Michael Kass: The Coronavirus pandemic, its impact on the markets, and how we are positioning our portfolios in the current environment

This is an edited version of a March 19, 2020 Q&A with Michael Kass, portfolio manager of Baron Emerging Markets Fund and Baron International Growth Fund. To access the full recording, please dial 866-595-5357, passcode 0878808#.

Key Discussion Points

Current market conditions
Black Swan event, takeaways from non-U.S. regions, key catalysts for market stability, comparison with past disruptions

Baron Emerging Markets Fund and Baron International Growth Fund
Fund performance, China, Brazil

Post-crisis outlook
Expected impact of fiscal stimulus, shift to MMT

Current Market Conditions

- ***What are your general thoughts on the coronavirus pandemic and its impact on the markets?***

  The pandemic is certainly a black swan event. The selloff in the last few weeks is by far the most sudden and steep that I've experienced in the 30 years since I've been managing client capital. The reversal in the dollar, reversal in treasury yields, sustained higher credit spreads in March, investment grade spreads, the VIX index -- this is all sending a loud message. The unpredictability, uncertainty, and volatility around its potential effects has resulted in a heightened panic. The pandemic also triggered a second black swan event, which was Russia backing away from OPEC and supporting oil prices and supply curtailments.

  The epicenter of the problem has moved in the last week or so. It has transitioned from the virus and its economic impact to a liquidity crisis. Certainly the virus and the economic impact is significant, but I am much less concerned about that at the moment.

  Together, the two black swan events – the virus and the Russia-Saudi oil war – triggered a breakdown in traditionally observed correlations. As a simple example from our portfolios, when oil prices go down, energy companies will suffer but that decline will be offset by airlines, which input oil prices into their business models. It is a natural hedge. What we're seeing right now is not only a complete collapse in oil demand but a complete collapse in airline travel. It doesn't matter how much oil prices may drop because airlines are not benefiting.

  This breakdown in correlations is important because large leveraged investment pools, which many are saying will dominate trading in the near term, rely on long-term observed correlations across different asset classes. All of them employ a reasonable to a significant amount of leverage. As these correlations have broken down, these pools are all being forced to reduce their leverage because their models are telling them their leverage is now too high. They must reduce it. They have no choice. The pressure on these leveraged investment pools has taken over as the prevailing dominant catalyst driving the direction of financial asset prices and credit spreads in the near term.

  We know there is distress within the financial economy, because the VIX remains hovering in the 80s. I can tell you, looking at spreads on securities have become somewhat dysfunctional. Market makers are

backing away. Wall Street and banks are in a much better position than 2008. But assets have moved off bank and Wall Street balance sheets into leveraged investment pools.

Investment pools carrying too much leverage are having regulators force them to de-lever. Or to the extent it's the equivalent of a margin loan on a retail account, a prime broker is looking at the positions and saying, “Okay you've reached your limits. We are stepping in reducing your leverage.” Whatever price the market bears is what you're going to get. That’s when you see the gut-wrenching drops.

There seems to be some sort of a whale out there that is overleveraged right now. A lot of people are talking about who that might be. It could be any number of entities. Some of these entities have $0.5 trillion, maybe up to $1 trillion of total notional exposure. It’s not unlike what happened with Long Term Capital Management in 1998. On the corporate side, you've got whales as well. Companies linked to the airline industry. Large entities that are immediately thrust into a liquidity crisis.

- ***As an investor in emerging and international markets, does the way in which the pandemic is playing out in regions across the globe offer any clues as to how it will progress in the U.S.?***

My team is tracking what's happening in Europe as some of the breakouts there were three or four weeks ahead of the U.S. In many countries, the curve has already flattened or parabolic and is now coming down from a parabolic.

In China, the virus peaked at the end of January into the first week of February. Now, six weeks later, the country is 80%-85% back to work outside of Wuhan. Of course, it may be easier to do something like that in a country like China. But I think we can look at that trajectory and project that we are looking at weeks or months rather than quarters or years for the U.S. to go back to work.

In the coming weeks, we are going to see a huge ramp in testing capacity here. The mortality rate in Korea, which has the best testing program, appears to be around 0.6%-0.7%. I would say the mortality rate in the U.S. will probably closer to that figure than the 3%-4% numbers we were hearing about three, four weeks ago. We weren't getting an appropriate denominator then because we were not testing.

