Market Commentary – First Quarter 2020

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Black Swan

Nassim Nicholas Taleb first discussed Black Swan events in his 2001 book Fooled by Randomness (the first of a five-essay series on uncertainty titled, Incerto) and was concerned primarily with financial events. He further delved into the idea of uncertainty and unpredictable events in his second book called, appropriately Black Swan. Specifically, in Black Swan Taleb states:

"What we call here a Black Swan is an event with the following three attributes.

First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme 'impact'. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable.

I stop and summarize the triplet: rarity, extreme 'impact', and retrospective (though not prospective) predictability. A small number of Black Swans explains almost everything in our world. From success of ideas and religions, to the dynamics of historical events, to elements of our own personal lives."

Taleb, in his books, is not attempting to predict or help to predict events which are unpredictable, rather they are to help prepare for inevitable negative events while still exploiting positive ones. Hence, he is trying to get us to understand one of the chief tenants of behavioral analysis which is that people have behavioral biases. They take near term information and extrapolate future outcomes erroneously in large part because the near-term information is relatively limited in scope and experience.

The pandemic that is now the scourge of the world, in our estimation, is one such Black Swan.

It lies outside the realm of regular experience, it has carried an extreme impact (economic, financial and health wise) and we are now coming up with reasons why or how we should have been able to predict its occurrence.

We realize that there are those that will point to somewhat similar outbreaks of SARS (Severe Acute Respiratory Syndrome), MERS (Middle Eastern Respiratory Syndrome) or even the Bird Flu as a cautionary shot that should have given us and the rest of the world a warning. The reality is that those epidemics, while certainly difficult, were relatively limited in scope and geographic spread. While the transmission of COVID-19 appears to have come from a similar source as SARS, no one could have predicted the rapid spread and impact of the current viral outbreak.

But that is what makes Black Swan events so pernicious. Because they can't be predicted you have no way of preparing or protecting yourself against the problems created by the event. The last viral outbreak with the reach and mortality of COVID-19 occurred more than a century ago and investors can't really draw any conclusions from that event as to the economic and financial impact of the current outbreak. What is clear now, and only in retrospect, is that the impact on a health, financial and economic basis will be/has been rapid, violent and large.

As we have stated many times, the market is a discounting mechanism. It takes the information currently available and uses that information to make predictions about what the future will look like. In so doing, the market must make predictions about the likelihood of various scenarios, focusing on the most likely path. That process involves making a number of simplifying assumptions, including the elimination of the scenarios viewed as wildly unlikely.

Why would the market ignore or why has it ignored large, negative, potential outcomes? Because they are viewed to be such a remote possibility as to be nearly impossible. The key word in the previous sentence is "nearly".

*The interesting thing about Black Swan events – particularly those with market and economic impact is that while each specific event, **by itself**, may be an extremely remote possibility, the events happen with alarming regularity.*

As such, while we don't have to assign a weighting in our probability analysis, we should understand and keep in mind that the likely outcome of such an event would likely be so large that it should be included in our analysis - at least as a footnote. In other words, we can't and shouldn't ignore the potential of a Black Swan event occurring even if ***we don't know what that event might be.***

Why do Black Swan events have such large and violent economic and market reactions? It goes back to a statement we made earlier that the market is a discounting mechanism that uses available information to reach conclusions. If the market doesn't know about a potential issue (i.e., an unknown unknown) then there is no way that it can possibly discount that potential to the present time. As a result, once the unknown becomes known, the market reacts instantly to attempt to discount that information and its potential outcome, usually over-reacting to the downside. This is where opportunities lay.

The Economy

We are in a recession. That much is pretty clear. That the official declarative body, the National Bureau of Economic Research, has not stated as much is to be expected as it only makes its decisions in hindsight. With the nation pretty much in lockdown, economic activity is limited, and job losses are mounting. Estimates for Q1 GDP which had been reasonably positive as late as early March are now expecting to show a decline of between -2.5% (Moody's.com) to -10% (JP Morgan) - which shows just how rapid and severe the decline has been. Estimates for Q2 GDP (which we won't know until July at the earliest) are expecting a significantly large, annualized contraction with estimates we have seen ranging from down 17% (JP Morgan) to down 30% (Goldman Sachs).

