

# YOSEMITE CAPITAL MANAGEMENT



## *“Those were the days!”*

Prior to the now ominous and ubiquitous Coronavirus, the U.S. economy was actually running on all 8 cylinders. As the Coronavirus (COVID-19) becomes a pandemic, we think it is important to maintain our perspective as we view the global equity and bond markets through a non-ethnocentric lens.

It appears the IMF (International Monetary Fund) has downgraded its global growth forecast for 2020 to a level below 2.9%. Given the world's densely interconnected global supply chains, the economic effects cannot be confined or contained to affected nations alone. The global economy has become focused and specialized. Consequently, what we see, is a paucity of unique parts from non-local suppliers combined with delivery and logistics challenges along every step of the development phase or manufacturing process of a product. This reduction in efficiency and productivity is evolving into a slowdown in global GDP.

Does this translate into economic malaise for everyone? The light shifts incrementally when we take a deeper dive into the health of the U.S. economy.

Nonfarm payrolls grew by a very strong 273,000 in January and another 273,000 in February. The unemployment rate was 3.5% in February and initial claims for jobless benefits were 216,000 in the last week of February. Retail sales in January were up 4.4% versus a year ago. In February, sales of cars and light trucks were up 1.9% from a year ago and were above the fourth-quarter average. This suggests that total retail sales for February rose as well.

Industrial production fell 0.3% in January, but likely rebounded sharply in February. After all, hours worked in manufacturing durable goods rose 0.9% in February and colder weather likely lifted utility output.

Housing starts have been particularly strong lately, coming in at an average annual pace of 1.597 million in December and January, the fastest pace for any two-month period since 2006. Yes, part

of the surge in home building was due to good weather, so February will likely fall off to around a 1.49 million pace, which excluding December and January, would be the fastest pace of building for any month since 2007.

The ISM Manufacturing index slipped to 50.1 in February from 50.9 the month before, but a level above 50 still suggests growth in factory activity nationwide. The ISM Non-manufacturing index, which measures a much larger share of the economy, rose to 57.3 in February, signaling strength.

Putting all of this data into their model, the Atlanta Fed recently projected real GDP is growing at a 3.1% annual rate in the first quarter. *That's not a typo.* However, March data, which isn't available yet will likely bring this number down.

Here is further context and wisdom from our partners at First Trust.

The early economic headwinds from the Coronavirus are coming from slower production in China, which likely led to a big drop in inventories. We expect this to pull first quarter real GDP down to a 2.0% growth rate and we are now thinking growth will be zero in the second quarter. After that, given previous episodes of rapidly spreading viruses, inventory replenishment should boost growth to the 3.5 – 4.0% annual rate range in the second half of the year.

This may seem optimistic, but keep in mind what happened when the “Hong Kong flu” hit the US from September 1968 through March 1969, killing around 34,000 people in the US according to the Centers for Disease Control. During the last quarter of 1968 and first quarter of 1969, real GDP grew at an average annual rate of 4.0%. The “Swine Flu” in 2009 also did not lead to a recession.

However, a much more negative story unfolded in late 1957 and early 1958 when the US was hit by the “Asian flu,” which killed almost 70,000 in the US and didn't spare younger people as much as the Coronavirus. Real GDP was growing around 3% annually in 1957, but as the flu started to peak in Q4, the economy shrank at a 4.1% annual rate, followed by an annualized 10.0% plunge in the first quarter of 1958, the deepest drop for any quarter in the post-World War II era (from 1947 through 2019).

But then, right after the plunge, the economy rebounded at a 7.8% annual rate for the next five quarters.

Before the Coronavirus hit we thought the odds of a recession in the next twelve months were about 10%. Now we think they're around 20%. Higher, but not high. There is no precedent for the first social media panic regarding the flu. Either way, here's a simple rule of thumb: if the unemployment rate goes up 0.4 percentage points or more compared to where it was three months prior then the US is probably in a recession, otherwise it's probably not. The jobless rate was 3.5% in December, so unless it goes above 3.9% soon the economy is still growing.

The bottom line is that we've had severe flus before without a recession and when we did have a downturn, the economy bounced back very quickly. The stock market is pricing in

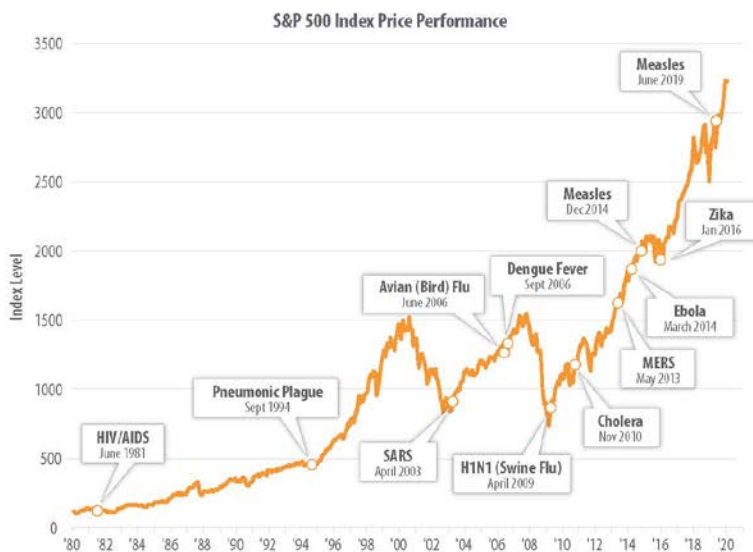
a steep drop in profits, which is certainly possible. A strong recovery, which we expect, will reverse this as it has in the past.

## Epidemics and Stock Market Performance



Since 1980

There are many factors that can impact stock market returns, but one concern of investors today is how the stock market will be impacted by a major epidemic or outbreak. Below we look at the historical performance of the S&P 500 Index during several epidemics over the past 40 years. We believe looking at the market's overall resiliency through several major epidemics can give us perspective on the benefits of investing for the long-term.



Epidemic	Date	Largest Drawdown from Peak in first 6 Mos.	S&P 500 6-Month % Change	S&P 500 12-Month % Change
HIV/AIDS	June 1981	-15.7%	-6.6%	-16.5%
Pneumonic Plague	Sept 1994	-6.0%	8.2%	26.3%
SARS	April 2003	-4.6%	14.6%	20.8%
Avian (Bird) Flu	June 2006	-3.6%	11.7%	18.4%
Dengue Fever	Sept 2006	-5.9%	6.4%	14.3%
H1N1 (Swine Flu)	April 2009	-7.1%	18.7%	36.0%
Cholera	Nov 2010	-6.4%	13.9%	5.6%
MERS	May 2013	-4.8%	10.7%	18.0%
Ebola	March 2014	-4.0%	5.3%	10.4%
Measles	Dec 2014	-3.6%	0.2%	-0.7%
Zika	Jan 2016	-5.6%	12.0%	17.5%
Measles	June 2019	-6.1%	9.8%	N/A*
<b>Average</b>		<b>-6.1%</b>	<b>8.8%</b>	<b>13.6%</b>

### Observations

- 6-month change of the S&P 500 Index was positive in 11 of the 12 cases, with an average price return of 8.8%.
- 12-month change of the S&P 500 Index was positive in 9 of the 11 cases\*, with an average price return of 13.6%.

Source: Bloomberg, as of 2/24/20. Month end numbers were used for the table on the right. \*12-month data is not available for the June 2019 measles. Past performance is no guarantee of future results.

The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Returns are based on price only and do not include dividends. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future.

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*From the Desk of the YCM Investment Policy Committee and guidance from First Trust's economic team.*

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