GVA Newsletter

April 2020

Crazy Train

"The most important decision: To live in a beautiful state of mind no matter what happens." -Tony Robbins

I keep that quote on my desk at work. Right now, it is as important as ever to be able to do two things at the same time. First, we must keep ourselves in a "beautiful state of mind." The people that we admire most in history are not those that had everything go right in their lives. They are the people that rose during unimaginable tragedies to lead in word and deed and show us what humans are capable of. As Wayne Dyer liked to say, "You can't feel bad enough to make anybody else's life better." Some suggestions to help you maintain an "beautiful state of mind" include; focus on your vision for the future, think about how you can grow in this moment and find a way that you can contribute to others.

The other thing we must do at this time is have a realistic, historically informed, fact-based understanding of where we are and what we are likely to see regarding the economy and markets. We love optimism, but hope is not an investment strategy.

"Bear Markets do not end on optimism, they end in despair."
- Bob Farrell, Technical Analyst Merrill Lynch 1966-1992

There are two critical errors being made in market analysis right now in our opinion. The first is that this down-turn in markets is being caused by the Coronavirus. The second is that we are likely to get a "V" shaped recovery and that stocks will "snap-back" to all-time new highs soon. These are both incredibly dangerous assumptions and are not born out by the facts.

The first assumption is dangerous because it ignores the years of terrible, reckless policy – both monetary and fiscal - that led to the most over-valued, overleveraged market in history. The Coronavirus is exposing what already existed.

The second assumption is dangerous because it assumes that first: we have any idea what the long-term impact of shutting down the economy will be or what the fiscal and monetary stimulus will actually do, and second, because it ignores the path that bear markets historically take. We do have experience to guide us. As Mark Twain famously said, "History may not repeat, but it does rhyme."

No one can predict the future. We have said all along that we will only know where the top is in this market when we see it in the rear-view mirror. We are fairly confident that Feb 19, 2020 will mark that day. But we respect the fact that the government and the Fed (two separate things) have gone "all in" to keep the markets and economy from falling apart and to drive asset prices higher.

We want to tread carefully here. We are optimistic that, after much fumbling about, we will get ahead of the Covid-19 pandemic eventually. We will see brighter days and this episode will be in the history books. We have grave concerns for the wellbeing of everyone. However, in regard to the markets, we have not gotten close to seeing despair. If we fail to understand that, we risk losing much more capital and more opportunity to reach your goals than is even close to necessary. The data that we review suggests that we are near the top of a bear market rally and that much lower lows lie ahead.

Please read on.

Matt and Tom

Executive Summary

Corona is just the pin- Debt is still the problem

The Path of the Bear – Likely much lower lows ahead – The three phases of bear markets

Way Too Bullish – Psychology of declines – Investors more bullish than ever on future market returns. Crazy Train!

Valuations – This last week saw valuations on the S&P exceed the highs seen in mid-February to make new all-time records! Crazy Train! Stocks are expensive!

Solutions – Flexibility vs Certainty. We don't need to predict the future. We can buy when assets are cheap and sell when they are expensive. Active management can navigate fast changing markets better than passive.

Create Your Own Economy Corner – Beautiful State of Mind

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Crazy Train

Corona is just the pin- Debt is still the problem

We keep hearing the same rationalization over and over again. "No one could have predicted this." Followed often by, "The economy was in great shape going into this crisis so we should see a rapid "V" shaped recovery once the lock-down ends." These are very misleading thoughts in our view.

The best characterization we have heard of what is going on in the financial markets right now comes from Scott Minerd of Guggenheim Partners who said the following:

