2nd Quarter Investment Roundtable

How COVID-19 has Disrupted the Market and is Accelerating Innovation

Earlier this year we published an Investment Roundtable in which our team of investment analysts shared their thoughts on compelling long-term secular themes we believe will have a profound impact on our society, our economy, and investment opportunities available to our clients over the next few years. In light of the global pandemic of COVID-19, we are noting from our reading and research, as well as in our discussions with clients and analysts, the recurrent idea that present disruption is leading to a rapid acceleration of some of the trends we identified, as well as the emergence of a few that we did not.

The present disruption is leading to a rapid acceleration of innovation in many areas like healthcare, supply chains, technology, governmental roles, and the e-economy.

In this follow-up piece we asked our team of Analysts to examine innovation and some new investment opportunities in light of the COVID-19 pandemic's deep impact on many areas of our personal and economic lives. You will see allusions to recurring themes like healthcare innovation, supply chain innovation, the respective roles of government and the private sector, the continued shift to an e-economy, and a reiteration of our earlier piece's overarching thesis that we are in the midst of a 4th Industrial Revolution powered by technology. Historically, disruption has led to amazing discoveries and breakthroughs that spurred new ideas, companies, technologies, and more. At 1919 we focus first on quality and competitive advantage, both of which have proven resilient as analytical frameworks over long cycles. That said, we also invest a lot of time uncovering and thinking about industry disruptors and innovators – those who will be the leaders of the future and not just the leaders of today.

None of us can predict exactly what life will be like when this pandemic is finally in the rearview mirror, but our analysts are hard at work with continuous research on both emerging trends and changes to mainstay institutions. We hope you enjoy reading our Analysts' perspectives on how the current COVID-19 pandemic is impacting and changing their industries of focus.

We hope you, your families, and your friends are staying safe and healthy.

CHARLES KING, CFA
Managing Director and Chief Investment Officer

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Healthcare is at the forefront of everyone's mind these days. What are some potential changes coming to medical research and healthcare investment?

CHRISTOPHER DELPI, CFA
Principal, Analyst

The novel coronavirus, and the resulting COVID-19 pandemic, has been devastating. Countries throughout the world have been trying to employ a containment and mitigation strategy to slow the disease's progression. Containment and mitigation are indeed the first steps in combating the imminent threat. They will hopefully be followed reasonably quickly by the identification or discovery of new and more effective treatments and drugs. Then, further down the road, as has been the case before, hopefully a vaccine and a cure are discovered.

One of the biggest impediments to the containment strategy is the inability to test for the virus and to have the results in a timely manner. Successful testing enables the authorities to accurately identify hot spots where the strategy needs to be implemented. Another issue is having effective treatment and proper medical care for those who contract the virus, especially those most at risk of death. Compounding all of this is the strain on the supply chain, which has highlighted the global lack of protective equipment for the medical staff treating these patients.

The COVID-19 pandemic will accelerate investment in many categories of global health issues.

Historically, when the world has witnessed a major health-related event, government funding and private investment in medical research has increased. This research has resulted in more vaccines on the market and more pharmaceutical research. If history is a guide, the recent events surrounding COVID-19 will accelerate investment in vaccine and drug treatment research, both for the current virus but also for many other global health issues (diabetes, cancer, heart disease, measles, and other viruses).

COVID-19 has also increased the focus on the need for viral testing's accuracy and timeliness, as the current containment and mitigation strategy begins with widespread virus identification. In a matter of weeks, the nation has gone from testing equipment that takes several days to generate results, to a test that can now give a reading in 15 minutes. Over the past decade, investment in medical equipment has stagnated as hospital budgets have been under pressure due to cuts in reimbursement. Post-COVID-19, investment in this area should accelerate as hospitals and governments recognize the need for better diagnostic equipment. Also, investment in hospitals in particular may improve as the public realizes the need to continually update infrastructures such as beds, medical equipment, and technology. Finally, the lack of a secure supply chain to produce protective equipment for healthcare workers will be a focus. It's highly probable that global investment in supply chains, along with research into more effective protective equipment, will increase exponentially over the next several years.

