Ep39: Coronavirus Correction

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PATTI BRENNAN: Hi, everybody. Welcome to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best lives.

Joining me today is Brad Everett. Brad is Key Financial's Chief Investment Officer, and today we are going to be talking about the coronavirus correction.

Folks, we are in a correction. It's happening right before our very eyes, and because of that, we're going to fast track this podcast, so that you get the information in a timely manner and understand the impact that it might have on your portfolio, as well, as your overall financial plan. Brad, welcome to the show.

BRAD EVERETT: Thanks, Patti.

PATTI: What are we doing? What are we thinking, and, frankly, what are we doing about it?

BRAD: I think in reality, we probably have no idea what we're doing. Every time a virus comes along, it's a new strain. It's a new strand. You start from scratch with a vaccine, and you see how it goes.

There's patterns from past viruses and past pandemics that you can hope work out the same way or even easier, but you just never know for sure. The market hates uncertainty.

PATTI: That is for sure. As you know, I was traveling last month in Australia and New Zealand, and it was very interesting in those conversations I was having overseas. They said the virus probably didn't really cause all this. It was just the spark that lit the fire.

I thought it was an appropriate metaphor, considering I was in Australia, and there was a lot of dry timber around. They hadn't cleared out the timber, and in using that as a metaphor, the dry timber for our markets was the valuations.

We were getting pricy when it comes to price-earnings multiples and valuations, so that's the dry timber, you get any little bit of uncertainty that's going to throw that spark, and voila.

BRAD: Right. I always think correction is such a funny word. That infers the market wasn't correct before, and after it's fallen, it's now correct. We don't call it a correction when it goes up 10 percent, only when it goes down.

In this case, you could argue that if we're in the middle of a momentum market, everybody was just afraid of missing out on more equity returns than maybe we have return now, whatever the reason. It just happened to be the coronavirus that gave us a little bit of doubt, and now we've returned to some kind of normal overall equity valuation.

PATTI: That's a really good point because we definitely saw the impact of last year's rise in the market, and people were feeling a little left out. Even though a balanced portfolio created a really nice double-digit return, there were some people who had been worried, moved into cash, and felt really bad that they didn't get to participate in last year's market.

Fast forward, here we are. You look at the multiples, and multiples are really about average, in long-term average for price-earnings results, so is it a correction or is it more of a normalization?

The real question and the uncertainty that we're seeing today with the 1,700-point drop in the Dow and S&P is way down, etc., is, that whole formula is based on earnings. What's going to happen with earnings, going forward?

BRAD: Sure. I think in reality, today, the coronavirus has taken a real back seat in the news to dropping oil prices, and maybe things that have a little more direct consequence on the economy that we can measure a little better.

PATTI: Let's talk about that a little bit, Brad, because everybody has their opinion in terms of the virus, and how long this is going to last, and is it going to be a multiyear issue for us, or how quickly can we get a vaccine? I thought it was interesting to hear that the composition of this particular virus is very similar to SARS. What is it, 86 percent?

BRAD: Yeah, that's the stat I saw. It's genetically 86 percent the exact same thing as SARS. I think you would hopefully argue that researchers have quite a head start on this one, so hopefully it won't take so long.

PATTI: We had a vaccine for SARS, right? There was a vaccine that was developed. It was never used though, right?

BRAD: Never needed. It ran its course, and before it was...I think part of the timing, you could have a vaccine tomorrow, but then by the time you give it the requisite number of testing and figure out a way to make 50 million doses, it takes some time.

PATTI: Yeah. Look at the problem we're having with getting the testing kits, right? It's just there's a delay of even determining exactly who is actually infected. We look at the statistics, and it's scary. I think that David Kelly actually had a webinar this morning, and he said this is not like the normal flu. It is more virulent.

At least as we look at the statistics as they are today, I think it can be argued that, can we really depend on what China is coming out with in term of their data? He mentioned that maybe that looking at Italy and South Korea would be a more reliable, credible source to determine just how virulent this thing really is.

BRAD: Yeah, there's plenty of ways to manipulate the stats. I think that people that we know would argue against overthinking the coronavirus, would say many more people die from the flu, so this is not that big of a deal. Many more people die from car accidents, and homicides, and heart disease, and everything else.

It's how fast is it spreading? How contagious is it and what is the mortality rate once you have it? I think those are important numbers that, technically last week...It's horrible if anybody dies from it, but in the grand scheme of things, probably a low total number of people.

