Be Careful What You Predict For!

"The fact that Treasuries, munis, and gold are getting hit tells me that everything is for sale right now. One giant margin call where even the safe-havens aren't safe anymore. Except for cash."
– Rosenberg Research's David Rosenberg

Frankly, I had written a much different EVA for this week but as conditions have devolved at breathtaking speed, I've been encouraged by my team members to shift the tone. It is a good suggestion but I'm doing a big re-write on the fly so my apologies in advance for any roughness. (By the way, because there was considerable interest in on our 2/28 EVA on the coronavirus and its possible escape from the Chinese biological lab in Wuhan, I've included a special section on that topic at the end.)

Let's start with what has unquestionably been the primary source of the panic now engulfing financial markets worldwide, the above referenced coronavirus. As I did in the 2/28 EVA, I'll once again hereafter refer to it as CV for brevity's sake.

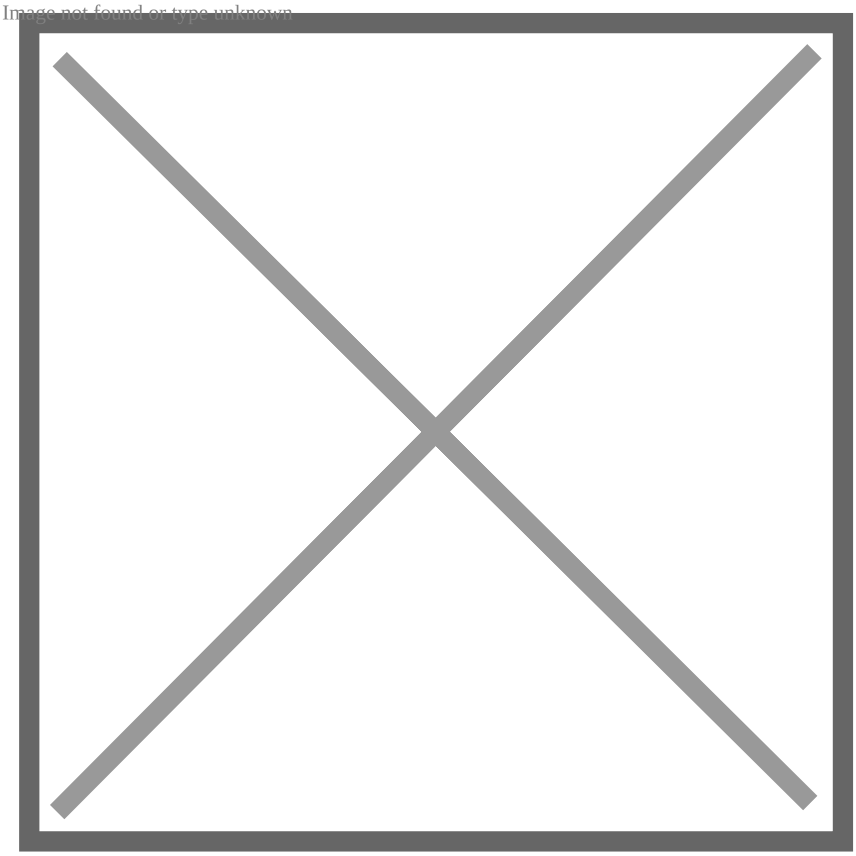
One of the more hopeful points I made in the 2/28 issue is that the CV should taper off as we move into late spring and early summer. However, a friend and biotech expert I've discussed this aspect with is not at all sure about that scenario. Further, I've read a number of other comments from different medical professionals along similar lines. In fact, some believe it could actually intensify, though those are minority views. Obviously, we won't know on this for certain until a number of months pass.

There are for sure many infectious disease experts who believe this entire situation is a massive overreaction. But it seems to me global policymakers are caught in a classic Catch-22 dilemma. If they allow life to go on as usual and the CV goes even more viral (the World Health Organization has now officially—and belatedly—designated it as a global pandemic), they will be thrown out of office. This is a risk that Donald Trump has been taking, until recently. If they reside in a totalitarian regime, they may be sent off to gulag or lined up in front of a wall.
The quandary is that what is more protective for humanity is devastating for the global economy. Complicating matters, the overall system is more fragile because of inflated asset values in the US (thank you, Fed) and extreme levels of debt (another hat tip to the Fed). Thus, its ability to withstand shocks like this is not what it once was.