How are macroeconomic, financial, and consumer considerations changing as we enter the second quarter of 2020?

CHRISTOPHER PERRY, CFA
Principal, Portfolio Manager, Analyst

The COVID-19 pandemic impacts our domestic banks who are working with the Fed to provide loans and liquidity to companies and consumers badly displaced by the coronavirus, and to help these customers bridge the gap until the situation improves. In addition, banks are helping to ease people's financial burden and help them through this extraordinary event by deferring payment of credit card, mortgage, auto, and other loans. Related to their own employees, many banks have offered one-time bonuses, in some cases for $1,000, for employees that are offering essential banking services during this period.

The disease also impacts REITs, as evidenced by the high volume of e-commerce distribution for customers unable to shop physically, and the high demand for consumer staples goods during this COVID-19 related uncertainty. Industrial warehouses, a key component for many REITs, are helping ensure that these goods are available quickly, including in densely populated areas.

We anticipate broad pressure on retail, including malls and shopping centers, during this crisis. One pressure could be that fear, about COVID-19 or other viruses, accelerates the shift to even more online shopping. Since many in society generally prefer to be social rather than cooped up in their homes for long periods of time, it seems there will be some level of returning to malls, sporting events, leisure travel, restaurants, etc. once these fears subside. The pace of this recovery is a currently debate. Meanwhile, there are understandable challenges for mall tenants currently struggling to pay rents to their landlords; we expect this will continue to be a source of tension during this current period. B and C malls, along with strip centers that are very dependent on one or two stressed tenants, will likely feel the brunt of the pressure.

Apartments and multi-family housing have recently come under pressure from concerns about consumers' ability to pay rents. We expect those concerns to subside once the economy begins to rebound and job growth returns.

One difference we expect to see is that office space demand will be questioned for some time. There is no doubt that there will be some rethinking about companies' current locations and whether they are sufficiently diversified geographically to protect against future catastrophes and risks. Pre-COVID-19, the leading global technology and life sciences companies – firms at the cutting edge of innovation and growth – demanded some of the newest-developed office locations. Post-COVID-19, the demand for cutting edge office space will only increase. Winners will likely include real estate that supports technology infrastructure growth such as towers and data centers.

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SHAYA BERZON
Principal, Analyst

The consumer staples sector is likely to see many short term disruptions and opportunities, but not many longer-lasting impacts once life returns to normal. Some areas are benefitting from pantry stocking and increased consumption of cleaning materials in the short term, but that is unlikely to be a long term investment opportunity. For many companies, the current COVID-19 conditions are actually making it harder to introduce new products or innovation as customers are mostly focused on getting the scarce items they are used to, and suppliers are focused on maximizing production lines for those same scarce goods consumers want. The shift toward online versus in-store buying could accelerate an already existing trend.

SEAN HUNG, CFA
Vice President,
Analyst

Food delivery has understandably seen increased adoption during the crisis, however, there has been a divergence in the trend between grocery and restaurant delivery. Beyond the initial spike related to the beginning of state shutdowns, restaurant delivery has seen demand level off as more cost-conscious consumers have begun to trade down for less expensive alternatives. Grocery delivery being the alternative has demonstrated the ability to retain consumer demand at a high satisfaction rate. This is important as prior to the crisis many consumers had doubts about grocery delivery, showing strong preference for picking out their own produce and meat, for example. With the wave of panic buyers and social distancing guidelines, grocery delivery has become a very attractive alternative to the weekly trip to a local store. As more and more consumers acclimate to this new mode of shopping and continue to report high satisfaction rates, we can expect there to be a paradigm shift in how consumers think about the way they buy groceries.

LAUREN KRIEGER, CFA
Vice President,
Portfolio Manager

State and local governments have been hit hard by the COVID-19 crisis. Municipal bonds, which are known for their ultra-high stability and come second only to Treasuries in terms of credit quality and default rates, are now facing unprecedented credit and liquidity concerns. For most municipalities, their sole source of revenue has been at best deferred and at worst completely lost. State income taxes have been postponed to mid-summer for most states, but fees such as those paid for public transportation and tolls have been lost and may be permanently depressed as we figure out a new normal post-crisis. The length and severity of the economic shutdown will determine how dire a situation these municipalities face.

