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Pandemic Pops the Asset Bubble

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It had to happen sooner or later. Unfortunately, it was the novel coronavirus (COVID-19) and the resultant global pandemic that finally brought our broad markets into bear territory. There were already a number of asset bubbles ready to burst before the panic accompanying the coronavirus sent markets into freefall. And as if that wasn't enough, we've seen a concurrent collapse in the price of oil. Unfortunately for junk-debt investors, oil-related companies make up a significant portion of the entire high yield debt market. Thus, the broad equity markets are now down over 30% and fixed income markets are on life support.

No one could have been expected to predict the massive reset we saw in March, which has been the worst month for investors since 1987. However, every investor should have known that the good times could not last forever. The market had charged up and rallied beyond reasonable expectations at the end of 2019 and into early 2020, and now we're in the midst of an astonishing selloff. As I write this, the State of New York where I live has implemented a mandatory "shelter in place" order which prohibits most workers from leaving their home in an effort to control the rapid spread of the virus. Similar orders are being rolled out across most states in the US and also overseas.

In case you're looking for some good news, coordinated central bank monetary policy easing has been swift and dramatic in the face of this market meltdown. In an emergency statement last Sunday, the US Fed lowered its benchmark interest rate to 0-0.25% while committing to purchase at least $500 BN of Treasuries and at least $200 BN of agency mortgage-backed securities. Over the next few days, the US Treasury provided the Fed with liquidity to purchase up to $1 trillion in commercial paper (to help stabilize money market funds) and the Fed committed up to $1 trillion per day to help stabilize the repo market! Just this morning, the Fed announced "extensive new measures" to support the economy including: $300 BN in new financing to support investment grade corporate bonds, ABS securities, student loans, money markets, commercial paper markets, and the Small Business Administration (SBA). These measures, combined with coordinated responses from other central banks globally, are extraordinary to say the least. At worst, they may send us down a path of never-ending money printing which will surely devalue the dollar to the detriment of all remaining savers.

On the fiscal policy front, the Trump administration and US lawmakers have announced numerous measures including: student loan interest relief, filling the US oil strategic reserve tanks, SBA relief, mortgage and rent relief, sick pay and family leave relief, as well as deferred tax payment relief. In addition, Congress is currently negotiating with the Trump administration to pass a massive ($1 trillion +) relief law which promises to provide stimulus checks to nearly every American as well as targeted relief for certain industries and companies. Of course, Washington lobbyists are salivating at the prospect of packing in goodies for their favored companies in this legislation so we'll have to wait to see the final details of whatever package is ultimately approved.

Now, as social gatherings are banned across the US and an ever-growing numbers of employees are forced to stay home, there's bound to be widespread economic damage. Although the exact level of recessionary contraction is uncertain, reasonable estimates include a drop in GNP of 30% in Q2'20 along with sky-rocketing unemployment. The hope among economists is that growth may return in Q3'20 if the virus medial emergency can get under control by then and pent-up demand can be released.

With modern technology, people in many fields can work at home. This helps contain the virus spread but when those people stay home they don't go to restaurants for lunch or stop to put gas in the car. And many people can't work at home because the businesses they work in — airlines and cruise ships, theaters, concert halls and sports arenas, restaurants and hotels, brick-and-mortar retailers – don't exist without public interaction. Many of the workers in those fields are hourly employees who don't get paid when they don't work, which means that they in turn have less money to spend, further contracting the economy as firms that rely on that spending see revenues contract. The impact from closed schools, colleges, gyms, and other businesses is similar and the knock-on effects from the resulting financial distress among the companies that previously relied on these customers could put our entire economy in jeopardy.

Undoubtedly, economic hardships brought on by the COVID-19 pandemic will force many firms into distress, particularly those that were already carrying excessive debt. As of this writing, the amount of distressed debt has already ballooned to over $500 billion. In addition, companies that were dependent on attracting large groups of people, such as casinos, movie theatre chains and malls, are on the brink. Companies with too much debt that operate in industries that rely on social gatherings will suffer a double-whammy while those with additional operational problems (like Boeing or those in the oil patch) have an even higher likelihood of default.

How long this crisis will last or what the ultimate price will be in human life and lost capital remains unknown. But the panicked selloff could bode well for long-term investors in companies that are financially sound, have good fundamentals and are now selling at absolute bargain prices. For example, many companies are now selling at record low TEV/EBITDA multiples (even after stress-testing projected EBITDA to draconian levels.) Moreover, some stocks in companies with pending M&A transactions are trading well below their expected cash takeout values despite a reasonably high likelihood of closing their pending deals. On the short side, numerous firms are still trading at unrealistic levels due to likely defaults on their overwhelming debt burdens – even if the US government passes an extraordinary fiscal relief plan.

In summary, a crisis like this one can present lots of opportunities for active investment managers. Although the onset of the crisis has been swift and likely caused losses for most investors, the carnage of mass liquidation necessarily means that great values will become available. Unfortunately, we entered this crisis with near record-low interest rates which had previously facilitated the inflating of an unsustainable and massive fixed income bubble. Thus, many over-levered capital structures will now be stress-tested by a massive demand-side shock and the US government may once again get involved in selecting winners and losers. For those companies that can't withstand a quarter or two of reduced revenues, their business plans (and balance sheets) were already unrealistically aggressive and they probably shouldn't be bailed out by US taxpayers. For those with important US strategic value, like Boeing or major airlines, the right governmental solution may involve letting their equity investors take complete losses while the US government temporarily steps in to provide support. We have seen this playbook before during the Great Financial Crisis when GM, Chrysler and many other major firms received US governmental support while their overly-optimistic equity holders lost their entire investment.

In any event, many good "babies" will be thrown out with the bathwater as the rapid market sell off leads to margin calls and forced liquidations by over-leveraged investors. Active managers with proven skills to navigate these new and turbulent market conditions should be able to prove their worth by digging through the carnage.