This was on vivid display yesterday (3/12) as credit and money markets froze up, forcing the Fed to inject $500 billion into the vital repurchase agreement (repo) market where banks lend huge sums to each other on an overnight basis. It appears they are poised to do another $1 trillion in the near-term. The Fed's intent is to drench the system with enough liquidity to stop the panic in the credit markets. This likely can work as long as the US economy revives over the next few months.

Unfortunately, this saturation bombing of liquidity probably won't be able to forestall a global recession, which appears to be underway. However, it is possible that it will be a relatively brief contraction. That happy outcome, at least from where we cringe sit today, is dependent on controlling the CV's spread.

On the encouraging side—and Lord knows all of us need some of that right now—are the recent infection trends in both China and South Korea. While it's tough to have confidence in the numbers out of the former, the latter are likely much more credible and lately there is a decided improvement occurring.



Source: The Market Ear

Thus, it's not unreasonable to expect the infection rate will drop off "bigly" in western countries over the next two to three months. Once the worst is over, there is almost certain to be a tremendous surge of the pent-up demand that is occurring as a result of America and Europe going into hunker-down mode.   This, in turn, should lead to a powerful rally in risk assets like stocks—with many others, even bonds--getting caught up in the vortex by the day. The issues which have been especially pulverized should have the most spectacular recoveries…but more on that in a bit.

The immediate challenge, however, is that the US has not yet experienced the straight-up, hockey stick, parabolic, vertical asymptotic, whatever you want to call it, infection increase yet. From an investment standpoint, a huge question is whether that is already priced in after the recent market power-dive.

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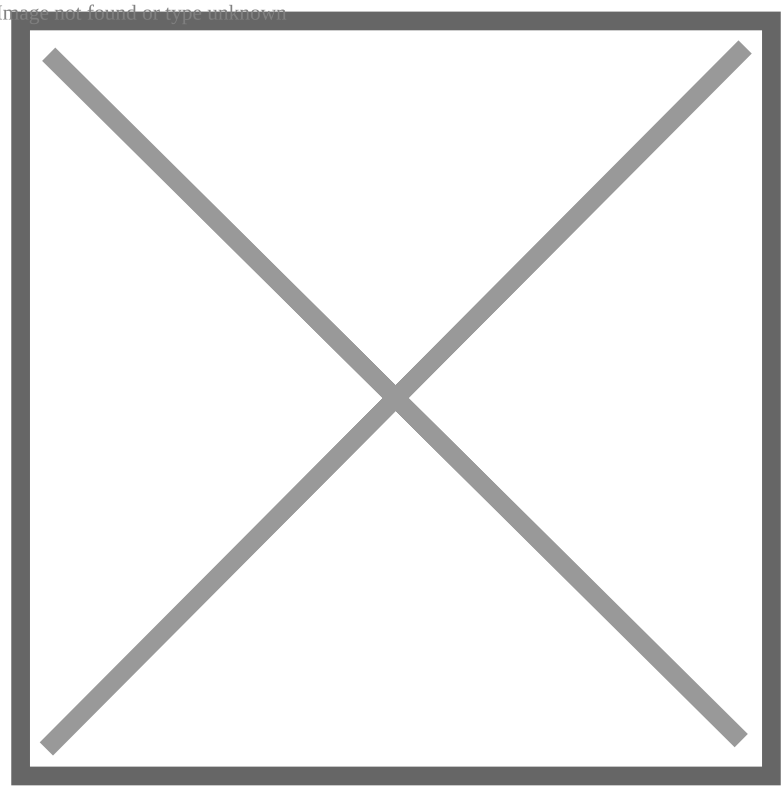

And, when it comes to virus victims, there is one asset category that is in a class by itself…and a very punished class it is. (Eons ago, I went to grade school under Catholic nuns so I know a thing or two about serious punishment!)

Last November, this newsletter made a bullish case for energy in general and the midstream energy infrastructure sub-sector in specific. For about six weeks, that worked like a charm…and then came the virus that has brought the world to its knees, at least economically.