The question is, how fast does it spread? How easy is it to give it to someone else, and what's the risk to that person once they have it? I think they're all important things to think about.

PATTI: Equally as important is, what are people doing in their lives? Are people hunkering down and staying at home, and what's happening in places like China? While I was overseas, I thought it was interesting to learn about the metrics that many of the money managers are using to determine whether or not there's actual economic activity in China.

They were looking at satellites, at traffic patterns in different cities. They were looking at the pollution index. I thought it was fascinating that the pollution index in China has plummeted because factories are offline.

It is interesting, some of the things that they have to look at to get the real story out of China, because they don't really feel like they are getting it from their government.

BRAD: They had to do their own research.

PATTI: Italy and South Korea, though, are far more transparent. Northern Italy is really getting hit hard, and I think that for us here in the United States, some of the measures, to your point, they're not kidding around here in the United States. I think South by Southwest was canceled. A lot of things are being canceled. Most corporations are saying no international travel.

BRAD: It's spring training time in Florida for baseball, and baseball players are pre-signing baseballs to be handed out or thrown out, rather than standing in front of the crowd live-signing balls. It's all done ahead of time so they can just be handed out to fans and...

PATTI: Let's go back to the timber. We were talking about the timber. This is the spark. What else is going on? You mentioned oil, and I think that's really important for our listeners to understand that the impact of a 20 percent drop in oil prices in one day.

Saudi Arabia is, let's use the word exploiting what's happening in the world, because they're ramping up supplies significantly. They are cutting prices. They're offering a 21 percent discount on the price of oil to their trading partners with the goal, Brad, fill in the blank.

BRAD: I think what happened is, they learned about how Wawa came to dominance in Pennsylvania by opening a store, charging very low prices for sandwiches and gas until all your competitors are gone, and then you raise prices back up to above where they were before. Saudi Arabia heard about Wawa, and they're trying to copy the same business model.

If you have at the same time that production is spiking, and you are offering incredible discounts on the supply that you're already are selling to preferred trading partners.

A barrel of oil is down in the 30s again, and you think of all the research and development that companies in the United States have spent to get oil out of the ground. Those are very long-term projects. You lease an area under the ground or you own the area under the ground, and it takes a long time to get enough oil out.

You have to have some kind of projected price to make that project profitable, and if oil is down, I've heard numbers that say that Exxon Mobile needs oil at $75 a barrel to have any kind of free cash flow at all. Maybe Exxon has the balance sheet to withstand this, but there's a lot of small upstream companies that will not be able to withstand this.

PATTI: Let's take that one step further. What is the problem with lower oil prices? What's the big deal? We see it at the pump, that means that I could fill up my tank for a lot less money. That gives me excess cash flow, theoretically, I can go out and spend it, but people are very worried about the impact of these lower oil process. How come?

BRAD: You try to think of it as like a zero-sum game, right? If every time you fill up the tank, you save three bucks. That's fine, multiplied across whatever, 130 million drivers in the United States, or whatever the number is.

The other side of that is, any of those companies that shut down are laying people off. You might save three bucks, but they lost their entire income. Unemployment creeps up.

Everything is zero-sum, the sum of all our savings equals somebody's loss. That's the risk, I would think.

PATTI: It goes back to, we're confusing correlation with causation. The virus didn't really cause this. There may be some sort of a domino effect that occurs here, and definitely certain industries are going to be affected.

The airline industry is feeling it. Certainly the cruise lines, when leaders of our country come out and say, "Don't go on a cruise," wow, that's going to hurt your business. It's definitely going to hit pockets of the markets.

BRAD: Banks, you mentioned.

PATTI: Banking industry, you get to these very, very low, literally record low interest rates. The 10-year bond today is trading at about a half a percent. We've never been that low. Is that unbelievable?

If you could panic about anything folks, panic about refinancing your mortgage. Panic about looking at your loans and saying, "Gee, what can I do to cut my payments?" because now's the time to do it.

BRAD: Where's the opportunity for you as a family, or a household, or a person.

PATTI: Exactly. Looking at these things holistically and figuring out, "OK, this is going to be tough." It could be tough. We don't know. Most people don't really expect a V recovery, meaning this thing is going to bounce back.

Last week was tremendously volatile, with down days over 1,000 points, up days of 1,300 points. That kind of volatility is crazy in terms of how to figure it out. By the end of the week, the market ended up flat for the week. During times like this, you do not want to play in that sandbox. It is dangerous.

