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2020 First Quarter Review
"History in the Making"

Recently I find myself pining for the good old days, like back in January when all we had to worry about was a presidential impeachment and a potential war with Iran. Events since then have brought tragedy for many, hardship and heartache for many more. My purpose here is to give you an idea of how we reacted to recent events, how the investment world has shifted, and how we can respond going forward into the new normal.

As I mentioned in your January letter, there were troubling signs that stocks had gotten expensive and that bull markets usually don't die of old age:

It usually takes an unfriendly Fed or an exogenous event to kill the bull... So, it's clear sailing for stocks, right? Maybe not. Exogenous events are much harder to anticipate.

Stocks marched up to record setting highs on February 19th before plummeting in the sharpest and quickest decline in stocks from a new high in the US stock market history. In a little over 6 weeks the indexes fell by 30 to 35% to a short-term low (so far) on March 23rd. Daily volatility has matched and often exceeded that of the stock market crash of 1929. Part of our thesis in owning more value-oriented stocks was that they would decline less than the more expensive variety in most market declines. This time, the selling was indiscriminate as value stocks generally matched the declines of more expensive growth and technology indexes.
At its height, selling was not just indiscriminate, it was forced. As leveraged investors and investment products came under stress, their holdings were liquidated with, in some cases, little to no regard for price. The corporate bond markets (and the money markets) began to freeze up, and the risk that we would suffer "systemic failure" was very real.

Back in February, as the market was rising to its peak and evidence of the dangers of pandemic was building, we had started taking steps to prepare for the possibility that it could be more serious than anticipated. First, we made sure that we owned no positions in the obvious economic victims. We owned no airlines, cruise lines, resorts, casinos, or even bricks-and-mortar retailers. As the dangers increased with potential repercussions for the financial sector, we took profits in long-held insurance companies and bank stocks.

The oil markets were already suffering a "demand shock" as airlines, cruise lines, and other industries were using less fuel. The Saudi prince evidently became miffed at Vladimir Putin when the prince tried to get Russia's cooperation in reducing production to help support the price of oil. Putin reportedly snubbed the prince. In a fit of pique, the Saudis began an oil price war to drive the Russians out of business, or at least to the bargaining table. With bad news compounding, the price for crude oil fell from $60 to $20 per barrel in a cascade that endangered the solvency of energy companies as well as their banks and other counterparties to whom they owed money.

As stresses increased still further and the risks of institutional failures rose, we sold positions that might have exposure to a domino effect of rapid economic shut-down and/or oil price collapse, and we moved all money market balances out of normal corporate money funds and into one investing only in US government securities. If the system began to fail, we wanted to make sure that we owned the financially strongest companies and that our cash reserves were not at risk.

Seeing the cascade of stresses in various financial markets, the federal government acted swiftly and massively to ameliorate the effects of the economic shut down brought about by efforts to stem the spread of the pandemic. As of yesterday's additional $2.3 trillion program, we are now seeing the greatest monetary stimulus in economic history pitted against arguably the most abrupt economic disruption this nation has ever experienced. These are two titanic forces opposing each other, and the range of outcomes is wide and dramatic.

To stop the falling dominoes mentioned above, the government initially back-stopped the banks, then investment grade corporate bonds, then municipal bonds, and now even "junk" bonds and ETFs. There is speculation that the government is prepared to use the powers of the treasury to buy stocks and ETFs if prices were to continue to decline. This is unprecedented. Some say it amounts to a nationalization of the investment markets. Suffice it to say that the investment world has changed and may not return to "normal" for a long time, if ever.

However, a few things seem probable. The intended as well as the unintended consequences of such massive actions will be many and profound. Since the Fed has backstopped even low-grade bonds, "junk" investments have rebounded sharply, often rising much more than high quality issues. The two titans of inflation and deflation will be battling as we work through any recovery. Certainly, the creation of massive amounts of money may lead to hyper-inflation, hence the recent rise in precious metals. Echoes of the Weimar Republic's experience (i.e. Germany's early 20th century hyper-inflation) ring in economists' ears. However, defaults (if they are allowed) are deflationary and tend to depress prices, especially when production capacity is ample and demand is down.