No market segment has been as punished as has been energy with the announcement by Saudi Arabia and Russia to increase output, rather than the expected decrease, threatening to take away the ventilator for an industry that was already on life-support. Two huge demand shocks nearly back-to-back—the first caused by the recent trade war and the second, far worse, crushing of demand due to the CV—is unprecedented. On top of that has been the warm weather this winter in the US Midwest and the East Coast which has suppressed natural gas usage. Indisputably, it's been a catastrophic confluence of negatives. (It may come as a shock to almost everyone that global oil inventories were *falling* sharply through last month, though, undoubtedly, they will surge over the next quarter, or more, based on a demand collapse even greater than was seen during the global financial crisis.)

Monday brought an energy crash worthy of October, 1987, with the midstream/MLP sector falling 23% on that day alone, after having already tanked 31.6 % since January 16th (the peak of the rally that began late last November). Some leading exploration and production companies fell by 50% on that dark day.

As they did late last year, mid-stream insiders are once again stepping up to make some heroic (and, so far, losing) purchases, in a few cases in the multi-million dollar range. It is likely that there will be even more intense insider buying soon considering that the main mid-stream/MLP index (the Alerian, AMZ) is now down 80% from its peak, comparable to what happened to tech after the dot.com crash and to financial stocks in the wake of the housing/mortgage melt-down. Over time, of course, those were fantastic opportunities to accumulate tech and financial stocks, a point that investors should consider with regard to mid-stream energy today.

Alerian (AMZ) Index

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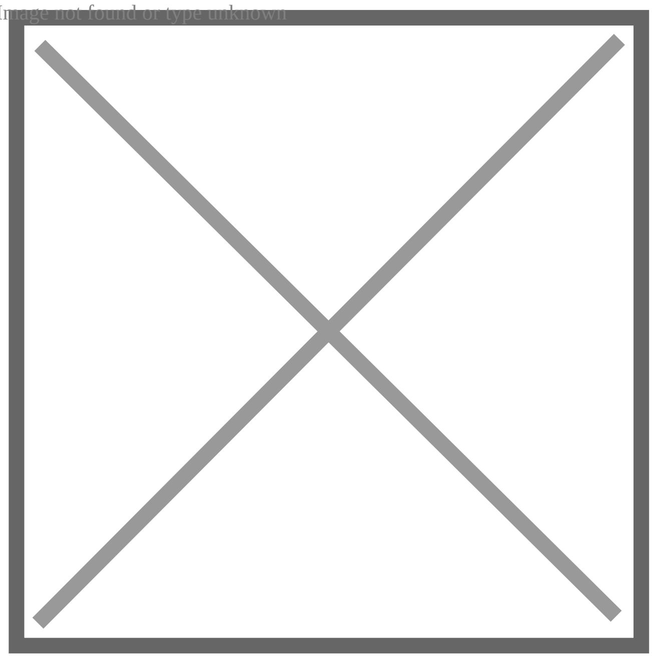

S&P 500 Financials Sector Index

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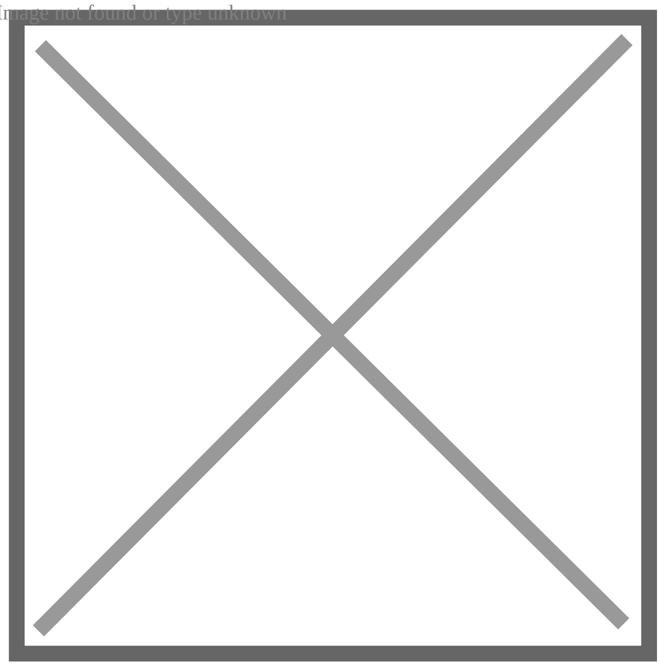
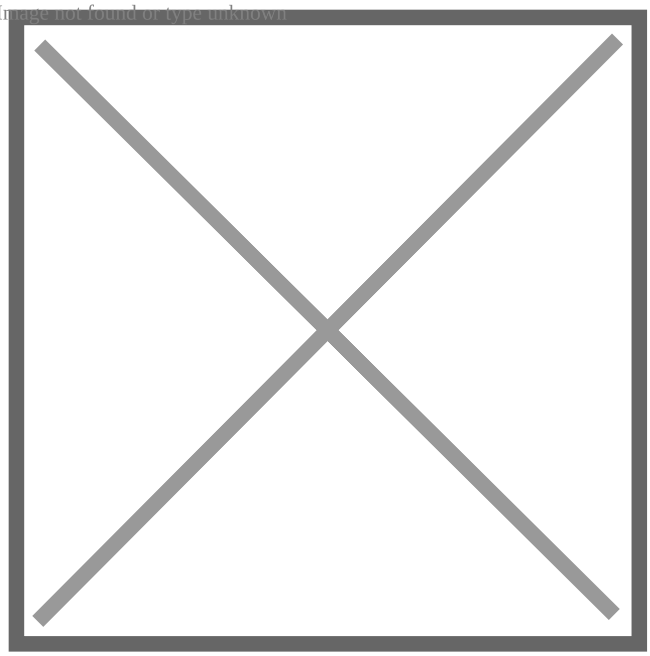