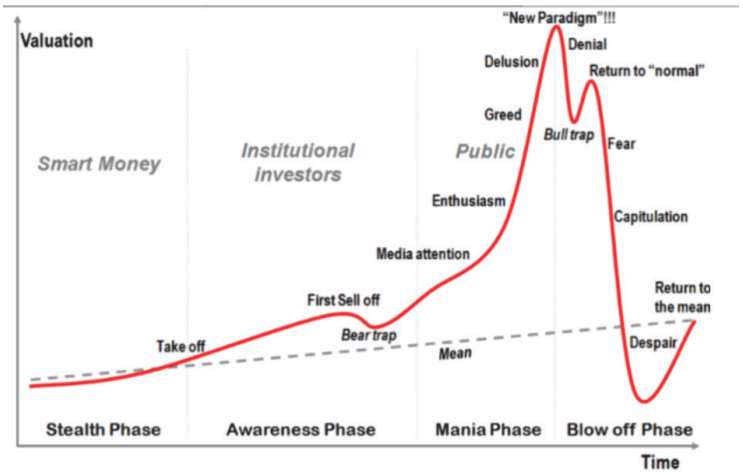
> *"We entered into the current crisis with a whole financial system that had been incentivized by policymakers to take on excessive levels of debt and leverage. The turmoil we are seeing right now is the result of the unwinding of this leverage. The primary catalyst of the turmoil is the collapse in economic activity due to the COVID-19 shutdown, but the fact that funding and trading markets are not functioning well is due to excessive leverage needing to be unwound in the financial system."– Scott Minerd, Global Chief Investment Officer of Guggenheim Partners and Chairman of Guggenheim Investments,* ***The Great Leverage Unwind***

Our concern over the past many years has been that we continue to try to solve the problem of too much debt with more debt. Currently the Fed and the Treasury are doubling down on that strategy which is really pure madness. We ask, if things were so great last year, why did the Fed need to cut interest rates three times in 2019 and pump $65 billion per month into short-term lending facilities starting in September? Even with all the additional stimulus, there was zero profit growth in the S&P 500 in 2019. Crazy Train!

What the market was reacting to in the initial sell-off phase of this developing bear market, in our opinion, is the expectation that we are about to see a wave of defaults in the debt markets that has the potential to make 2008-2009 look mild. This is why the Fed is backstopping as much debt as it can, putting the U.S. taxpayer on the hook for the negative results of poor corporate management. We don't think it will be pretty.

The Path of the Bear

In our last communication we shared the Psychology of Full Market Cycles. Here it is again as a reminder:



We believe we reached the peak of "New Paradigm" on February 19, 2020. In case you are wondering, that "New Paradigm" was that the Fed had achieved omnipotent powers over the economy and had ended the Boom-Bust Cycle forever. We won't know for sure until all this is in hindsight, but we think we may have reached "return to 'normal'". Late last week CNBC trumpeted "Best week since 1974!" and keep in mind that in 1974 the Dow was suffering through one of the worst bear markets in history that ended in December of 1974. We will cover some of the stats in our conclusion in the next two sections.

Bob Farrell was a market technician at Merrill Lynch from the late 1960's to 1992 and he is revered in the industry. You can Google his 10 rules for investing. Rule #8 states that bear markets have three stages: sharp down, reflexive rebound and a drawn-out fundamental downtrend. Below is a chart from Lance Roberts of Real Investment Advice that shows how these phases played out in 2000-2002 and 2007-2009 compared to the current market:

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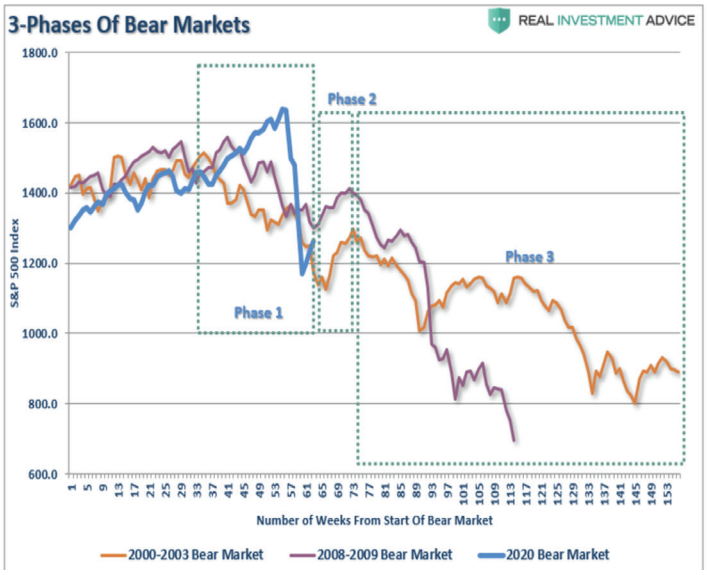


