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TIME: 21:09

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MICHAEL CEMBALEST: Good morning. This is the early-March Eye on the Market podcast. This is Michael Cembalest. What I'm going to do today is give you a brief update of all of the topics we've been covering in both the Eye on the Market and in the webcasts we've been holding for clients, where you get to dial in, and I spoke for about an hour and presented information you could see on the webcast in charts.

So let me get started. Well, as we wrote in the outlook, we felt this was going to be a year of a very small, modest recovery in profits and economic growth, but valuations weren't really set up for any kind of a shock. We didn't think we'd see an inflation shock, we didn't see, think we'd see any further trade shocks. We thought we might see a political shock in the U.S., but what we did not anticipate was a global virus shock of this magnitude.

Right now, the supply chains around the world are pretty stressed out, worse than they were right after Fukushima. You've probably seen everywhere the data, showing that the infection rates in China have crested and are falling throughout China with the exception of inside Hubei itself, which is the epicenter.

Two things. One, there are questions about the validity of that data, which I understand, and, second, even if that's true, that has come at an incredible economic cost, the likes of which I can't remember ever having seen anywhere. If you look at coal consumption, railway traffic, home sales, transportation hubs, box office revenues, restaurant receipts, and things like that, they're all down anywhere from 20% to 50% to 60% versus normal levels. So the kind of lockdown that China has imposed upon itself is going to be enormously painful for China and reverberating throughout the rest of Asia, even if it is, does turn out just to be for a quarter or so.

And now, as you all know, the infection rates are rising outside China, where, historically, there are not too many instances of quarantines, contact tracing, and things like that, which I'll touch on a little bit later. But the bottom line is that if you look at the slope of the infection rate outside China, it's a little bit slower, but similar enough to the acceleration in terms of the infection rate within Mainland China, just lagged by about a month.

The important thing to keep in mind here is to slow these outbreaks—and I've spent more time talking with virus scientists than I ever thought I would, including reading articles in something called the Journal of Hospital Infection, which, believe me, is not a fun read. You can aggressively isolate infected individuals, but unless you also trace their contacts that they had before getting sick and isolate those people as well, you probably won't be able to effectively control an outbreak.

And we have a chart here in, that we've had in the Eye on the Market and also in the webcast deck, that shows you different scenarios in terms of how many outbreaks you can control based on reproductive numbers and percentage of contacts traced and isolated. And the speed with which this particular virus travels makes that kind of exercise even more difficult. So there are real questions about the ability of western societies to engage in the kind of contact tracing and economic shutdown that we've seen in China.

You probably are well aware now that the vast majority, in terms of the concentration of mortality rates, are people over the age of 70 and/or people with severe preexisting conditions. That's well known. The other thing I think, we'll see, but China is uniquely bad amongst all the countries in the world in one way, which is it has the highest combination of bad air quality and high cigarette-smoking rates. So the mortality rates globally are about 3.5%, obviously, very heavily weighted by China. I have reasons to believe that that number may be substantially lower outside China for reasons related to not just healthcare system quality, but also lower levels of smoking and

better air quality, which means that most other populations are not nearly, don't nearly have as much compromised lung capacity amongst the elderly population.

I will say this. This whole episode has raised questions about the right risk premium for investing in China, particularly as MSCI and Barclays think about making huge additions of China to global benchmarks. And there are some articles that we cited here. One of them was called, "Coronavirus and the Blindness of Authoritarians," in the Atlantic Monthly, that's definitely worth a read, "How China's Incompetence Endangered the World," Foreign Policy magazine. You get the point. I think there are some real questions here on a long-run secular basis about the risk premium that you'd pay for Chinese assets given what we've now learned about this episode.

We've got a whole bunch of data in here that's pretty straightforward on why the economic reverberations would be greatest inside China, and then, secondarily, in Asia, much less in Europe and the U.S. But that's looking at the shock from the perspective of its impact, of the China shock, on the rest of the world.

We're now grappling with the fact that we may have a virus shock within Europe and within the United States. And over the last 48 hours, I've been involved in discussions with our own company and other companies in terms of travel restrictions and all sorts of other things that will have cascading effects on both services and manufacturing.

I think, at this point, there's a few things to keep in mind. First, the history of pandemics, whether it was the original SARS virus, the swine flu, bird flus, Eboli, MERS, you have an economically, and with respect to equity markets, you have a drawdown in a certain quarter. And then within one or two quarters, you start getting a payback to above trend growth. And by the time you're six months out, growth and equity markets are kind of right back where they started from and growing at whatever trend they were growing before the pandemic hit. So that's the pattern.

