GVA Newsletter

JUne 2020

Covid Creates Cover

"The big money is not in the buying and selling. But in the waiting." Charlie Munger

"The risk reward for equity maybe as bad as I've seen it in my career" Stan Druckenmiller to the Economic Club of New York on Tuesday, May 12, 2020

"Doubt is not a pleasant condition, but certainty is absurd." Voltaire

In response to the crisis around the coronavirus the Fed has expanded their balance sheet by $2.5 trillion since March and that number could reach $5.5 trillion. It is a massive experiment and will have consequences. Could it drive markets to all time new highs in the short-term even as the economy continues to decline? In a word, yes. Does that make it a sure thing or a good investment? No.

We have been spending a tremendous amount of our time listening to different perspectives from leading thinkers and seeking to understand the landscape and workable solutions. What we want to remind our readers is that our focus is to help you get to your goals, regardless of the circumstances. These are very challenging times, there are no easy solutions and the dangers are great. But you do not need to risk everything you have to get to your goals.

For the past several years we have had a working thesis pertaining to markets and the economy. To put it as simply as possible: the main driver of markets has been the Federal Reserve and other central banks perpetually feeding the markets with low interest rates and quantitative easing. This was driving growth of debt in every sector of the economy in ways that were unsustainable. Ultimately, either through the normal business cycle or just by the pure size of debt, we would see debt become unserviceable. In other words, if income (GDP) could not keep up with debt service we would ultimately see a cycle of defaults, even without a shock to the economy.

From 2008-2014 the energy markets grew to capacity, financed by debt, way beyond demand and have gone through a painful cycle of debt defaults and restructuring. In 2017 we saw demand for chemical products used in manufacturing, everything we use from electronics to automobiles, decline steadily and then sharply at the end of 2019. Even with a massive corporate tax cut in 2017, the economy had been slowing beginning in mid 2018. In 2019 the Fed injected billions in short-term credit facilities to address the stresses that were already appearing. This was all before Covid-19. Now those trends have accelerated across the economy.

Currently we are facing a shock to our economy that is unlike anything we have ever seen in modern history. Unemployment is rising rapidly, (The recent bounce in May was a total farce – we call it BLS BS) demand is falling rapidly, and debt defaults are beginning to accelerate. Beginning from the February highs to late March, the S&P 500 fell 34%. This decline was the steepest, fastest decline we have seen in the past 100 years and that data includes the Great Depression.

There are many predictions of what kind of recovery we will see, usually in the form of various shapes. Will it be "V" shaped? Or will it look more like a U, a W, a Nike swoosh or a square root? This will take time to find out, but markets seem to think it will be "V" shaped or at least V shaped for big business and Wall St. One of our favorite economists Gary Shilling believes it will be "L" shaped. The CBO (Congressional Budget Office) is forecasting a Nike swoosh that takes ten years to return to the previous highs in GDP – 2030.

The greatest challenge in the investment world is that markets are different than economics. Markets tend to be a leading economic indicator meaning that they tend to tell us where the economy is going. But markets are also about sentiment in the short-term and at times can be very misleading. What were the markets telling us in February this year? Or at the peaks in 2000 and 2007?

Here is what we think we have to adjust to: How does the cover of the Covid-19 crisis expand the possibilities of what policy makers will do and how do we prepare accordingly?

Thanks for reading,

Matt and Tom

Executive Summary

Liquidity vs Solvency – This is the central question for the next phase of the economy and market.

Deflation vs Inflation - If the Fed has done too much – inflation, if the Fed has done too little – deflation.

Markets – Who Is right? On one side we have Warren Buffet, Howard Marks, Jonathan Tepper, Stan Druckenmiller – on the other side we have 35-year-old first time investors opening Robinhood accounts. Who do you want to follow? Currently markets are saying the 35-year-olds are right. Not sure how long that will last.

Create your Own Economy Corner – Be Patient, Be Kind

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Liquidity vs Solvency

In our last communication we shared the three stages of Bear Markets. Raul Pal of Real Vision and Global Macro Insider has a different way to describe the three phases we are going through and likely to go through. We believe it is worthy of our attention.