S&P 500 Information Technology Index



Source: Bloomberg, Evergreen Gavekal

Unfortunately, having seen these types of MLP selling frenzies a few times in the past (though not nearly as suddenly), I'm virtually certain that the leveraged closed-end mutual funds dedicated to owning US midstream energy are the victims once again of forced liquidation. In plain English, they are getting margin calls and have to sell, regardless of price.

This situation has consistently characterized past bottoms in MLPs/midstream but, frankly, I've never witnessed anything this severe—mostly because there's been nothing like it in the history of this asset class, as the above chart illustrates. The carnage is incredible even in the strongest names. Support price levels have been taken out in nearly all of these securities, with the overall MLP index now yielding 18.7%. *In our view, there is no connection between true value (much, much higher) and the current market prices for pipeline and other midstream energy securities*. Frankly, I believe some of these can double or even triple over the next year, though I could be dead wrong. However, it has happened before after past drubbings.

The assumption seems to be almost every constituent will slash its distributions. Unquestionably, current conditions have the potential to become wickedly tough in this industry but, as many are now realizing, the hardships are spreading to a wide range of other sectors. There are almost certain to be some payout cuts. Yet, singling out pipelines, storage terminals, natural gas process facilities, et al, strikes me as most unfair but that's what the investment world has done recently (though, lately, the hit-list is expanding fast!). It's as if the assumption is there will never be a demand pick-up again and, if that's right, the world has some truly cataclysmic problems.

The reality is that America can't function without our energy infrastructure. Once economic activity begins to recover—as it is already doing in China—energy demand will rapidly increase. It's also likely that Russia and Saudi Arabia will end their mutually suicidal game of chicken of raising output into a global demand collapse. This has been an incredible, and incredibly brutal, chain of events for the energy industry. It's hard to believe there won't be some relief in the near future.   Simply ending the forced liquidation by the levered closed-end funds will remove considerable downside pressure. Any détente between Russian and the Saudis would be an enormous boon though I'm not sure how soon that will happen. Eventually, it's highly probable. The key for all energy investors (and those invested in most other sectors now) is to hang on until the eventually.

Fortunately, because of our rising fears about the severity of the CV in early February, Evergreen began to sell a large number of its energy holdings, primarily mid-stream infrastructure. We did this even though we had—and still have—immense amounts of defensive securities in our client portfolios that allow us to buy into panics. However, because we set maximums on exposure to a sector, we felt we needed the room to be able to add to MLPs in case the CV did become the mythic Black Swan (i.e., a totally unparalleled and very nasty event).

In hindsight, we wish we had sold even more but we did reduce by about 40% - with the market collapse lowering our energy allocation even further (not the best way to lower exposure, by the way). Thus, we are in a position to buy into the devastation which we have been slowly doing. At these nuclear-winter prices, we feel it is now time to pick up the accumulation pace.

