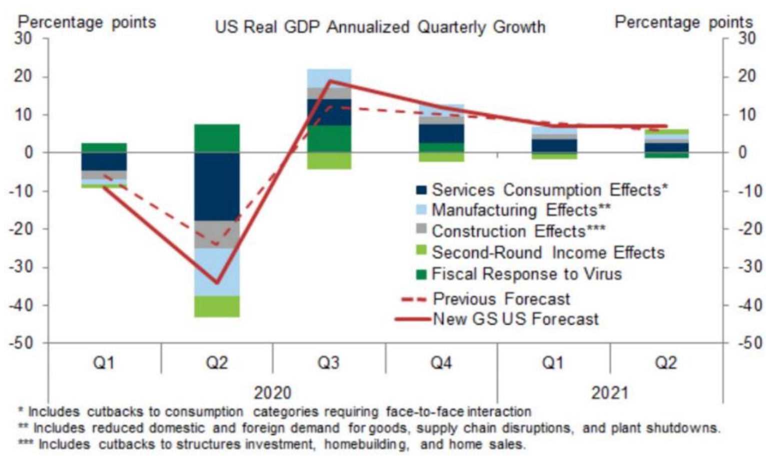
These claims likely understate the extent of the layoffs and are expected to continue to rise in the coming weeks. State unemployment insurance offices have reported severe capability constraints in processing in the past week. They have ramped up hiring additional workers in the past several days to help with overwhelming volume and this increase should be reflected in claims data going forward. Additionally, self-employed workers, gig workers, and independent contractors are currently not eligible for unemployment insurance but will gain eligibility from the recently passed stimulus package.

With nearly 30MM of the labor force in the most directly and immediately impacted areas of retail, leisure & hospitality (see chart below), it is fairly realistic to fear that as many as 50% of this total will be subject to layoffs with other, less customer-facing areas also at risk. Thus, the first wave of economic victims are the low-wage and hourly workers who are already the most vulnerable in our society. We now expect to see the unemployment rate approaching 15% over the next few weeks and even higher if there are greater than expected lags in receipt of the stimulus from the 2020 CARES Act.



Source : Oxford Economics/Haver Analytics

The estimates on the impact on overall economic output is even more surreal. Below we show the most recent iteration of expected GDP in the next 6 quarters from Goldman Sachs that depicts a bad 1Q reading of -9% followed by an unprecedented and virtually unfathomable decline of -34% in 2Q, a period where the majority of U.S. commerce will be shutdown. Though this is followed by a powerful rebound in 3Q of 19% as we emerge from the virus isolation.



Source: Goldman Sachs Global Investment Research

In a $20T dollar economy, a 34% decline represents about a $1.7T economic hole for the 2Q alone. The full year estimate from Goldman is for a -6.2% reading that narrows that shortfall to a still enormous $1.25T that is not made up until the middle of 2021 at the earliest.

While all of this is clearly deflationary in its immediate impact, there is the potential for a different outcome following the downturn. Unlike the two previous global recessions in this century, this one is centered in the service sector and is both a supply shock as well as a demand shock to the economy. Our country last experienced something like that during the mid-70s with the oil-supply shocks. While tens of millions of Americans will be in an enforced lockdown during much of the second quarter, vanquishing demand, the supply side will suffer as well as global value chains break down, borders are closed and all countries basically shut down. Even as demand picks back up, sharp declines in production and widespread bottlenecks may subsequently create shortages and actually engender rising inflation.

FISCAL & MONETARY RESPONSE:

The enormity of the fiscal and monetary response may end up being as much as 40% of U.S. GDP and perhaps more when all is said and done. The fourth iteration of quantitative easing (QE4) was barely introduced in March when it almost overnight morphed into QE4ever as the Federal Reserve announced it would buy securities with no schedule, no upper limit and no end date in sight. The program for purchases includes all agency commercial mortgage backed securities (MBS) in addition to Treasuries and all MBS with the inclusion of investment grade corporate and municipal bonds.

This was the go ahead sign from the Federal Reserve to the government to provide whatever bridge it takes to protect the economy during the shutdown. The Federal Reserve is in essence providing up to $4T in helicopter money that is backstopping the financial markets and helping to restore liquidity to the high-quality segments reducing the fear of delinquencies and defaults. This is not monetary policy easing but rather credit easing to maintain the functioning of the credit markets and support the fiscal stimulus.

The roughly $2.2T recently passed CARES Act (highlighted below) is a gargantuan attempt to bridge the economic shortfall for households, businesses and state and local governments that a near complete shutdown in the second quarter creates. The most immediate payments into the economy should be distributed by the third week of April in the form of stimulus checks ($290B), increased unemployment compensation ($260B) and the $350B rescue plan for small businesses that collectively seek to replace $900 billion of lost income over the next quarter.