When we start to see the curve peak or flatten, we can start relaxing the draconian measures in place and begin talking about the slope of the return of economic activity. When that happens, we believe that the entities that had been most impaired in the recent weeks are going to experience significant recoveries.

- ***What do you see as the key catalyst or critical variables, and what do we need to see to suggest a stabilization or more orderly markets?***

To stabilize the financial markets, a series of things need to happen. First, we need to migrate from peak virus panic to looking at the likely progression and duration of the virus. We then need to focus on the duration of the economic disruption due to the virus. We need a line of sight on that for credit spreads to normalize and market distress to decline.

We also need a concerted effort by policy makers to allow an orderly de-leveraging of the large leveraged investment pools in a way that does not drive further asset deflation. The good news is that we are seeing exactly that happening. If we had had this call three days ago [March 16], I would have provided a list of things we'd be looking for, but we've checked nearly all those boxes now. I'm astounded by the speed of the policymakers’ response to the interruption to economic activity. It almost matches the scope and speed and abruptness of the decline in market activity.

Everything being put into place is highly encouraging and should provide for more orderly markets. The commercial paper conduit being rolled out by the Fed is helping address the liquidity crisis in the real economy. Providing nearly unlimited liquidity in the near term will allow for a more orderly de-leveraging by the entities that are driving asset deflation. We need to see those conduits get filled with securities. We think that we are on the verge of seeing that. Stabilizing the financial markets should allow investors to begin to contemplate the fact that not all assets should be pricing in the level of distress we are in at the moment.

- ***How is this event similar to or different from past events? Why do you think this is a Black Swan event?***

This event diverges from the traditional pattern of economic and financial cycles where usually you have a period of excessive credit growth, lax lending standards. Too much lending, too much growth, too much speculation, which leads to either asset price inflation, real inflation through oil prices, PPI, or CPI, or an overheating economy that forces the Fed to move into tightening mode. That move then triggers a slowdown and, since the Fed typically can't time it perfectly, you reach a point where it's tightened a bit too much, triggering a freeze or reversal of credit flows. This, in turn, triggers asset deflation and an economic slowdown. The question then becomes whether it remains an economic slowdown and a market correction or turns into a broader recession and a bear market.

This event is playing out in a different order. Nobody saw this coming. The coronavirus pandemic has resulted in both a near-term collapse in demand and supply and the reversal of credit conditions in a rush to liquidity. Everybody wants to be sure that they have a larger cushion of cash, given the uncertainties that we're staring at in the very near term. It's also the catalyst that led to the second black swan event, which is what happened in the oil market when Russia exited the OPEC commitment. And at the time, many or most investors were positioned or positioning for an organic reflation and an economic expansion.

The abrupt nature and scope of the decline in activity is much larger than anybody was anticipating. That is being priced into equity and credit markets. Most equities are trading based on some level of anticipated distress. Analysts are all focused on debt, working capital, liquidity, balance sheets. What is the duration of stress a company can manage under the current scenario? Not an analyst in the world is currently focused on growth potential.

Elements of this crisis are similar to what happened in 1998, when Long Term Capital Management suddenly de-levered. At the time, I was running my hedge fund and a long-only portfolio. Nobody was prepared for the shock. The LTCM crisis triggered an emerging market currency crisis similar to what we are seeing now. The ruble declined 90%. Nobody could have imagined that literally six to eight weeks after that market and financial crisis, equities would be recovering, and, in fact, would ultimately reach new highs, but that's exactly what happened. I'm not predicting that to happen in this case, but I do think it is within the range of possible outcomes, and it is one that nobody is putting any weighted probability on today. As we get closer to a shift of emphasis and a sense of duration, we should get a significant recovery rally in lots of equities, particularly those that have been most impaired.

Baron Emerging Markets Fund and Baron International Growth Fund

- ***How are you managing your portfolios in response to the crisis?***

We are stress testing all the companies in the portfolios, starting with those that we believe are more exposed. We're finding that most of them ought to be able to manage in the current situation for upwards of a year, in most cases, with a near-to-complete halt to revenue generation. That doesn't mean that it will not take some time for earnings and margins to recover. There might be some near-term impact on balance sheets because of working capital builds as well. But certainly nothing that would warrant the kind of disruption to asset values that we're seeing.