We do realize the reason javelin-catching never became an Olympic sport was because of the lack of surviving participants. We are obviously running the risk of being speared by prematurely reaccumulating MLPs but we are not going "all-in". We are in a position to add more should prices fall even further, which they could. But with one long-time MLP yielding 60% (yes, sixty not six!), and a decent chance of not being forced to cut their payout (though it is a risk, in this case), we think the values in this space have become nearly irresistible.

Moving beyond energy to another profound question, has CV finally popped Bubble 3.0, the third speculative mania of the last quarter-century? Just a few weeks ago, that seemed unimaginable, as did a US recession. But the risks of a global economic contraction, including in America, have risen dramatically, as mentioned above. One could plausibly argue the odds are now very high—well above 50%—that's what will happen. If so, a true bear market decline of 30% or more is probable based on history. The good news is that we're most of the way there…unless this becomes one of those 50% price collapses such as seen in 2000 – 2002 and 2008 – 2009.

If one believes the energy and bond markets, then the probability of a recession is close to 100%. They could certainly be wrong, as they were in 2015 and early 2016; however, current conditions feel *much* more like a true crisis versus a growth scare as we had back then. As of late this week, we are now for sure in a bear market even for the S&P. For broader measures like the NYSE composite and the Value Line Index, the losses have been even worse, down 29% and 35% respectively from their highs through 3/12. Thus, it does look as if Bubble 3.0 has finally met its maker. Rest in peace, Great Bull, you ran a glorious and very, very long race – with a lot of help from the Federal Reserve.

Speaking of the Fed, one senior Fed official even stated the possibility of another round of quantitative easing (that would be QE 5), or large scale asset purchases, as it prefers to call these asset price inflation measures. That was no surprise, but the shocker was that he even allowed for the possibility of using the fabricated money to buy stocks…and this was all before this week's latest melt-down. If the Fed does such a radical thing, it goes beyond my long-standing prediction that the Fed would buy corporate bonds in the next crisis. Frankly, I think the odds of that reaction are rising on a daily basis as credit spreads* have exploded to the upside of late, a very, VERY, concerning development.

For years, many people have ridiculed me as a perma-bear, despite recommendations to buy during prior mini-panics. Therefore, to be glacier lake clear, I believe, as does the entire Evergreen investment team, that now is a time to be dollar-cost-averaging into the stock market. We believe the focus should be on the legions of stocks that were decently valued before the—dare, I say it?—crash and are now often down another 40% to 50%. As usual, the big cap tech heavy S&P is masking the severity of the damage done to most US stocks. Because of this, we believe investors should be buying now; however, we're not recommending going all in yet. Make sure to keep "some" buying power on hand in case the market falls another 20% or 30%, as it very well could.

One reason I think we might have further risk over time, is that downside was so long suppressed by Fed manipulation and also $4 trillion of stock buybacks. As suggested in the 2/14 *EVA*, "Bye Bye Buybacks", Corporate America is doing what it always does when a panic strikes and stocks are on sale: as in, freeze. Because most companies borrowed trillions in order to buyback said trillions of shares (now at much higher prices, in many cases), they are increasingly finding themselves with balance sheet concerns. This is especially true for those where their cost of capital is rapidly rising due to the previously mentioned credit spread eruption. This is how it always goes—big buying during bull markets and then, often, forced selling of equity to repair financial health during downturns.

It may also surprise you that because of the recent "value restoration process", the vaunted S&P 500 has now had a twenty-year return of just 4.6%!   Has that meager return been worth the wild ride of the last two decades? And the even sadder fact is that most investors have likely done worse due to their well-documented tendency to buy high (as they were doing up until late last month) and sell low, as seems to be happening right now (even some Evergreen clients are hitting the panic button this week).

It's also fair to wonder if 4.6% per year was worth all of the debt creation, share buybacks, and frenetic stimulus that has been done to keep the market show on the road. Certainly, during outright panics, like 2008 and now, massive liquidity infusions are reasonable. But the addiction to constant Fed rescues during even mild corrections and/or economic hiccups, has created a dangerous dependency – not to mention the premature and unnecessary depletion of vital remedies, such as enough room to cut interest rates when real trouble strikes.

