

Market Watch with RMH, “Only when the tide goes out do you discover who’s been swimming naked”

March 30, 2020

I wanted to make sure I got your attention, a wonderful quote from Warren Buffet. It seemed for a while, a day felt like a month, and several weeks felt like a year.

The current situation is unprecedented in our lifetime, and we are humble about what we don’t know, and we continue to gather information to serve you best.

Well, what did happen? We had a good old fashioned liquidity squeeze that came out of nowhere that affected all of the fixed income markets. With interest rates as low as they have been, the “smart” people (hedge funds and others) thought that 4, 6, 8, 10 times leverage was a successful recipe for investing profitably. One borrows at 0 – 2%, and buys securities that pay 4 – 10%, and when that works, one does it all over again, and again... Works wonderfully until it doesn’t, **then that is when the mess starts**. Next, a margin call is received, and one has to sell securities, sometimes at a loss, and as this lower price is posted in the bond market, this then lowers bond price for similar securities (as not all bonds or securities trade daily) and triggers other margin calls, and soon you have a vicious cycle. At this stage, anything **that can be sold is sold** for the ones with margin calls, **there are NO exceptions**.

In addition as investors figure out a problem exists, they start asking for redemptions (sales), and this increases the pressure on the prices of the assets being sold, again creating a reinforcing pricing cycle going lower, leading to, and you guessed it, more margin calls.

This all started in the mortgage back security markets, and quickly spread to the collateralized loan obligation, to investment grade bonds, to high yield bonds, junk bonds, preferred shares, U.S. Treasury bonds, to stocks that had high dividends, and finally common stocks. **Nothing was immune.** If a bond was re-rated from investment grade to a lower grade, it had to be sold out of the investment grade mutual fund or exchange traded fund, all repeating the cycle lower.

I have found that Blackstone (started in 1996 as an Alternative Investment Manager) has a unique view on the economy. They have an ecosystem of 1,000+ companies that they have lent funds to (through GSO a subsidiary), to private equity investments, to other investment platforms. They reach out to their companies to see how they can help (for example, Blackstone has the lowest price for FedEx worldwide), and provide synergies with other companies in their ecosystem. This gives them an excellent overview of the economy, what they call the middle market U.S., if measured as a country, would be the 7th largest in the world.

The following is from - Joe Zidle, Blackstone – March 27, 2020

There Are Signposts: What We Need to See

The coronavirus is a global health emergency first and foremost. We express our sympathies to all who are affected. This disease is a uniquely serious threat to our health. However, history does provide a roadmap for what needs to occur for everyday life to resume, and for the global economy and markets to function normally again. In our view, volatility will remain elevated across all assets classes until three conditions are satisfied: a solution to the underlying cause, the implementation of effective policies and a return of consumer confidence.

A treatment Slowing the spread of new coronavirus cases will reduce the strain on the healthcare system. However, reinfection rates and a potential second wave will remain a source of uncertainty. Reflecting back on the Global Financial Crisis (GFC), actions taken to reduce the severity of the recession included multiple interest rate cuts, the takeover of Fannie Mae and Freddie Mac, and the Troubled Asset Relief Program (TARP).

But these measures only addressed symptoms of the GFC. It wasn't until the American Recovery and

Reinvestment Act of 2009 that we saw the underlying causes addressed, confidence restored and a bottom found for the economy. Today's problem is a health issue. Fiscal and monetary stimulus will help, but only a vaccine or cure for the coronavirus can lift the uncertainty and put a floor under capital markets.

Policy implementation, not policy announcements The second condition that needs to unfold is the implementation of fiscal policy. At the time of this publication, we've seen three fiscal stimulus bills in the US, as well as pronouncements across Europe and the UK. Central bank activity like bond-buying is immediate. Conversely, there are lags between an announcement of a "protective shield" to be placed around companies (such as the protocol Germany announced on March 13th), the crafting of the policy (currently ongoing) and its implementation. In the US, the government is poised to pass its third stimulus package, with an estimated \$2 trillion in fiscal relief.

We don't dispute that this package will have positive impacts. Stimulus payments under two very different types of recessions in 2001 and 2008 boosted consumer spending immediately. Stimulus payments in 2001 resulted in households spending 20%–40% of their rebates on non-durable goods within three months.⁴ But we don't underestimate the enormity of distributing checks to approximately 130 million American households.

In addition, the decline in service-related hours and pay means that the country won't immediately bounce back as the economy normalizes. People won't take extra vacations this fall to make up for the vacations they didn't take this spring. As a result, activity will recover more slowly. GDP growth rates will bounce back relatively quickly, but the period of time that it takes for the size of the US economy to exceed Q1'20 levels depends on your assumptions for the depth of the recession and subsequent pace of growth. Based on current consensus expectations for the decline in GDP (approximately 20%) and rebound growth rates, a peak-to-trough recovery to pre-COVID-19 GDP levels could, in conservative scenarios, take several years.

The Return of Confidence A subdued virus, once and for all, is the third precondition for the US and global economies to start building back toward trend line growth. Currently, expanded testing, social distancing and home isolation are the only options we have to suppress the spread of the virus. But even after we have seen a peak in the number of cases and authorities relax some of these policies, we will all be on a heightened state of alert. If reinfections occur, we can expect these policies to be quickly reinstated. Any post-crisis peace of mind will be fragile until science finds a vaccine. Until then, we can

expect structurally lower activity that restrains earnings and keeps economic growth trajectories below recent levels

After Coronavirus: Secular Changes

We can trace some of society's greatest productivity gains to the aftermath of our most severe economic upheavals. Such was the case after the Great Depression, World War II and other periods of extreme dislocations. From radar to penicillin, electric razors to car radios, we are exceptionally good at innovating under stress. The novel coronavirus exposed serious weaknesses in the areas of medical preparedness, supply chain dependence and dollar-based funding around the world. These are a few areas, among others, that we believe are set to undergo secular shifts.

