Palmetto Wealth Management

"Pactum serva"

John M. Gustafson – 30 June 2020

"It is during our darkest moments that we must focus to see the light." – Aristotle

After 27 years in the investment business and almost 11 since founding this firm, I've learned that almost anything can happen at any time. For example, in the past 2 ½ years we've experienced two stock market drops of greater than 20%. The first one, in the fourth quarter of 2018 caused by uneconomic tariffs and a trade war, recovered almost immediately. Primarily because it was entirely self-inflicted by government policy that was quickly reversed / somewhat mitigated when the markets complained loudly.

The most recent fall that we all just rode through (well beyond 20% to the downside) was triggered by a non-economic event, but certainly has caused historic economic damage to this point. That is what concerns me today…

Although I'm very happy with the changes we made in early February that protected the downside and have now recovered nicely to basically restart the year; I'm still curious as to why the market has rallied this strongly off the bottom. We did have a vibrant and growing economy before COVID-19 hit, and as we discussed in our last quarter's note, after 128 months of expansion economic that growth clearly hit a wall.

The old market saying "the markets climb the wall of worry" has almost never been truer than what we've just experienced in the last 8 to 10 weeks. However, it has gone against another cliché that states, "Bulls take the stairs, bears take the elevator" with such a rapid snapback. My concern is that because of the unpredictable nature of this virus the view to the future in economic terms is more than opaque.

And of course, we don't simply have a global pandemic with a record, historic unemployment rate, we are inside of 150 days until a Presidential election that is only going to get crazier as we move through the summer into fall. I'm going to try and outline the risks and potential upside of several different scenarios as I see them currently and give an idea as to how I'm looking to manage our portfolios over the next several months.

"The greatest glory in living lies not in never failing, but in rising every time we fall." – Nelson Mandela is

First up, COVID-19... The changes to our portfolios we initially made at the beginning of this crisis in early February. (Feels like last year…) The initial lockdowns, as we gather more information, appear to be working well, but as everyone understands we can't close everything off and still have a functioning economy. We are however, seeing what happens when people ignore science and act as if everything will immediately return to "normal."

Our Lieutenant Governor here in Ohio, John Husted, made a statement at one of our daily briefings a month or so ago where he correctly stated that just because businesses are reopening doesn't necessarily mean consumers will patronize them. That is where I see the real risk to small businesses and smaller companies as we move forward. Enough people are still concerned that it will be incumbent on businesses to take measures to make their employees and potential patrons feel safe. We can't rely only on those who believe they need not be concerned with the virus.

Despite the social media arguments both for and against wearing masks and social distancing in public, whether COVID is "just the flu" or whether it should be avoided at all costs, the reality is that people's actions speak louder than their words. If citizens are confident that they're going to be safe, everyone will begin to venture out to restaurants and shops and fully support our consumer driven, service economy. (Hopefully this does push a return of American companies manufacturing more in America, but that is a topic for a future note…)

Best case scenario, the latest surge as things reopen will convince people to follow the health guidelines and get the spread ("R0" as we've all learned) back under control. If not, I'm afraid the current level of unemployment and pending small-business bankruptcies will hang around for months and cause heavy long-term damage to the U.S. economy. I'm betting on Americans coming together for the sake of the country - as we always have in the past. It will still be a bumpy ride in the near term.

The good news in the midst of the surge is that the death rate looks to be moderating. I don't believe it's simply because younger people are the majority of those testing positive currently - that's clearly part of it - but I also think it shows progress in our therapies. All of these ER Docs and their staff have now had months of experience with this new scourge and the knowledge base grows hourly.

Originally when people were getting the disease fast and furious the doctors simply had no facts as to what it did to the body and how to head off that path before reaching the point of needing a ventilator. Now it appears that more aggressive, early treatments are being employed to avoid that final step that may save a person's life, but also causes quite a bit of long-term damage. This is a big step toward making people feel safe. If you reach a point where you know you may contract the virus, but it isn't as potentially damaging or even fatal, many people will be more likely to venture out to try and act somewhat normal once again.

What can go right? Because this situation, unlike the trade war, is globally damaging it truly is an all hands on deck scenario when it comes to finding a vaccine and/or effective therapeutics. I've read several articles recently outlining vaccines and therapeutic studies being performed at not just American pharmaceutical companies, but inside drug companies and Universities companies around the globe. With all of this capital, knowledge and other firepower focused on the problem I'm confident something will break through on the positive front.

The conventional line in the media states that we will never get back to "normal" until we have a vaccine. I somewhat disagree, only because COVID-19 appears to act more like the flu. What I mean is, there are different strains (or at least there will be soon as it mutates) versus polio or the measles where vaccines completely eradicated those maladies. (At least as long as people were using them as directed…)

As previously stated, I think successful therapies that can mitigate the damage and accelerate recovery will go much further toward getting our economies back on their feet than simply a vaccine. Again, it's a confidence situation. And history has shown, early editions of vaccines have not always been the safest and with the highly charged debate over the situation I can imagine there will not be huge penetration of the population right out of the gate.

