Sentinel Trust
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2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

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Market Update on the Coronavirus

Executive Summary

- There have been 81,109 confirmed cases and 2,718 deaths worldwide of the highly-contagious coronavirus.
- Largely due to uncertainty about the spread and impact of coronavirus, US and international stock markets have recently declined, while less risky assets like bonds have rallied.
- Chinese and Hong Kong governments are using fiscal and monetary stimulus efforts to reduce the economic impact of disruptions of commerce resulting from the virus.
- Sentinel has increased portfolio liquidity to capitalize on investment opportunities when they arise and continues to hold excess cash and maintain underweight positions to both stocks and high-yield bonds.

Market Volatility

On January 31, investor concerns about coronavirus interrupted the S&P 500's rally with a nearly 2% decline, the largest in over four months. Domestic stock markets quickly recovered, however, and hit new all-time highs earlier this month. The S&P 500 was up 4.6% year-to-date through February 18, on the heels of a staggering 31.5% gain in 2019.

US and global markets have since resumed the decline on renewed coronavirus fears while cases outside of China have significantly increased. Yesterday, the Centers for Disease Control and Prevention (CDC) reported the first US case of the virus (in California) without known origin and indicated it may be "community spread." We are writing to communicate our current views on the markets, but first and foremost, our thoughts are with those most impacted by the virus. We recently met with one of our China-focused investment managers who shared the difficulty in securing and sending supplies back home to loved ones in impacted areas with limited access to essential goods.

Worldwide Cases

As of this writing, the World Health Organization (WHO) reports 81,109 confirmed cases and 2,718 deaths have occurred globally. Although this puts the fatality rate at roughly 3%, the cases and fatalities are most prevalent in the epicenter of Wuhan and the surrounding Hubei province in China, where medical care delivery is highly stressed and air quality is poor. The mortality rate outside of China has been significantly lower at 0.5%, which still represents a much higher risk of death than the last flu season in the US (0.09%). The H1N1 ("swine flu") outbreak from 2009-2010 infected an estimated 700 million to 1.4 billion people, but also had a much lower fatality rate (estimated to be .01-.08%).

The spread of coronavirus from asymptomatic individuals also distinguishes it from other recent outbreaks. Leading virologists estimate that a person carrying the virus will infect 1.5-3.3 others. On an optimistic note for containment, the official number of new confirmed cases in China has dropped by over 80% in the past two weeks. The government reports that this has led to work resumption exceeding 50% at industrial companies. This claim appears to be roughly in line with coal consumption and industrial pollution levels that have recently rebounded, but some health experts fear additional infections from asymptomatic patients who rejoin the workforce.

Global Economic Impacts

On the economic front, the immediate impact of coronavirus has been significant and negative, especially in China, with ripple effects into global markets. During the SARS epidemic, the Chinese economy was merely 4% of global GDP. Today, its economy composes 17% of global GDP, and its small businesses and large, highly-leveraged firms are experiencing financial problems resulting from the disruptions of commerce. Additionally, global supply chains reliant on China to produce their "just-in-time" inventories are experiencing delays. Apple and many other US companies have announced they will not meet quarterly revenue projections due to Asian plant closures and falling sales.

Despite these negative short-term implications, it is important to highlight some of the positive economic countermeasures. China's central bank, the PBoC, has rolled out thirty policy initiatives to support businesses and has provided the equivalent of $42.8 billion in liquidity to impacted banks. Hong Kong's government, impacted by both the coronavirus and social unrest, just announced plans to pay every adult resident the equivalent of $1,283. With new cases of the virus emerging in Italy, European countries may also respond with fiscal stimulus measures. Finally, the economic uncertainty has reduced borrowing rates for consumers, corporations and governments globally, and has driven down the 10-year US Treasury to new all-time low yields.

In short, the economy and markets are experiencing volatility while there is uncertainty as to how the virus will unfold. A return to normalcy would likely lead to a V-shaped recovery with stocks regaining recent losses. If the contagion worsens, the virus mutates, or fear spreads further, we could see additional volatility and declines.

Sentinel Trust's Investment Positioning

We ended our February 3 letter noting that "[a]lthough we expect increased volatility and lower expected returns in 2020, we generally will be looking to add risk when other investors are fearful and move closer to our long-term targets." We reviewed our asset allocations last week and were surprised by how sanguine the markets were as US stocks continued to rally and the Chinese markets were only down just ~3% (through February 19) amidst the global uncertainty. We elected to hold firm, maintaining excess cash and remaining underweight both equities and riskier (high-yield) bond positions. Since then, the markets finally appear to be reflecting the possibility that we will not see an immediate V-shaped recovery, with the S&P 500 declining 10.6% and Chinese stocks down 4.6%. As we noted in the last market update, these types of movements are common and should be expected to occur periodically.

Though we are monitoring the coronavirus situation closely, we have not yet used this volatility to add to risk assets primarily for the following two reasons: (1) we have not reached the average peak-to-trough decline experienced by markets over the past 40 years, and (2) while stocks have pulled back, forward expected earnings have been reduced, so stocks have not necessarily become cheaper based on conventional valuation metrics.

While we have yet to implement any major asset class changes, we have been actively preparing portfolios for this type of event. First, we have systems in place to actively harvest losses which we are doing now. Next, we have committed capital to a solely China-focused manager that spends all their time identifying "anti-fragile" companies with strong moats and balance sheets that will allow them to gain market share while highly-indebted companies struggle in stressed economic environments. We have also been increasing liquidity both within the Sentinel comingled vehicles and in our clients' direct investment holdings so that we can be more nimble when opportunities arise. We have been considering working with new outside managers who are philosophically aligned with us and investing in well-run and capitalized companies like Berkshire Hathaway. The company's CEO, Warren Buffett, recently published the following update we found apropos for this letter:

> *"If something close to current rates should prevail over the coming decades and if corporate tax rates also remain near the low level businesses now enjoy, it is almost certain that equities will over time perform far better than long-term, fixed-rate debt instruments. That rosy prediction comes with a warning: Anything can happen to stock prices tomorrow. Occasionally, there will be major drops in the market, perhaps of 50% magnitude or even greater. [Structural advantages of the US economy and benefits of compounding returns], will make [domestic] equities the much better long-term choice for the individual who does not use borrowed money and who can control his or her emotions. Others? Beware!"*

Conclusion

As always, we are happy to speak with you anytime regarding the markets, your portfolio, or any other concerns you may have. We view these types of market events as great opportunities to review your allocations and risk tolerance, and to confirm that your portfolio is appropriate for your long-term needs, tested under the pressures of market volatility.