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Let's connect

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Bizarro World

If you grew up exposed to DC Comics and Superman, you will remember Bizarro World. It was introduced in the sixties as the cube shaped planet htraE (earth spelled backwards), where everything was the opposite of Earth's reality. One of the retrospectively amusing situations was the salesman of Bizarro bonds: "Guaranteed to lose money for you." In August 2019, we hit a peak worldwide of $19 trillion (i.e., $19,000 billion) negative yield bonds. Today the number is still a huge $13 trillion.

In many respects our western capitalist market model is now the bizarro market model. In the last few years corporations ran up debt owing to cheap money. This was the worst set up possible for the pandemic crisis where revenues collapsed and, as a result, earnings went negative. Central banks have caused a flood of money into the system together with massive federal government cash stimulus. This has given rise to zombie companies whose cash flow cannot make the interest payments on their debts. Absent the central authorities, they are dead. Notwithstanding the massive risks entrepreneurs take, in the end, their corporations exist as a result of the national institutions and advanced societal structures around them. Society provides the air by which they breathe. They are part of an integrated ecosystem, and certainly not independent from it, as some may imagine.

The big story for capital market investors has been the central bank purchases of BB rated (below investment grade) corporate bonds, municipal bonds, mortgage backed securities, junk bond exchange traded funds, and loans to medium sized businesses. These purchases by the US Federal Reserve Bank since March have amounted to more than $4 trillion. Where does this money go that was received by the sellers? These lower risk assets have been removed from circulation so the sellers cannot, in the aggregate, buy similar assets. The cash goes into the banking system firstly.

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Next, a lot of it is allocated to more risky assets, like stocks. Hence the phoenix-like rise of the markets since March 23. Rising asset prices is one of the intended effects of the strategy. There is no current plan to change these actions and the expansion of the Fed balance sheet should continue to at least $10 trillion from a current $7 trillion.

So now it should be apparent why the stock market seems so dislocated from the real economy. The US Federal Reserve bank is the cause.

In the Spotlight: Santen Pharmaceutical

The US market has become increasingly bifurcated between richly valued hyper growth tech stocks, and now COVID-19 advantaged stocks, and everything else trading at sub mariner levels. This anomaly raises the risks of a mean reversion to historic norms. One of the advantages of our global portfolio is that there is an ability to side-step the eventual adjustment by owning non-North American stocks. As the world also now moves to a bipolar hegemony (i.e., US and China), it may be wise to have a foot in each sphere.

In this regard, Japanese companies oftentimes depend on the Chinese market for growth. Santen Pharmaceutical is a perfect example. Santen is a specialized ophthalmic company. Their products address the following areas: intravitreal VEGF inhibitor, allergy, glaucoma, dry eye, and bacterial conjunctivitis. The pipeline is well developed with promising drugs addressing various indications in glaucoma / ocular hypertension at developmental stage 1. At stage 2 there are products addressing indications such as uveitis, allergic conjunctivitis, myopia and cataracts. Santen also has numerous alliances with worldwide partners including: *jCyte* (therapies for retinitis pigmentosa); *verily*, an Alphabet company (opththalmic microelectronics and digital technologies), and *Oxford Biomedica* (gene therapy products to treat inherited retinal disease.)

FY2020 revenue is forecast at Yen 235 billion (CAD$2.97B) with IFRS net profit of YEN 23 billion. The balance sheet is pristine with equity at 89% of capital. Composite analyst earnings estimates for 21-23 are Yen 79.2, 92.4, 93.7.

There is an aging demographic in China, Japan, and Europe that will need more therapies for failing vision, providing a great tailwind for Santen. We own the stock.

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Ask Brian

Hi Brian

Notwithstanding the money flooding through world economies, I am shocked at the positive market performance given the deep recession, the number of unemployed, American political incompetence, the world-wide debt acceleration, and the evident second wave of the virus that may yet cause a depression. How do you explain it?

Bob

Dear Bob:

Markets can be seemingly irrational for quite a while in the short/medium term. The money flood was unleashed to neuter the tremendous negative forces that you have described. They are very deliberate policies to get us over the deep valley. The problem is, as the programs are currently implemented, the measures were designed for some economic normalcy to return by about now. There is great hope that an effective vaccine(s) will be available soon. There is no doubt that markets are optimistic that this will happen. One issue may be that exuberant market participants have not studied the problem as it is considered by bio-mathematicians and epidemiologists.

On June 30th, the US FDA issued immediate guidance setting its expectations for any vaccine targeting SARS-CoV-2. On July 9th on raps.org, Regulatory Affairs Professional Society, Peter Marks, director of the Center for Biologics Evaluation and Research, explained the FDA's guidance. The FDA stated that any vaccine targeting SARS-CoV-2 must be at least 50% effective in part due to allowance for a negative 20% variance. If they held out for a 70%-80% effective solution, it would take too long to develop, and thus implied only infections would advance progress to herd immunity. So, it is reasonable to assume that an approved vaccine or combination may provide 60% efficacy, meaning the fail rate will be 40%. Marks suggested a best-case scenario with a 70% effective rate and a 70% vaccine uptake. This translates to a population that has 49% of its members protected by vaccine. To achieve herd immunity, the rest of the people, up to the required percentage, must be infected. How many is that?

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In a recent issue of The Scientist an article discussed the difficulties in modeling the transmission rate for SARS-CoV-2. The epidemiologists note that with this coronavirus, a significant percentage of asymptotic people are infectious. This feature increases the virus' natural transmission rate (the number of people an infectious person subsequently infects.) The rate is commonly described as R_0. Early estimates from Wuhan were 1.4 – 5.7 but this was before it was known about asymptotic spreaders. By way of reference, 2003 SARS was 1.7-3.6, and 2014 MERS was 0.45-3.9. These two viruses did not have asymptotic carriers.

The R_0 is related to the percentage of a population required for herd immunity. When herd immunity is achieved, the virus gradually stops spreading as it can find no new hosts to infect. Herd immunity is 60% at 2.5 and 83% at 5.7.

Social mitigation measures in Canada have suppressed the transmission rate to well below 1, but this condition is artificial and cannot be maintained without causing a depression, social chaos, and long-term economic collapse. The world will reopen and then the inherent high R_0 will apply, meaning that herd immunity will occur at approximately 83% of the global population. The virus will have to infect a significant percentage of global humanity before it recedes. I do not see a happy outcome.

The direct economic effects will last years. It is doubtful the markets have priced this.

Regards,
Brian

Sources: Financial Times, BMO Capital Markets, J.P. Morgan, Barron's, Wall Street Journal, The Globe & Mail, National Post, The Scientist, Regulatory Affairs Professional Society

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