KEY 2020 CARES ACT PROVISIONS

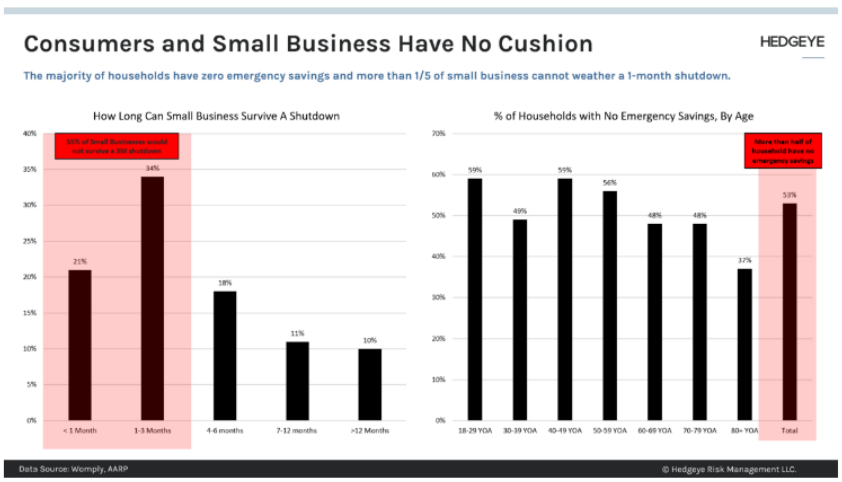
RECOVERY REBATES	CORONAVIRUS-RELATED DISTRIBUTIONS	OTHER PROVISIONS	UNEMPLOYMENT COMPENSATION BENEFITS	SMALL BUSINESS BENEFITS
• Refundable income tax credit against 2020 income of up to $2,400 for married couples filing a joint return. All other filers begin with a refundable credit of up to $1,200. The credit amount then increases by up to $500 for each child a taxpayer has under the age of 17. • AGI threshold amounts: Married Joint, $150,000; Head of Household, $112,500; All Other Filers, $75,000. Payment reduced by $50 for every $1,000 over threshold amounts. • Individuals must have a work-eligible Social Security number (and not be claimed as a dependent), but they do not need to have had reportable income in 2019 and can also be eligible for other income-benefit programs as well.	• Coronavirus-Related Distributions are distributions of up to $100,000, made from IRAs, employer-sponsored retirement plans, or a combination of both, which are made in 2020 by an individual who has been impacted by the Coronavirus. • Distributions are exempt from the 10% penalty, not subject to mandatory withholding requirements, are eligible to be repaid over 3 years, and the income may be spread over 3 years.	• Required Minimum Distributions are waived in 2020, and taxpayers who have already taken their RMDs for 2020 have the option of returning them, if they so desire. • 2020 is ignored for the purposes of the 5-Year Rule that applies to Non-Designated Beneficiaries (e.g., charities, estates, non-See-Through Trusts) who inherit a retirement account from decedents who die prior to reaching their required beginning date. • New $300 above-the-line deduction for "qualified charitable contributions", and the AGI limit for cash charitable contributions has been temporarily repealed. • Student loan payments deferred until September 30, 2020, and employers can exclude student loan repayments from compensation.	• 'Regular' Unemployment Compensation is 'bumped' by $600 per week, and the benefit period is extended by 13 weeks. • Unemployment benefit will be available the first week of unemployment, waiving the 'normal' one-week waiting period.	• Certain small business can qualify for small business loans up to a maximum of the lesser of $10 million, or 2.5x average payroll costs to cover payroll, rent, utilities, mortgage interest, group insurance premiums, etc. • Such loans (which have a maximum interest rate of 4%) are eligible for full or partial forgiveness. Eligible amounts must be spent during the first 8 weeks after the loan is made if spent on payroll costs, rent, utilities, and group health insurance premiums, BUT business MUST maintain the same number of employees (subject to certain timeframes). • Payroll tax credit for qualifying businesses not receiving a covered loan (above). • Employers are eligible to defer payroll taxes from the date of enactment, through the end of the year, until the end of 2021 and 2022.

Source: Coronavirus Aid, Relief, and Economic Security Act

The long-term ramifications of all of this fiscal stimulus is unknown. All of the negativity towards Modern Monetary Theory is now thrown out the window and something for future taxpayers to worry about. For now, we are hopeful that this infusion of money (and perhaps a further stimulus bill behind it) helps stem the worst of the recession in its tracks preventing a spiral into a depression rivaling the 1930s. The size of this package would hit the economy with a very short lag and, hopefully, remove the big tail risk and buy at least 3-4 months of time for the economy to move to the other side of the economic risk from the virus.