I think that pattern will be maintained this time. I don't think there's going to be a lasting output shock on the world from this, but I do think that the depth of the shock and the length of the shock may be much longer than things that we've seen in the past because of the impact on so many different sectors in so many parts of the world. I don't think we're dealing with anything that will have lasting effects in 2021 and 2022 and beyond, but there's going to be a fairly big shock in 2020 to both growth and earnings.

One of the more important charts that we put in here was how should we measure what's being priced into equity markets? And one of the charts we have looks at that. To us, it looks like this year's earnings, based on the market decline so far, are expected to decline about 50% in both the U.S. and Japan and Europe. And that seems like a pretty big number if you assume that the shock is all felt in this calendar year.

There are some other silver linings here, which is that the manufacturing sector and the wholesale inventory, and the wholesaling sector had inventory ratios well above normal heading into this, so they've got a buffer in terms of their supply chains. In contrast, both retail and computer, electronics, more broadly, have very low levels of inventory compared to the past relative to sales. And so it's a little bit of a mixed bag, but at least parts of the U.S. economy have some cushion against a decline in intermediate goods imports.

And the other thing we look at—and, I think, most of our clients were surprised about this when I've shown it to them—is that if you look at reliance on China by industry and you look at intermediate goods imports from China as a percentage of all the intermediate goods that you use both domestic and imported, only electronics, that number's about 20%. The rest of the sectors are 5% to 10%. So, in other words, 5% to 10% of inputs, intermediate goods inputs, by sector come from China; the rest either come from some other import counterparty or are produced domestically.

And so there are times when I think people overestimate the impact of a Chinese supply chain shock on the United States. Obviously, for certain companies it's bigger than others. But this level of China dependence on inventory levels may act as something as a buffer for the next couple of months.

From a scientific perspective, I've been doing some interesting reading on the impact of changing seasons on virus transmission rates. So, for example, the SARS virus in 2003, when temperature rates went up, the infection rates went down. Now, there are a lot of other changes taking place from March to May in 2003. They were improving healthcare delivery, they were changing hospitalization rates, they were giving doctors better medical equipment and more disinfected

gowns, and so a lot of things were happening. But there's a lot of science that shows, there's a lot of research that shows that viruses like the flu and SARS slow, the infection rates drop really sharply as temperatures go up, as humidity goes up, and as you have higher levels of solar radiation.

And one way of thinking about that is that in colder weather, a lot of these disease particles can travel longer distances and survive for longer periods of time than they do when you have warmer, more humid conditions. And with respect to solar radiation, UV radiation is very well known to kill all sorts of surface viruses and bacteria. As a matter of fact, one of the more interesting businesses I've seen are companies that make these UV radiation robots that travel around high school gyms and hospitals at night when the rooms are empty and sterilize everything.

So I do believe that, at least as we head from the end of winter into the spring and the summer, there should be an organic decline in the rate of infection, at least in the northern hemisphere. The problem is in the southern part of the southern hemisphere, you're heading into their winter in June, July, August, and it's possible that the infection rates pick up there.

And one last thing on potential impacts. There's an enormous difference in the global financial system, and in particularly, the U.S. from 2007. And some of the charts we have in here show much higher capital ratios, higher liquid assets as a percentage of short-term liabilities, much less repo usage by financial intermediaries.

In the United States, banks have way more retail deposits than they have loans. So they have more than 100% coverage of their loan book with sticky deposits. That's very different from where the U.S. and Europe were in 2007, where there was a whole lot more wholesale banking that was at risk of having a run. There's been also a sharp decline in the risk in money market funds based on money market reform. And so there's been improved underwriting in securitization, for instance, commercial mortgage-backed securities.

And so, to me, the risks in the financial system, in terms of its ability to absorb this shock, are much improved. And a lot of credit goes to Tim Geithner and his team, who were the ones that insisted on all of those things, at times over the objection of the banking system back after the crisis in 2008.

So, to sum up a lot of work that we've been doing here, the markets appear to be pricing in a pretty sizable shock in terms of both economic growth and profits in 2020 from this virus. And if we do get any kind of a vaccine or an organic, a cresting of transmission rates within the next month and a half, you, I think, we would then, in the summer, in the late spring/early summer, find ourselves on the other side of this with people looking forward and taking a fresh look at how to value financial assets from there.

