The Black Swan Returns

John M. Gustafson – 31 March 2020

Before launching into our report on the worst quarter in the markets since 2008, I'd like to say that I hope everyone is hunkered down and doing well. It is certainly an odd situation and I look forward to seeing everyone in person again on the backside of this infection curve.

The strangest thing, for me at least, is looking at my calendar up on my screen each day. It hasn't been this devoid of places I need to *be* since I was probably ten years old. My daily office routine hasn't changed much but everything else has simply disappeared. Since (mostly) everyone is in the same boat, I can only imagine the frenzied buying and activity-seeking when the all-clear horn is blown. We just have to make it there healthy & economically...

A quick recap leading into the important aspect of where we go from here… Unlike market and/or economic drops in the past, this one was truly unique – we went from all-time-highs on February 12th, to bear market territory in only a few weeks. From the peak to the trough the Dow dropped an eye-watering 37% - now recovered to approximately a 24% drop from the peak. Our portfolios have suffered about half that volatility on average. Still stomach-churning, but the diversification and some of the early moves we made certainly slowed the bleeding.

In a couple of early blasts I sent as this tsunami grew, I pointed aspects of this situation that is not the same as the '08 crisis that bore the Great Recession, though this could be as damaging simply because of the breadth. 2008 was a system crash that removed liquidity from global credit markets and froze up real estate and hurt corporations. This is strictly a demand drain caused by a huge portion of the world trapped at home from grave health concerns and unable to participate in the global economy.

Some of the differences are slightly positive. For one thing, the "bailouts" are very different this time. The true problem with the bailouts and the political consequences of 2008 was that the government was in effect giving enormous sums of money to the companies and people who pushed the system and its previous rules until it broke. No company or individual – certainly not in the U.S., is responsible for this crisis, nor could have seen it coming. Should our response have commenced sooner? Probably, but that's all politics at this point. The response is underway and there are no political constraints to throwing all manner of financial tools at the economic problem caused by the virus.

Our governments, both State & Federal, are effectively hitting the off switch on our economy to slow the growth of infections ("flatten the curve") to keep our medical facilities functioning and buy time to find an effective cure and will now need to prime the pump to get the engine firing once again when it's safe.

One benefit of experiencing two "Black Swan" events in slightly over a decade is that many of us – including those operating the government's financial levers – have actual experience in this type of crisis. Nobody was around for the Spanish Flu, so the medical side of this is scary and new, but the economic and market actions are very similar. This is evidenced clearly in the Federal Reserve's swift action.

Back in 2008, Chairman Bernanke did an excellent job of creating the tools and policies based on his understanding of the Great Depression of the 1930's – the one mistake that they realized would have helped a more swift recovery was to move faster and get ahead of the curve. That lesson has not been lost on Chairman Powell and his current board of Fed Governors. They moved drastically and quickly to reopen every crisis tool in the toolbox almost immediately and are working daily to create more – even to the point that they are helping to coordinate central banks and their actions around the globe

Even Congress has seemingly learned something from the last crisis. The CARES act, just signed into law has several pieces of clean, direct help to individuals and small employers. There is plenty of controversy and some pork – they can't help themselves – but it is surprisingly easy to understand and directed across the board to do one thing: keep employees working or at least get them paid to essentially put our economy into an induced coma to ride out the progression of the infection. I'm sure this will require more, and that is exactly the job of the government in a crisis like this. Deficit spending and filling corporate pockets when times are good is foolish - these are the times when we need that firepower.

Will it work? Probably, for a little while... There is almost certain to be a second or even third tranche over the next six to nine months. The only effective way shown to stop the infection spread right now is keeping people apart and that will continue to punish the global economy until we have a treatment.

The good news is that once again American ingenuity is stepping up on the fly. We were woefully unprepared, on top of being slow to act, which is how we got behind the curve – and why the drastic measures that are currently punishing the economy needed to be set in motion.

In just the past week we have had not one, but two new testing protocols emerge that allow tests to produce results in minutes rather than days or hours. We have also ramped up production of necessary PPE (an acronym that now everyone knows, not just those in healthcare) via non-traditional manufacturers of those items - and a local non-profit, scientific research firm in Central Ohio (Battelle) even developed a machine that will sterilize 110k facemasks per day! (and received FDA approval within a week) Battelle is now looking to expand that to all forms of potentially reusable PPE. That way, even if the supply doesn't arrive in a timely fashion – or the problem briefly accelerates - we will have ample back-up.

