A View From Home - April 2020

"Gradually and then suddenly." - Ernest Hemingway

Radical uncertainty

We have found ourselves in a series of unprecedented events, which Mervyn King (former governor of the Bank of England from 2003 - 2013) termed, *"Radical Uncertainty".* As little as a month and a half ago you would be hard pressed to find anyone talking about why the world economy is being deliberately shut down by governments in order to battle a virus that we didn't know existed three months prior. These are events that you couldn't imagine in advance and, even if you did, how would you know what kind of virus it would be, how it would spread, and perhaps most importantly, how people would respond to the measures that were put in place. Perhaps in the end what we believe influences the outcome.

Virus economy

While the virus is not a financial event per se there are significant economic implications most of which are hard to determine at this time. Looking back on the financial crisis of 2008-2009 as a guide policy makers were quick to take action as it was an occurrence that had never happened before and, as such, required an appropriate response.

During late 2008, it became apparent that the problem was banking liquidity and policy makers identified that there was a lack of confidence in the solvency of the financial system as a whole. While they did not know how it would solve the potential economic fallout, it did solve the immediate banking issue. As a result, economic activity in western economies began to recover. They were ultimately successful putting in measures to save the financial system.

But dealing with a global virus pandemic is something else completely, so we have a different set of circumstances to tackle.

Is lowering interest rates today the right answer to a pandemic?

While one can debate the nature of the ongoing policy of keeping interest rates low over the past years during economic expansion, one of the unique circumstances that came out of that is that too many have seen the central banks become the answer to every issue that we face. As such, there has been pressure to maintain economic activity by continuously reducing interest rates. While this is not a sustainable long-term policy, it is one that we have found ourselves in when the virus occurred.

It's hard to believe that cutting interest rates and incurring larger deficits is one of the answers to the virus, from an economic point of view, other than offering a sense of reassurance and giving the impression that central banks are taking action. The most important thing central banks can do now is to help with the very sudden cash flow problem. There are many businesses, big and small, that have been forced to close and find themselves with no cash flow. Examples that come to mind are restaurants (waiters) or gyms (personal trainers), or individuals in the medical profession and the list goes on. These are people who desperately need help with their cash flow and there is a case to be made under these unique circumstances for government lending - either directly or through the banking system to help deal with the sudden cash flow circumstances. There are a few ways that have been identified to achieve this goal by deferring tax payments and to provide government assisted compensation. The burden of these events are to be shared among the population and could have longer term affects, but at this time there needs to be an appropriate level of compensation in order to help those in need.

We are being asked to stop economic activity and that is the difficult situation that we need to confront, however, while we debate the way governments have tried to tackle this circumstance, ultimately they are doing their best so that the public can receive the help needed as we go through this period.

I remain hopeful that these immediate responses will go a long way to lifting us out of the self-imposed recession, much like the policy makers did during the financial crisis. Fingers crossed!

Markets are in a panic but was this coming anyway?

"Just before a panic all is well - usually more than well. Then the panic strikes, chaos ensues and a dramatic status upheaval commences. People who were on top of the financial order plummet to the bottom. People whose opinion was most valued are now ridiculed. Others who were on the sidelines race onto the field of play. The guy out in the wilderness who had been saying for the past four years that the good times were an illusion and a sham is wheeled in to take a bow and then hustled off stage, so that everyone else can regroup, and the whole process can start over again." - Michael Lewis

While it seems as though markets were strong in North America prior to this event, it has been my concern for the past few years, as stock market indices climbed to new heights, that it was being done so on the back of just a finite number of companies - namely large U.S. technology companies. A successful investment advisor once told me that bear markets (markets which decline 20% or more) begin when your positions are under-performing but indexes are still moving higher. What has transpired over the past few years is exactly that.

Dating back to 2018, many excellent business valuations began to retreat, yet the indexes were increasing, with less and less participation of the wider market. What I mean by that is referred to as 'market breadth' - or the wide participation of stocks when markets climb which is the best type of bull market. Narrow participation is not as healthy, much like Nortel did for the TSX's returns during 1999 and 2000 where it represented over 35% of the TSX 300 index. As such, any investment fund that based its portfolio on the composition of the '300' and other indices in which Nortel figured prominently had to hold large quantities of its stock. The Canadian investment world was dangerously exposed to any reversal in Nortel's fortunes. And we know how that turned out. Today, the large cap technology companies, an acronym known as the *"FAANG"* (Facebook, Apple, Amazon, Netflix, and Google) represents 15% of the S&P 500 index - a staggering figure considering the S&P 500 is generally viewed as a proxy for the U.S. economy as a whole. A quote often used is what Mark Twain said, *"History doesn't repeat itself, but it does rhyme."* I remain hopeful (actually, very hopeful) that recent market events is the 'blow-off' that will set the stage for a resurgence in performance of a broader range of equities once this crisis ends.

