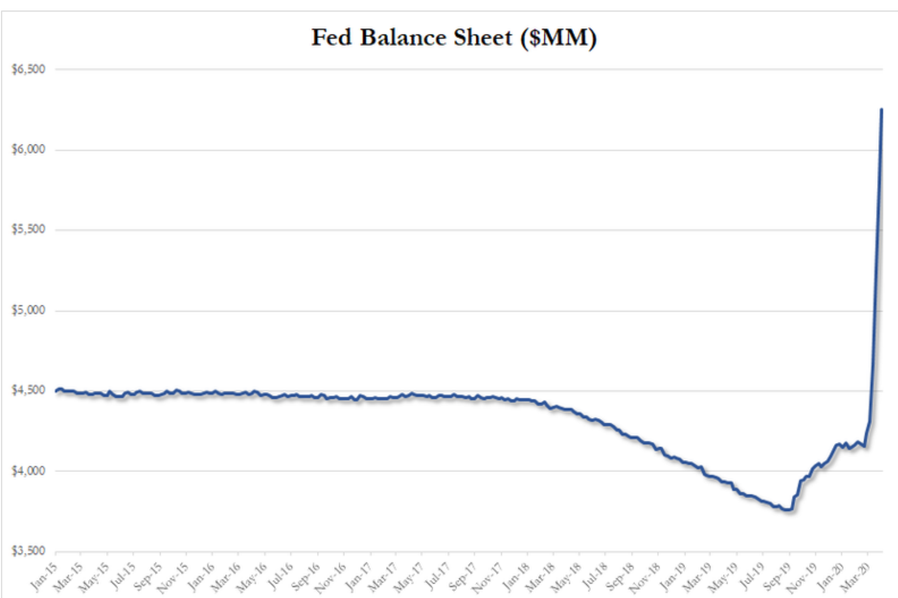
First Quarter 2020 Newsletter

“Pandemic as 3-axis disruptor to economy, healthcare systems, and global supply chain” John Chambers, former CEO Cisco Systems

This is perhaps the most difficult newsletter we have had to write. The Covid-19 pandemic has caused a tragic toll on human life and suffering. Nurses, doctors, and EMT’s on the front lines have gone beyond what could be expected of them and are among those suffering from the virus. Covid-19 has turned our world upside down as we self-isolate, social distance, and fear catching the virus from one wrong human interaction. There will not be a return to life as usual but a new normal that we are just starting to realize.

Covid-19 and the lock down taken to control its spread resulted in the most violent correction in stock market history, falling over 30% in the fastest decline ever. The Federal Reserve reacted quickly and announced unlimited Quantitative Easing. With the Fed’s balance sheet expanding to about $9 trillion; this is far above the $4 - $5 trillion after the Financial Crisis of 2008/09. The Federal Reserve is back-stopping the stock market. This and the slowing number of new Covid-19 cases led to a 20% recovery in the market. With the Federal Reserve’s takeover and control of the financial economy, there is now no accurate pricing discovery in the capital markets. One may rightly accuse the Fed of stock market manipulation. While the stock market did recover, there has been no confirmation rally in other markets-bonds or commodities, such as copper. The stock market rebound has priced in a V-shaped economic recovery (an economic slide followed by a quick resumption of growth). Such a recovery is difficult to imagine.



We see four stock market phases:
1.The initial shock that Covid-19 was real and led to the closing of our economy.
2. The impact of the virus fading and stocks rising. Our letter of March 17 discussed this.
3. The release of corporate earnings in late April. This will provide a stark picture of the harm done to demand and supply on businesses. The corporate outlook for the remainder of the year may be a nasty surprise to expectations.
4. Economic data will be released in the summer providing an indication of a stronger or weaker recovery.

Historically, recessions see earnings decline by 30%. **A market low has not taken place outside of a recession** with the last several recessions seeing the market bottom hit late in the recession. In 1929, stocks bounced 18% before dropping 30%.

Once the economy has been locked down, it is not like turning a switch to bring it back. The U.S. lost a decade worth of jobs in a matter of 2 weeks. There will be a slow return to work. The economic restart will be uneven; and the hope for the V-shaped recovery that has been priced into the market recovery will be dashed. Importantly, the psychological toll Covid-19 is likely to play cannot be understated and will have a significant effect on just how the economic recovery will take shape.

The financial (both fiscal and monetary) response to the virus is worrisome. There is seemingly unlimited deficit spending, unlimited quantitative easing with the Fed now buying junk bonds, and unlimited money printing. Never underestimate, the capacity to make problems worse.

Our view is that those companies with strong balance sheets are best situated to weather negative cash flow from the economic downturn. We think that digital transformation will be utilized more – cloud computing, security as a service, digital payments, and e-commerce – and will be accelerated as many companies, their employees, and consumers are forced to adapt. Pharmaceutical and healthcare companies are diverting their resources in the fight against Covid-19. If the industry can produce treatments and vaccines for the virus, the need for a strong pharmaceutical industry will be recognized. The risk of legislation that has hung over the sector will be lessened. There will be a clear need to bring the supply chain back to this country, not just for drugs and medical supplies, and this will have a beneficial effect on our manufacturing. Finally, there is the likelihood of an infrastructure program to put to work those that have permanently lost their jobs. Our aged electric utility grids, water systems, and roads will be rebuilt and updated. These will be areas of opportunity.