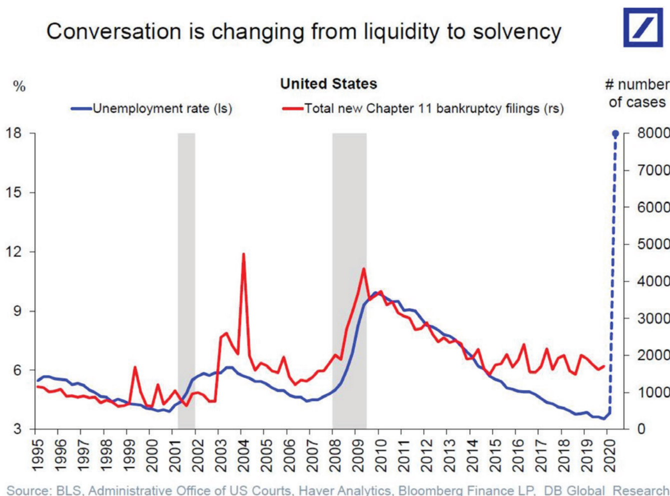
The Fed can help solve issues of liquidity, which it did in March as markets were crashing. What they cannot do, is solve the bigger issue of solvency. This is very likely the next phase of the Bear Market.

Phase 1: Liquidation Phase – Rapid panic selling. The Fed provides liquidity to keep markets functioning. This is where we were in March.

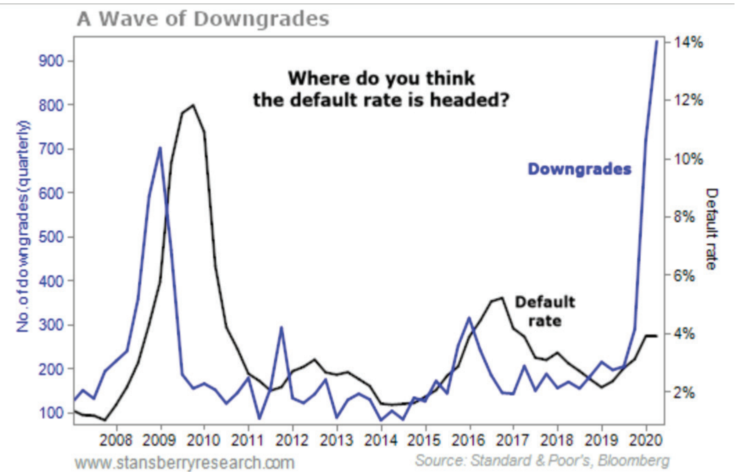
Phase 2: Hope Phase – This is where we are now. Hope for a "V" shaped, rapid recovery. That things will get back to "normal".

Phase 3: Insolvency Phase – Bankruptcy. Cash flow is reduced and debts cannot be serviced. There begins a realization that we were operating right at the edge of our cash flow and any interruption to that cash flow is unmanageable.

Below is a chart from DB Global Research showing the correlation between unemployment and bankruptcies:



Another way to look at this is the correlation of downgrades and defaults. Mike Dibiase, Credit analyst at Stansberry Research, put out a note recently. He reports that Standard and Poors currently forecast that the default rate will rise to 10% by the end of this year. That is roughly what we experienced in 2008. DiBiase expects the rate to be higher this time. Below is a chart he shared showing the correlation between downgrades and defaults:



DiBiase notes that default rates have only past 10% four times in the past century – 1932, 1991, 2002 and 2009. Below is a chart of the results:

Default Wave Beg.	Default Wave Peak	Stock Market Bottom	Default Rate Peak	Stock Market Decline*	Economy
1930	1932	1932	15%	-86%	Depression
1989	1991	1990	12%	-20%	Recession
1999	2002	2002	11%	-49%	Recession
2008	2009	2009	12%	-57%	Recession
AVERAGE			**12%**	**-53%**	
2020	?	?	?	?	Depression

** From peak before default wave*

www.stansberryresearch.com

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Howard Marks of Oaktree Capital is unquestionably the leading player in distressed debt. His communications to investors are widely followed. He is soft spoken, humble and thoughtful. He has made his career from being prepared to take advantage of opportunities when things go bad and he was raising cash going into the end of last year because he thought things were elevated and that investors were taking on high risk behavior in a low return environment. For brevity sake, below are a few quotes from Marks from his writings and an interview he did with Raul Pal on Real Vision:

"To quote Warren Buffett: 'The less prudence with which others conduct their affairs, the greater the prudence you must conduct yours.'"