If you have been following our commentary for any length of time you will remember that we have been stating that the key to domestic economic activity is the consumer (personal consumption). Representing more than two-thirds of economic activity, the consumer is the biggest driver of economic activity. If the consumer is buying, the economy moves forward. If not, the economy stalls or, in the case of our current situation, free-falls.

The Federal government has certainly been doing their part to try and revive spending or at least put a floor under it, through both monetary and fiscal methods.

The Federal Reserve Open Market Committee (FOMC) had done an initial one-half of a percent rate cut on March 3, only to follow it with an emergency cut of 1% on Sunday, March 15 (enacted on March 16). These rapid-fire cuts were quickly followed with dramatic liquidity support announcing $700 billion of quantitative easing (QE) through purchases of Treasury and mortgage-backed securities. They revived the Primary Dealer Credit Facility (PDCF) offering low interest loans to the 24 largest institutions known as primary dealers; the Money Market Mutual Fund Liquidity Facility (MMLF) to backstop money market mutual funds; expanded its repo operations; lowered its discount rate (the rate that it charges banks for direct loans) to 0.25%; has temporarily relaxed regulatory capital limits; established two new loan facilities to support highly-rated US corporations in the Primary Market Corporate Credit Facility (PMCCF) and Secondary market Corporate Credit Facility (SMCCF); reinstated the Commercial Paper Funding Facility (CPFF); restarted the TALF (Term Asset-Backed Securities Loan Facility); began backstopping state and municipal borrowing; and effectively became the lender of last resort to the world central banks by making dollars available to other central banks whether or not those central banks have an established swap line of credit with the Federal Reserve (Fed).

On the fiscal front, President Trump signed an $8.3 billion spending bill that was termed "Phase One" which funded research for a COVID-19 vaccine, gave money to state and local governments to fight the spread of the virus and allocated money to help with efforts to stop the spread overseas. On March 18, the senate passed, and President Trump signed "Phase Two" legislation that included money for "free virus testing", expanded unemployment benefits, additional funds for Medicaid and a provision requiring paid sick leave for some workers affected by COVID-19. On March 20, Education Secretary, Betsey Devos announced that all borrowers' federally held student loans would have their interest rate set to 0% for a period of at least 60 days and each of the borrowers would have the option of suspending their payments for 60 days after March 13. On March 27 the House passed, and President Trump signed the $2 trillion "Phase Three" stimulus bill that established $301 billion of direct payments of $1200 per single taxpayer earning up to $75,000 in adjusted gross income and $500 per child and established several lending and grant programs for small businesses among other items.

Unlike the Great Recession, government response to the economic fallout from COVID-19 has been rapid and far-reaching, and while the fallout has been and is extreme to the downside, we believe that the rebound could be equally as rapid.

What makes us optimistic in this regard? Historic precedent.

We realize that we stated that there has not been a pandemic like COVID-19 since 1918, there were two other global influenza pandemics that caused widespread global deaths: the Asian Flu in 1957-1958 and the Hong Kong Flu in 1967-68. All three of these influenza outbreaks (including the 1918 Spanish Flu) were followed by recessions and all three of the recessions were reasonably short - lasting less than one year. We believe that the current pandemic could follow the same path – particularly with the stimuli enacted on the fiscal front.

We could also be in for some rather interesting inflation data – including the rather volatile food and energy segments – as they are being impacted by disparate forces. Energy prices have been diving as Saudi Arabia and Russia seem locked in an energy price war, each trying to prove a point to the other. This has caused energy prices to dive to multi-decade lows with the result that energy companies starved for capital are hurting (some heading for bankruptcy) and prices at the pump dropping nearly a dollar a gallon or more.

On the other side of the price fence, the lock-down in the economy is causing food prices to rise rather dramatically. Prices of staples like bread, eggs, milk, etc. have risen dramatically as shelves have been routinely emptied by shoppers seeking to stock up for the lockdown of indeterminant duration.

The other thing that the pandemic may do is further speed the transition from a manufacturing economy to a knowledge-based economy.

