

The Corona Effect

Note: Louis Gave has an equity ownership in Evergreen Gavekal and is the founder and CEO of Gavekal Research. Louis' views and opinions are his own and are not necessarily the views of Evergreen Gavekal.

With offices around the world in North America, Europe, and Asia, Evergreen and its partner firm Gavekal have boots on the ground in some of the places hit hardest by the Coronavirus. This gives our firms a unique picture of how the virus is impacting businesses, societies, and markets.

Earlier this week, nearly 500 people joined a live webinar where Tyler Hay, CEO of Evergreen Gavekal, and Louis Gave, CEO of Gavekal Research, discussed the long-term impact of the Coronavirus. The session also included a live Q&A, where listeners were able to pose questions to the team. Due to high demand for a replay of this webinar, we are presenting a condensed transcript on five fascinating topics that were discussed:

1. The impact of the pandemic on global supply chains and how transportation, hotel, and casino companies will fare
2. ETFs and whether they will be a good investment vehicle moving forward
3. The impact of coronavirus on real estate and the potential tailwind for consumer-based tech stocks
4. Current events and whether they will lead to a period of inflation or deflation
5. The Fed's money-printing binge and whether it has set a near-term floor for stocks and corporate bonds

We've also provided a replay of these topics below for those who would rather listen to a recording of this discussion. During these challenging times, if you or your family feel like you could use guidance on how to navigate markets, please consider taking our [client compatibility survey](#) to get in touch with an Evergreen financial advisor. Please continue to stay safe and healthy and let us know if there's anything we can do to help.

Tyler Hay: How many companies are rethinking their supply chains and are we going to move from a period of vast globalization to increasingly domestic supply chains? Also, it seems like transportation, hotels, and casinos are some of the hardest hit industries by the coronavirus pandemic. What's your opinion on how long it will take for some of these industries to recover?

Louis Gave: I think the question around global supply chains is already a big focus of the US presidential campaign. The arrow in President Trump's quiver is to say that this all happened because China is an untrustworthy partner. There's going to be tremendous pressure on industries coming out of this to reduce their exposure to the international supply chain.

I wrote a piece at the beginning of this crisis called "Exponential Optimization." I think that if you look at the past decade, we've lived in a world where everything has been optimized as much as possible. That includes optimizing balance sheets, share buybacks, and portfolios; but it also meant optimizing the supply chain. If that meant businesses could find a producer in the middle of Wuhan, China that would produce goods cheaper than alternatives, then they would do business there. Of course, the idea of producing things in Wuhan might no longer seem like the

best idea.

One of the first things to look at when constructing a portfolio is how much government pressure will be placed on a business to produce at home rather than in China, which will undoubtedly impact margins. Take healthcare as an example. We live in a world where 90% of antibiotics are produced in China. Is that something that the government will feel comfortable with going forward? My guess is that drug companies around the world will be told that if they want to sell their drugs somewhere, they have to be produced at home without regard to cost. We can't live in a world where all of our drugs are produced somewhere else.

We had a 30-year stretch of globalization in the supply chain, but it turns out that finding the cheapest producer actually has an embedded cost that we weren't recognizing. Now that we're recognizing this cost, we're finding out that it's actually really, really high. I think there will be big disruptions to the global supply chain and people will probably want to invest in companies that aren't going to be massively dislocated from needing to relocate their supply chains.

Regarding transportation, hotel, and casino companies, it's fairly obvious that business travel is going to be negatively impacted by the coronavirus pandemic for years to come, so I wouldn't want to be long airlines or hotel groups. However, I am long casinos and I've started buying them over the last couple of weeks. The reason I've started buying casinos is that we're all the fruit of our own experiences. In China, the government responded to the 2008 crisis through massive fiscal and monetary stimulus. Well, at the time it felt massive, but compared to what the Fed has been doing in recent weeks, it's actually quite small.

What China tried to do was push as much money out into the system as quickly as possible. But, what happens when you do that is that a lot of money falls into the wrong pockets. And when money falls into the wrong pockets, one of the first places that money goes is to casinos because casinos remain the easiest place to recycle money.

Fast-forward to today, and the US budget deficit is going to reach \$4 trillion. The US government is trying to shovel as much money into the system as possible and you're already hearing stories about how some of that money is falling into the wrong pockets. Some of that money will end up in Las Vegas and Atlantic City because casinos remain the simplest way to clean and recycle money.

One of the biggest concerns when you see a huge surge in government spending such as the one we've just seen is that you get a surge in corruption. Casinos always do well when corruption goes through the roof.

