July 2020

AS THE WORLD TURNS

THE BIG PICTURE

The Covid-19 pandemic is at the core of current economic and market uncertainties. Most developed countries shut down unprecedented portions of their economies starting in the first quarter of 2020 because of estimates coming out of China of projected population death rates as high as 3%. That was uniquely unsettling. There was concern about a massive number of deaths occurring and health care systems being overrun if populations were not restricted in their interactions. The result was a quarantine of entire populations and the shutdown of a wide range of economic activities.

With the population lockdown and the resulting economic impact, the federal government moved quickly to provide substantial relief to businesses and the unemployed. The intent is to help to stabilize economic activity by helping businesses keep their doors open, and helping consumers continue with their lives. Even though we would not be surprised to see more government relief actions, such massive government support cannot go on forever. Ultimately economic activity has to be restored job-by-job to get America back on its feet. It is a complex task that involves a circularity of human choices and actions involving jobs, activities at shopping malls, restaurants, food production and distribution, hotels, travel, and more.

The International Monetary Fund now predicts 2020 global GDP to shrink by about 5%, and U.S. GDP by about 8%. Those are big numbers. Even if we do not have a second wave of Covid-19, the economic recovery is likely to be slowed by changes in activities, such as continuing social distancing, damage to sources of supply caused by the size and scope of the lockdown, changes in consumer spending habits, and changes in workplace safety and hygiene practices. Events seem to have moved at warp speed, as the Covid-19 pandemic has deeply affected economies around the world.

The core question is, how do we mange investment portfolios in the context of both serious economic concerns and massive government supports? To be explicit, this is the first time in at least a decade where we have seen truly major economic problems. How cavalier should we be in trusting that the Fed and Congress can paper over these problems with nary a hitch?

THE ECONOMY AND INVESTMENT MARKETS

Covid-19 has slammed jobs and dramatically impacted the economy. The U.S. unemployment rate is currently estimated at around 14%, with as many as 40 million people unemployed. We have seen a material worldwide deterioration of economic activity and corporate balance sheets. The government response is unprecedented — trillions of dollars of liquidity from the Fed poured into the financial markets, and additional trillions of dollars distributed by Congress to businesses, the unemployed and a broad array of the general population. Beginning in February the stock market declined about 33%, and beginning in late March the market increased about 40%. That is volatility, first with dramatic risk aversion and then with impressive risk indifference.

In both 2000 and 2008 we were able to lead our clients though the market gyrations with less pain than what was inflicted by the benchmarks. But every event is different and there are real economic and financial uncertainties looking forward. At this point, we have undeniable economic problems on both the supply and demand sides. We have rapidly growing debt, which is often a burden on economic activity that leads to business bankruptcies. Can we just look across the valley of this downturn to the next economic upturn? No. The fog in the valley is too thick. We have gone from a worldwide slowing GDP trend to an outright GDP contraction along with worldwide unemployment. Debt burdens are heavy and business bankruptcies have just gotten started. The government's response has been massive, but will it be enough to drive a full economic recovery? If the monetary and fiscal largess does continue, will it result in serious inflation? It's difficult to imagine when and how we might see a full economic recovery. Because of all the uncertainties, we view this as a time to be cautious.

There are massive forces at play in the markets. As long as we have a very accommodative Fed pouring liquidity into the markets, should we continue to expect that Fed actions will make all the difference? Again, no. The Fed has been saying that the economy is OK, and all the markets need is some liquidity that the Fed is supplying. According to the Fed, that solves the problem. But as we continue to have a weakened economy and we start to see an increasing number of bankruptcies, the issue becomes solvency, which is a problem the Fed liquidity magic can't counteract. Taking the market liquidity issue off the table does not resolve the business solvency issue.

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

Much that's happening now in the market seems like a redo of 2000, with tech stocks becoming more and more expensive relative to the rest of the market. Could we once again be close to the moment where all the dreams come crashing down, as they did beginning in March 2000? Possibly, but we don't see a real catalyst. With all the government support, it is hard to find a smoking gun here. That said, there's ample reason to be

cautious at least in the short term. With the upturn that started in late March, markets are way overbought, a growing supply of bonds seems to be coming to market, and with low trading volume and particularly low liquidity there is potential for more volatility like we saw earlier this year.