Typically bear market rallies retrace 20-80% of the initial sell-off with the median retracement being 55%. This rally retraced over 50% of the initial sell-off and is waning. Our conclusion in all of this is that the bounce off the lows is a great time to reduce equity exposure as we likely have much longer to go with much lower stock prices. Again, we quote Bob Farrell: "Bear markets don't end on optimism, they end in despair." And:

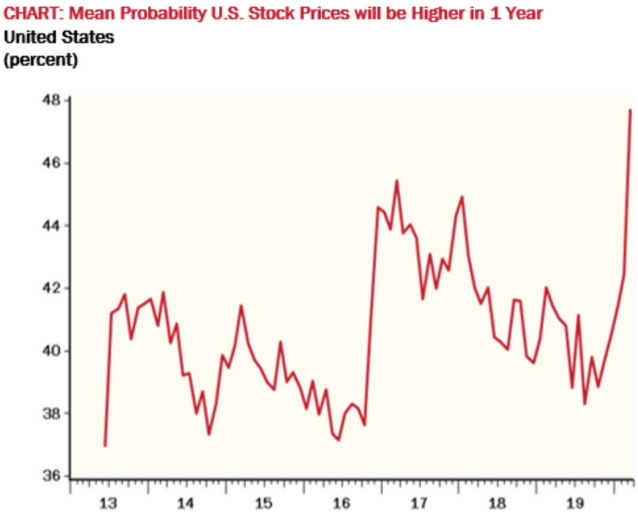
Rule # 2: "Excesses in one direction will lead to opposite excesses in the other direction."

Our lessons from 2000-2002 and 2007-2009 were clear. It takes time for markets to price in big changes in the economy. Right now, we want to stay nimble, maintain a high allocation to cash, and preserve capital to redeploy when valuations and long-term return opportunities are much more attractive.

Way Too Bullish

David Rosenberg remains one of our favorite economists. He saw the chart below of "Mean Probability U.S. Stock Prices will be Higher in 1 Year", on April 6th and Tweeted the following:

> *"I was so close to turning more bullish (less bearish?) until I see the metric was released by the New York Fed on consumer expectations. Since when do bear markets end on record optimism?"*



This is exactly the kind of behavior you would expect at or near the peak of a bear market rally. Let us now look at valuations.

Valuations

Valuation is not a market timing tool. However, valuations historically give us a pretty good picture of future returns. This is critically important in planning. If you buy stocks, or any asset, when the expected return is very low, due to high valuations, that should be reflected in the assumptions that you are making when creating your financial planning forecasts.

In February of this year we reached the highest valuations ever – higher than 1929 or 2000. Subsequently we reached a point where the expected future returns of U.S. stocks over a 7-10 year time frame were the lowest ever.

What is remarkable is that while the market has retraced roughly 50% of the decline in price in the S&P 500, valuations have moved to a level higher than we saw in February. Why is that? If we look at PE, or Price-to Earnings ratios, for the next 12 months (NTM) we can see that number is now higher than it was in February. This is due to the fact that earnings, the "E" in the equation, continues to fall, while the "P" or price has moved higher. See the chart below:

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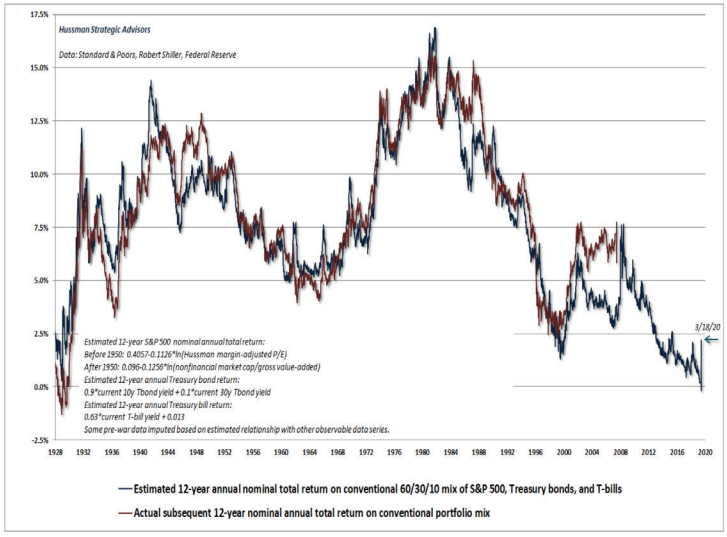
This chart was published by Credit Suisse Chief Equity Analyst Jonathan Golub on April 7th. Golub is generally considered a bullish analyst, but this data struck him as noteworthy. It's really quite breathtaking.