"If you have never experienced anything before, you can't say you know how it is going to turn out."

"There are large, highly levered companies and investment vehicles that the government rescue program is not likely to reach and take care of."

"Those of us in the markets believe that stocks and bonds are selling at prices they wouldn't sell at if the Fed were not the dominant force. So, if the Fed were to recede, we would all take over as buyers, but I don't think at these levels."

"And in theory, if they bought aggressively, they could make all the markets rise. Now everyone would know that's a Potemkin market, a fake, and the minute they stopped things would collapse."

Marks believes that the recovery will be halting and that there will be plenty of opportunities to invest in his area of expertise – distressed debt. Following his lead, we have been spending a good deal of time in this space looking for the appropriate opportunities for our clients to execute over the next 12 months.

Inflation vs Deflation

In our very first newsletter released in January 2009, we discussed deflation. The newsletter was titled "Deflation vs Inflation." Over the last 11 years, the Fed has been fighting deflation through low interest rates and quantitative easing. We have made the argument that their policies have made our economy weaker, more fragile, more susceptible to exogenous events or shocks.

The Fed was successful in creating inflation in risk assets – stocks, real estate, junk bonds, even artwork. Early in their stimulus efforts they created the fear of inflation – headline risk, which drove gold to $2,000 per ounce in 2011. Gold remains $300 below that level nine years later.

However, what they have really done is created and encouraged the creation of massive amounts of debt at every level of our economy. Corporate debt is at record highs and has been used to finance share buybacks – the primary driver of the stock market over the past ten years. Student debt, auto debt, credit card debt, government debt – are all at incredible levels. And still we are trying to solve the problem of too much debt by, you guessed it, issuing more debt.

It's Like a Prize Fight

"In this corner – weighing at $5 trillion in stimulus and disrupted supply chains – Inflation!" Just as in 2010, many are arguing that we will see a surge in inflation due to a combination of massive fiscal and monetary stimulus and supply shocks.

"And in this corner, weighing in at $80 trillion in debt (just in the U.S.) and massive demand shock caused by surging unemployment, a wave of credit downgrades and defaults, declining wages and increasing savings rates – Deflation!"

Here is a basic reality. Almost everyone talking about inflation has something to sell. Mostly its gold or commodities, or investment firms wanting companies to issue debt, or banks and mortgage companies wanting you to borrow, or the Fed or politicians wanting you to spend money to get the economy growing. Also, anyone selling cars or houses or hard goods or anything. They all want us to believe prices will go up. Just consider the incentives.

The only thing deflationists might be trying to sell is newsletters. There really is very little incentive to discuss deflation unless you are an economist or consultant trying to give what you think is accurate advice. There are very few investment strategies that benefit from deflation.

However, as financial advisors, we must understand and factor in the real possibility of deflation. This is critical in making decisions at almost every level of your financial life. The assumptions we make for inflation and expected rates of return inform your spending and saving decisions in the present – just as one very critical example. This discussion is first and foremost about financial planning and helping our clients reach their goals.

