THE COVID-19 IMPACT ON ECONOMIES, MARKETS, & STOCKS:

THE GOOD, BAD, & UGLY ROADMAP

MONEY MORNING
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The Good, Bad, and Ugly Roadmap

Dear Reader,

The novel coronavirus, officially named COVID-19 by the WHO, is already affecting economies, markets, and stocks. What's next could be good, bad, or ugly.

Investors need a comprehensive roadmap to navigate each of the potential pathways the virus could take markets – because it's going to take them down all three roads.

Here's what you need to know.

THE GOOD

Viruses can and do "burn themselves out," according to scientists. The best-case scenario for economies, markets, and stocks is if COVID-19 burns itself out in the next few months without any significant increase in either infection or mortality rates.

And according to John Nicholls, a professor of pathology at the University of Hong Kong, we might just know when the virus will become inactive.

Following Nicholls's remarks in a leaked transcript from a conference call organized by Hong Kong brokerage firm CLSA,

AccuWeather staff writer Mark Puleo contacted the professor for on-the-record commentary. Nicholls said he believes weather conditions will be a key factor in the collapse of the virus, as they were for the SARS outbreak from 2002 and 2003.

"Sunlight will cut the virus's ability to grow in half so the half-life will be 2.5 minutes and in the dark, it's about 13 to 20 (minutes)," Nicholls said. "Sunlight is really good at killing viruses."

Nicholls noted the virus can remain intact at 39 degrees Fahrenheit (4 degrees Celsius) to 50 degrees (10 Celsius) for longer periods of time. "But at 30 degrees (86 degrees F), then you get inactivation. And high humidity – the virus doesn't like it either," he said.

As the seasons change, Nicholls believes that "…it will burn itself out in about six months."

Whether the virus burns itself out or is effectively contained in the coming months – to be evidenced by slowing infection rates worldwide, most importantly in China, South Korea, Iran, and Italy – markets would likely experience a "V-shaped" recovery.

Jeffrey DeMaso, director of research at the ***Independent Adviser for Vanguard Investors*** newsletter looked at 55 days over the past 33 years when the S&P 500 has fallen by 3.5% or more in a single day (as it did in last Thursday's 4.4% plunge). He found that, following 45 of those plunges, Vanguard's S&P index fund has been up an average of 20% a year later.

That's what a V-shaped market recovery would look like.

If the virus "burns itself out" or containment effectively stems its spread, then delayed demand, "pump-priming," reconstituted supply chains, and ramped-up production would energize global economic growth.

Economies whose trending GDP growth had been positive or moderately declining prior to the virus's impact would likely experience V-shaped recoveries, and countries whose trending GDP growth had been falling, or moderately negative, could expect to see U-shaped recoveries.

Equity markets would quickly price in prospects for a robust rebound in global growth.

That's as good as it could get.

So plan on raising cash and using the gains from short positions and put options profits (which you'll read about in the bad and the ugly) to buy beaten-down names, in particular all the names that get beaten up the most, including oil companies, airlines, banks, and especially tech stocks.

Just not yet.

The sell-off could get uglier before it gets better.

THE BAD

The bad news is COVID-19, besides spreading in Northern Hemispheric countries under late-winter conditions, is spreading in equatorial and Southern Hemispheric countries in late-summer conditions where skies are already sunny and temperatures are high.

As of March 4, 2020, 87 countries and territories reported 96,954 cases and 3,310 deaths from the novel coronavirus. New nations to report infections include Southern Hemispheric countries Argentina and South Africa.

And while the latest news out of China is that infection rates there are slowing and the epidemic has "peaked," investors rushing into

beaten-down stocks might want to remember Chinese officials declaring similar progress the weekend of February 1, 2020, which led to a 4.6% rise in U.S. equities in just two weeks… and was followed by Chinese news on Saturday, February 15, 2020, acknowledging 15,152 new cases and a single-day death toll of 254.

Equity markets in the U.S. "corrected" in record time.

Two weeks after the three major U.S. equity benchmark indexes reached all-time highs on February 12, 2020, the Dow Jones Industrial Average fell 12%, the S&P 500 fell 11.49%, and the Nasdaq Composite fell 11.49%.

With Chinese factories now being prodded to re-open to get economic growth back on track, any "boomerang" effect, where anyone who left China and returns with the virus, or anyone who contracted the virus outside China reintroduces the coronavirus back into the country and the labor pool, risks shutting down factories and cities… again.

Investors have been focusing on the coronavirus's direct impact on volatile markets and not the virus's direct and indirect impact on economic growth or corporate fundamentals. That's bad.

Economic growth is predicated on demand, first and foremost, and secondarily on companies' ability to source, manufacture, and supply goods and services.

Demand destruction is worse than investors realize.

Occasionally, rebounding equity markets reflect investors' hopes and expectations that delayed demand will power both corporate revenues and profits higher once the epidemic has passed or been contained.

