ClearBridge Investments

Evaluating Equity Impacts from the Coronavirus

A Q&A with Scott Glasser

Key Takeaways

- We cannot remember other waterfall declines coming right at new highs for the market without some notable deterioration in various indicators.
- For our U.S. strategies, the impact of the virus outbreak in China figures less on our direct investments and more on the supply chain of portfolio companies, particularly in information technology and manufacturing.
- We are less focused on how bad the next few quarters could be and instead are evaluating good long-term businesses, trying to use periods of high volatility to upgrade portfolios and add to high conviction ideas.

Volatility spiked to its highest levels in recent history in late February as fears of a coronavirus pandemic roiled equity markets around the world. The S&P 500 Index suffered a 12% correction during the month as COVID-19 cases spread well outside the outbreak's origin in China and prices have continued to bounce up and down significantly into March. We sat down this week with ClearBridge Co-Chief Investment Officer and Portfolio Manager Scott Glasser to get his perspective on virus impacts on equities and managing through a period of heightening volatility.

Markets appeared to shrug off risks from the coronavirus until the last few weeks. What caused investors to start selling?

News of the virus' spread to Italy, South Korea and the reporting of several initial cases in the United States caused investor sentiment to rapidly turn negative and sparked a flight out of risk assets. Prior to the selloff that began in earnest the last week of February, equity markets had been discounting the outbreak being largely isolated to China, leaving a limited and temporary impact. The odds of a global pandemic appeared to be set fairly low by investors. The nature of today's equity markets, which are dominated by computer programs, factor funds and options traders, further amplified the selling pressure. The leveraged quant-oriented funds don't care about company fundamentals, they simply react to price volatility, direction and volume.

Has the selloff been mostly sentiment driven or were there warning signs that markets were due for a decline?

February practically took our breath away, and the first few days of March are proving to be no less frantic (Exhibit 1). Though we had been wary of some parabolic moves in a handful of stocks, there were no important signs of overall internal market weakness. Valuations of many stocks seemed high, but it was the very low level of interest rates that enabled these valuations to remain more elevated than usual. In prior declines in which the graphs of the market looked like waterfalls, such as 1987, 2002 and 2008, there were many signs of internal market deterioration. We cannot remember other intense declines coming right at new highs for the market without some notable deterioration in various indicators.

The support from very low interest rates vanished when the coronavirus, coupled with election uncertainties, hit a critical mass with market participants. It was not just the stocks that had been bid up to very pricy levels that got hit in the hurricane. Virtually every stock was crushed, regardless of quality, yield or business model.

How are you managing through the volatility? Has the recent selling provided buying opportunities?

We are reviewing potential impacts to all of our investments on a stock-by-stock basis and will also look to take advantage of any short-term price dislocations to start new positions. Our commitment to owning self-financing companies with strong balance sheets provide us comfort that management teams will be able to continue investing in future growth during times of macroeconomic uncertainty. This advantage tends to widen the competitive distance at our companies compared to less financially stable peers.

We put some cash to work during the worst of the decline, simply because stocks were being tossed out the window. We will now watch for a bit until things settle down. We are less focused on how bad the first and second quarters could be and instead are evaluating what are good long-term businesses and do we see good entry points into these companies. We always try to use periods of high volatility to upgrade portfolios and add to high conviction ideas.

What are you hearing from companies about the near- and longer-term impact of the coronavirus on their business and those of their suppliers?

As the political and economic fallout from recent events are moving targets, we expect continued extreme swings in both sentiment and prices. Companies are still trying to get a fix on projections. The last week of February was the market's first attempt to price in the uncertainty.

For our U.S. strategies, the impact from China figures less on our direct investments and more on the supply chain of portfolio companies, particularly in information technology and manufacturing. We saw the Apple revenue warning due to delays in sourcing iPhone parts from Chinese suppliers. We are hearing from several of our software and semiconductor companies that Chinese manufacturing is operating at anywhere from 30% to 70% of full capacity, depending on the location of the plant and industry, and that it may take a couple of quarters for production to ramp back up to normal levels.