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Deflation is complicated and pretty negative. And the Fed is very much focused on avoiding it and the deflationary spiral where consumers put off purchases expecting lower prices. Ultimately, they may get their way but first we may see deflation. Here is how Lance Roberts explains it:

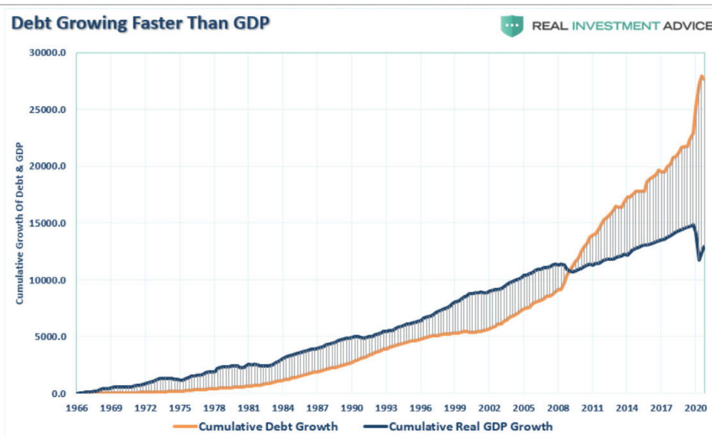
"If the Fed is correct, and a credit crisis is in process, then the current level of stimulus may fall short. We are now looking at a potential decline of 20% in GDP, which will equate to roughly a $10 trillion reduction in debt as defaults, bankruptcies and restructurings rise. There is a possibility the Fed is 'filling in a hole' that is growing faster than they can fill it (The Fed is injecting $6 trillion via the balance sheet expansion versus a potential $10 trillion shortfall.

Unfortunately, that estimate of the decline in GDP was a bit optimistic. Last week the Atlanta Fed's real-time indicator was predicting a -53% decline, or nearly twice the levels of most estimates.

However, if this turns out to be a short-lived crisis and economic activity comes surging back, then the Fed's stimulus may be too much, leading to a surge in inflation and downward pressure on the middle class.

Regardless of the eventual outcome, there is one consequence of the massive debt and deficit expansions that will not change – slower economic growth."

Below is a chart showing just how much faster debt is growing than GDP – particularly since 2008.



It is hard to make this simple. The simple answer would be to let capitalism work. Let companies go bankrupt. Let the system clear. But no one really expects the Fed to follow that path at this point. Especially not during an election year. However, consider that it took 94 years of the Fed's existence to grow their balance sheet to $500 billion and then in just 10 years from 2008 to 2018 it grew to $4.5 trillion. They promised that it would be easy to reduce the balance sheet and that these were temporary measures. But when Powell attempted to reduce the balance sheet in 2018 the markets cratered so they reversed course. Now it looks like they're using the current crisis to take their balance sheet to $10 trillion or more. If that falls short, they obviously feel unlimited in their ability to take their balance sheet ever higher.

We are not suggesting that all the Fed's actions are wrong. We are suggesting that you can't overstate the potential implications.

If you are curious, look up the name Kiril Sokoloff. Even better, for $1 you can get introductory access to "Real Vision" and see an interview he did with one of our favorite monetary economists Lacy Hunt. Sokoloff is the advisor to some big names – including real estate investor Sam Zell. Here is a recent quote from Sokoloff:

"I think we are at the beginning of a long-term period of deflation, falling prices and loss of pricing power. The only way out of it will have to be to have a long period of austerity, and to get the savings rate up dramatically."

In his interview with Lacy Hunt they discussed several interesting observations. One comes from a study done by Mackenzie which we sighted years ago that showed in the case of 24 countries that were over indebted, every single one solved that problem through austerity. Furthermore, Lacy Hunt pointed out that contrary to the common belief that the spending on World War II was what got us out of the Depression, it was rationing. Americans were forced to save, and it was this savings that helped drive the recovery after the war. Real investment based on savings is something we rarely hear about these days, or the use of productive debt that can self-finance rather than debt used for non-productive asset purchases that simply drive wealth inequality, but we hear these concepts from some of the best thinkers we come across.
Mohamed El-Erian was on CNBC on June 2nd speaking to the implications of Fed Policy. Here are some quotes:

"I understand people who bet on moral hazard, who bet on the Fed put. I don't do it. I invest based on fundamentals."

"The question we should be asking the Fed is why they continue to step in and suppress volatility. Markets are functioning and yet markets are calling for negative interest rates, yield curve control and more forward guidance."

