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Wealth Management

Quarterly Economic and Market Comments
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"There are decades when nothing happens, and there are weeks when decades happen," said Lenin. It is ironic that he came up with this line roughly a century ago around the time of the Spanish Flu, although that was not, of course, what he had in mind. Writing a quarterly commentary over the past decade was challenging because nothing dramatic happened from an economic point of view. True, there was the European debt crisis in 2011, the collapse in the price of oil from over $100 to under $30 in 2015-16, and the broad sell-off in financial markets in 2018 as the Federal Reserve made a half-hearted attempt to "normalize" interest rates. However, the basic picture, no matter how much monetary fuel was added to the fire and no matter who was in charge politically, was one of low inflation, low interest rates, and low growth. No boom. No bust. Until now. Be careful what you wish for.

It is perhaps helpful to borrow the title of the famous Clint Eastwood movie, "The Good, the Bad, and the Ugly." to frame the current situation. The ugly - medical, social, economic, and financial - is what we have been living through over the past five or six weeks and continue to endure today. The medical and social costs of the coronavirus, while significant - over one and a quarter million cases with more than 70,000 dead and climbing - are not within the purview of this letter. The economic and financial fallout is, however. Almost every discussion of the economic and financial scene today references the great financial crisis (GFC1) of 2008-09. Indeed, as various indicators of economic activity collapse, it is inevitably noted that it is the weakest performance since, or in some cases weaker than, 2009. Some have taken to calling the current episode the second great financial crisis (GFC2) and, indeed, these two incidents do share at least one important feature. They are both classic Minsky moments; to wit, a sudden, major collapse of asset values marking the end of the recent growth phase of the cycle in credit markets and business activity. The economist, Hyman Minsky, hypothesized that such a rapid instability can occur when long periods of steady prosperity and investment gains - in this case, the longest U.S. business expansion on record, a record streak of 113 months of job growth, and a ten-year uptrend of stock prices - encourage a diminished perception of market risk, which in turn promotes the debt-leveraged financing of speculative investments which are vulnerable should asset prices begin to fall for whatever reason. As in 2009. Like now. While almost no one foresaw that the coronavirus could trigger a Minsky moment any more than they anticipated the fall of Lehman Brothers, it is important to note that global growth prospects were weakening prior to the current crisis and all the major global economic organizations, such as the International Monetary Fund (IMF), had identified "imbalances", in particular, the fact that global debt rates had, by the end of 2019, risen to levels well above those prevailing prior to the last crisis in 2008. The economist, J.K. Galbraith, in his book on Minsky moments (a term he did not use) noted that "all crises involve debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment".

In any case, as in 2008, a collapse in asset values began and, when the dust settled, the first quarter was the worst first quarter ever for the venerable Dow Jones Industrial Average and it was the worst for the MSCI World Index since its inception in 1970. In what was dubbed "the sub 20% club", equity markets in every major region and country declined, typically by around 20%. In the U.S., all industry groups finished the quarter with double-digit losses. Energy suffered its worst quarter ever, falling more than 50%, while financials turned in their second-worst quarter, falling by a third. Nor were equities the only casualty. Commodities fell by 40% on average, with the CRB Commodity index trading at levels not seen in decades. Even milk and cattle prices plunged and hog futures hit a 17.5 year low. Non-gilt-edged bonds got pummeled with junk bonds, leveraged loans, and emerging market debt falling between 10% and 18%. Junk bond prices have made new lows relative to investment-grade and the number of bonds trading at distressed levels is approaching the April 2009 levels at the end of GFC1. The current pace of corporate credit rating downgrades is the strongest on record going back to 2002. Real Estate Investment Trusts (REITS), typically considered safe, income-producing vehicles, were down across the board, typically by more than 25%. It was a classic rush to safety as only the highest quality government debt, the greenback, and gold showed a positive return. In the worst week in March, mutual funds in the U.S. saw their

biggest drop in assets under management since 2008. The decline in the capitalization-weighted stock indices actually understated the carnage, as the flight to safety was evident within the equity universe. While the largest 200 stocks within the Russell 2000 had their worst quarterly return (down 18%) since 2008, they outperformed the broader index by the most since data began in 1979.

While the action in the markets in the first quarter was eerily reminiscent of the fourth quarter of 2008 during GFC1, there are some important differences. The Minsky moment of GFC1 was triggered by the subprime loan crisis, which led to a massive financial panic, and, in turn, an economic downturn. Once the banking system was stabilized, it was assumed the economy would recover, which it did, even though it never regained the trajectory it had been on before the crisis. In contrast, the current GFC2 is the result of two massive deflationary shocks in the real world - the shutting down of large chunks of the global economy to fight the coronavirus and the drop in the price of oil – which, in turn, has led to a financial panic. A unique feature of the current crisis has been the speed with which it has unfolded and the level of volatility. It is worth recalling that the first case of the coronavirus in the United States was only reported on January 19th. By mid-February, only 400 Americans had been tested and the American stock indices were at record highs. On February 25th, Larry Kudlow, Trump's chief economic advisor, stated, "We have contained this. It's not going to be an economic tragedy at all." At about the same time, Predictit estimated about a 25% chance of a recession in Trump's first term. Between February 19 and March 23, the U.S. stock market experienced its fastest 30% drop in history. Excluding the freak one-day market crash of 1987, of the four worst days in American stock market history, two were in October 1929 and two in March 2020. The first trading day in April was the worst start to a quarter in U.S. history stock market history (the previous being in 1896!). Nor was it just in the U.S. The Italian stock market fell a record 17% in one day. However, the volatility was by no means all to the downside. From their March low, U.S. stocks recorded their best three day-gain since the 1930s as well as their biggest daily advance since 1933. The last time the U.S. market posted three days with moves of more than 9% was in 1929. It goes almost without saying that when your terms of reference are 1929 and the 1930s it is not a good thing. March was unquestionably the most volatile month in U.S. market history - not the worst (15 months have been worse). The average absolute daily change of more than 5% was 30% higher than the three next most volatile (October 2008, 1929, 1987) months. Nor was it just equities. Oil in March had its worst month since oil futures started trading in 1983, with Western Canada Select - the Canadian oil price - falling unbelievably to less than $4 per barrel, but also saw its best single daily gain in history.

Volatility in the markets was reflecting what was unfolding in the real world except that most economic data is not available until a week or a month after the fact. A sampling of random data points: the New York City Business Conditions Index fell to a record low of 12.9 in March, down from a solid 51.9 in February; consumer confidence in Australia has plunged to a record low; new car registrations in Italy are down 85% year-over-year and Italian manufacturing output has fallen at the fastest pace on record; tourism arrivals in Thailand have fallen to a record low, down almost 75% year-over-year, and visitor arrivals in Hong Kong are down 96%; ridership on public transport in Lima is down 88%, in Santiago down 73%; U.S. airline passenger traffic is less than10% of normal; the unemployment rate in Norway has skyrocketed from just over 2% to almost 11% in one month; in the U.S., the collapse in economic activity and tightening of credit led to the biggest drop in the history of the Credit Manager's Index. The list goes on and the story is the same. If there is one statistic that stands out, it is the fact that, in two weeks, there have been almost ten million new claims for unemployment insurance in the U.S. It took 28 weeks to generate an equivalent level of claims during GFC1 and the peak weekly number was 665,000.

Clearly, the speed and ferocity of what is taking place is jaw dropping and unprecedented, but what really separates GFC2 from GFC1 and, indeed, anything since the Depression and World War Two is the epic level of uncertainty. Indices of Economic Policy Uncertainty are at record levels in Brazil, in Germany, in the United States - no doubt pretty much anywhere. Estimates of growth in the U.S. economy for the second quarter among blue chip forecasters range from minus 9% to minus 40%! In short, they don't have a clue. In fairness, how could they? Will the coronavirus spread to parts of the United States that have been largely spared? Will Americans try to go back to business as usual as they seem to want to do and cause a second wave of the pandemic? In the Spanish Flu, admittedly a tricky analogy, the second wave killed more people than the first in many places. What about India, Brazil, and Africa? Uncertainty, volatility, and fear add up to ugly.

What about the good? What can possibly be good? From a stock market point of view there are at least five obvious positives. First, the coronavirus will ultimately burn itself out even if we don't come up with an effective vaccine first. People will come out of their foxholes and life will go on, not exactly as it was, no doubt, but it will be some sort of return to normalcy. Secondly, the price of oil will eventually rise. Saudi Arabia's economy is falling off a cliff and Russia's service sector is deep in contraction territory. Anything less than $50 oil is not remotely working for anyone. Of course, a higher oil price will require a pick-up in demand which will only occur with the end of the coronavirus shutdown. Thirdly, it is almost impossible to overstate the degree of monetary and fiscal stimulus that is being thrown at the current crisis. It took 94 years for the Federal Reserve Board's balance sheet to reach $1 trillion. In mid-March they added more than $1 trillion in one day and this is over and above the biggest interest rate cut, to zero, in modern Federal Reserve history. A couple of weeks ago, the Federal Reserve was buying $125 billion of assets every day. By way of comparison, the famous bailout of Long-Term Capital Management in 1998 amounted to $4 billion in total. That's how far things have come. The Global Monetary Policy rate fell from just over 2% to under 0.5% in a matter of days in March. Central bankers are going "all-in". A checklist of tools available to the European Central Banks suggests that only "helicopter" money (i.e. outright money printing) is still available and no doubt will be used if necessary. Nor is fiscal policy being left behind. Traditional skinflint Germany is planning fiscal stimulus of in excess of 20% of GDP compared to 3% during GFC1. In the U.K., it's 16% compared to 3%. Same story in France and the U.S. seems set to do about double what it did in GFC1. Canada is catching up fast. The one big outlier so far is China which provided the main fiscal thrust in GFC1 and this time is very much taking a back seat. Nevertheless, no doubt this massive and swift policy response, whatever the long-run negatives, will provide support for the world economy and fiscal markets in 2020.

The fourth positive is valuations. One of the big problems facing equity investors in recent years has been the difficulty in finding companies trading at sensible valuations. Well, problem solved, in part. The big U.S. indices like the S&P 500 are by no means cheap. This is largely because the technology sector and the quasi-technology stocks like Amazon and Facebook represent a staggering 40% of the market capitalization and faith in this part of the market has not faltered. Elsewhere, it's a different story. Smaller capitalization American stocks relative to larger capitalization stocks are at their lowest level since 2001. Half the stocks in the Russell 2000 Index are trading below book value. Of course, some of these are distressed, as evidenced by the fact that a record number of companies around the world are trading at half of book or less. Still, for the first time in a while, there is a pool of stocks that could represent reasonable long-term value. None of this is to suggest the bottom in the market has been seen - although it may have been - or that this is "the" time to buy. It may, however, as the astute observer, Howard Marks, notes, be "a" time to buy even if only, as he suggests, "nibbling".

The last "good" thing in stock-market terms is zero percent interest rates. In Victorian novels, characters talk about living on their 3% income from safe investments, primarily government bonds. Since there was no inflation and minimal tax, this meant a low-risk 3% after inflation and taxes. No doubt many investors today would plunk some of their funds in such a vehicle were it available. Obviously, it isn't. Investors who want a low-risk profile are looking at negative real returns, not 3%. This is what Keynes called - and advocated - "the euthanasia of the rentier." Whatever the morality of it, it's the way it is and is unlikely to change anytime soon. Today, investors are traumatized and happy to hold cash, but most investors want or need a higher return. Given, as J.K. Galbraith notes, "the extreme brevity of financial memory", it seems inevitable that investors will be lining up to purchase risk assets once the skies have cleared (and prices are higher).

So, what's the bad? The bad are all the structural economic, monetary, and geopolitical problems that the world avoided facing over the past decade and which will be that much more daunting as a result of the actions taken to get us through the current crisis. The dilemma is wonderfully outlined recently by Scott Minard of Guggenheim Investments. We quote in part:

"In Goethe's 1831 drama Faust, the devil persuades a bankrupt emperor to print and spend vast quantities of paper money as a short-term fix for his country's fiscal problems. As a consequence, the empire ultimately unravels and descends into chaos. Today, governments that have relied upon quantitative easing (QE) instead of undertaking necessary structured reforms have arguably entered into the grandest Faustian bargain in financial history."

He actually wrote these particular lines in 2012 which demonstrates how long we have been able to kick the can. He is revisiting his comments today because he believes “the bill may be coming due.” He may or may not be right, but his concerns must take back seat for now. Today, our task is to survive the ugly, so we can take advantage of the good, even as we worry about the bad.