In my mind, based on what I've read we need several things to come online to get us back to somewhat normal and allow the economy to unfreeze and function again. This is what I look for when reading the news daily – just to give me some indication as to how much longer this storm may last.

First, we need the capacity to effectively test everyone regardless of symptoms or lack thereof since COVID-19 seems to be easily spread long before anyone has any idea they are infected. Unlike the flu or other viruses that generally let you know quickly that you have it. Hopefully the two new tests mentioned above will kick that off sooner rather than later.

Second, we need to continue to see good data on the experimental drug treatments demonstrating broad effectiveness. Those used for Malaria & Ebola combined with other treatments.

Third, we need to be able to test everyone who isn't sick to see if they have the antibody because they were previously infected but never really fell ill. Once we can determine who had it (and may likely now be immune) combined with effectively screening who is currently a carrier, we will then have a concrete number of useful workers who can safely and without worry get back to work while continuing to protect the vulnerable. Things as simple as going to the barber can come online quickly. If you are tested and cleared and so is your barber, you can both confidently return to "normal" in that basic activity.

I'm reading that there is an ability to test for the antibody, but just as with testing for current infection, at this point it is cumbersome and too time-consuming to process the volume. This is likely on the front-burner of a number of labs and companies at this point now that the virus testing seems to be under control.

Finally, a vaccine... This is obviously the last step to keep this disease at bay in the future. It's not necessary to get people back to work with the other steps in place, but it will be the final "win" to signal the crisis end.

At this point, from a market perspective, I do think we have seen an interim bottom a couple of weeks ago. The panic level we hit just prior to Congress stepping in with the CARES act was pretty spectacular – always enhanced by our high-frequency trading friends and the other machine-driven algorithms. That doesn't mean I think it's *the* bottom if the medical steps I outlined are too far delayed or if several states who have dragged their feet when it comes to their isolation orders (which clearly work) continue to let people mingle and spread the disease. We could definitely see a second acceleration and that would be greeted poorly in the markets - unless the drug treatments are proven broadly effective or even approved for interim prophylactic use to keep the masses safe from the careless in our society.

Currently I'm comfortable with our allocation and how it has reacted to what's going on and how I view the path forward. The rebalancing and removal of specific exposure did what was expected and I don't see a need for drastic changes at this time.

In terms of actual economic numbers, there is no question we are now in a recession. It may not be officially declared until later this year, but it's clearly coming. Most reports I hear form economists at a few of the firms I trust, this does seem like it will be a "u-shaped" situation in terms of economic growth. They term it, the fall, the stall and the recovery.

We're having the fall currently, the stall will arrive because it will take time to get everyone back to work as outlined above, but the recovery on the back-end is likely to be quite strong. We were in an economy trucking along for 128 months, still accelerating, that basically hit a wall. That power won't disappear immediately, but it won't return like a light switch either. However, I do believe it will return.

Economic growth will also be hindered once this is over depending on how the balance is kept as states cut budgets and the country pays on a debt equal to 100% of GDP after all the stimulus payments. It may also cause inflation having all that debt, but it's not enough to halt a recovery once the virus is under control. At that point, it's back to pure economics again and not a health crisis. Much easier to value and project from an investment perspective.

Finally, some positive news for America's future on the horizon... There are plenty of places to point fingers as to why were unprepared or why it took so long to react, but that's not a helpful discussion here. What has become blatantly clear is that America had turned so far into a service economy that lost so much manufacturing, we were simply too reliant on other countries for basic infrastructure, equipment and pharmaceutical base compounds.

Taxing Americans via tariffs can't change the course of that ship, but a national emergency that shows who can pivot and react should encourage more companies to do so. Ideally with the backing of the government now anxious to have supplies replenished and to avoid a catastrophe the next time a new bug comes a-callin'. America still doesn't need to manufacture everything in our economy, but I hope we all realize that some things are critical and should be made here – even if it costs more during the transition. These goods and medicines could be as critical to national security as fighter jets and missiles down the road. Stay tuned...

Thank you as always for your business and trust. Stay safe…