SYMONS® CAPITAL MANAGEMENT

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MANAGING RISK/REWARD IN AN UNCERTAIN ECONOMY AND MARKET

THE BIG PICTURE

2020 continues to be a time of enormous challenges — Covid-19 scientific uncertainties, notable economic contraction, financial markets' volatility, a contentious November election, and the ever-changing China trade deal. There is a lot of divergence of opinion on every one of these challenges.

Financial markets remain optimistic. The stock market is constantly changing and often volatile. Many institutional investors track each other's investment ideas, and that often causes them to be on the same side of the boat, which can cause sudden market surges and sudden declines. Such sudden shifts occurred in both the lead-up to the 2000 dot com bubble and decline, and in the lead-up to the 2008 financial bubble and decline. C. S. Lewis (who wrote *The Chronicles of Narnia* and numerous other famous books) once wrote that "When the whole world is running towards a cliff, he who is running in the opposite direction appears to have lost his mind." Back in early 2000 tech stocks were king and Warren Buffett was derided as a dinosaur. Now in 2020 tech stocks are again king and Warren Buffett is again derided as a dinosaur. Is this time any different? We don't think so. In both cases we think it's fair to say the tech frenzy was encouraged by low interest rates, as well as by more than ample liquidity supplied by both government stimulus and Fed financial markets supports. Low rates are likely to be with us for the foreseeable future, but the flood of government supplied liquidity is less certain.

While financial markets are generally optimistic, global economic data are in recession. With all of the economic uncertainty, how do we manage our investment objectives for investors? For us, the core is constant risk/reward analysis on both a macroeconomic and individual asset basis. Risk/reward is about probabilities, because a sure-thing doesn't exist and there is always uncertainty. As either the economy or market gets better or worse, we make incremental shifts in our investments. For example, at the start of 2020 we had close to zero assets in precious metals investments. Today, we have close to 10% allocated to precious metals investments in all three of our strategies.

Currently, we see more risk than reward in the markets. We have a stock market near an all-time peak and stocks (particularly technology) near all-time high valuations relative to their revenues and earnings. At the same time, the economy is in recession with record unemployment and bankruptcies, while being supported by government stimulus that we doubt can go on forever. In this environment, where are the best risk/reward opportunities? It depends. As the data change the portfolios evolve as we stay focused on our goals of seeking to protect savings, build durable wealth and create financial security. We seek to provide a smoother, less volatile, path for our risk-managed portfolios. We both never forget about risk as we try to limit the downside, and, at the same time, we never forget about looking for opportunity, whether in a stock, a sector, or the entire economy.

THE ECONOMY AND INVESTMENT MARKETS

Simply put, the macroeconomic backdrop we have to deal with is a mess. Every day we see optimistic stories about the economy and the market. But beyond the warm and fuzzy stories, there is a lot of concerning data. In every case of considering both stories and data, the basic question is whether the information is temporary or longer lasting. Will the economic downturn (recession) be quickly followed by a sustainable V-shaped recovery and follow-on growth, or will the range of recent economic dislocations take years to recover? The market expects the former. We suspect the latter is a higher probability.

Semiconductor stocks are an interesting study of stories and data. A lot of people seem to be on the same side of the semiconductor boat. In late July AMD (Advanced Micro Devices) reported financial results that were pretty good, and the market responded positively. AMD's trailing P/E was 192, it's forward P/E was 51, and its Price/Sales was 11. Those are all very high valuation data. AMD's big competitor is INTC (Intel). Intel reported some disappointing financial results. They actually had pretty strong earnings, but they had a big product delay that made investors nervous, and the stock dropped 20%. INTC had a P/E of 9, a forward P/E of 9, and Price/Sales of 3. The valuation differentials between AMD and INTC are enormous, and the probabilities are that over time the gap will close. But the popular narrative is that AMD is the future and INTC is the past. Here as elsewhere, the popular narrative seems to be causing one stock to be treated generously and the other to be treated harshly, as if there are few uncertainties about the futures of the two companies.

What do we do with such stories and data? Are we in a new world where it really is winner-take-all? We doubt it, but we have to respect what is happening and think about it. Is AMD really worth that much more than Intel? Is Amazon the permanent Ma Bell of retail? Is Facebook going to be able to buy all their competitors, or have them banned from the Internet? That is what investors seem to be pricing in. Maybe they're right, but those probabilities are a very high bar. With expectations so high, what can such popular stocks do for an encore to maintain their high valuations?

We believe the biggest reason the stock market is so optimistic is the idea that the Fed has our back. The idea is that while some of the stock valuations may be high, as long as the market keeps going up investors will follow because since 2009 Fed actions have protected them. That strikes

us as a dangerous position. Even if the economy is no longer in freefall, the slowly improving jobs and other numbers are still far below the historical context of the numbers generated by a normal economy.

