2Q 2020 Market Insights
The Economics of Fear
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"History has not dealt kindly with protracted periods of low risk premiums." – Alan Greenspan

The challenge when writing research pieces is always timing. We take pride in producing unique, insightful research that is our own. For anyone that has conducted research of any form, you tend to run into far more brick walls than immediate successes and tend to lay waste to a figurative warehouse full of prior great ideas that just don't prove themselves in the real world. Suffice it to say, quality, thoughtful research takes time, as does quality composition and editorial work. In an environment where relevant information tends to change by the hour, I will leave most of the time sensitive material to other outlets. Specifically, we've seen a large increase in our social media following across various platforms and we encourage anyone who is interested to follow us there for our most up-to-date material. That said, I will do my best to update the information in this letter at the last possible minute before distribution. Additionally, I find that there are many outlets that are providing a current events perspective on the new coronavirus now referred to as COVID-19. My intention for this quarter's Market Insights *The Economics of Fear*, is to keep those comments brief and focus on what few are talking about. How can the economic impact of this crisis spiral badly out of control? What do policy makers need to do to prevent this? What value opportunities (and traps) lie in wait for investors?

Background & Timeline of Events

On December 31st Chinese officials informed the World Health Organization about an outbreak of pneumonia among 41 patients in Wuhan China. The outbreak was connected to a local wet market and within a week was identified to be a new form of coronavirus. According to the National Foundation of Infectious Disease, coronaviruses are a large group of viruses that cause diseases in animals and humans. In humans, the viruses can cause mild respiratory infections, but can also lead to serious illnesses, such as pneumonia. Mostly benign coronaviruses include the common cold and only become serious if they progress to infection. The coronavirus family of disease does include more serious strains like Middle East Respiratory Syndrome (MERS) and Severe Acute Respiratory Syndrome (SARS), which experience mortality rates of between 10-40%. COVID-19 is from this family of virus.

As of March 31, there were about 802k confirmed cases globally with 39k deaths, equating to a mortality rate of 4.8% overall. Most experts acknowledge that the calculated mortality rate is likely to be high due to mild and unreported cases not being counted. The CDC states that a range of .25% to 3% should be considered, but that the experience for China excluding the Hubei Province, which was .9%[1] ,might be most accurate. They also acknowledged that under strained resource conditions the experience should be expected to be near the upper-end of the range.

While COVID-19 is a global healthcare and economic concern, the relevant timeline of events as it pertains to our topic today started to accelerate around mid-March, as the US began to impose steps to curtail COVID-19. By Monday March 15th, the CDC advised against gatherings of 50 or more, resulting in widespread school and business closures across the nation with

[1] CDC EID Journal Volume 26 Case-Fatality Risk Estimates for COVID-19 Calculated by Using a Lag Time for Fatality

many implementing stricter shelter in place guidelines. On March 29th President Trump extended the nationwide social distancing guidelines to April 30th.

Economic Impact

The economic side of this equation is on one hand rather difficult to assess, but by the same sense simple to explain. Now, let me acknowledge that there are many layers of obvious economic pain being felt in our day-to-day lives ranging from closed businesses, to lost jobs, not to mention the healthcare aspect which involves real human suffering. I'm focusing on several aspects of this environment that, in my opinion, are what can take a bad environment and make it much, much worse and is why the $2T COVID-19 Stimulus Bill and perhaps more may be necessary.

Our current economic predicament is directly relatable to three prior quarterly Market Insights: *The Most Dangerous Game, The Paradox of Profits* and *The Minsky Journey*. *The Most Dangerous Game* was a Market Insights piece addressing wealth effects from 2011. *The Paradox of Profits,* written in 2013, broke profits into its component pieces. *The Minsky Journey* was written all the way back in 2008 and discusses negative feedback loops. All are very relevant today because there are negative feedback loops smoldering in both the profit and wealth effect channels that need to be stamped out.