The CARES Act has allocated emergency relief to state and local governments, but will it be enough? Luckily most states have built up healthy rainy day funds in the aftermath of the credit crisis, and essential services, such as water and sewer, should continue to function properly. While getting through the health aspect is the first priority, municipalities will be under unprecedented stress to meet their financial obligations.

Finally, the new infrastructure projects I described in January, which are already long overdue, will be put on the back burner. Instead, we may see issuance related to recovery and economic stabilization. Rates are expected to be lower for much longer now given the zero interest rate policy in place by the Federal Reserve, but there should still be opportunities for our clients. Municipal bonds are essential to the functioning of local municipalities, states, and the Federal government. We have never experienced a State defaulting on its obligations. While we still do not see that happening, we do worry more about some states than others, and so we are even more credit quality focused than ever. The length and severity of the economic shutdown will determine how dire a situation these municipalities and publicly funded entities face. The municipal market is the lifeline to airports, parking garages, non-profit hospitals and retirement communities, stadiums, convention centers, colleges and dorms, among others.

Interest rates are expected to be lower for longer.

BAYLOR LANCASTER-SAMUEL
Vice President,
Credit Analyst

In response to the COVID-19 crisis central banks around the world, including the Federal Reserve, have reacted with multiple rate actions and policy tools to ensure smooth market functioning in fixed income and currencies. Beginning in mid-March, the Fed lowered the federal funds rate to zero at an inter-meeting cut. The Fed also revived many of its programs from the financial crisis, including the Commercial Paper Funding Facility (CPFF), the Money Market Mutual Fund Liquidity Facility (MMLF), the Primary Dealer Credit Facility (PDCF), the Term Asset-Backed Securities Loan Facility (TALF), and the establishment of U.S. dollar liquidity arrangements (swap lines) with foreign central banks.

In addition to these crisis-era tools, the Fed also created several new programs, including a Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance, a Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds, and a Main Street Business Lending Program, to support lending to eligible small- and medium-sized businesses. The Fed's efforts appear to have stabilized fixed income market functioning through a combination of lessons learned from previous crises and innovative as well as massive financial intervention.

Although corporate spreads are still significantly wider than the pre-COVID-19 levels, they have tightened substantially following the announcement of the Fed's various support programs and liquidity has improved. Following the Fed’s announcements, new issue volumes reached new records of over $100 billion per week for back-to-back weeks in late March. In the near-term, corporate earnings will remain under pressure given the widespread economic impact, and the Fed may continue acting as a key support for the markets.

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Earlier this year we discussed how technology continues to evolve at the speed of light with ever-shorter discovery and adoption time frames. Can you point to specific areas you are excited about, and companies you expect to benefit?

THOMAS KRYGOWSKI, Ph.D, CFA
Managing Director, Analyst, Portfolio Manager

In January we identified three foundational technologies expected to play an important role in the Fourth Industrial Revolution: Networking, Cloud Computing, and Data Storage. History has shown, particularly in the Technology sector, that economic turmoil has a way of *accelerating* transitions already underway. We believe that the current crisis will not be an exception.

The Fourth Industrial Revolution will accelerate changes in foundational technologies.

- **5G Networks** – With the handset supply chain in Asia recovering and getting back to work, leading handset vendors are racing to introduce flagship 5G handsets while US carriers continue to build, all in an effort to capture a first-mover advantage at this key inflection point.
- **Machine Learning & Artificial Intelligence** – Cloud computing gained momentum in the 2008 recession because it shifted spending towards a *consumption-based* model, allowing companies to conserve capital. But it also triggered an arms race of innovation among hyperscale cloud companies which led to breakthroughs in Machine Learning and Artificial Intelligence (ML/AI). Today, ML/AI is gaining strong momentum, and is being offered as a service in the Cloud, positioning the most forward leaning companies well for the recovery.
- **Direct-To-Consumer (DTC) Media** – The current “shelter-in-place” orders around the world have reportedly led to a spike in viewership for services such as Netflix, Disney Plus, Amazon Prime, and Apple TV, by as much as 50%. We believe this will accelerate the shift in cord-cutting that has been apparent for some time, benefitting not only DTC media companies, but also digital advertising-driven companies like Facebook and Google.