Tyler Hay: One thing I would add is that since gambling has been legalized in many states, there is a shift to online gambling and the ability for people to gamble without having to physically go to a casino. So, I agree, there are some interesting ways to play the gambling theme.

Let's switch gears a little bit and talk about the overall investing landscape. Over the past ten years, the S&P and Nasdaq ETF have been a good place to invest. Do you think that buying ETFs and ignoring individual stock and country selection is the way of the future or are we heading towards something different?

Louis Gave: It's a very interesting question. First-and-foremost we have to acknowledge that the idea that markets will always remain liquid, constant, open, and reliable is embedded in the

very idea of ETFs. The reality is that during this crisis we've started to see this isn't always the case. For example, the BND Vanguard ETF – the biggest bond ETF out there – has been viewed as a decent place to hold capital. But, if you thought you'd buy BND and sell it when the stock market dipped, what you found during the recent crisis is that BND traded at a 3.5% discount to its net asset value (NAV) because markets were completely dislocated.

Also, ETFs were developed that got more-and-more complicated and less-and-less appropriate for retail investors – who ETFs are meant for. As an example, you are able to invest in ETFs that track the inverse of volatility. Why a retail investor would need that is beyond me. ETFs were also created around things that were fairly illiquid like junk bonds, and things that shouldn't have been ETFs in the first place like commodities. In this crisis what you've seen is the failure of a number of ETFs. If you were a bull on gold miners, you might have bought the leveraged gold miners ETF. That ETF is trading at about one-third of its value since January, while gold mining stocks are making new highs every day.

The point I'm making is that investing is a hard business with some of the smartest people in the world working in the field. It's tempting to think that you'd be able to pass on important decisions to a computer and that a computer would work out great over the long-term. The reality is that passing on decisions to a computer will not return the outcome you want or need over the long-term. Instead what ends up happening is that computers make assumptions that might work most of the time, but for the 1% of the time where the assumptions are wrong, then the end-result is devastating. Of course, you never know where lightning is going to strike and in the future it might strike elsewhere.

I still believe nothing replaces working hard and thinking through your portfolio. This approach might not give you the best result at any one time, but the idea of managing money is partly to protect your downside risk, which is a very hard task to outsource to a computer.

Tyler Hay: As companies come out of this pandemic and reevaluate how they operate, what are some of the implications? For example, are companies going to look at their workforce and ask if they need as many people coming into a physical location? Also, what types of companies are best positioned to emerge as beneficiaries of this pandemic? Do tech companies with a virtual workforce that sell digital products have an advantage?

Louis Gave: It's a very good question. We've never been through something like this so we have to keep an open mind as to how things will evolve. What seems pretty clear to me is that we will see much more government interference and regulation across broad sectors of the economy. The first thing people should do is to look at the different sectors in their portfolio and ask the question, "How much government interference is there going to be in this particular sector?" Frankly, I would shy away from sectors where governments will come in and interfere a lot. An increase in the weight of government very seldomly increased the returns on invested capital for a given sector.

If you look at real estate, the government is telling landlords not to kick people out because they haven't paid rent. That's going to make it harder to kick out tenants that basically stop fulfilling their end of a contract. I think real estate is one of the sectors where you could have big question marks. Utilities is another one. If you're a utility company and somebody doesn't pay their electricity bill, will you be allowed to cut their electricity or is the government going to come in and tell the utility company they have to keep providing electricity even if they don't pay their bill? Healthcare is another obvious one where you're going to see much more government

interference. I'd much rather be involved in sectors where the level of government interference is going to be modest.

To your point, tech stands out as one of those sectors. If you're buying software from Salesforce or Adobe or Microsoft, does the government have a good reason to come in and tell you what software to buy? It doesn't seem obvious and shouldn't be an immediate priority. The challenge is that a lot of tech businesses rely on sales to small- and medium-sized businesses where there is going to be a lot of pain. Personally, I'd rather be exposed to tech businesses that deal directly with the consumer.

Tyler Hay: A key debate that's emerging is whether we are headed into an inflationary or deflationary period. Where do you stand on this topic?