What is a little more complicated is future returns. The chart below comes from John Hussman and it shows the correlation of valuations and expected returns. The blue line is the estimated 12-year annual nominal total return on a conventional 60/30/10 mix of S&P 500, Treasury Bonds and T-Bills. Hussman notes that this line dropped below zero for the first time ever in February. The red line is the Actual Subsequent 12-year nominal annual total return of that mix – that is why it ends in 2008. Notice how closely the two lines match over time – that demonstrates high correlation.



What you can see is that at the peak of the sell off, expected future returns barely budged. They got better – but not by much. What you want to see is closer to what we saw briefly in 2009 where forward returns were 7.5% on the or even better – what we saw in 1982.

Both Hussman and GMO have very good track records of long-term forecasting of stock returns. GMO expects the market to lose roughly 5% per year for the next 7 years and Hussman expects a roughly 1% return over the net 10-12 years of the mix he uses for this model. That is not the kind of return expectations we are seeing when people are planning for their goals over the next 10 years.

As we segue into solutions, here is what Hussman said about the investment climate in his March 26 update "Navigating Turbulence:

> *"I expect that the most valuable aspect of our investment discipline over the completion of this cycle will be our ability and willingness to flexibly respond to changes in observable market conditions as they emerge. While my impression is that passive investment strategies will become nearly excruciating over the completion of this cycle, there is no need to worry about various scenarios, to project targets, to predict market movements, or to become tied to any particular forecast about future economic or financial events. This is not about prediction, and projection, and forecasting. What's needed in the ability and willingness to flexibly respond to changes in observable market conditions as they emerge."*

Solutions

We do not have a crystal ball. Our job as advisors is to try our best to understand the world we are in today and do some amount of looking forward with reasonable assumptions so we can help our clients have the highest probability of success. Our work led us to expect lower interest rates and greater deflationary outcomes while much of the market was expecting higher rates and inflation. We have seen pretty much what we expected on that front.

We still think it is likely that we will see lots of defaults across the debt markets and are keeping fixed income exposure higher in quality and shorter in duration. We also think that investors are well served

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to maintain a higher than average allocation to cash. If there is one over-riding theme, we would emphasize it is this – **remain flexible.**

Active, flexible managers are doing their work right now. Adjusting portfolios to a changing landscape, improving quality, trimming weakness. We are not a fan of passive, indexing strategies in markets like these. The following are a couple of themes we would highlight:

1. 20-30% of liquid assets in cash
2. Rest of portfolio baseline allocation of 30-30-30. That is: 30% Equity, 30% Fixed Income, 30% Alternative – currently we would lean more heavily on Alternatives like Absolute Return, Tactical and Long/Short Strategies.
3. Gold and Commodities are hard to call. We lean toward gold declining along with commodities in general. Eventually we will see inflation, but we think that comes after more debt defaults. We can stand aside here and watch. Gold has not gotten back to the 2011 highs and we would not be surprised to see it go down.
4. Interest Rates – Japan is probably a good guide post. They have been trying to stimulate their markets through direct asset purchases since 1989. But here we respect that we could get some big moves in either direction on interest rates.
5. Equities – Covid-19 has massively changed the landscape here. For a time, we thought the market would move from growth to value, but a different dynamic is taking place. Certain sectors of technology and delivery management have proven critical to adjusting to our new world. We still like the themes of infrastructure, renewable energy and biotech long-term. Remain flexible.
6. Real Estate – This area is likely to go through some pretty big changes. Working from home is not so bad once you try it. Demographics still favor health care real estate, but there will be pressure given Covid-19. Data centers, industrial and apartments still look good, relatively speaking, but commercial, office and retail look pretty bad.