CHRISTOPHER PERRY, CFA
Principal, Portfolio Manager, Analyst

At the beginning of the year, I described how banks of all sizes were improving their core technologies and leveraging new technological partnerships. As many consumers worldwide have been, or are still, under shelter-in-place orders due to the COVID-19 pandemic, banks’ abilities to serve customers online or through mobile banking services is increasingly important.

Additionally, with the high number of employees working from home and on their wireless devices, the cell tower companies, in conjunction with their telecom customers, are helping to ensure that the cellular connections are maintained and operating at a high level.

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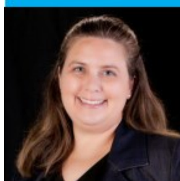
We know interest in responsible investment (RI) continues to grow. How has the current disruptive state affected RI trends?



ALISON BEVILACQUA
Principal, Head of SRI Research

Investors utilizing ESG criteria are not exempt from the short-term pressure to deal with the immediate demands of the COVID-19 pandemic.

Broadly speaking, climate change had been the focus of ESG investment analysis prior to the COVID-19 pandemic. Since the outbreak, the focus has shifted to social issues and community welfare. The pandemic highlights peoples' interconnectedness and shared pursuit of prosperity and peace; all countries, all communities – poor, rich, or middle-income – are dealing with the impacts.

Many companies have faced a swift decline in demand amid varying isolation directives, and thus have been forced to cut back or even shutter their doors, which means laid-off or furloughed employees. Workers without reliable healthcare and/or regular income strain social safety nets and add a degree of instability to communities. Companies' long term success is tied to the welfare of its stakeholders including employees and local communities.

Another investor expectation is that companies fulfill their obligation to support their employees and their value chains.

Amid the current downturn, RI or ESG oriented investors and stakeholders are promoting standards for how companies should behave in the face of this global economic and societal shock. The primary expectation is that a company support its workforce or, in other words, put the worker first. The focus on employees means prioritizing their health and financial security during this time of economic demobilization. This prioritization may manifest itself in various ways, including: providing paid leave for quarantined family members; providing free backup childcare; or adopting shorter shift hours or job rotations to minimize overall job losses. All types of workers – especially those without the option to work from home – and their families need novel forms of support from their employers right now.

Another investor expectation is that a company do what it can to support its value chain. We have seen some companies review their philanthropic plans and even shift support to urgent needs such as donations (monetary or in-kind) to food banks, programs providing lunches for out-of-school children, or to service organizations such as the Center for Disaster Philanthropy[1] or local health services. Further, investors and other stakeholders might reasonably expect a company's leadership to exemplify and practice financial prudence during economic uncertainty. Some corporate leaders have announced C-suite pay cuts or are forgoing bonuses in conjunction with layoffs, thereby demonstrating some solidarity with their employees at a time of financial stress. Others have announced the suspension of stock buybacks as one approach to conserving corporate resources. It isn't clear when or how the global economy will recover, but from an ESG investor viewpoint, companies that act with care during a crisis would be expected to be better placed for long term success.

Although attention to the "S" of ESG is now prominent, interested investors have not forgotten about the "E." Observers have recognized the clear decreases in pollution and greenhouse gas emissions while the economy has paused. Some stakeholders are advocating for a "green recovery," or seeing this pause as an opportunity to reset markets on a greener path when economic activity resumes. Whether these efforts have an impact will only be seen in the long-term.

[1] In this time of great need, 1919ic proudly supports Americares and the Center for Disaster Philanthropy to aid their efforts at COVID-19 containment, response, and recovery.

