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Update on the coronavirus outbreak

As a result of recent developments, we would like to update you on our thoughts regarding the potential economic and financial market impact of the coronavirus.

Officially known as SARS-CoV-2 (the virus) and COVID-19 (the disease), the coronavirus emerged in China in December 2019. It has continued to spread and multiple countries are now dealing with their own regional epidemics. The drastic containment measures put in place in China, especially in Wuhan and the Hubei province, have slowed the outbreak. However, the profile of this virus makes it very difficult to detect in time for effective isolation measures.

This new coronavirus presents unique challenges to human countermeasures. It has a long incubation period of up to 14 days (even 27 days in outlier cases), it can be contagious before symptoms appear, infected individuals can present with mild symptoms or no symptoms at all, and symptoms are very similar to the seasonal flu and common cold. These combined factors can make the virus virtually invisible to screening and detection methods.

Our health care team has devoted considerable time to understanding the virus and its implications. Currently, there are two potential outcomes: (1) full containment of all infected individuals or (2) the virus spreads until humans reach a point of herd immunity. The first requires the identification of all infected individuals and their effective isolation from others. China's experience demonstrates that this measure is difficult to achieve. The second outcome occurs once a threshold of individuals has developed immunity and the virus cannot find a new host to infect. This requires a large proportion of the susceptible population to be immunized. Immunization can be attained in two ways: through infection or vaccination. The latter is clearly the preferred route.

The most advanced vaccine candidate against SARS-CoV-2 is being developed by Moderna Therapeutics, a Boston-based biotechnology company. In collaboration with the U.S. National Institutes of Health (NIH), a first batch is ready to start Phase 1 clinical trials. This was achieved in a remarkable 42 days between the sequencing of the virus by Chinese researchers and the manufacturing of first doses for human trials. If the vaccine candidate is effective and substantial resources are put in place to develop manufacturing capacity, a vaccine could be widely available in 2021. Until then, measures to slow down the spread of the virus and to lessen the adverse health outcomes of the infected population are important.

There are ongoing developments in treatments for the disease. The leading drug on this front is Remdesivir from Gilead, a holding in our non-Canadian equity portfolio. The antiviral compound is currently being studied in clinical trials in China and the United States. If the treatment is successful, it will help to significantly reduce the health complications and fatality rates for COVID-19.

Social distancing will be required to slow the spread of the virus until we have a vaccine available. Some of these measures include quarantines, public event cancellations, travel restrictions and port closures. In China, economic activity has almost certainly contracted substantially in the first quarter. Should other countries adopt similar measures, the disruption to the global economy may be more than initially expected. It is fair to say that our growth forecast for 2020 will need to be revised.

In past destabilizing economic events, such as the European debt crisis, Brexit and the U.S-China trade conflict, we had concluded that the global economy was fundamentally solid and able to digest the headwinds. This event, though temporary in nature, differs in that the duration, extent and severity of the impact are extremely unclear, thus substantially raising the risk of a real economic cost.





Fear and uncertainty regarding the human and economic impacts of the outbreak are currently weighing heavily on equities and commodities. Since mid-January, investors have been aggressively selling shares of companies exposed to global growth, seeking refuge in bonds and other perceived havens such as gold, healthcare and utility stocks.

Our investments in the energy, mining and travel industries were hit particularly hard in the months of January and February. Since the beginning of the year, the WTI price of oil decreased from around \$60 to \$46 per barrel while the price of copper declined from \$2.81 to \$2.56 per pound. As a result, our energy holdings are down on average by 25% while materials stocks are down by 17%. With investors understandably concerned about the impact of travel restrictions on traffic and pricing in the industry, airline and other travel stocks have reacted negatively. Air Canada's share price, one of our largest and most successful investments in the portfolio, saw a 29% decline in value. While physical demand for oil, materials and travel has suffered the most immediate impact of the outbreak and related countermeasures, both demand and share prices should recover to previous levels once the situation stabilizes.

We recognize that certain asset classes such as long-term bonds, technology, real estate and infrastructure have benefited from inflows, but we remain concerned about the level of frothiness in their share prices. Since the beginning of the year, the price of long bonds increased from 56x Price/Interest payments to more than 70x (with no possible growth in interest payments for the duration). We do not believe it is appropriate to speculate on how low rates can go as we see significant risk of permanent capital impairment for long bonds on the horizon. Similarly, we are troubled about exuberance in some areas of the technology sector. An example of this would be Shopify, which is trading at 31x sales with zero earnings. Although some investors may find comfort in hiding in these assets during turbulent times, we worry about the risks of permanent losses of capital when conditions in financial markets normalize.

We continue to review the portfolio to identify companies that might struggle under challenging economic conditions. With the more recent developments in mind, we have reduced or eliminated some positions that may be vulnerable should the adverse impact last a year or longer. Exposure to companies which have strong balance sheets and are expected to remain resilient even in the face of economic disruption are being maintained. In these cases, we judge the recent decline in prices to be temporary in nature and should see significant value creation ahead for our investments over the medium term.

Finally, we have decided to raise overall cash levels in the portfolios. Not only will the cash serve as a buffer, but it is on hand to be redeployed if quality investment opportunities present themselves.

We have not concluded that we are headed with certainty for a recession. We anticipate that looser monetary policy and fiscal stimulus will mitigate some of the damage and are confident that the longer-term structural underpinnings to growth remain unchanged. We are taking utmost care to protect your capital. Our equity portfolio is trading at a very reasonable valuation of 1x book value, 5x cash flows and 3.5% dividend yield, with strong growth prospects over the medium term.

Rest assured we continue to monitor developments and will make additional adjustments to the portfolio as necessary.

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