"The Fed is undermining the system itself and undermining the

credibility of an institution that is so critical to this and future generations"

"What do you do, you focus on people…Social elements will begin to infringe on financial. Unless we do that sufficiently this economy is going to be so imbalanced that it will be difficult to produce high economic growth."

We are witnessing social unrest. The match that is lighting the fire is racial inequality. But the conditions are social inequality. One driver was globalization, but the other is financialization driven primarily by Fed policy.

Our best guess is that we will see deflation first, high unemployment, bankruptcies, declining wages. However, if the approach by the Fed is to continuously stimulate, we could see inflation or worse, stagflation. Historically all of these conditions are not conducive to stocks doing well.

Markets

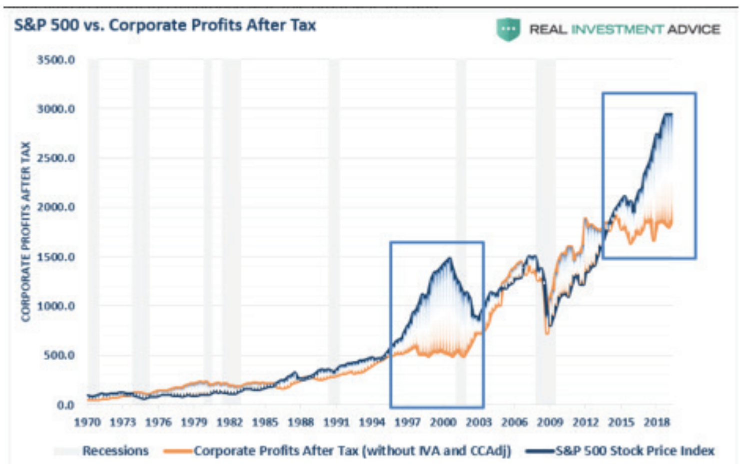
As of this writing, the markets are pricing in a "V" shaped recovery. The S&P has regained its 200-day moving average and the Dow has retraced 62% of its decline. As we stated earlier, it is possible that we see the markets reach new highs. This retracement may force even more trading programs to buy, potentially driving the markets higher. However, many of the market's leaders are not buying into this rally.

Stan Druckenmiller has compiled the best performance of any manager ever averaging 30% per year over his long career. We quoted him at the beginning of this newsletter where he said to the Economic Club of New York on May 12th "Risk-Reward for equities is as bad as I've seen it in my career."

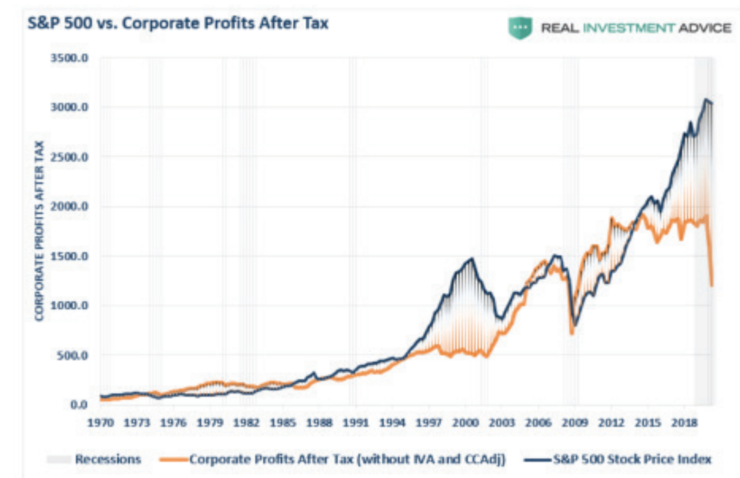
We could quote similar remarks from Sam Zell, Howard Marks, David Rosenberg, Gary Shilling, Jim Rogers, Warren Buffett, John Hussman and even Jonathan Tepper, a notorious bull. And yes, we can also quote legendary investor Kyle Bass who believes we could see new highs. But Bass is not really a stock investor as much as he is a currency speculator. Or Hugh Hendry, who believes the Fed could engineer a rise in the S&P to 10,000.

