STRANGER THINGS

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The Netflix mini-series Stranger Things has nothing on reality. To recap the year so far, we are battling through a global pandemic unlike any in the past 100 years. The novel coronavirus is highly contagious and extremely dangerous, particularly to the elderly, those with pre-existing health conditions, and those without easy access to our healthcare system. To counter this deadly virus, all fifty states issued some form of stay-at-home order creating a self-induced economic coma. In just the past quarter, we've seen negative oil prices (see Free Oil, by Michael Molitor on our website), an increase in the number of countries issuing debt with negative interest rates, massive anti-racist protests throughout the country including one in which a six square block section of a city was taken over by protestors, hand-to-hand combat on the border between China and India, and North Korea antagonizing South Korea by blowing up a building. Also in the category of "strange," Hertz, a company in bankruptcy, rallied 400%, and then decided to try to issue new stock because of the rally. To be fair, its disclosure statement did say it is highly likely this new equity would be worthless (caveat emptor to the extreme). The stock market responded to all this news by rebounding with a vengeance. The most common question we have received over the last couple of months is, "How is that possible given all of the uncertainties (and oddities) we're facing today?"

The very short, simplified answer is the shear financial power of our government. The speed with which the pandemic hit our markets was matched by the speed with which our government responded (as shocking as that might sound). Congress passed numerous stimulus bills costing several trillion dollars and the Federal Reserve pumped in several trillion dollars more. It used every trick ever learned from past financial crises and added a few new ones. The dollar amount of the stimulus projected through the end of the year will end up totaling approximately 20% of our nation's Gross Domestic Product (GDP), a staggering amount with most of that money literally created out of thin air.

This aided the stock market on several fronts. First, this money went directly to those most affected by the pandemic. Unlike during the Great Recession when the stimulus money went through the banking system, this money went directly to taxpayers and business owners with the goal of keeping wage earners afloat. The government incentivized business owners to hold onto their employees. Despite this, there were massive layoffs and furloughs as the economy came to a screeching halt. The government also approved more unemployment benefits (with a bonus $600/week) than in past recessions. 75% of those who applied received benefits. Normally, only about 25% get them. This allowed most people to continue to pay their bills and minimized damage to businesses (companies in the stock market).

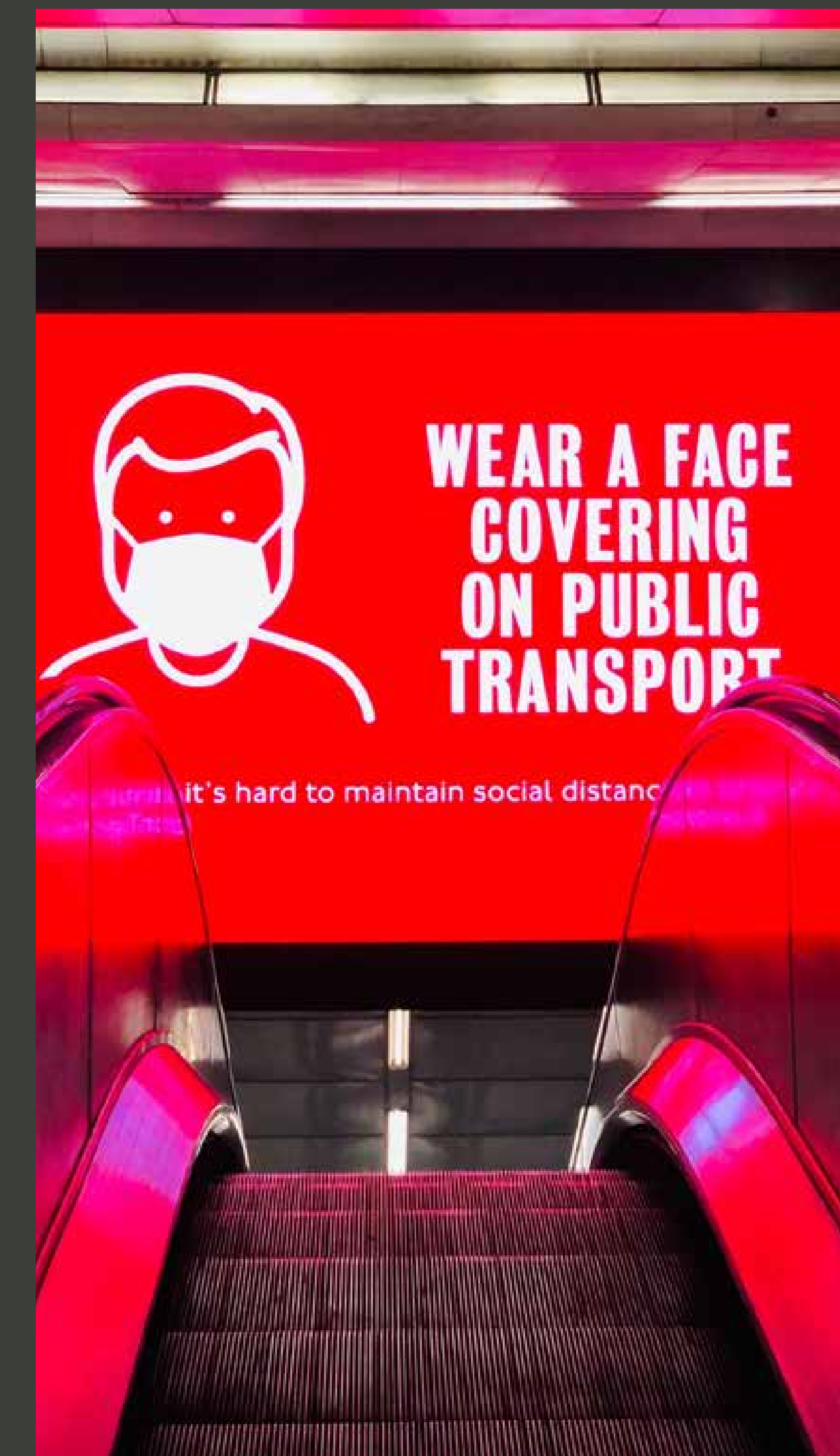
One other possible reason for the surprising rebound during a pandemic is a bit more troublesome. Schwab reported that during the first quarter, they opened a record 609,000 new retail client accounts. Relative newcomer, Robinhood, signed over 3 million new clients. The combination of no commissions, a stimulus check, no sports to bet on, and a lot of free time has perhaps contributed to a retail investor boom in the stock market. The total effect of this is difficult to gauge, but the Hertz example mentioned above highlights why this might be dangerous if this is indeed a major contributor to the rally. Contacts in the brokerage industry have mentioned that a lot of these accounts are starting with $1,200 or $2,400 values, the exact amount of the stimulus checks received early in the quarter.