First, some background information. The equation for economic growth or GDP is C+I+G+(x-m) or Consumer Spending + Business Investment + Government Spending + net exports. From this equation consumer spending overshadows all others combined, representing roughly 2/3 of all economic impact. Therein lies problem number one, consumer spending will and has declined sharply presenting a major problem for our economy that is rather intimately intertwined. Said differently, it's very apparent in just a few weeks that most things in our financial lives are some form of a levered bet on US economic growth. You'll see momentarily why consumers who spend, create profits, their own jobs, and ultimately their own ability to continue to spend. Conversely, businesses that try to preserve profits by cutting wages are essentially tethering themselves to an anchor, jumping into the Atlantic and yelling cannonball! Probably doesn't end well.

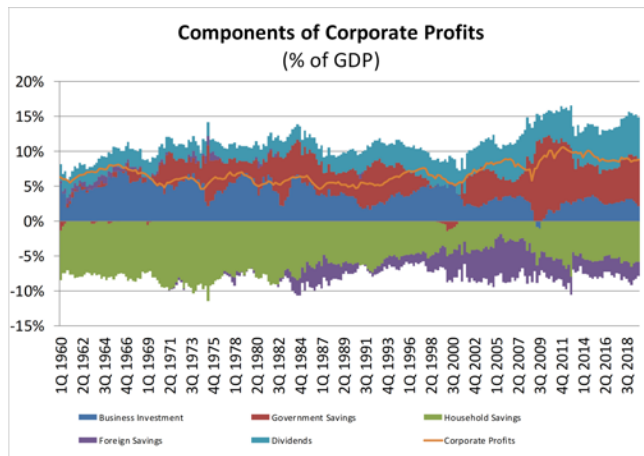
While hardly a household name, Hyman Minsky, Ph.D. was an American economist and professor of economics at Washington University in St. Louis. Dr. Minsky believed that stability in financial markets was inherently destabilizing, as it encouraged risk taking and speculative behavior that would become destabilizing. There is much to relate here, but for now the takeaway is about feedback loops, in this case negative feedback loops. As I mentioned a moment ago, an example of this is when one negative thing causes another and another. It's essentially akin to tipping over the first domino in the line or removing the bottom card in a house of cards. When one thing falls, so do the rest. In our current environment, there are several feedback loops operating.

Businesses that are forced to close are, in many cases, likely to lay off workers in an attempt to preserve profits (solvency in this case) absent any intervention or incentive not to do so. In the aggregate, this can further depress the profits they are attempting to preserve through a feedback loop. Corporate profits, at an aggregate level in closed economy, are derived as follows:

Profits = Business Investment – Household Savings – Government Savings – Foreign Savings + Dividends

In the formula above, household savings is where you find consumption and is the residual of personal income minus consumption. Notice that the operation prior to it in the formula is negative. This implies that savings is a drag on profits. Simply stated, an alternative to saving is spending. Spending is good for profits, while saving is bad because it removes money from circulation. If businesses attempt to preserve profits in aggregate, in a closed economy they are essentially negatively impacting their own profits. Some caveats…. this operates in the aggregate and in a closed economy. One business may certainly be able to cut wages to improve profits. If all businesses do this simultaneously it impacts the consumers' ability to spend and results in further damage to the business. The aggregate is important for diversified investors, since we invest in the aggregate.

Negative Feedback Loops



Data source: Federal Reserve Board

In simple terms, business investment and dividends (received by consumers and spent) make a positive contribution to profits, while savings (or reduced consumption of any sort (remove dollars from circulation and diminish overall profits. Wages and consumption are both important pieces to the puzzle, but are netted together to form savings. In this case, negative savings, or borrowing, is a positive contributor. As we look ahead, reduced consumption and declining business investment and dividends are likely to become headwinds offset partially by rising government spending.

Closed economies are those with no outside influences or trading activity with other economies. That is, no consumer is paid by anyone other than a business within the same economy. Therefore, as businesses are forced to lay off workers, they are actually harming aggregate profits in our economy, not helping. In reality, this relationship is somewhat elastic in that downward pressure on wages can be absorbed through reduced savings, while holding consumption constant. It is only to the extent that wage cuts interfere with consumption that profits will be impinged. But what if consumption is impinged by non-essential business being forced to close across the board? Our economy begins to look very closed and the aggregate becomes very relevant because this applies to a large number of consumers and businesses simultaneously. I would argue that it doesn't matter what the reason is, reduced consumption will drag on profits and is the start of a negative feedback loop that creates less profits, future reduced consumption and so on and so forth.