Similar to 2000, plenty of tech stocks are selling at many multiples of revenues, with no earnings, and no ability to scale into future earnings. At some point that breaks, and given the deep economic problems out there, we would not be surprised if something breaks in tech stocks within the next year. Just as in 2000, there are some acceptable tech stocks that we would be happy to own at the right price. The problem is they're too expensive vs. their prospects. Tech isn't above the broad economic problems we face, even though they're priced like it. Remember Cisco Systems in 2000? They were and are a good tech company, but be aware that since 2000 their sales and earnings have grown about four times, while their stock price has declined about 40%. As companies become large, including tech companies, their sales and earnings growth rates slow significantly and move toward the growth rate of the overall economy. Eventually, as reality overtakes hope, the market reflects that reality. Valuations matter and risk matters.

Another current aspect of portfolio management to be aware of is the extent to which U.S. markets have dominated worldwide performance over the last several years. Could that also be coming to an end? U.S. equity and currency valuations have become pretty extreme. Because of that, overseas markets generally are starting to look more attractive. That doesn't mean they have to outperform starting now, but we think it's something to keep an eye on. We purchase ADRs (American Depositary Receipts) when we identify attractive opportunities in foreign companies. Going forward, being more of an international investor seems likely to make good sense.

More specifically, since late March the attitude toward risk in the market has been pretty cavalier. In February we held a lot of cash. As the market declined from late February into March, we were aggressive about putting that cash to work because there were several opportunities that looked good. As the market turned upward in late March we began to do some selling at better prices and again increased our cash position. The reason is that with all the unresolved economic uncertainties this seems like a good time to be pretty cautious. We think there are pockets of the market, where we are principally invested (e.g., consumer staples, utilities, precious metals), that can do fine, but at these index levels the broad markets look pretty expensive. In particular, many growth and economically sensitive names are trading like there are few problems, which based on real-world issues seems more aggressive than we want to be. People seem to think that since things have worked out pretty well for stocks so far, things should continue to work out well going forward. What motivates this view? It's not earnings or valuations. It looks more like the psychology of risk indifference driven by the idea that the Fed will prevent any bad scenarios from happening (moral hazard). That has worked out pretty well for the last 11 years, but are there limits? We will see. Japan has been playing this game for decades, and their markets gave up the ghost long ago.

We currently see two supports for the market. One is government stimulus, which has a long history. History tells us that throwing the money out there initially makes everyone happy. But then you have to fund it by raising debt, which pulls money out of the system. That's why we don't see inflation anytime soon. History shows the current scenario to be deflationary. Generally, inflation shows up when there is a serious loss of faith in the currency. The second market support is technicals, in the form of a continuing uptrend. If the technical support lines break, will the Fed save us? That is a possibility we respect, but it is a risk we are not willing to take.

At this point, if things again turn adverse, we generally are willing to hold onto our current positions. We seek to be disciplined and patient. Right now we see few opportunities, but markets change and opportunities surface. What is clear to us is that right now it is hard to want to buy the broad, passive index, market. As part of our Intelligent Risk Management investment process, we have built up a "war chest" of potentially attractive names for purchase at the right price. Such opportunities arise in a variety of ways. An individual stock's price can decline with no change in the underlying business. In the same way, an industry or sector can decline. Whether you term market action a decline or a rotation (such as away from momentum and into safety), opportunities do appear and we believe we are well positioned to take advantage of those that, in our considered judgment, have particularly attractive future possibilities.

CONCLUSION

We respond to investment factors as they change over time. The ability to respond to changing conditions is something that passive index investments can't do. The ability to respond to changing conditions is a major factor in protecting savings, building durable wealth and so creating financial security over the coming years. In a volatile market, lacking a flexible discipline looks like a difficult investment path. The reason is that passive investments ride the most richly valued stocks in an up market as their portion of the index increases. But those same index-overweighted stocks face the worst headwinds in a sector rotation sideways market or in a down market. For flexibly managed portfolios, the same valuation dispersions should create the best investment opportunities. We saw this same type of rotation opportunity with the Nifty Fifty stocks of the 1970s, the TMT stocks of the 2000 tech bubble, and the financial stocks of the 2008 crisis. We would not be surprised if we see the same process in the coming years.

All of the Fed interventions misprice risk and create moral hazard. We seek to be disciplined, cautious and patient, and lean away from risk when that makes sense and toward opportunity when that makes sense. Having a flexible long-term investment discipline is more important than chasing short-term momentum performance that can take you over a cliff. At the heart of our responsibility to clients is to keep them from buying overpriced glamour stocks during periods of enthusiasm, to guard against paying too high a price for good stocks at any time, and to guide clients to buy undervalued stocks during periods of worry and concern.

Yours sincerely,

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