Secondly, the Fed provided a great deal of liquidity to markets that were not functioning well during the initial panic from the first quarter. They propped up prices by buying the bonds of companies. This kept companies' borrowing costs down and prevented marketplace panic forcing unnecessary bankruptcies. Thirdly, the Fed cut interest rates on short-term bonds to near zero. Long-term bonds followed suit with the 30-year bond dropping below 1% at one point. This has an indirect effect on the stock market. Treasury bonds represent the risk-free investment option. When the expected rate of return drops to essentially nothing, investors look elsewhere. Many of those dollars flowed back into the stock market, thus forming some semblance of equilibrium between these two markets.

So now what? An extremely wide range of possible outcomes exists for the next 18 months. We use scenario analysis to help us position portfolios in times like these. As you might expect, the progression of the virus and our government's response to it will drive all these scenarios. Our base case suggests the virus will not be under control until a vaccine comes out. The fastest this could happen, with enough of us vaccinated to have a meaningful effect, is some time in mid- to late 2021. Past experience with pandemics predicts a second wave is highly likely by the end of this year. We are already seeing cases rise now that most states have reopened to some degree. What will happen in the fall when children possibly return to school and colder temperatures drive people indoors?

In this base case, our economy stays in recession, or at best a near zero-growth environment for a couple of years. Earnings don't top 2019 levels until at least 2022. Many companies with high debt levels and a high dependence on travel or hospitality will fail. Stay-at-home workers discover they do not need to go to the office as often, and this becomes a more permanent part of how our economy functions. This affects commercial buildings negatively but does have some positive side effects (lower pollution, more efficient workspaces, etc.). Our government will continue to add stimulus to the economy in an effort to keep things from completely unraveling.

A more positive scenario would involve new therapeutics coming to market. While this wouldn't end the pandemic, it may allow more people to feel safe enough to venture back out to restaurants and travel. We have already seen improvements in patient care and outcomes, but the risk of death is still too high – especially for the most vulnerable groups. If this risk could be diminished down to a level similar to that of the flu, the worst would be behind us.



A more negative scenario develops if the vaccines prove ineffective or dangerous. There are over 150 trials right now. We have attacked this challenge with all that modern science has to offer. This makes this scenario somewhat remote, but not impossible. This scenario would cause a great deal of financial setbacks and a prolonged recession as governments do not have an endless supply of resources.

In consideration of all of these possible scenarios, we have positioned portfolios with a higher cash balance, more gold, fewer cyclically sensitive stocks, more growth names somewhat insulated from the effects of another quarantine, and a few stronger value names that would perform well if a positive scenario develops. As the United States seems to be an epicenter of the virus, we have continued to add to our international exposure. At some point, it will make sense to add some of the riskier, badly beaten down stocks to the portfolio. Now is a bit early to implement this tactic.

Survival is paramount in this moment. This is true of your portfolio, but of even more importance is your health. Please take care of yourself and your loved ones and follow the CDC guidelines: wear a mask in public, stay six feet apart from others, and remain home as much as possible. As we try to do with your portfolio...avoid unnecessary risks. One long-time client succumbed to this disease; we grieve along with her family. Know that you are all in our thoughts and prayers during this very difficult time.

Sincerely,

Tony

Anthony J. DiGiovanni, CFA