Most of you listening, you've heard this before. You've got a long-term plan. Chances are, hopefully, you've followed the prescription of, make sure you have plenty of short-term bonds, cash, money that will get you through the next two years, three years.

I don't know that this is going to last that long, but if you don't need that kind of buffer, it might be a great opportunity to get some of that money working, the old buy low phenomenon. As long as you don't need the money for a period of time, you would probably look back at this period of time and say, "Wow, I'm really glad I did that."

Keep an even temperament about this. If it really worries you, I'm going to pull out the nursing jargon that I use, go into the coma. Do the coma thing.

I think that if you do so, when you wake up, you're going to be happy that, A, you didn't' sell anything, because I do think that you'll regret that, and B, if you or your adviser were able to take advantage of this because you had that buffer, I think, that you're actually going to wake up quite happy.

Let's talk about the economy, because we're looking holistically. Think about people listening. Should they be worried about their jobs, for example?

BRAD: It never really is that smooth. I think there is certain industries that would suffer more than others. Energy, I think, as we discussed, is...

PATTI: Vulnerable.

BRAD: It's going to be a little scary there, but even in that, it's not so cut and dry. What are the companies that have the balance sheets to withstand it? It could affect anybody.

You could work at a mall and you could work for a store, that if people are afraid to go to the mall, you might have a rough go of it. Even at the mall, some businesses are barely getting by, and other ones cannot make money for years and still stay in business.

PATTI: That was happening already, so it doesn't necessarily mean that this whole situation is causing that.

I think the other thing to keep in mind is that for many companies, for many industries, they were having trouble finding workers. If you're already below capacity as it relates to being able to provide the goods and services that you want to provide, you're probably not going to lay a bunch of people off because you need everybody that you have.

In fact, you needed more, but you couldn't find those skilled workers, but as with anything, you've got to be ready for these outliers.

You've got to be ready so that for those of you who are working, have concern about your position or your jobs, these are the times where you're going to be happy that you did what a lot of people didn't want to do, which was rebalance last year and understand that the market was going up, and up, and up, and it did even in the beginning of this year, but we rebalanced anyway.

You do these things when you don't think you should. You don't think you have to. Do it anyway, because that's when it's even more important.

As it relates to all of that, let's talk about tax planning opportunities that a correction of 17 percent presents. Can you talk to the folks, remind them, how does tax loss harvesting work?

BRAD: Tax loss harvesting is an opportunity to book an unrealized loss. Like if you hold…We'll just make up an example, you have a small cap value fund. You spend $20,000 on it. The market goes down 15 percent. You now have $17,000 in this fund. We want to still maintain the same risk profile. We want you to be exposed to the same things.

We still want you to have small cap value in your portfolio because we feel that it's a good place to be for the next decade, but we can book the loss by selling that holding and just taking the proceeds and reinvest it in something in the exact same asset class, so you never actually even spend a day out of the market.

You're still exposed to small cap value one and stage two, but you've banked this $3,000 loss that you can use. It can either offset other gains, or if you don't have other gains, then you can take it against your income at tax time.

Markets go up and down, you gain or lose money in…It almost seems like it's just all this mystical up or down $3,000 today, but you can actually concretely take that loss and still be in the exact same position because you've just replaced it with something very similar.

PATTI: In other words, if I hear you right, Brad, you're basically asking Uncle Sam to offset a third of your losses.

BRAD: Yeah.

PATTI: In other words, on $3,000, you're going to get $1,000 back on your tax return.

BRAD: Exactly.

PATTI: t's just a different way of benefitting from what unfortunately does tend to happen in markets over time. You said $3,000, but let's be real. What if it's $30,000? How does that work?

BRAD: It does the exact same thing.

PATTI: Exact same thing, so basically let's pretend for a minute that we don't have a gain. You've got this $30,000 loss. There's a limit of $3,000 per year that you can use against ordinary income.

BRAD: Yeah.

PATTI: Does that mean that we've got a $27,000 loss that goes completely wasted? A, you can take gains in holdings that held on to the gains, and you've been wanting to reduce your exposure there. That's number one.

Let's just assume that there aren't any gains. There isn't any opportunity. How will you talk about this carrying forward losses? How many years can you carry forward losses and use them in the future?

BRAD: Forever.

PATTI: Forever.

BRAD: Yeah, assuming you live forever.