Just as an aside, there was a vaccine that was developed for the SARS virus. It was developed after they didn't need it anymore because the virus faded by late May 2003. But they were able to find the antibody necessary to create a vaccine for SARS. This new coronavirus COVID-19 is not the same as SARS, but it does share roughly 80% of the same underlying characteristics. And so a lot of the scientists that we've spoken with suggest that they're not starting from scratch and will be starting with pretty much of a head start in terms of trying to figure out a potential vaccine for the next season.

Now, until recently, we've been looking at the Democratic primary, because there is a double-whammy risk this year for financial markets investors, because the first risk was the impact of the coronavirus and the second risk for investors was that the markets would begin to price in a substantial possibility of the following scenario. Now, there's a lot of if's here, but just hear me out.

Scenario one. So, step one, Sanders wins the presidency. Step two, Democrats retake the Senate by a small margin. They pick up three or four seats, plus they have the—if Sanders won, they'd have the VP seat for a tiebreaker. And third, and perhaps more importantly in this whole food chain of ideas, the new Senate majority leader, which is expected to be Chuck Schumer, has, it has been suggested to him that he kill the filibuster. And just to be clear, without the filibuster, major legislation could be passed with a simple majority instead of by 60/40. So, look. Anything can happen, but, as financial market investors, that is a risk that was starting to be priced in and still exists even after the results of Super Tuesday.

And I just, I want to be clear about something because it's very hard to have these discussions. It's always been hard to have these discussions, but it's even harder now.

With respect to the progressive agenda that we've written a lot about, its supporters can't have it both ways. You can't support an agenda which involves major restructuring and reordering of multiple sectors of the U.S. economy, whose largest companies have been driving stock market returns, without people like me saying, Well, I then have to reprice those financial assets in light of those policies.

I'm not commenting on whether I think those policies are good or bad, or whether I agree with them, or whether I would support them, or whether I wouldn't support them. All I'm doing is saying, Well, therefore, if Policy X, Y, and Z are implemented, it has the following impact on this financial asset price.

And so, as we talk through politics, starting now through to the end of this year's election, I'm hoping that everyone understands that people like myself are in the position of having to evaluate things like, well, if we're going to raise corporate tax rates, that's going to affect valuation of corporate cashflows. If we decide to ban hydraulic fracturing, which accounts for 60% to 80% of U.S. oil and gas production, that's going to have implications for deficits in the dollar and imported energy, and geopolitical risk, and things like that. If we prohibit or curb stock buybacks, we're going to be inhibiting the single largest sources of demand for U.S. equities over the last few years, which has been companies themselves.

So, all of these things are about tradeoffs and the price that financial assets experience in light of those tradeoffs. And none of this is meant to be some kind of value discussion or value judgment.

And, now, of course, things look a little bit different than they did a few days ago. Most of the research I read a few days ago suggested that by the end of Super Tuesday Sanders would have a commanding lead. Biden now has, based on our estimates, a slight lead in delegates of about a hundred delegates. Remember, it takes 1,990 to win, and we think he's got something like 690, and Sanders may have something like 580. But those numbers are a little bit of in flux because it takes time to allocate these delegates after the state primaries.

The bottom line here is that there are several things that have to happen before the progressive agenda, as outlined, would impact financial asset prices, but, I think, some people go too far in assuming that, Oh, well, that'll never happen because of the Senate. You have to take a very close look at what happens with the filibuster.

And I'll leave you with two things to think about. The first is Harry Reid, who's the former Senate majority leader for the Democratic party, wrote an article last year in the New York Times, saying the filibuster is suffocating the will of the people and is advising the next Senate majority leader to scarp it, particularly if they have a chance of implementing a once-in-a-lifetime progressive agenda.

And the second thing is there was an article in the Atlantic Monthly recently that talked about how Schumer voted against the U.S. Mexico trade pact, even though 80% of Democrats in Congress supported it. And they speculated that he's concerned about hearing a primary challenge from his left in the next couple of years. And if that's the case, there could be implications for the new Senate majority leader's decision on the filibuster as well.

So, the details matter here. It does seem like, in the wake of Super Tuesday, that this is going to be a closer race and that Sanders is not going to, that markets are not going to price in a Sanders' victory quite so quickly. There's still a lot of delegates to go. Take a look at the Eye on the Market that came out today. It's got a whole bunch of charts in here, including a really interesting one for history buffs with an ideological roadmap for the ideology, the partisanship score for every candidate that's ever run for the Democratic presidential nomination in the modern era.

Okay. That's a lot longer than usual, but there's a lot of things going on. Thank you for listening, and I'll talk to you next time.

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