To close this written-under-fire EVA, maybe you're like me and you shake your head wondering how markets could have been so complacent about the coronavirus as recently as three weeks ago. It's astounding—and actually, record-breaking—how quickly we've moved from raging bull to snarling bear market conditions. Perhaps this will end up like the crash of 1987 where the pain is intense but fairly short-lived. It's clear the Fed won't let credit markets collapse and if the CV infection rates do in fact look much better in a month or two, a 1987 repeat could be in the wings.

But in the meantime, we need to face the reality that a medical contagion has mutated into a financial contagion. For those contrarian investors, like nearly all Evergreen clients, who are extremely cash and cash equivalent heavy, it is tempting, after such a severe decline, to become close to fully invested. However, as mentioned above, we're not recommending going all in yet. It's essential for investors to retain buying power in case the market falls another 20% or 30%. Being in a position to capitalize on opportunities that present themself will certainly make it a lot easier to sleep at night in uncertain times, a respite that is harder to come by with each passing day.

*The gap or yield premium on corporate bonds compared to US treasuries; when this spread rises, it poses serious problems for stocks, corporate bonds, and the real economy.

Addendum Section on the Potential Genesis of the Coronavirus

The February 28th *EVA*, titled "The Virus Heard 'Round the World", definitely caught the attention of some of our readers. For one thing, it is one of the most "opened" newsletters we've ever run. For another, the contention that the coronavirus may have come from the Chinese military's biologic lab based in Wuhan elicited feedback varying between alarm and skepticism.

In this special section of today's *EVA,* I will do my best to both challenge and defend some of the key points from the February 28th edition. If this sounds confusing, that's appropriate because the more I dig into the coronavirus, the more perplexed I become—similar to how I feel about climate change. (By the way, I believe in climate change but that's like saying I believe the sun rises in the east, the Seattle Mariners won't make the playoffs this year—again—and that politicians lie for a living.)

So, let's get right to the issue of whether the coronavirus (CV) is, to borrow a climate-change term, anthropogenic; in other words, it was/is caused by human activity. Let me now state emphatically and unequivocally…I don't know. Since the February 28th *EVA*, I've checked in with one of Evergreen's most brilliant clients who is a scientist and long-time veteran of the biotech industry, after his return from an extended vacation. While infectious diseases aren't his area of specialization, he is nonetheless very knowledgeable in the realm. And he has serious doubts that the CV was bioengineered or that it is mutating into something more lethal as it spreads.

He's also doubtful the CV was an intentionally weaponized virus. His view is that if the attempt was to use a virus as a biological weapon, it would not only be highly contagious (which the CV is) but also that it would kill people quickly, which it doesn't. Those are certainly logical points.

However, one thing that I may not have made clear previously is that no one I've read or talked to on this issue believes it was intentionally released. To a person, they feel it accidentally escaped, though perhaps due to human avarice. Yet, this is not to say that the idea it came out of the Wuhan biologic lab is far-fetched. My opinion, which I know counts for next to nothing, is that it would be a remarkable coincidence if it did not emanate from that lab. Of all the hundreds of major cities in China, what are the odds that it incepted in a city that houses China's first and, so far, only level 4 biosafety lab? A level 4 lab is supposed to mean the highest level of caution and diligence is employed, which is vital since these facilities test and study some of the world's deadliest pathogens.

Here's a portion of the Wikipedia overview of these facilities:

> "Biosafety level 4 (BSL-4) is the highest level of biosafety precautions, and is appropriate for work with agents that could easily be aerosol-transmitted within the

> laboratory and cause severe to fatal disease in humans for which there are no available vaccines or treatments.[9]
>
> *(Skipping the next few paragraphs for brevity.)*
>
> Biosafety level 4 laboratories are used for diagnostic work and research on easily transmitted pathogens which can cause fatal disease. These include a number of viruses known to cause viral hemorrhagic fever such as Marburg virus, Ebola virus, Lassa virus, and Crimean-Congo hemorrhagic fever. Other pathogens handled at BSL-4 include Hendra virus, Nipah virus, and some flaviviruses. Additionally, poorly characterized pathogens which appear closely related to dangerous pathogens are often handled at this level until sufficient data are obtained either to confirm continued work at this level, or to permit working with them at a lower level.[13] This level is also used for work with Variola virus, the causative agent of smallpox, though this work is only performed at the Centers for Disease Control and Prevention in Atlanta, United States, and the State Research Center of Virology and Biotechnology in Koltsovo, Russia."