But markets rallying after dramatic sell-offs isn't proof of anything related to demand or supply functions. Rebounding equity markets only reflect investors' bets that the crisis is containable.

Investors counting on a rebound in aggregate demand aren't discounting the amount of forgone demand that will never be made up. They aren't discounting what effects a spreading virus will have on the demand over time or how the virus will change demand dynamics.

More chillingly, investors aren't discounting how current and future demand destruction will affect corporate sales, revenues, earnings, profits and losses, supply chains, cash flows, debt servicing, and capital expenditures.

In other words, as bad as equities have been hit, the worst may be yet to come.

To play this, you should start thinking about shorting benchmark index ETFs or buying puts on the biggest, most-liquid index ETFs, like **iShares Russell 2000 ETF (IWM)**, **SPDR S&P ETF Trust (SPY)**, **Invesco QQQ Trust (QQQ)**, and **SPDR Dow Jones Industrial Average ETF Trust (DIA)**.

THE UGLY

Demand destruction is already impacting cruise lines, airlines, auto rental companies, hotels, restaurants, travel booking companies, theaters and movie exhibition companies, shipping companies, and oil and gas exploration, producing, refining, and pipeline companies, just to name the most obviously impaired industries and sectors.

What investors aren't focusing on, because they're focusing on equity market dynamics and not corporate economics, is what

impact and to what extent lost sales and revenues from demand destruction are having and going to have on corporations' capital structures.

The market sell-off that began in mid-February reduced the equity value of U.S.-listed companies by $4.5 trillion. Investors see that as a market impact.

However, equity impairment is more a function of corporate economics and a company's capital structure than a market-event repricing of stockholder wealth.

Hundreds of public companies and thousands of private companies whose equity capitalization supports their ability to raise, roll over, and service debt will struggle to meet debt covenants and refinance themselves as the equity component of their capital structure continues to decline.

We saw in 2008 what equity decimation did to banks' and investment banks' capital structure. Falling share prices rendered all the country's too-big-to-fail banks and biggest investment banks insolvent because equity capital is included in net capital calculations and as "reserves."

Lower interest rates aren't going to lift equity prices or benefit leveraged companies whose declining sales and revenues won't be enough to meet debt service requirements.

While bond investors, reaching for yield, have been plowing money into high-yielding debt instruments, leveraged loans, and bond ETFs for a decade now, their appetite for further investment in increasingly leveraged companies, no matter what yield prospects are, is going to be increasingly guided by the hoped-for return of their capital as opposed to return on their capital.

"There can be a self-fulfilling prophecy here," says Christian Stracke, global head of credit research at Pacific Investment Management Co. in Newport Beach, California. "These companies really do require confidence, and if you have a mix of market volatility with unexpected fundamental weakness, then that could create a much more difficult situation than investors are expecting."

All of this means that when markets do turn, and they've only started to turn, investors may be in for a rude awakening.

According to ***Bloomberg***, "The bonds they own may end up being worth less than they expect. Companies may find that the lines of investors clamoring for their debt may not be there the next time around. And if panic ensues, regulators who have been laser-focused on preventing another meltdown in the banking sector will suddenly have a new group of shadow lenders to worry about."

Markets are just starting to reprice equities; that's not the bad news. They'll reprice them more dramatically as companies' and countries' true leveraged levels are exposed.

Frighteningly, the most leveraged, overvalued, and potentially destructive entity in the world isn't a bank or a company. *It's China*.

Right now, the Chinese economy is leaning over the same kind of precipice the United States and global financial institutions looked over and almost fell into in 2008.

Giant, systemically important, Chinese state-sponsored companies, the country's giant state-sponsored banks, provinces, municipal and local governments, and virtually all public and private companies in China are all leveraged to each other against bank loans, shadow bank loans, mutual fund-like loan products, borrowed money from leveraged companies who take out loans to

capitalize loans they pool together to earn interest on, to domestic consumption sales and exports that are imploding.

China isn't just the epicenter of the novel coronavirus, it's the epicenter of what's shaping up to be a global depression if COVID-19 keeps spreading and global economies start contracting.

Investors should sell their airline and cruise line stocks, and either short-sell or buy out-of-the-money puts on names like **Carnival Corp. & PLC** (CCL), **Royal Caribbean Cruises Ltd.** (RCL), **Delta Air Lines Inc.** (DAL), **JetBlue Airways Corp.** (JBLU), and other major carriers and cruise companies.

Oil companies are another ugly opportunity. Shorting oil and gas exploration and production and pipeline companies or buying out-of-the-money puts on stocks like **Exxon Mobil Corp.** (XOM), **Total SA** (TOT), **Marathon Oil Corp.** (MRO), **ConocoPhillips** (COP), **Transocean Ltd.** (RIG), and **TC Pipelines LP** (TCP) will yield big gains as the price of oil falls on demand destruction and over supply.

Sincerely,

Shah Gilani

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