PATTI: Which is a good point, you can't take it at death, which actually is an important thing, because we do have clients who are older.

If we are banking losses, we want to recognize the fact that that, hey, you're not going to be able to use this once you're no longer above ground. We want to make sure that there are some gains to offset, so you're taking advantage of this tax deduction.

Let's bring this back to the virus, this is about coronavirus correction, so we're in this correction. Maybe today might mark the first bear market that we've had since 2009. Yes, the coronavirus may have been the trigger. I think it's been fascinating to read some of the articles, as I know you have, comparing it to the Spanish flu in 1918, right?

BRAD: Right.

PATTI: In 1918, on a worldwide basis, there was this horrible, horrible flu. Ironically, it was called the Spanish flu, but it did not originate in Spain. It was just that Spain was a neutral country at the time, and so during that period of time, the war propaganda and that sort, there wasn't the independent journalistic approach that we have today in most countries.

BRAD: That can't be true.

PATTI: It is true, Brad. I'm telling you.

BRAD: It was worse than today.

PATTI: Yeah, it was worse than today. Think about all the stuff they were talking about. Anyway, that's a whole different subject. Going back to that, what happened during the Spanish flu was anywhere from 50 million to 100 million people died from the flu, and so a lot of people are making this comparison because that too was very virulent.

It was easily spread, but it was a different world then. We didn't have the healthcare that we have today. We didn't have the government shutting things down as we do today, and the plans. World Health Organization has had these plans, "If this happens, we do A, B, and

C."

In many respects, there is no comparison. For me, the only thing that we want to be cognizant of, and I mean this as a nurse, the resistance to antibiotics, people aren't necessarily dying from the flu. They're dying from secondary infections, typically pneumonia.

People with respiratory illnesses or where their immune system is compromised, that's who is most vulnerable, and it is the resistance to the antibiotics that have occurred that makes this scary on the other end.

For anybody who is 60-year-old or what have you, I think it's also interesting, and you brought this up earlier, the fact that in 1980, the average life expectancy was what, Brad, about?

BRAD: I think between 50 and 55.

PATTI: Literally, in 1980, you in your 40s would have been considered elderly.

BRAD: Yeah, I should be retired and sitting on my front porch every day.

PATTI: Don't even think about it. We need you here.

BRAD: Another year or two.

PATTI: In your dreams. It is different. Life expectancies were much shorter, but it's something that we're watching. The numbers are, and you probably know this already, we don't know what the real numbers are. So many more people probably have it that haven't been tested, probably will never get tested.

They're in their home. They're dealing with it. They might not have symptoms, or very mild symptoms. It goes away, so the ratios are skewed.

We don't know what's going to happen with the virus itself, but we do know a couple of things. First of all, it is a fact that economies throughout the world have slowed down. There is not as much economic activity. Dollars are not exchanging hands here in the United States or globally, so that's one thing we do know.

We do know that oil prices have plummeted. We also know that we were probably vulnerable already to a drop in the market because valuations were stretched.

What we don't know is how long this is going to last. What we don't know is the impact of the election. What we don't know and never know is where we're going to be next week, in three months, a year from now, even three years from now.

However, from a practical perspective, I believe in my heart of hearts that 5 years from now, 10 years from now, we're going to look back at this and say, "Wow, it was really rough while we're going through it, and it was scary, both from a personal level as well as a financial level."

If we keep our heads level and understand that this is long-term, and we understand that there's a longer-term, a really good financial plan that's solid, you're going to be OK, right?

BRAD: Yeah, it makes sense.

PATTI: Folks, thank you so much for listening. I hope that it's helpful. Brad Everett, thank you as always for your very practical, right to the bottom line guidance and advice. I appreciate how proactive you and the team are today. It's reaching out to people.

We know the people who are on cash flow, and we know the people who have a balanced portfolio probably won't need the money, and we are treating each individual and each family very differently, given what's happening in the markets today.

BRAD: Please do.

PATTI: Thanks to all of you for joining us today. I hope this was helpful. Always feel free to give us a call any time if you're worried. If you're thinking about these things, if you want to know the impact of your personal situation, go our website, send us a note.

We will be happy to talk to you over the phone, bring you into the conference room. There's no charge for that. This is why we exist, www.keyfinancialinc.com, that's how you get a hold of us. Thanks so much for joining us today. I am Patti Brennan. I hope you have a great day and a healthy year.