Old economy, low skill, no skill positions will have seen their obsolescence hastened as businesses and consumers have turned increasingly to automation and online to deal with shortages, initially, in labor and product. Corporate travel may also take a longer term hit as businesses have turned to collaboration and video conferencing options from Microsoft, Zoom, WebEx, etc. As businesses see the bottom line impact, they may jump more fully onto the collaboration software bandwagon – particularly if they can get comfortable with the security risks.

Interest Rates

We've been here before – kind of. The Fed Funds rate, which had climbed "all the way up" to 2.5%, is now back to zero – and we expect that it will stay there for some time.

The Fed has been pulling out all the stops to keep liquidity flowing to the marketplace – a valiant effort that should eventually bear fruit. In the meantime, if investors are willing to take some credit risk there is (currently) opportunity in shorter corporates and callable government agency bonds. While it may be short lived, and while the interest rates are certainly nothing to write home about, investors in shorter-term bonds can get yields in the 1% to 2%+ range. (Investors should understand that these rates can and do change very rapidly.) Given the ultra-low interest rate environment, we would currently discourage investors from venturing too far out the maturity spectrum as (eventually) rising rates will do quite a number on long(er) term bonds. For those that are interested, we would suggest looking at the chart from Bloomberg below which provides yield, duration and time to maturity data for a number of bond indices just one month apart (March 9, 2020 to April 6, 2020). Yields have dropped noticeably within government bonds, but those indices exposed to credit risk have seen yields rise, which makes sense given the more negative near-term business outlook.

The upshot is this, investors looking for yield and that must own bonds, in our view, the best option is to stay short (under three years) and take a little credit risk as the extra yield versus cash should offset much (but not all) of the credit risks taken. In fact, if rates rise just one percent from current levels, the only fixed income asset class that should not lose money is 1-3-Year US corporates. (This is found by subtracting the duration, which is viewed at as the price move of a bond if interest rates change by one percent, from the
Yield-to-Worst of each

	9-Mar-20			*6-Apr-20*				
Index/Security	*YTW*	*Duration*	*Time to Maty*	*YTW*	*Duration*	*Time to Maty*	*Change in Yield*	*Change in Duration*
Bloomberg Barclays US TR T-bills 1-3 Mo	*0.62%*	*0.15*	*0.15*	*0.07%*	*0.14*	*0.14*	*-0.55%*	*-0.01*
Bloomberg Barclays 1-3 Yr US Gov't	*0.55%*	*1.94*	*2*	*0.27%*	*1.94*	*2*	*-0.28%*	*0*
Bloomberg Barclays 1-3 Yr US Gov't/Credit	*0.76%*	*1.93*	*2.01*	*0.91%*	*1.95*	*2.02*	*0.15%*	*0.02*
Bloomberg Barclays US Corp 1-3 Yr	*1.41%*	*1.91*	*2.06*	*2.91%*	*1.95*	*2.06*	*1.50%*	*0.04*
Bloomberg Barclays US Agg Intermediate	*1.18%*	*3.78*	*4.12*	*1.33%*	*2.75*	*4.08*	*0.15%*	*-1.03*
Bloomberg Barclays US MBS Index	*1.53%*	*3.17*	*3.43*	*1.29%*	*3.1*	*3.35*	*-0.24%*	*-0.07*
Bloomberg Barclays US Agg	*1.37%*	*6.33*	*8.11*	*1.58%*	*6.14*	*7.91*	*0.21%*	*-0.19*
Bloomberg Barclays US Tsy	*0.72%*	*7.16*	*8.69*	*0.53%*	*7.14*	*7.24*	*-0.19%*	*-0.02*
Bloomberg Barclays Global-Agg	*0.90%*	*7.47*	*9.14*	*1.23%*	*7.3*	*8.95*	*0.33%*	*-0.17*
Bloomberg Barclays US Agg Gov/Credit	*1.31%*	*7.52*	*9.91*	*1.67%*	*7.37*	*9.78*	*0.36%*	*-0.15*
Bloomberg Barclays US Corp	*2.22%*	*8.4*	*11.98*	*3.48%*	*8.13*	*11.82*	*1.26%*	*-0.27*
Bloomberg Barclays US Agg Baa	*2.64%*	*8.4*	*12.41*	*4.39%*	*8.01*	*12.15*	*1.75%*	*-0.39*
Bloomberg Barclays Us Treasury 20+ Year	*1.22%*	*19.35*	*25.75*	*1.19%*	*19.42*	*25.83*	*-0.03%*	*0.07*

Bloomberg Bond Index.)