An additional negative feedback loop in the profit equation is in Business Investment. Business Investment has typically been the primary positive contributor to corporate profits. This occurs at the aggregate level because cash outlays for inventory, property, plant, and equipment are not expensed, yet revenues received by the seller are recognized into income immediately. The second observation about business investment, which may not be so surprising, is that most dips in corporate profits correspond with the initial dip in business investment at the downturn of the business cycle. As businesses attempt to weather the storm, outlays for inventory, property, plant, and equipment will grind to a halt. In the aggregate, this will place further pressure on corporate profits and could potentially set off an unrelated negative feedback loop, a negative wealth effect.

The negative wealth effect feedback loop works as follows and was addressed in our 2011 Market Insights *The Most Dangerous Game*. On August 27th of 2010 the Fed Chairman Ben

Bernanke was questioned on how the Fed hoped to implement monetary policy with rates at zero. He made the following statement:

"*The channels through which the Fed's purchases affect longer-term interest rates and financial conditions more generally have been subject to debate. I see the evidence as most favorable to the view that such purchases work primarily through the so-called portfolio balance channel, which holds that once short-term interest rates have reached zero, the Federal Reserve's purchases of longer-term securities affect financial conditions by changing the quantity and mix of financial assets held by the public.*"

By Fed Chairman Bernanke saying that he hopes to "affect financial conditions by changing the quantity and mix of assets held by the public", what he was really saying, even by his own admission, is that Fed's goal is to create a wealth effect for those holding risk assets and simultaneously reduce the cost of capital for the issuing organizations.   The wealth effect, or making people feel wealthier, creates spending which stimulates economic growth. In 2011, I wrote that the practice of inflating asset prices to whatever end can have disastrous consequences. Anything that moves an asset away from its fundamental fair value is unstable. While a positive wealth effect stimulates economic growth, a negative wealth effect can diminish it. As profits feel the squeeze from our prior feedback loop, stocks will inevitably decline.   Does this decline create even less consumption? It can if left uninterrupted.

In the preceding paragraphs I identified several Minsky moments or negative feedback loops emerging. There are likely to be more. In Minsky moments, unemployment rages, businesses close defaulting on debts, banks and pension funds fail as financial markets collapse, resulting in more and further economic hardship. It is critical to break the feedback loop, otherwise things can degenerate very quickly to levels where even strong businesses and households are impoverished. Considering this, there is no dollar amount that is too great and no assistance package that should be refused. The cost and consequence of doing nothing is far greater than the dollar amount required to break the feedback loop. It is crucial that we, as a society, bridge whatever gap this is so that 6, or 8 or X weeks from now most can return to the same job that they had just a few weeks ago. If we are successful in that regard, life will quickly return to normal, including a return to normal for financial markets and investment portfolios. I am not suggesting an immediate return to prior record highs, which were likely too high to begin with, but rather a normal upward trajectory. The $2T COVID-19 Stimulus bill providing relief to individuals, businesses, and states is certainly a good first step to breaking the feedback loop. If more is necessary, lawmakers must be undeterred.

Financial Markets Review

It's no secret that for quite some time leading up to this we had warned of the dangers of an overvalued US stock market, the 2nd most expensive market in 140 years. Much to the chagrin of value investors like ourselves, great bubbles take their time continuing uninterrupted until a catalyst for a reversal emerges, often taking several years. At peak valuations, US equities traded at 37.87x cyclically adjusted earnings (PE/20) and 23.43x trailing earnings, 40%-54% overvalued and priced to provide an average return of approximately 1.72% for the next decade. That all changed 4 weeks ago. The catalyst, in this case, was a global pandemic, but could have been literally any one of a hundred different things. At such extreme valuation levels, investors need things to go perfectly. When they don't, prices recede. Catalysts can be spectacular, like a global pandemic or housing crisis. They can also be rather ordinary. During the internet bubble, stocks crumbled under the weight of their own lofty expectations, with the assumptions for future growth becoming so lofty that markets simply ran out of marginal buyers willing to wager higher or more. At quarter end, US large cap stocks improved from peak valuations, at one point rested within 10% of true fair value (approximately 2100 on the S&P

500) and have since inflated back to about 21% above fair value, depending on the metric. Better? Yes, but hardly at the level where we would urge anyone to push their chips to the center of the table.

