—New Albany—
Investment Management

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The Marathon Has Just Begun

The past thirty days have been a medical, emotional and economic shock like no other in our lifetime. The avalanche of news, the fluidity of the Covid19 crisis, and the evolving oil price war has made it difficult to put relevant thoughts on paper because the situation is continually changing. Though the initial shock and panic has receded, the reality and implications of this enormous crisis have just begun. As hopeful as we all want to be, the likelihood of the economy getting back to normal in a matter of months seems highly problematic. Indeed, this is not a sprint situation, rather the start of a marathon with some very tough hills ahead. But I do have faith our country will rebound with unity and strength.

Fast Stop: The US economy and everyday life hit a fast stop. After having record low unemployment just one month ago, there are now estimated 6-10 million people out of work! Likewise, Corporate America went from nearly 100% capacity to 25-50%, and most small business activity went to zero. In simplistic terms, the 'plug' was pulled on the entire economy, making this event unprecedented to any other time in history. Thus, there is no road map of the course ahead. A new path must be carved out. We are still in the first stage of this marathon.

Assessing the damage: The human toll cannot be diminished, nor ignored. The crisis at hand is indeed a medical crisis that is leading the course for almost everything else. <u>The personal and economic ramifications are still unfolding and thus the damage is unknown at this point.</u> The only consensus is that the longer it takes to contain the virus, the greater the impact will be on every business and household. Time is the great lever (positive or negative) to growing or destroying capital and wealth. In this case, time is a negative lever. The longer the economy is shut down, the greater loss of wealth and destruction of capital will occur which will in turn inhibit the speed of the recovery.

Super-Size Stimulus: The good news is both the Federal Reserve and Treasury are literally pouring enormous credit, liquidity, and cash into the economy. The size of these programs is like none other in history (even the 2008 financial crisis). These actions, especially the Federal Reserve's, have been a strong first response that has prevented a complete melt-down of the economy and collapse of the financial markets. However, now the challenge is getting the stimulus to the right people and businesses in a timely manner so that the economy can actually start to function again. The speed of delivery will determine the fate of many businesses.

War time Debt: How is all this stimulus paid for? There are two parts to this answer: New debt issuance from the Treasury; and monetization of debt by the Fed. This is the ugly side of the stimulus package. On the Treasury side, the $2.2 trillion stimulus will quadruple the US annual budget deficit and potentially place our total national debt to a level not seen since WWII. This means more borrowing will occur through issuance of US Treasury securities. Fortunately, with rates at an all time low, the Treasury can borrow for 30 years at about 1.2%. Who will buy all this debt? Investors and the Federal Reserve.

Printing Money: On the Federal Reserve side, the Fed is set up to provide liquidity through purchasing securities. When they buy securities, a credit is put into the banking system which in turn then can be used to lend to borrowers. This action is known as 'increasing the money supply' or 'monetizing debt' and is a fancy way to say the Fed prints money. Since February 17, 2020, the Fed has purchased over $1.6 trillion in securities to meet the liquidity needs of the financial system. If there is a good side to this, it is the fact that almost every other country is doing the same thing, monetizing debt, to one degree or another. As long as the US dollar remains the 'go-to' world currency, the US can continue down this path. (This will be the next generations problem, indeed.)

Restarting the Economy: The multi-trillion-dollar questions! How long? How fast? The answer to these questions are predicated on the Covid19 path. What will the economy look like: Unemployment, Spending & Savings patterns, Debt load, Capital levels? What industries do the taxpayers bail out, what industries/businesses are allowed to fail? Every business has been greatly impacted, so where is the line drawn? These questions will take many, many months to sort out. Consumers and business alike will be cautious in spending and rehiring. The recovery is likely to be lumpy and slow.

Financial Market Recovery: Expectation and Reality. It is often said the stock market is 6-9 months ahead of the actual economic news meaning expectations about the future are a huge contributor to the direction and valuation of assets. So, as the virus news ebbs and flows, so will the direction of the markets. However, valuation is also a fundamental component of stock price levels and this is where it gets even more elusive because the damage to the economy is still unfolding. The positive is that interest rates are at all time lows, and this alone is a huge boost to valuation. The negative is the sudden stop and length of time of resumption in business activity. How long will it take Corporate America to get back to the pre-crisis levels? 6,12, 18 months? While the timing is uncertain, businesses will likely be functioning differently.

Bond Market a Key to the Speed of Recovery: Credit is what makes the world go around and it is the life blood to every economy. The cost of credit (interest rate level) is a barometer of the health. During the panic stock sell off in March, interest rates actually rose (prices of bonds fell) as huge liquidations of Corporate and High Yield bonds flooded the bond market. This was most unusual as normally Bonds are considered a place of refuge when stock prices are falling. To put this in perspective, the 10yr US Treasury rate have fallen to the lowest level ever at 0.68% however Investment grade Corporate bonds and High Yield are now 2.3% and 6% (respectively) higher in yield as compared to where yields were on Dec 31st. This divergence in rates indicates fear of default and severe strain in the credit markets, and it explains why the Fed has been so aggressive in buying bonds.

Is this a Bear Market? According the definition, a market is considered a Bear market when it drops more than 20% from its peak. The market declined over 34% from its peak on February 20th. This was the fastest decline ever. Bear markets are characterized by huge whipsawing rallies that can last from a few days to several weeks. In 2008-09, the market initially dropped over 34% from its peak, had two +20% rallies before falling again and reached new lows of -50.9% in March of 2009. Is this crisis worse than 2008? Most definitely. But every Bear market is different and that is what makes them so hard to forecast and track. Bear markets are primarily driven by emotion and headlines, not the fundamentals. The 'fear of missing out' and 'fear of losing everything' are very strong polarized forces that result in high volatility. So, yes, we are currently in a Bear market.

Investment Strategy Priority: Liquidity, High Quality, Growth and Income. The focus of every strategy has always been Capital Preservation, Income & Growth. While these objectives are always present, their priority varies according to a client's needs and risk tolerance and it also changes as market conditions turn.

As of this writing, the Covid19 crisis has yet to be contained; severe liquidity strains, while improving, still remain across the financial system; the extent of the damage to the economy is as yet unknown; and volatility is at bearish levels. All this combined has warranted some changes to the investment strategy. Cash was raised for liquidity to allow for greater flexibility in the portfolio. On the Bond side, one High Yield bond position was swapped into a higher quality government backed mortgage fund (before credit spreads blew out). On the stock side, exposure was increased to solid blue-chip Growth sectors, while reducing exposure to Value sectors. *Value sectors are relied on for dividends and many companies/industries are expected to cut their dividends, hence Value stocks are not as attractive.*

Confident: As shocking as the last thirty days have been, it has been uplifting to see the country pulling together. In addition, there are many, many brilliant minds across every aspect of this economy finding solutions to get our nation back on track. We will ALL make it happened! Though the Nation will be different, I think it will be stronger.

As always, please contact me with questions or concerns. These are my thoughts. Your feedback is always appreciated.

A prayer of protection to each of you. Stay well, stay safe.

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