Most agree that stocks are expensive. What that means is that buying stocks today is just chasing momentum and will not likely lead to good returns over a full market cycle. That is not to say "sell everything".

Below is an update of a chart we shared in February of this year showing the gap between the price of the S&P 500 and Corporate Profits After Tax. First let's look at what we shared in February:



Now here is the update:



This gives some visual to what Stan Druckenmiller was referring to. Prices are rising while earnings and profits are declining. We don't have an apocalyptic forecast for the future. Money will flow somewhere. We do expect there to be a market in three years, investments and real estate won't all disappear. We just think it is reasonable for investors to have some recognition of the risks that are present to be reflected in their strategies.

Solutions

The dislocations today are creating opportunities for the prepared. We have been on countless calls covering every sector and asset class in the investment universe. There will be growing opportunities in credit, real estate, and stocks. Currently there are strategies that are designed to do well in markets with high volatility.

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Our base strategy for markets during times of high valuations come from years of following endowments and from partnerships with investment firms. Each category has specific components that we are constantly working on but it is simply a replacement of the traditional 60/40 strategy with a 30/30/30/10 strategy.

- 30% Bonds – Focus on high quality with some opportunistic actively managed strategies
- 30% Stocks – Diversified, risk managed equity exposure
- 30% Alternative – Absolute Return – volatility and risk managed strategies in particular
- 10% Cash – for developing opportunities and hedging severe outcomes

Currently we recommend our clients hold a larger cash allocation outside their investment portfolios. While this strategy does not capture all of the upside of equity markets when they are running and give you that sugar high, it has done well at cushioning the downside and avoiding the crushing emotional lows.

Deflation would favor the U.S. Dollar and Treasuries and we are building modest exposure here.

Inflation would favor hard assets – commodities, gold, and other specific inflation hedges like treasury inflation protected securities, floating rate bonds and certain types of real estate.

We keep an exposure to some real estate sectors like multi-family, healthcare, data centers and industrial in both scenarios.

The mathematics of loss are very important to understand when creating plans for achieving your goals. Especially as you get closer to achieving your goals. Especially when your goal is retirement when your capacity to make up for losses is diminished or college education which has a finite timeline.

Our focus is to have clear, unemotional investment strategies that are not based on hope but based in reality. If you are not yet working with us, we would love the opportunity to show you how we help our clients plan and invest with confidence.

Create Your Own Economy Corner - Beautiful State of Mind

Little things can make a big difference. Perhaps the best way to make the world a better place is to treat everyone that we come in contact with, in all the little everyday interactions, as well the big important conversations, with all the kindness and patience we can muster. What if we decided that everyone we meet is great, even if they appear otherwise. Maybe they are having a bad day. Maybe they are looking for an opportunity to be great. Maybe they are dying for kindness and they don't even know it.

Wealth comes from wellbeing. Being truly wealthy means to feel good, happy, prosperous. Being angry, resentful, anxious or depressed is not living a wealthy life.

The world is a little on edge right now. It is easy to justify being short-tempered, living in blame, being a victim. We have a system that is geared to making you feel badly about what ever side you are not on. We feel it. We give into it sometimes. It doesn't help.

Human beings come in all shapes, sizes, colors, religious beliefs, political orientations and sexual orientations. There is no sense in feeling hate toward any other human. It's poison. And indifference is just about as bad.

The best leaders in history taught us how to live well. They taught us to love, they taught us to walk a mile in another man's shoes, and to live the golden rule. As humans, that is not always easy, our minds get in the way. We justify, we defend, we make others wrong. That is the ego at work. But we can transcend that base experience of being human, and to be wealthy, really wealthy, it is what we must do.

"Darkness cannot drive out darkness: only light can do that. Hate cannot drive out hate: only love can do that. I have decided to stick with love. Hate is too great a burden to bear." - Dr. Martin Luther King

Please note: Indices mentioned are unmanaged and cannot be invested in directly. Past performance is not a guarantee of future results. These are the opinions of GVA and not necessarily those of Cambridge, are for informational purposes only and should not be construed or acted upon as individual investment advice.

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