Strategic R&D One possible and welcome change would be a reversal in the decline of government-led investments in critically important sectors of the economy. The decrease in spending on healthcare and biotech R&D as a percent of GDP put the US at a noticeable disadvantage to our competitors globally. New programs should be funded to increase preparedness for future disease outbreaks. Policies should also be implemented that encourage companies to return medical supply chains to the US. We may realize that "redundancy" is not always a dirty word in critical parts of our economy.

Better connectivity The trend towards working from home is likely to become more deeply entrenched in our culture as a result of recent shelter-in-place policies. This would serve to increase demand for internet bandwidth and encourage further development of 5G technologies. Internet traffic and wireless networks threaten to swamp our existing networks, with important business implications for companies that rely on the internet to deliver their services. Netflix was recently asked to reduce its transmission volumes in order to allow millions of displaced workers to communicate with one another online. The federal government is escalating its fight with China over 5G; it's not a battle the US can afford to lose.

Modernized consumption The recent boost in e-commerce penetration is likely permanent. Some trends borne out of necessity might be less likely to continue once the necessity fades. But other trends will endure as consumers experiment with new services and realize the benefits. Anecdotally, drugstore chain CVS said its prescription deliveries are up nearly 300% after the company waived fees in March.

Supply chain reset Look for acceleration toward localization and regionalization, and moves away from globalized supply chains. China became the world's factory floor, and that model succeeded in delivering lower prices to US consumers in a world of low tariffs, stable currencies and the promotion of free trade. But the US–China trade dispute started to pressure that model, and the rolling closures of so many economies around the world will compound that pressure. Companies might be forced to choose between efficiency and supply chain security. Their decision could result in higher-paying manufacturing jobs, but at the expense of lower profit margins or higher prices.

Yes, the coronavirus pandemic is a massive stressor on the economy and, of course, our psyche and health. But from it, we expect resilience, strength and new ways forward to emerge.

Lis Ann Sonders from Charles Schwab shares her thoughts on what to look for as the economy recovers.

What to look for

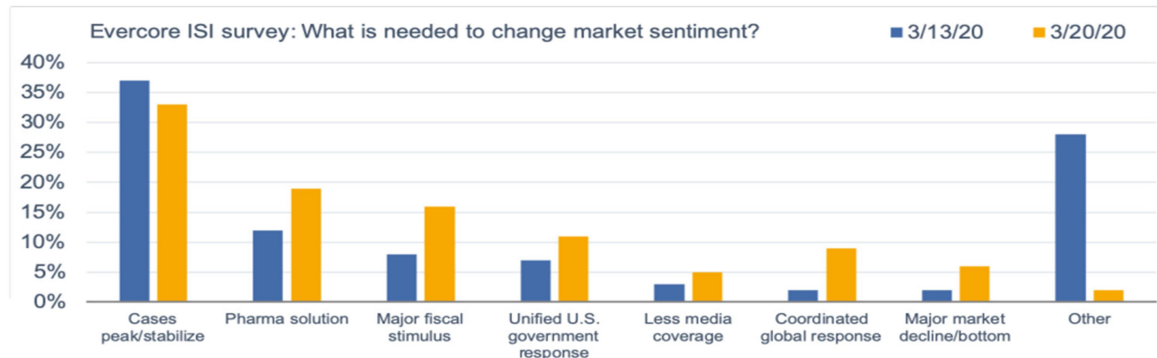
In addition to looking for a stabilization in the number of COVID-19 cases, there are broader signs we can look for economically, once the cases start to taper—some of which I've highlighted in this report; others I've been highlighting on Twitter (@LizAnnSonders):

- Unemployment claims
- Consumer confidence
- Restaurant reservations
- Mortgage applications
- Hours worked
- Financial conditions
- Hotel occupancy
- Cinema/Broadway box office receipts
- Anecdotes from small businesses
- Traffic conditions
- Retail sales

What's needed to change sentiment

Evercore ISI does some of the most-widely watched surveys in the business. They recently surveyed a large swath of investors about what is likely needed to shift market sentiment. You can see the results below; and it should come as no surprise that the top answer was that the virus case count needs to stabilize and/or peak.

Investors looking for case stabilization



What steps are we doing at RMH?

- We are looking at the portfolios and rebalancing where necessary.
- We are looking at what insiders are doing with some of the stocks we have purchased.
- We are talking with portfolio managers on a one to one basis, and participating in conference calls.

We understand that we are in a turbulent time, one that we have not faced for a while. As such, now more than ever, please reach out with any and all questions. We are here to help and guide you through these volatile times.

Sources include the following:

Quotes from Warren Buffet

RiverFront – “The Stay at Home Recession Mar 24, 2020”

Joe Zidle March 27, 2020, Blackstone

Lis Ann Sonders March 23, 2020 “Triage throwing everything at the virus”

We thank you all for taking the time and reading “Market Watch.” It is meant as an educational piece on the always evolving markets. It is something we plan on providing every month, and your feedback is very important to us. Please feel free to always reach out with questions, thoughts, or comments. If there are ever any topics you wish us to explore, please share.

On a personal note, RMH is now in the position to bring on new clients and please be sure to share this informational letter with whomever you wish. RMH’s focus is on the customizable investment needs of individuals, families, and foundations. We enjoy working with our clients to better understand their goals, values, and passions for what is important in their lives. In expanding our client base, we look forward to working with people who share these same desires

Richard Mundinger, CFA

Research and Editing by Erica Mundinger