The world is changing fast and we must remain flexible. Money has to flow somewhere. But we still think it is time to play more defense than offense.

If you are not working with us and would like to review how you are positioned, we would welcome the opportunity. It can be hard to think about making changes when buying every dip and holding on has worked so well for so long. We have had success in helping people find the right level of adjusting their portfolios without giving up on the principles that have worked for them for so long. It's all a matter of degree and remembering that none of us knows exactly what will happen next.

Planning comes first. It makes sense to know what you need to achieve first. Then you can plan out the highest probability path to achieving it.

Create Your Own Economy Corner - Beautiful State of Mind

The following came from Bill Gates and we think it provides a good example of how we can orient ourselves to learn, grow and contribute during these challenging times:

"*What is the Corona/Covid-19 virus Really Teaching us?*
I'm a strong believer that there is a spiritual purpose behind everything that happens, whether that is what we perceive as being good or being bad.

As I meditate upon this, I want to share with you what I feel the Corona/Covid-19 virus is really doing to us:

1. It is reminding us that we are all equal, regardless of our culture, religion, occupation, financial situation or how famous we are. This disease treats us all equally, perhaps we should to. If you don't believe me, just ask Tom Hanks.
2. It is reminding us that we are all connected and something that affects one person has an effect on another. It is reminding us that the false borders that we have put up have little value as this virus does not need a passport. It is reminding us, by oppressing us for a short time, of those in this world whose whole life is spent in oppression.
3. It is reminding us of how precious our health is and how we have moved to neglect it through eating nutrient poor manufactured food and drinking water that is contaminated with chemicals upon chemicals. If we don't look after our health, we will, of course, get sick.
4. It is reminding us of the shortness of life and of what is most important for us to do, which is to help each other, especially those who are old or sick. Our purpose is not to buy toilet roll.
5. It is reminding us of how materialistic our society has become and how, when in times of difficulty, we remember that it's the essentials that we need (food, water, medicine) as opposed to the luxuries that we sometimes unnecessarily give value to.
6. It is reminding us of how important our family and home life is and how much we have neglected this. It is forcing us back into our houses so we can rebuild them into our home and to strengthen our family unit.
7. It is reminding us that our true work is not our job, that is what we do, not what we were created to do. Our true work is to look after each other, to protect each other and to be of benefit to one another.

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8. It is reminding us to keep our egos in check. It is reminding us that no matter how great we think we are or how great others think we are, a virus can bring our world to a standstill.
9. It is reminding us that the power of freewill is in our hands. We can choose to cooperate and help each other, to share, to give, to help and to support each other or we can choose to be selfish, to hoard, to look after only our self. Indeed, it is difficulties that bring out our true colors.
10. It is reminding us that we can be patient, or we can panic. We can either understand that this type of situation has happened many times before in history and will pass, or we can panic and see it as the end of the world and, consequently, cause ourselves more harm than good.
11. It is reminding us that this can either be an end or a new beginning. This can be a time of reflection and understanding, where we learn from our mistakes, or it can be the start of a cycle which will continue until we finally learn the lesson we are meant to.
12. It is reminding us that this Earth is sick. It is reminding us that we need to look at the rate of deforestation just as urgently as we look at the speed at which toilet rolls are disappearing off of shelves. We are sick because our home is sick.
13. It is reminding us that after every difficulty, there is always ease. Life is cyclical, and this is just a phase in this great cycle. We do not need to panic; this too shall pass.
14. Whereas many see the Corona/Covid-19 virus as a great disaster, I prefer to see it as a *great corrector*. It is sent to remind us of the important lessons that we seem to have forgotten and it is up to us if we will learn them or not."

Stay safe and healthy. We are sending you thoughts of peace and prosperity.

With gratitude,

Matt and Tom

GLOBAL VISION ADVISORS
101 Longwater Circle, Suite 103 | Norwell, MA 02061 | 781.740.8883 | www.globalvisionadvisors.com