Louis Gave: As a firm, Gavekal has been firmly in the deflationary camp for years and years. The reason for this is that every shock to the system was a fundamentally deflationary shock in that it didn't really reduce supply – in fact, it often increased supply – but it did destroy demand. If you take the 2008 crisis as an example, we saw Quantitative Easing (QE) 1, 2, and 3, and a lot of people made the case that this was going to lead to a massive inflationary problem. But what people missed is China's response to the crisis. It went on a capital and infrastructure spending boom such as the world has never seen. Up until 2008, if you were producing in China that meant you were either producing in Shenzhen or Shanghai. The production base for China was actually relatively small at that point. After the huge infrastructure spending boom China went through in 2008, you could produce in many other cities in China. The 2008 crisis resulted in nearly 500 million Chinese workers joining the global economy, which was a fundamentally deflationary shock. At the same time, oil prices were at \$150/barrel and companies were pouring into new production all around the world. As money poured into energy infrastructure, oil prices came down over the next several years and today we're much, much lower. Of course, the current economic hit means a destruction in demand, but the big question today is what happens to supply. What I see in the energy space is capital spending being slashed, so if I'm projecting three years down the road, I don't think there will be an increase in supply of energy but a deterioration in the supply of energy.

Similarly, I don't think that there will be an increase in the supply of workers. I think that the world will turn their backs on the Chinese workforce. Instead of bringing a supply of 500 million workers to the global economy, we're going to be pushing them back. So even though I see a destruction in demand, for the first time in quite a while, I also see a destruction in supply. In fact, this entire crisis is really about a destruction in supply. We're now seeing it in industry after industry.

My big fear is that if you look at the TIPS market (Treasury Inflation-Protected Securities), it's now projecting inflation of 1.1% every year in the US for the next ten years. Aside for 2008, the US hasn't had an inflation rate of 1.1% in the modern era. Now we're supposed to have 10 years in a row?

Right now, the rate of inflation is 1.5%. What happens over the next six months if, instead of going to 1.1% as the market anticipates, inflation goes to 2.0% or 2.5% as the result of supply chain disruptions? I think that would create a whiff of panic in the markets. I'm much more afraid of inflation that's not priced in, than deflation that's fully priced into markets.

Tyler Hay: As a firm, Evergreen was positioned defensively heading into the Coronavirus

pandemic. While nobody knew that the pandemic was coming, being positioned defensively worked to our advantage because it allowed us to step in and buy while others were selling.

Louis Gave: Tyler, I don't mean to interrupt you, but from the moment the Coronavirus started to break out in China, I began having conversations with [David Hay] who said that he believed this was going to be a really big deal. Admittedly, my response was to tell him to stop being a nervous Nellie because there were only 3,000 deaths at the time. It turns out Dave was right.

Tyler Hay: Having great research at hand, access to the Gavekal team, and knowing about this before the mainstream media started discussing it was a huge advantage.

Switching gears, what's your take on the Fed's money-printing binge, specifically to buy corporate bonds? As an investor, do you think the Fed has put a floor on corporate bonds and equities in the near-term?

Louis Gave: What you're highlighting is today's challenge. We have two things happening simultaneously that have never happened before. The first is severe economic collapse. The other is money printing on a scale that is mind-boggling. Investors are left with a quandary of investing in companies with dismal earnings or holding onto the "don't fight the Fed" premise. I agree with you that what the Fed is doing is absolutely revolutionary and completely changes the system we operate in. What we know from the Bank of Japan and European Central Bank experience is that once you go down this path, there's no turning back. The Fed can't turn around and do something else; they'll likely be stuck doing this forever. This will create a split in our society between those who have access to Fed funding and those who don't. If you're a big company, it's great. If you're a small company, you will have a hard time accessing capital. We're already seeing this with banks. The treasury has said they'll backstop any loan to companies fitting certain criteria. The result is that banks don't want to give loans to any company that isn't backstopped by the government.

This has been my experience with China for the last twenty or thirty years. Companies that are big have access to capital and an embedded government guarantee, so they're inherently focused on getting big rather than profitable. As a result, marginal investment is not made on the basis of whether it will improve marginal return on invested capital, but whether getting bigger will result in more government guarantees. As you go down this path, you destroy competition that doesn't fit these criteria.

There is a cost to all of this. If the US government wants to guarantee anything and everything, the US dollar will become a structurally weak currency, which feeds into inflation. I believe inflation will accelerate sooner rather than later. The cost of all these promises will be paid for by the exchange rate, which will end up settling the debts you see.

Additionally, one of the things you have to consider is not just the kind of assets you own, but where you own them. If the value of the assets you own are being measured by a currency that is constantly being debased, then it might not be a worthwhile investment.

Correction from [last week's issue](#):

In the commentary that explained money velocity, the line that read, "For monetary purists/geeks, money velocity is an independent variable, i.e., it doesn't drive inflation it merely

indicates when the economy is growing faster than the money supply, indicating rising money velocity” should have read:

For monetary purists/geeks, money velocity is a dependent variable, i.e., it doesn't drive inflation, it merely indicates when the economy is growing faster than the money supply, indicating rising money velocity.

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