Any positive news regarding treatments or cures for COVID, as we've seen over the past couple of months, lead almost immediately to an explosion upward in the equity markets. It is the reason that although we made changes and have triggered rebalancing to the portfolios - raising our cash positions higher than almost any other period - I wouldn't be comfortable completely out of the equity markets. Historically, most upside returns come in short bursts that you'll never be able to catch if you're sitting fully on the sidelines.

Remember, we build these portfolios like a rheostat, not a light switch. Capture the upside and mitigate the downside as effectively as possible.

"The greater our knowledge increases the more our ignorance unfolds." – John F. Kennedy

Politics, politics, politics… As has been the case for well over a decade we remain in some of the most highly charged, political environments affecting our lives daily. I've mentioned to several people recently that the United States has become more like Israel and Palestine in terms of the way the political parties view the country. Not only does each side consider a 65% win a 100% loss, but half the time they seem to be arguing about two completely different things.

There is no question that the craziness, the personal attacks, the conspiracy theories, the unbelievable volume of television ads will do nothing but ramp up to a fever pitch over the next four months, but I think that scenario is at least somewhat baked into the cake. Nobody really expects either side to change tactics at this point so the rhetoric shouldn't affect the markets as much as you may think. Remember, in the investment world, "good" or "bad" doesn't necessarily matter as much is "known" versus "unknown." We are certainly dealing with known quantities at this point… There can (and will) be extreme extrapolations as to what each may enact when in the seat but that feels more like background noise at this point.

My real fear in terms of the election is the 4 to 6 weeks after voting closes if we have no definitive result. If you recall our experience 20 years ago – Bush v. Gore – the dot-com bubble peaked the NASDAQ in March of that year and started to roll over. However, I can still remember that the markets actually recovered nicely through the end of the summer.

I recall this because I was preparing to get married in September 2000 and was calling all of my clients to discuss the market and where we sat. The conversations all seemed to focus on the volatility we had experienced, but that we were back to almost even (just like today) at that point. That all changed with hanging chads in Florida…

The moment we had no political result in the near term, the markets just completely fell apart. If you look at the return for the S&P 500 in 2000 (-10.1%) all the negative performance came in the last seven or eight weeks of the year. That is a concern of mine for 2020. Stay tuned…

If we do have a definitive's results – no matter who wins – I believe it will be seen as a relief. The economy may be suffering more by then than it is now but at least again we won't have uncertainty.

One caveat regarding a potential Biden win… Currently, the gambling odds say there is zero chance of the Republicans reclaiming the House, but if there is a blowout presidential win there is a chance that the Senate could go to 50-50 or even 51-49 in favor of Team Donkey. That outcome will likely be viewed as troublesome by the markets.

It's been proven many times throughout recent and long-term history in America; we function better in our two-party system when each party has at least some control. The assumption is made that the checks and balances will work to keep the most extreme policies of each party from becoming law. I'm not sure that's 100% correct, especially in our most recent history, but you can certainly see examples of when single party rule allows significant changes to be pushed through.

The most recent examples of course are when the Democrats had control for two years beginning in 2008 and the Affordable Care Act was pushed through. And when the Republicans had total control for a couple of years beginning in 2016, the current tax bill was passed.

My hope is that whatever the result of the election, it is obvious and agreed-upon quickly that lawmakers (I don't care to call them "leaders") finally realize that the other side of the aisle isn't necessarily the enemy and beneficial laws can be crafted on a bipartisan basis that will stop the whipsaw effect of each successive president exchanging executive orders. (I'll let you know if I see any flying pigs…)

"True wisdom comes to each of us when we realize how little we understand about life, ourselves, and the world around us." – Socrates

Now that we've wound down the long and winding path, trying to level set our current environment, what's on the road ahead? My belief (and our portfolios reflect this) is that any potential upside is going to be mostly aggregated in mid-to-large-cap equities, simply because they have the economy of scale in their favor; allowing bond issuance in our extremely low rate environment to replenish cash and continue to operate as the global economy winds itself back into motion. And they also generally have the ability to produce revenue across the globe and not just in the U.S. In case our recovery is delayed by the virus.

As outlined earlier, the incredible snapback has basically given us a "do over" for 2020, at least in terms of investment portfolios. It sure would be nice to grant that to high school and college kids who had senior years or sports seasons completely obliterated. That was the reason for our full rebalancing on Monday. What occurred was forced profit-taking on the equity side and moving it further into the fixed income arena and realigning everything with our current allocation and risk profile.

As the virus and its economic effects become clearer over the next few months (fingers-crossed) there may be more changes to protect against the downside. Unless something drastically changes we may rebalance on a tighter schedule to keep things aligned but avoid major changes from here until there is some clarity on the three legs of the stool I've outlined: COVID-19, economic activity and the November elections.

It is funny (strange funny, not ha-ha funny :) how our history is repeating itself from almost 100 years ago. Global pandemic, simmering global tensions, significant unemployment… It will be nice if we come out the other side of this into the next "Roaring 20s" - and learn from our previous mistakes to avoid the unfortunate ending in '29. We shall see…

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." – William Arthur Ward

Cheers!