The table below provides a good summary of how we view a range of equity asset classes. The greatest opportunities continue to exist in those assets that were undervalued previously. These include; broad emerging markets equities, emerging markets value stocks, and international developed markets. All which are priced to provide solid double digit returns over the next decade, excluding currency, which should also be additive.

Equity Valuations & 10 Year Return Projections

	US Large Cap	US Small Cap	US High Quality	US Lg. Growth	US Lg. Value	Int'l Dev. Eq.	Emerging Mkts. Eq.	Emerging Mkts. Val.
Fair Value	21.0	30.9	25.6	28.1	17.5	21.8	18.4	15.1
Jan. 2020 CAPE	29.5	42.3	29.3	41.2	21.5	18.7	14.2	10.4
% Over/Under	40%	37%	14%	47%	23%	-14%	-22%	-31%
Jan. 2020 - 10 Yr. Return Est.	2.5%	2.4%	7.6%	2.3%	3.5%	7.7%	9.5%	11.5%
March 2020 CAPE	23.2	29.1	26.0	33.9	16.0	14.7	12.3	8.3
% Over/Under	10%	-6%	2%	21%	-8%	-33%	-33%	-45%
Current - 10 Yr. Return Est.	4.4%	5.8%	9.0%	3.6%	6.2%	9.9%	11.0%	13.7%

Source: iCM Capital Markets, Bloomberg

Within fixed income, we see a range of opportunities emerging outside of traditional nominal treasury bonds, which I would describe as a continuum with just about everything being varying degrees of undervalued compared to treasuries. Treasury inflation Protected Securities (TIPS), municipal bonds, and corporate bonds (both investment grade and high yield) have moved very quickly to undervalued levels. While TIPS and munis were both prior tactical overweights for us at different horizons, corporates bonds have stretched the farthest and, in our view, represent the greatest opportunity in a buyer-beware marketplace. Currently, upper credit quality corporates represent the better bargain when compared to high yield or junk bonds, but the gap is closing quite rapidly.

Finally, perhaps the best opportunity that we've seen thus far is in closed end funds. Closed end funds endured the downturn exceptionally well up to the week ending March 13th. Beginning March 16th, selling became rather indiscriminate to say the least. All major assets, including treasury bonds and gold, traditional safe havens that are negatively correlated to equities during times of crisis, declined during the week. Discounts for closed end funds widened significantly during this period, ending at levels not seen since the financial crisis with the broad universe of closed end funds trading at an average discount of 20% to NAV and with average yields of over 7%. With strong performance in the last week of the quarter, discounts have now closed substantially, but still offer investors an opportunity to acquire the conventional assets previously discussed at even lower prices.

Is this over? What can go wrong?

At this point, quite a bit can still go wrong, but I'm encouraged by what I see thus far. The key data point to monitor is non-financial; recovery from the virus. Any clarity as to how long the country and businesses will be required to remain closed will greatly influence our near-term path. To the extent that it appears that this may stretch into the summer or beyond, markets will be looking for another backstop or two. Along the way, there will be many feedback loops that are not apparent, but emerge. This can include rising defaults, issues with leveraged loans, valuations that remain high, or the impact that this environment puts on the corporate bottom line, which is sure to be great. Most analysts estimate the impact to 2q earnings at 10% or less. To call this wishful thinking is an understatement. We would not be shocked to see earnings decline by 30% or 40% over a short period, before rebounding sharply later. The unknown here is how long and how much? In influencing an economy, monetary impacts, fiscal stimulus, and wealth effects are exceptionally powerful influences. Nothing compares to fear. In fear, you can give consumers unlimited dollars and they will not or cannot spend them until fear subsides. As a result, we are proceeding cautiously as a discriminating buyer looking for great deals, not just plain good deals. We thank you for your continued trust and confidence.

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