There are multiple level 4 biosafety labs around the world, including in the US, Canada, Europe and Russia. Clearly, these places deal with some very deadly stuff and apparently testing of the various pathogens involves animals. One of the more credible theories I've heard—and it's just that, a theory—is that a few of the exotic test animals at the Wuhan lab were illicitly sold by rogue employees. These can command high prices on the black market. Reportedly, one individual made around $1 million US selling such animals and reptiles before being arrested. Is that a for-sure fact? Not that I've been able to determine but it is plausible and it synchs with human nature.

Frankly, everyone I've discussed this with who has deep connections in China believe something along the lines of what I've described is the most probable scenario. Does that mean many others disagree? Of course, but I haven't found one yet. On a personal anecdotal basis, I shared this theory with a long-time Evergreen client a few weeks ago and he was not in the least convinced. However, his partner's sister is an infectious disease expert who lives in Asia and she told him she believes the CV did indeed come from that biologic lab.

Further, famed financial newsletter publisher, Grant Williams, who has an extraordinary digital Rolodex of contacts, is staying with my wife and me this week. He was willing to go on record saying that his network is telling him the same thing, particularly those individuals who are based in Hong Kong. He's also heard this from a woman who is considered one of the planet's foremost geopolitical experts.

Most China-centric research firms and experts are naturally reluctant to put their suspicions on this topic in print. Simon Hunt is not one of them. Simon has spent decades scrutinizing the nearly inscrutable Middle Kingdom and has cultivated extremely high-level relationships within the country. In his February 25th note he wrote: "Our theme has always been that the source of the virus was never the seafood market in Wuhan but the military laboratory there. Now three Chinese institutions, including the Chinese Academy of Sciences, published a report last Friday (*my note: presumably, Feb, 21st)* concluding that the virus was introduced outside the seafood market and began passing between people earlier than thought probably beginning in mid- to late-November."

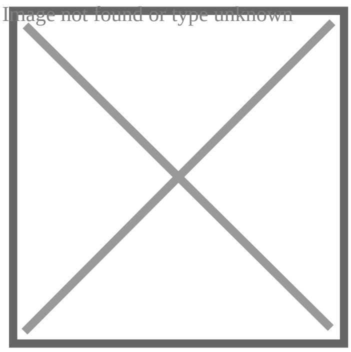
Of course, Simon could be wrong, as could be the many other highly informed people I've communicated with on this topic. However, since the CV is now totally out of the barn (or market, or lab - take your pick) there are now much more relevant questions. One of the most pressing is the fatality rate. So far, it is clearly much more lethal to older infectees which doesn't strike me as particularly surprising. But the fatality range is massive with the World Health Organization (WHO) claiming it is around 3.4% while others assert it's closer to the typical flu's mortality rate of about 0.10%. Most predictions seem to cluster around 2% to 3% but that number could be much too high if it's eventually determined, as many believe, that the infection rate is far above what has been reported thus far, both inside and outside of China. We likely won't have an answer to this vital question until many months have passed.

Another urgent query is whether it is mutating. As is the case with so many aspects of this outbreak, there are contradictory beliefs. My friend and biotech expert doesn't feel there is convincing evidence of that. However, another friend who self-admittedly is not a medical professional but who has studied the CV extremely diligently thinks it has. He was quoted without his last name in the February 28th EVA and his response to my question on whether he believes it has mutated and also that it has some unnatural features is below:

"It seems highly likely (*that it is mutating*).   The genetic make-up of the main virus strain looks highly suspicious—why does it contain DNA strands of the HIV virus? How does that happen naturally? Also, note that the virus continues to mutate. Several different versions of it are now active, and it seems the one that emerged in Italy and Iran is particularly contagious and deadly." This may explain why Italy is almost fully locked-down now.

(For those who want to dig deeper into this topic, please use this link to video presentations by Chris Martenson, an acclaimed pathologist.)

As I wrote above, this is an extraordinarily murky subject right now but I'm taking solace in the fact that most people who contract it have mild symptoms and even those hit harder almost always survive. My main concern from a medical standpoint is that we may see the healthcare systems in the US and Europe strained to the breaking point over the next two months. Here's rooting for the optimists!



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