But by the same token, we are at a very precarious moment in time in a way that we've never seen in our lives, and simply buying for the sake of price drop can prove to be dangerous and very speculative. This is when stress tests have to be done on every holding because the world is shut down for the time being. If it lasts a quarter, I suspect that businesses will be given a pass, as the 30 plus percent drop is already factored into their lowered valuations; however, we don't know how long this circumstance will go on for. Looking at my 30-year plus history in financial services, this event can be considered a combination of three : the technology bubble in 2000, 9-11, and the 2008-2009 crisis merged into one. The fact that we came out of those panics stronger, in a short enough duration, is an encouraging sign that the actions of policy makers can be impactful. One never knows for sure, but recent history suggests that it can.

If I were a betting man, I'd say we are in the apex of the situation at this time that could resolve itself from a 'market' perspective in the months ahead. I'm glad we have ample cash in our accounts because the gains we can make if we pull out of this can be substantial. I also believe that those gains might not be made in the usual suspects that took the markets to where they were over the past decade, (ie: banks, large tech).

What did we do and what could we have done?

I have found markets unsettling over the past few years as investors have transitioned from fund managers to ETFs (exchange traded funds). We have a successful long-term track record as value-based investors, but found this transition difficult as there has been a reduction in active fund managers were also purchased individual companies as opposed to index related investments. And now investors are faced with a decision to 'Make That Call', that is whether to buy or sell this crisis. Successful investor, Peter Lynch famously said *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in the corrections themselves."* There is no question that if we got this one call right, we would have been wrong so many times before that it would have been the boy who cried wolf over and over again. I also believe, which was certainly in the case of this other 'rhyming' time - 2007-2009, that more money is made coming out of these events then was lost in them.

Looking back on that time, our investment accounts in general had reached all-time high valuations in October of 2007, sold off throughout 2008 and then rapidly late into the year and into early 2009. But it was only when we began to re-deploy our cash lightly in late 2008 and a little more aggressively in 2009, that we set the stage for exceeding that level again by November 2010 and never really looked back...until now. Even during the past three years, our accounts have had some growth, albeit - not what we have been used to previously.

What is the best & worst case scenario?

The worst case is beyond a recession - maybe even a depression. How long this goes and how people respond is going to make the difference. But there are few places to hide. It is clearly too early in the process to say for sure exactly where it is going, but I can offer up my experience only:

1. Markets are well aware of the current predicament and as such fell as much as 35% from their all-time highs made only weeks before. That was an efficient response when you consider that markets have 'discounted' into valuation a reduction of 35% of profits expected from the S&P index.

2. Historically, when we've seen a 'Panic', markets come down, bounce and then reset back as news circulates. I believe we are in the second phase of this scenario where we are in the midst of a 'bounce'. That means we will see lots of volatility based on news and responses to the virus, (ie: numbers of infected and windows of possibilities as to when the economy can begin to produce goods and services).

3. It is possible that if it is going to be worse than we first imagined, the markets would have sold off even more. This can be seen as a good sign for the future. Markets tend to operate in a 'shoot first and then ask questions' model. If that's the case here, then I see its response ultimately optimistic.

4. I believe we are still in a long-term Bull market (referred to as a secular bull market) that began its run in 2009 and has years left in it. Hopefully, what we are experiencing now is a cyclical or short-run bear market. Bear markets occurring within secular bulls tend to be less severe in terms of losses, have shorter durations and exhibit faster recovery times.

'Never Waste A Crisis' - Emanuel Rahm

Lastly, I offer up what I've mentioned before - the best way forward for our accounts will be to capitalize on the circumstance through purchase of excellent value that when recognized, could lead to substantial profit. This is never an easy and comfortable task, but one that has stood the test of time during previous circumstances that had the power to change the world as we know it.

I hope everyone is well and making it through this unique period,

Thanks for taking a look and, as always

All Good Things,

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