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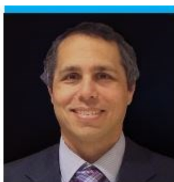
What noteworthy disruptions are you seeing in the industrial, materials, and energy sectors as we track COVID-19's rapidly-changing outcomes?

SHAYA BERZON
Principal, Analyst

Clean energy technology is likely to see near term challenges as social distancing makes sales efforts more difficult and financing challenges could emerge as well. While investing in rooftop solar for a home or business is generally a positive cash flow event (most are financed by third parties and monthly fees are lower than the utility bill), consumers and companies are distracted by the need to deal with more pressing matters to their health and finances. Longer term, benefits from the current disruption may emerge from pent up demand and a desire for lowering grid dependence through the adoption of rooftop PV (photovoltaic) energy and battery storage. Some countries have already turned to renewable energies as a fiscal stimulus lever by offering strong subsidy programs and in turn driving investment and job growth; if this happens in additional markets, there could be accelerated deployment of renewables.

Conversely, traditional energy and materials companies are experiencing pain points from the COVID-19 pandemic. Specifically, traditional oil and gas companies and related industries are seeing demand collapse while OPEC drives oversupply. In the short term, demand is down a staggering 20% for oil and many other commodities. It is hard to see many disruptive long term benefits from this volatility. The companies with the strongest balance sheets and lowest breakeven costs are the most likely survivors of this period and will stand to benefit as demand normalizes in the future. Packaging companies might see some benefits from the stickiness of increased use of online, versus brick and mortar, in consumers' purchasing trends once life returns to normal, but this may not be significant.



ERIC THOMPSON, CFA
Principal, Analyst

For industrials companies, at the last roundtable discussion we talked about IIoT (Industrial Internet of Things), connectivity, and water conservation. For the latter, the COVID-19 crisis shouldn't have much impact, but in all likelihood, water usage will decline temporarily due to shut downs, which in turn may create revenue pressure on municipal water systems alongside those Lauren outlined above. Similar dynamics are at work across electric utilities where residential load growth is increasing, while industrial and commercial load growth is compressing. The net impact should be modest and several utilities are isolated by something called decoupling mechanisms. Related to connectivity, shelter-in-place and work from home directives underscore the benefits of having a connected facility. Even if it is temporarily idled, systems and equipment need to be monitored to ensure proper functioning and uptime.

A theme across industries has been the impact on their supply chains – especially second- and third-tier vendors.

One of the early themes throughout the disruption has been the impact on supply chain and lack of visibility into second-tier and third-tier vendors. It's possible that global shutdowns could facilitate a move toward on-shoring of production back to the US, which would impact industrial capex and perhaps transportation networks. However, this could prove disruptive and uneconomical, especially if a v-shaped recovery ensues. The airline industry is perhaps suffering more than any other and the shape of recovery in passenger traffic is unclear. With confidence in testing and treatment of COVID-19, leisure travel mostly likely recovers, but has Zoom Video proven to be an acceptable substitute for corporate travel, at least in some cases?

From a higher-level perspective, the impact from COVID-19 is clearly disruptive, but the shape of recovery is unknown. There may be parallels to the recession of 1958 when there was an influenza outbreak (H2N2) and a sharp quarterly drop in GDP that was followed by a v-shaped recovery. Early feedback from companies is that they plan to be very surgical with cost cutting strategies and are hesitant to trim muscle if the recovery is equally as sharp as the downturn. Most are still in evaluation mode and are prepared to take action. Longer term, it is worth considering that ensuing austerity measures similar to the BCA (Budget Control Act) could be part of the conversation following a stimulus package that is already 2x that of the great recession. The first priority is to normalize the economy, but a year or two from now, it wouldn't be surprising if the budget was front and center.

ABOUT 1919 INVESTMENT COUNSEL

1919 Investment Counsel, LLC (1919), an investment management firm, provides discretionary separate account management services for affluent individuals, families, trusts, foundations, endowments, and institutions. As of March 31, 2020 the firm managed approximately $13.2 billion of assets. The cornerstone of 1919's investment process is proprietary, fundamental research with an emphasis on quality, risk management, and diversification.

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