We're comfortable with the liquidity and solvency levels of our companies. Even in the case of the airlines we own, for the most part they could suffer an 80%-100% shutdown of all operations for upwards of nine months, and in many cases a year. They have the cash on the balance sheet and the liquidity to manage through that without having to draw down any incremental debt. And those are the most impaired assets we have.

Although we carry some cash, we have no leverage. If you're not under the gun of leverage, you don't want to be selling alongside sellers that are being forced to reduce exposure. So we are trying to limit our sales activity.

- ***How are your portfolios performing during the crisis?***

We are currently in line with our benchmarks and in the middle of the pack of our peer group.

As quality growth investors, we are overweight Health Care, IT, Consumer Discretionary, Industrials, and Consumer Staples in the EM fund. We are underweight Materials, Financials, Energy, Communication Services, Real Estate, and Utilities. I feel these sector weightings are the way you'd want to enter this storm.

As for countries, we are overweight China, India, and Brazil. We are underweight Korea, Taiwan, Thailand, Russia. We are zero weight Saudi Arabia, Malaysia, Qatar. With the exception of Brazil, I feel pretty good about the country weightings as well.

China Going into the crisis, we were increasingly optimistic that the trade conflict between the U.S. and China would resolve, which should lead to a pent-up demand and expansion recovery led by China and across emerging markets. Emerging market equities and our portfolios were holding up incredibly well heading into early March.

I would also add that the China domestic A-shares market, the closest proxy to domestic economic activity in China, is currently the best performing equity market in the world on a dollar-adjusted basis. The A-shares market is down about 3%-5% year-to-date, or about 7% in dollar terms. Other than the dollar, the RMB currency is one of the strongest in the world, down just a percent or two. I think those two factors have positive implications for the relative performance for EM, as China is the anchor economy and the RMB is the anchor currency for the region.

Brazil Brazil is viewed as more of a commodity country. It also bears currency risk and runs a significant deficit. The Bolsonaro administration has done a lot to drive home significant fiscal consolidation, put a fiscal spending cap in place, and make a material reduction in social security obligations. Markets caught Brazil in midstream of engaging in a massive reform effort that involves privatizations and reduction of the state's role in the economy. Although interest rates have come down significantly, if you have a shutdown, you're not going to unleash consumer spending or an investment cycle. I think Brazil is viewed as vulnerable because of its fiscal deficit, which is now under pressure due to macro-economic conditions.

Overall, we feel good about the businesses and the companies we own, the management teams we're partnered with, and their ability and thoughtfulness in managing their own liquidity.

- ***What is your post-crisis outlook for the markets, both near- and long-term?***

Near term, a combination of monetary and fiscal support – a fiscal bazooka, if you will -- is being implemented to help manage economic disruption and to meet immediate working capital and liquidity demands of businesses and individuals. When the crisis subsides, that bazooka is going to go on offense. At that time, I expect we will see a significant recovery rally in equities, particularly those that have been most impaired. When we start to see EM underperforming by less, that's a leading indicator that we're transitioning into a different environment. The fact that we are not underperforming notably year-to-date is the first check in that box.

Longer term, I think we are going through the portal into the world of Modern Monetary Theory [MMT]. Right now we have a short squeeze on dollar liquidity so the dollar is rising. When policymakers get in front of that curve, we will see substantial fiscal easing funded by central bank money printing around the world. With interest rates near zero-bound, there is not much more the European Central Bank can do. Policymakers will eventually move into MMT as a way to drive up inflation expectations and growth, protect pension assets, etc. Ultimately, this will be bearish for the dollar and positive for international and EM currencies and equities.

Entering this year, we were gaining optimism that that's where we were heading. I think now we have our answer. We're risking an asset deflation and de-leveraging that warrants going through the portal to MMT. It is a reactionary transition to MMT, but we will end up in the same place.

As this massive shift in policy maker action plays out, there is significant potential that it will be a game changer for the longer-term direction and leadership of financial markets. I think it also could bring the

tunnel of underperformance for EM currencies and equities to an end. I know that sounds hard to digest today, and unfortunately it's coming at the expense of a de-leveraging and asset deflation. But when we get to the other side of this, I think we're going to be in a world in which we will want to rethink the longer-term positioning of portfolios, whether you are talking about a broader asset mix or whether you're talking about the equity world.

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