Short term interest rates are going to zero and may stay there for quite some time. Money markets will yield practically nothing again. That will have a tendency to reduce savers' income and increase the demand for income-producing investments like stocks with good dividends (if the companies have enough cash flow to maintain them) and bonds (especially if the government won't let them default). This could lead to a "TINA RIPPER" if and when things stabilize, as "There Is No Alternative" becomes the rallying cry for another round of rip-roaring asset inflation (i.e. stock market rally).

The Fed has averted a systemic financial crisis for now. The debate about the market's direction is currently primarily centered around two schools of thought: "The Bottom Is In" and "A Retest Is Coming." Post-crash financial markets often include record-setting rallies. We recently saw the largest single-day rise in the US stock markets ever. Sometimes, the panic low turns out to be the bottom (such as on December 24, 2018) and sometimes there is a "retest" where the market rallies for several weeks or months, then rolls over and goes down again to either visit or breach the previous low, thus reaching a "demoralization phase." The primary emotion of panic gives way to "FOMO" (the Fear Of Missing Out) as the market initially recovers. The panic selling appears to have peaked on March 23rd. The subsequent rally has been incredibly strong as panic has subsided and the federal government makes increasingly large commitments to stabilize the economy and the markets. We will only know whether March 23rd represents the final bottom with the luxury of hindsight. However, we shouldn't forget that an alternate script shows a rally that inspires confidence, only to shatter that confidence as the full economic impact of the aftermath is fully revealed.

This is the fourth stock market crash I have witnessed in my career as an investor. Having been through something somewhat similar before, I am at least familiar with the basics of the emotions, mood swings, and market gyrations. The range of reactions from clients is extremely wide. Some are entrepreneurial in spirit and in a position to make investments early, even if it includes riding the market down through another trough. Others are traumatized and fearful of any further loss, unwilling or unable to take the chance that the worst may not be over. Again, there are two primary schools of thought about investing in a crash. The first investor buys earlier into declines and hopes to catch the bottom before they run out of buying power. The second waits to buy until an upswing is in place during the recovery from a low. They then plan to hold only so long as the market doesn't fall below the previous low. The first risks buying too early, and the second risks missing the first move off the lows and/or being "whipsawed" by buying a recovery rally that fails. It is never easy.

Having been through this market crash and survived, we now need to review your assets and allocate them in a way that is consistent with your investment desires and personal financial situation. I have no desire to subject you to more market volatility than is appropriate for your risk tolerance or appetite, and I also do not want to hold you back from taking advantage of what might prove to be historically cheap prices if you want to add to your holdings. My first and most important question of you would be, "How much of your portfolio do you want (or can tolerate) to be invested in equities (stocks), and how much in bonds and cash reserves." It would be best to have that discussion as soon as possible so that we can prepare for the next phase of our investing lives.

Examples of some of the likely winners in the next phase may include e-commerce and connectivity stocks, including those participating in the new 5G technology, pharmaceutical and testing companies, defense and infrastructure stocks benefitting from new government spending programs, and high-dividend stocks that may look increasingly attractive in a zero-interest rate world. Banks and financial companies may reap rewards from government-sponsored asset buying programs. Precious metals including gold and silver mining stocks could also be beneficiaries of a world where currencies lose value after massive inflation of the money supply. Opportunities will abound but not without risks. We want to be able to take advantage of opportunities in a way that is consistent with your financial position and tolerance for volatility.

Please review the enclosed reports and feel free to call me to discuss these portfolio allocation decisions at your convenience. As we pull through this most challenging time, we look forward to working with you in managing your investments in a rapidly changing world.

Best regards,

Claude R Carmichael CFA