INVESTMENT STRATEGIES AND PORTFOLIO MANAGEMENT

The S&P 500® large cap index is near all-time highs and YTD is an incredible 17% ahead of the S&P 500® Value index, while the small cap indices peaked and turned down in August 2018, over two years ago. Interest rates in the U.S. are as close to zero as they have ever been, and in much of the rest of the world, such as Europe and Japan, they are at or below zero — which simply makes no sense. Sovereign and corporate debt burdens are at all-time highs, as are government stimulus and central banks' financial markets supports.

Valuations for the huge tech stocks are extremely high — they are priced for perfection. The disparities between tech and the rest of the market are about as big as they have ever been. Going forward, what is the probability that tech will underperform the market? There have been many times in market history when an expensive market has dropped to match up with broadly weaker earnings. But we can't think of a time when earnings broadly jumped to match up with a broadly expensive market.

The stock market looks similar to 2000 in the sense of tech stock exposure to risk. The economy and government response looks similar to 2008 in the sense of bailouts/stimulus, except that this time the support is much more massive. Even with the massive government response, in our judgment it is doubtful we can get the kind of 2020 economic recovery people are hoping for. We appear to be on the downside of the credit cycle. Business capital expenditures are down, business expense budgets (jobs) are shrinking across the board, and defaults are rising. Those business cycle problems don't disappear quickly.

Bottom line, in general we aren't buying tech stocks right now. Their prices are up because their P/E multiples have expanded dramatically, not because their revenues and earnings are up. The world has seen this type of frenzy before, starting centuries ago with tulip bulbs. We have no problem investing in "growth" stocks at the right price, but right now seems a questionable time to do it. The market is largely being driven by government and Fed supplied money flowing into a handful of tech stocks. The rest of the market is mostly sitting out this dance.

If not tech, where are we invested? For one, we have added precious metals stocks. When the market had its dramatic drop in February-March, precious metals stocks dropped along with everything else. That didn't make a lot of sense to us, so we started buying, and we see those stocks as one area that should hold its strength for the foreseeable future. The rest of the non-tech market is priced for some type of continuing recession risk. Utilities and consumer staples stocks are still reasonably attractive. People spend money in those areas in all economic environments and so the companies' top-line revenues are relatively stable. As the economy begins to recover, we should likely see traditional value sectors outperform, such as industrial stocks. And we certainly are willing to buy cheap tech, which some people call old tech. How we are positioned right now makes a great deal of sense to us.

CONCLUSION

History suggests that the continuing effect of Fed monetary policy supporting the market is uncertain. How investors allocate their money is materially dependent on investor psychology. If investors are optimistic, then they are willing to invest Fed monetary inputs in momentum stocks and passive index products, and not worry about risk. But if investors become fearful of a serious recession or a market downturn, then risk matters and cash or safety stocks become more attractive investments. The result is that investor psychology either can support the goals of the Fed's liquidity efforts, or it can cause the Fed's market support efforts to be useless.

Passive investing has a similar problem. Passive index products don't worry about risk, even if investors do. For passive investing the value of a stock is determined solely by its market capitalization, the bigger the better. Similar to the Fed's liquidity inputs distorting market risks, passive investing works only as long as no one's behavior changes from viewing revenue and earnings as irrelevant in determining a stock's price. By definition, a passive investor should purchase more AAPL than any other stock. But if earnings matter when considering investment risk, what is AAPL worth? Over the past 5 years AAPL sales have grown at a rate of 3.2% per year, and earnings have grown at the rate of 1.8% per year. But AAPL's stock price has gone up at a rate of 38% per year, and its P/E is about double its historical average. Passive investors don't care about any of those concerns. Does the passive nature of the market driving up the price of AAPL "compel" you to own it? If the mega stocks don't continue to maintain their market share, passive investing will have a problem. We don't want to be one of those who later say "no one could have seen that coming."

Can the government create permanent prosperity simply by keeping the money spigots flowing freely? We don't think so. If that were the case, Japan would be doing fantastically, and Zimbabwe would have the greatest stock market in the world. Is tech on its own economic island? We don't think so. If consumers don't have jobs, are they going to spend their limited assets on tech, or on food, shelter and energy?

The economic problems have not gone away, even though a good chunk of the first quarter stock market losses have. The idea of another market downturn strikes us as quite possible, although we wouldn't expect it to be as sharp as the decline earlier this year because of the lower possibility of a huge surprise, like Covid-19. In addition, both government stimulus and Fed financial markets supports seem unlikely to go quietly into the night. Bottom line, it wouldn't surprise us to see a noticeable decline, followed by a partial retracement, followed by another decline, and so on. Simply put, while the U.S. still has the biggest, strongest economy in the world, with both real risks and real opportunities, this is not a time to swing for the fences.

Yours sincerely,

Ed Symons, JD
Chairman & Founder

Colin Symons, CFA
Chief Investment Officer

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