Investors have entered a phase of bond investing where there are increasingly fewer and fewer attractive options.

Market Overview

Bear market. Defined by many as a decline of at least twenty percent from market highs, arrived mid-March. The fourth longest bull market since 1929 had died a quick death - another victim of COVID-19.

Market PE ratios are in a deep state of flux as more and more companies suspend earnings guidance and analysts hurry to dial down expectations for the calendar year. While analysts are often overly optimistic regarding earnings outlook near an economic peak, it does take them time to dial back expectations as it becomes clear that those expectations weren't warranted. This becomes doubly true during Black Swan events. Analysts often dial in the worst scenario, and any focus on good times once the economy turns upward get swept away. We call this "Ready – Shoot - Aim" behavior.

While all stocks have been down in this current bear market, smaller company stocks have been hurt more. Where large cap stocks, as identified by the S&P 500 or Dow Jones industrial Average were down nearly twenty percent, smaller company stocks as represented by the S&P MidCap 400 and the S&P SmallCap 600 were down nearly thirty percent or more. Yes, earnings are going to continue to fall and yes, smaller companies are going to be hurt, but as the domestic economy improves, many of these smaller companies may see improvement on a larger scale than their larger cousins.

In fact, we would posit that the raft of stimulus efforts enacted by the federal government are geared predominantly towards helping protect smaller businesses which should help them to recover more quickly.

In our view, bonds, as indicated above, are more risky investment alternatives than just about any other type of asset class. Having said, that, bonds did provide positive returns for the quarter just ended. In order for that circumstance to persist, interest rates must remain stable. We view that as a likely scenario least through the balance of 2020.

Unfortunately, investors looking for cash flow will not find acceptable options in bonds. We have been suggesting and continue to suggest that investors looking for cash flow must be willing to accept a higher degree of price volatility in order to generate cash flow returns at a more acceptable level. In our mind, the need to generate more reasonable cash flow from investments should have investors looking to dividend paying common stocks. In addition to higher degrees of cash flow, investors should have the added benefit of being able to grow their cash flow stream over time while also seeing at least modest growth in principal value – also over time.

Outlook

It is interesting the perspective having started in the investment business on Black Monday (1987) gives. When you begin your investment career on the day in which the market endures its biggest single day loss in market history, you get an immediate appreciation for what perspective can offer. During violent market downturns as happened in 1987, 2000-2002 and 2008-2009 all investments get painted with the same broad brush. Having started in the business during the first of these violent downturns we understand that things do get better, perhaps more than many.

As a result, we believe that investors who have available resources or who can reallocate resources and have the benefit of time and rational thought can find some excellent opportunities.

We have confidence that this time is no different.

That does not mean, however, that prices might not fall further. Rather, we have faith that the worst is now behind us, opportunities are available and now is probably a good time to go hunting. Will companies go under due to the financial and economic fallout of COVID-19? Most definitely. However, there are still those companies which went into the crisis with significant available resources and should weather the storm quite nicely. It is our job to find them.

We do expect that interest rates will remain at or near zero well into 2021 as the Fed continues to pull on all available levers in order to get the economy on sound footing. This should keep capital costs low and allow those with means to significantly outperform those marginal players. Interestingly, we believe that it also means that, unlike during the great recession, those who were struggling financially before the pandemic may end up throwing in the towel.

Strategy Overview

Volatility is not bad.

Volatility, in many cases, can end up being our friend as volatility often causes mis-pricings and attractive return potential.

The trick is making sure that one is pricing risk (volatility) correctly. Fortunately, we have the benefit (option) of deciding if the risks we take are worth the rewards offered and time is on our side.

In our mind, making sure that we are appropriately compensated for the risks that we take is the single most important decision investors make. Making sure that our valuation models encompass the risks that we, as investors, face every day is our primary duty. As risks get elevated, it is our job to ensure that we adjust our return requirements upward in conjunction. Importantly, by ratcheting up our return requirements in times of elevated risks, the opportunities end up being at levels that, were we to own the entire business outright, we should be more than pleased with the result.

In our mind, the real risks are those not taken.