Many of our portfolio companies are reporting a single-digit impact on revenues in the first quarter, but acknowledge limited visibility beyond that as they explore: 1) the crucial role that China/APAC plays in numerous complex supply chains and inevitable second and third order effects resulting from that disruption, and 2) the pending impact on demand in the second quarter as the virus' influence spreads to the United States and Europe. We have also seen early signs of demand weakness in travel companies and expect our companies will witness further demand weakness into the second quarter.

We are long-term investors and if there is a delay in production that delays shipments that doesn't change the long-term total addressable market for iPhones, for example. We are experiencing short-term disruptions more than thesis changers.

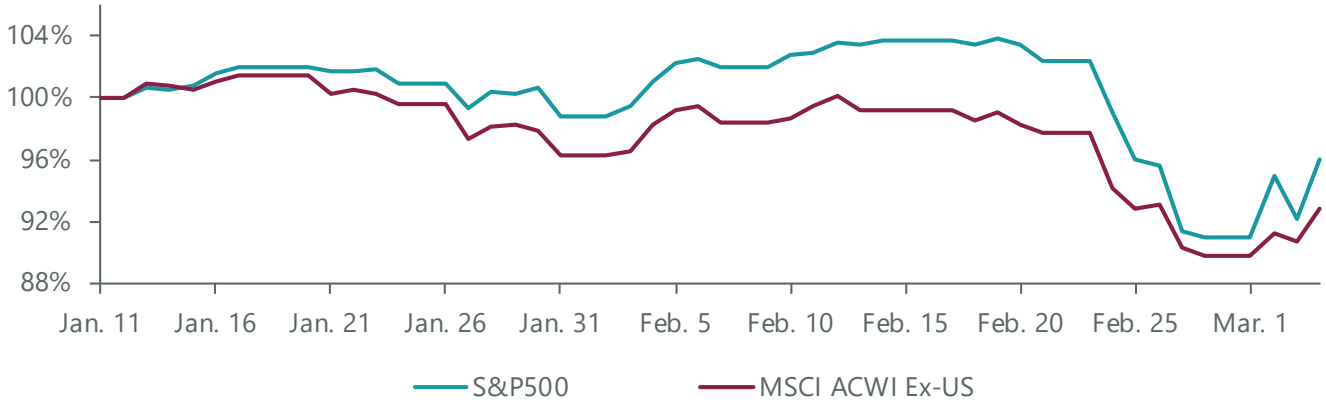
What impact could additional interest rates and other monetary stimulus have on equity markets?

Consumers around the globe could pull back if they see their hours reduced or even go unpaid as a result of the virus becoming a pandemic, to say nothing of being unable to go out and shop. Company managements may also be less motivated to make capital expenditures if they are unsure of the reliability of supply chains to produce the goods they need or concerned about end demand. We are not sure how

additional cuts in interest rates from such already ultra-low levels would make a material difference for the economy. Fiscal stimulus, particularly efforts tailored to help those directly impacted by the virus, would likely help boost near-term growth to a greater degree. Regardless, the Fed's rate cuts could act to improve or stabilize the sentiment of consumers and businesses and give them more confidence to go out and spend.

Equities initially sold off following the Fed's emergency 50-basis point rate cut this week, which speaks to the continued uncertainty about the virus and its impacts. Greater liquidity should be beneficial, but not until we have a better sense of how and when the outbreak will be contained. Global monetary policy is going to be accommodative as we see a meaningful step down in global growth over the next six months, however, we are hopeful that we will see a rebound in the second half of the year.

Exhibit 1: U.S. and International Stock Performance Since First Reported Virus Death



Data as of March 4, 2020. Source: Bloomberg.

About the Author

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- 28 years of investment industry experience
- Joined predecessor in 1993
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