While it is our current base case for the economy in the second half of 2020 to start to improve, the recovery will depend critically on the depth and intensity of the recession along with its duration. While it is reasonable to expect the length of the downturn may be on the shorter side of prior recessions (the 2007-2009 Great Recession lasted 18 months), the depth of the decline will be on a magnitude not seen since the Depression of the 1930s. The mandated shutdowns and widespread job losses may start ebbing by the summertime and, by definition, the recession may technically have ended. However, from what base level will the economy be recovering and what changes to our economy and way of life should we expect?

The chart below shows that the majority of households have zero emergency savings built up at a time when the largest cohort of baby boomers is in or entering retirement. Additionally, small business which comprises over 50% of total employment is not prepared to survive a business shutdown of more than a couple of months.



THE OTHER SIDE:

So what will we look like on the other side when life starts to resume again? While by late spring we should have passed the worst of the virus spread and will start to re-emerge with social distancing receding. But life may be quite different. There will likely remain great reticence to congregate in populated areas. Sporting events may resume but with no one in the stands. Restaurants will likely have less tables allowing for a continuation of social distancing but challenging the economics of the owner. Airlines will clearly be less crowded and travel will remain soft for both business and consumer use that have learned the capabilities of remote conferencing. Let's be clear that when this recession ends, we will be recovering with a much higher unemployment rate than we enjoyed before the virus as millions of previously employed people will still be without jobs and income. Returning to our prior routines will likely be elongated and staggered meaning that the likelihood of a v-shaped recovery is smaller until at least a vaccine is discovered.

It is also likely that we will see additional behavioral changes in consumption sparked both by the crisis and also economic concerns as to job security, incomes and the market downturn. People will find that they have not saved enough for emergencies and that their retirement accounts have taken a powerful hit derailing many plans. This will clearly increase consumer savings and decrease discretionary consumption.

Among the impacts we expect to see will be changes in how employers and employees interact now that the work-from-home standards have had thorough vetting under stress conditions. This will benefit both quality of life for employees and costs and time for employers. Second-level impacts here may be on demand for commercial office space and knock-on effects from that to retailers, restaurants and other related industries where the on-line world will more than suffice. Having the government come in with bridge loans, forgiven loans, and equity stakes, means a larger public sector presence in the economy. Attitudes towards taxation and income inequality are bound to go through a profound change. Globalization trends will reverse course, to be sure, especially in vital areas like medical supplies, food and semiconductors. Corporate America will also see impacts, and we foresee a world of decelerating debt. In corporate parlance that will likely mean less hiring and capital spending with a clear reduction in stock buyback plans to further husband cash. This deleveraging will make the job of monetary policy more ineffective in attempts to stimulate borrowing via lower interest rates.

For now, there remains the expectation that intense social-distancing alongside other mitigation efforts will allow the coronavirus to run its course and that our country will engage in the process of a rebound to more or less our normal lives in the summer. However, epidemiologists still fear that the virus will return in the fall and stem any rebound as people will still be reluctant to return to crowded venues and schools may remain closed.

Aggressive screening to warn of new infections are not enough as new therapeutic drugs need to bridge the time until a vaccine is discovered. This would give most Americans the confidence to return to work and their daily lives and get our economy back up and running. This must be the focus of both our government and American industry, and we are optimistic that their teamwork will allow the build out of manufacturing capacity that allows for both therapeutics and a vaccine to be made quickly and able to scale. Though many of these behavioral changes will be with us for a while, we maintain the optimism that our economy built on independence and ingenuity will return more powerful than ever.

The S&P 500 closed 1Q 24% lower than the peak of February 19th and down 19.6% for the full quarter. At the lows, the S&P 500 experienced a drawdown of almost 34%. Other broad domestic and international averages experienced similar declines. Earnings estimates for the impact of the virtual global shutdown do not yet reflect the full extent of the potential declines. How quickly our economy is up and running will obviously be critical in determining the extent of those lower estimates. We find little investing value in throwing a dart around those numbers that are fully predicated upon variables outside predictive power.

What we do know is that at Coho Partners we will continue to seek out high quality companies with higher visibility around their business models, resilient earnings streams, anticipated growing cash flows, strong balance sheets, and reasonable levels of expectations and valuations. With financial markets expected to experience high levels of volatility and uncertainty, we feel this philosophy to be well suited to address the unique challenges facing our current environment.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA