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Across the Valley

Only three months ago, people were ringing in the new year and decade with a sense of cautious optimism. The U.S. economy was strong and the global economy seemed to be improving, especially on the heels of a trade agreement with China and new NAFTA deal with Mexico and Canada. The unemployment rate in the U.S. was at 3.5%, the lowest level in 50 years and the S&P 500 was at its highest level ever. Barring some significant event from left field, most economists and strategists saw smooth sailing ahead for the global economy.

And then, from left-field, or, more precisely, Wuhan China, came Covid-19, and what started out as an isolated problem in China has quickly morphed into a global pandemic unlike anything any of us has seen in our lifetimes. Covid-19 has literally brought the global economy to a standstill. Countries around the world have had to shelter their populations and shutter non-essential activity to curb the virus' rapid spread.

Since February 19th, only six weeks ago, global financial markets have plunged further and faster than almost any time since the great depression, wiping out trillions of dollars in market value. Bond markets have also been roiled, as investors have sold everything to raise cash. Meanwhile, beyond the enormous human tragedy unfolding around the world, the economic toll is becoming increasingly evident. This past week 6.6 million people filed for unemployment and in the coming months we could easily see 20 to 30 million people out of work in the U.S. It is estimated that every month that the U.S. economy is in lock-down reduces GDP by 2%. For reference, the Great Recession of 2008-2009 only involved a decline in GDP of 4% over six quarters.

Unlike the Great Recession, which was largely an economic crisis that could be addressed with economic solutions, Covid-19 is first and foremost a human crisis that can only be solved with medical solutions and time. All past pandemics have eventually ended and there is nothing to suggest that this one will not either. We just don't know how long it will take. There is little evidence to suggest that it will be any time soon. There is some reason to hope that life might return to a state of limited activity once the arc of the disease has been substantially reversed, as has been the case in China and Korea. Physical distancing clearly works: it saves lives and buys our healthcare system critical time to get the equipment and resources needed to treat patients.

Physical distancing also comes with a high economic cost in that it involves putting large parts of the global economy into a self-induced coma for an indeterminate period of time.

In the U.S., the Federal Reserve and Congress have quickly stepped in with unprecedented amounts of monetary and fiscal support to stabilize markets and build a bridge across a very deep and very dark economic chasm. The Federal Reserve Bank lowered short-term interest rates to zero and has intervened to provide liquidity and support to credit markets. At the same time, the U.S. government has stepped in with three fiscal aid packages, the latest of which is the $2.3 trillion dollar CARES Act, which provides direct cash grants and loans to households and businesses to help get them through the next few months. This is a massive stimulus program, several times what Congress passed to help support the economy during the 2008-2009 credit crisis. It is likely Congress will need to do even more. In Europe and China, Central Banks and governments are also pledging to do "whatever it takes."

The metaphor of a valley or chasm is a good one. Like the proverbial valley of the shadow of death, we know that we have to go through it and across it to the other side. We know that the journey will be grim from a human standpoint and that the scale and scope of the economic decline will be severe. And we also know that there is another side and we will get there. Most of the world's medical minds are working around the clock on solving the same problem. Although a vaccine may be 12 to 18 months away, there will likely be discoveries in the near future that improve the effectiveness of prevention and treatment. This could allow a return to semi-normalcy sooner, in measured steps and supported by extensive testing.

A Framework For Investing:

So how should one invest in the face of so much uncertainty. Should one sell everything and wait for the all-clear signal, or ride through it with the faith that we will get through this, and the economy and markets will rebound in the coming year or two. History suggests that the latter remains the far better strategy.

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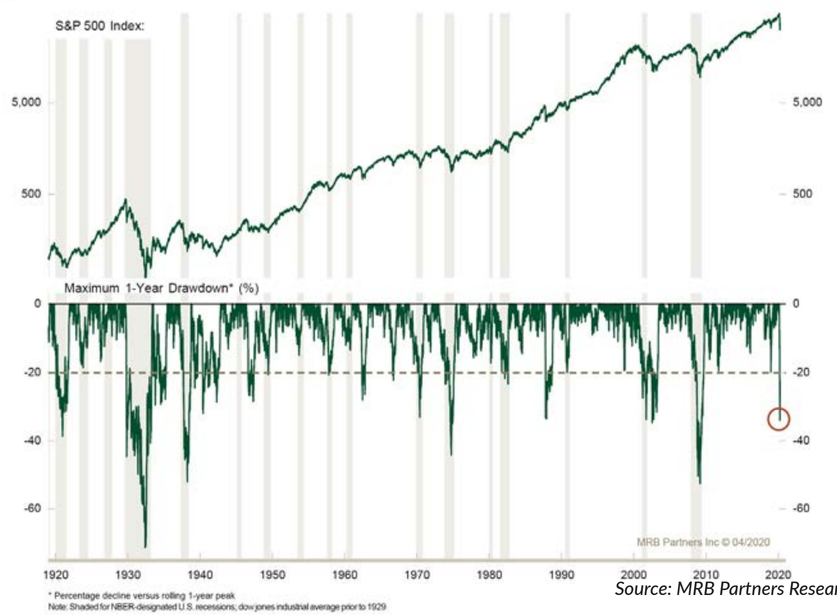
Although we are all in unchartered territory and the future looks both scary and murky, it is important to take a rational approach, driven by reason, history, and a long-term focus.

Chart 1: A Century of Bear Market Declines: 1920 to 2020



Source: MRB Partners Research

The chart above shows a century of market declines including the great depression, World War II and some other very difficult periods. Despite these setbacks, the economy and markets invariably declined and then resumed their natural tendency towards growth.

We will get through this crisis, as we have others, but will likely emerge on the other side in a different place, with an altered set of priorities and behaviors.

Our baseline expectation is that the current crisis will be more severe and take longer to resolve than most people would like to believe or than is currently priced into the financial markets.

But markets have already reflected a significant amount of economic damage and prices have fallen to levels where they offer attractive expected returns over the next two to three years. They will likely fall further, but as they do, they offer even greater value and even higher expected returns looking forward.

At the same time there will be large amounts of government stimulus flowing through the economy and Congress is already working on the next major stimulus package. When and as the economy starts to rebound, hopefully in the next few quarters, there will be a lot of pent-up demand for goods and services.

And there is always the chance that things could normalize more quickly if the virus starts to die out at a faster than expected rate as a result of physical distancing, seasonality, or some unforeseen breakthrough. We are not counting on this, but know that things often play out differently than expected, sometimes for the better.

We were fortunate in positioning portfolios more defensively going into the crisis and portfolios now have a reserve of cash and defensive investments for reinvestment back into stocks and other risk assets.

So, the first guiding principal of our framework is to invest with a long-term perspective and avoid the temptation to wait for the crisis to pass and the "all clear" signal to be declared before reinvesting. By that time, markets will have already rebounded. **Good investment opportunities are rarely comfortable and comfortable investment opportunities are rarely good.** In addition, as the chart below shows, a significant portion of the stock market's return occurs in a small number of days, many of which are clustered around the worst days. Since the market has an upward bias over time, it tends to be better to ride through the bad days to enjoy the good ones.

Chart 2: The Cost of Missing the Best Days in the Market
1989 to Present

Source: Bloomberg and GSAM. As of April 2, 2020.

Our strategy is to incrementally put this defensive capital to work over time as prices come down and/or as fundamental information improves.

A second guiding principle of our framework is that Covid-19 will change the investing landscape on the other side of the valley. It is a crisis that will impact countries, governments, industries, and people differently, resulting in an uneven recovery, an altered competitive landscape, and a changed set of priorities and behaviors. It is important to invest with this changed landscape in mind.

Here are seven issues that we think will be significantly altered by the Covid-19 Crisis:

Healthcare:

The crisis has exposed the weakness of our current healthcare system and the critical importance of a centralized government role. If a virus can kill hundreds of thousands of people and cripple the global economy, then having a robust national healthcare system is not only a humane imperative, it is a matter of national security and economic necessity. Aircraft carriers and border walls are of little value in combating a pandemic, but a well-stocked and coordinated healthcare system is. Just as after September 11th we realized the need for a much more robust and coordinated intelligence effort, we expect a similar outcome in the wake of this pandemic. Covid-19 is a serious healthcare threat but it is also a dress-rehearsal for potentially more deadly viruses to come down the road.

Globalization:

Covid-19 is a global problem and will likely affect every region and country. Many countries, especially in the developing world are lacking the resources and ability to deal with a large infected population, setting the stage for a potentially catastrophic human tragedy. In the past, there was a much higher level of coordination among governments, typically with the United States playing a leadership role. As the world has generally eschewed globalization in favor of nationalism in recent years, and the United States has relinquished its leadership role, the ability of world governments to deal with this common problem in a coordinated and effective way has been greatly diminished. Perhaps, in the wake of Covid-19, as in the wake of World War II, we will see a return to greater global cooperation and coordination.

At the same time, the current crisis also underscores the vulnerability inherent in a globally dispersed supply chain. The majority of the masks, respirators and even antibiotics that we consume in the U.S. are made outside of this country, in places like China. During a crisis, globally dependent supply chains make it harder for companies to source materials to maintain domestic manufacturing capabilities once foreign factories are shuttered, ports are closed and aircraft are grounded. In the wake of Covid-19, we would expect that many companies will move more manufacturing capabilities back to the U.S.

Consumer Behavior:

Even after Covid-19 has passed, across the valley, there are likely to be long-term changes to human behavior in its wake. Human beings are inherently social creatures who crave physical connection, especially in times of struggle. Covid-19 has turned physical proximity from a comfort into a danger. Until the virus has been fully extinguished as a threat, we think people will be reluctant to gather in large groups or crowded venues like shopping malls, concert halls, places of worship, or cruise ships.

At the same time, we are being forced to connect, meet, shop, and order food online, including many of us who might otherwise be slower to adopt new technologies. Our online activity has moved from discretionary to *essential*. We may find that even after the Covid threat has passed, we continue to favor these online alternatives because they actually work well and are a better use of time and money. This has large implications for the airline and hospitality industries as well as the world of retail.

Competitive Landscape:

Winners and Losers: The global economy is not an even playing field and Covid-19 will have a very different impact on industries and companies. Some will actually be helped by the current and post-Covid world and others will be temporarily or permanently harmed. Healthcare and technology companies involved with finding a cure, stocking hospitals with vital equipment, and allowing people to connect online are seeing a surge in demand for their products and services. Conversely, businesses in economically sensitive areas such as energy, manufacturing, airlines, hotels, restaurants, and discretionary retail are seeing demand for their products fall off a cliff. In some cases, it may take years before things return to normal for them. Companies with large amounts of debt face an especially perilous time ahead.

Strong get stronger: We have also observed that in past crises, strong companies tend to get stronger. Weaker competitors don't survive and/or are purchased at bargain prices by industry leaders. A strong balance sheet is a vital asset through an economic storm.

Style versus Substance:

The political pendulum tends to swing from one extreme to another. The current crisis has revealed the sharp contrast between style and substance. The Trump administration has earned political capital with its base in recent years by touting a strong economy and stock market while discrediting scientists and other experts, and defunding government agencies and programs that didn't serve its political narrative and priorities. This has left the Federal government spectacularly ill-prepared to handle a real crisis such as Covid-19 that requires a high degree of professional expertise and leadership, as well as coordination among a large number of Federal, State and Local government agencies. When times are good, it can be easy and politically expedient to criticize the government, but in a crisis, people expect the government to come and save the day with the full competence of a Seal Team Six, as was the case in the wake of September 11th and Hurricane Katrina.

Although President Trump is currently enjoying a bump in polls, it remains to be seen if this bump will endure and how he will be judged in the months leading up to the election, especially without a strong economy and stock market to stand on. Voters may be more inclined to vote for a change, which could lead to a full Democratic sweep of the White House, House of Representatives and the Senate.

Debt:

Before Covid-19 hit, the world was already awash in debt, with total private and public market debt 2 to 3 times GDP in the developed world. The monetary and fiscal response to Covid-19 will cause public debt levels to explode with no easy path to ever put the genie back in the bottle. At some point, excessive amounts of debt should result in slower economic growth, higher interest rates and inflation. We do not think this is an immediate concern. In the near term, fiscal stimulus should be supportive of a return to economic growth. And, with the world's largest economy and reserve currency, the U.S. has a greater ability to borrow than most any other nation. Most other countries may not be so fortunate, especially those in the developing world who are forced to borrow in dollar-denominated debt. Countries that are dependent on oil exports are in a particularly dire situation.

Based on these framing issues, we are allocating client portfolios around the following areas of focus:

1) High quality companies focused on technology and innovation that are less impacted by the downturn and have strong balance sheets.

2) Companies involved with healthcare and innovation including biotechnology and medical technology. Demand for their products and services should only increase.

3) Quality growth companies that may be more impacted by the downturn but have strong balance sheets and should rebound over the long-term.

4) Chinese and other emerging market growth companies focused on technology and consumer markets. China appears to be on the other side of the valley in terms of curbing infection rates and slowly returning back to normal. In addition, the government has put a large fiscal stimulus program into effect which should help the Chinese economy to rebound.

5) Well-capitalized companies with attractive and sustainable dividend yields. The U.S. 10-Year Treasury bond currently yields only 1%. By contrast, the annual dividend yield on many high-quality companies is several times this.

6) Financial companies and investments that have large cash reserves and can be opportunistic buyers of distressed assets, including equity, credit and real estate. We think there are some particularly interesting opportunities in the credit markets and look to increase our exposure there as well.

Over the long-term we continue to invest with a global focus; balancing investments targeted at areas of long-term growth and innovation with more defensive equity, alternative, and fixed income strategies aimed at mitigating volatility and risk.

As always, please let us know if you have any questions and/or if there is anything we can help you with relating to your financial life. And, if we can ever be of any help to a family member or friend, we always welcome referrals from our clients.

Jurika, Mills & Keifer,
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Based in the San Francisco Bay Area, Jurika, Mills & Keifer provides wealth management, planning and advisory services to a limited number of individuals, families and foundations.

We combine a forward-looking view of the world with a deep understanding of our client's needs and aspirations to build and preserve wealth and financial well-being over time.

Over the years, we have built a reputation for independent thinking, sound judgement, and a high level of individualized advice and service.

We welcome the opportunity to discuss your financial goals and priorities and how we can help you achieve them.

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Important Disclosures