04/30/19

Quarter in Review

The Markets

Q1 was the worst quarter in the investment world I have seen, with mid and small cap value ranked the 44th and 45th out of the 45 indexes I look at. Down 32 and 36% respectively I believe these two segments performed worse because of the basic premise that an extended lockdown would probably shutter a third or more of the businesses. US fixed income performed the best with Long Bonds posting a 6% gain while intermediate posted a 3%. High yield performed poorly at -12% but that pales in comparison to the equity markets, as the Fed stepped in with TALF and 11 other plans, essentially making swaths of the financing market public, and most forms of analysis worthless. Global bonds performed poorly thought down close to 3% for the quarter, but that made the -27 and -31% for real estate and Commodities look fantastic.

National Observation

The Fed has definitely made headlines this quarter, starting with dusting off the 20-year treasury in early January. But that was hardly news following their March, where they cut rates to the zero lower bound from the 1.5-1.75% after two off cycle meetings concluded on the 16th. But were they done there… no, by the 23rd of March they had introduced or reopened (old Global Financial Crisis era) no less than 12 different programs for a total of 2.3 Trillion to attempt to quell the a new liquidity crisis caused by Covid-19. And it has seemed to work, as spreads on the Barclays Aggregate bond index went from 151 bps to 95 bps in three weeks (with a yield to worst of 1.5%). For some context the spread and yield to worst after Lehman Brothers went under in late 2008 was 315bps and 4.96%. At both times the funds rate was at the lower zero limit. In a nutshell the Fed has nationalized the finance market to prevent market instability, this should end so very well. In other less excited news, Joe Biden took care of business fending off Mike Bloomberg and Bernie Sanders to seemingly win the democratic nominee which will probably be part of the lowest turnout election ever on a percentage basis. Our current NY Billionaire president was acquitted from his impeachment by a republican held senate in early February. Wells Fargo will pay roughly $3 Billion to settle federal investigations, while the President asked congress for $2.5 billion to help with the covid-19 in late February. Also, in late February Bob Iger stepped aside as the CEO of Walt Disney Co. handing it over to Bob Chapek… that lasted about a month, with Iger and the rest of the world realizing covid-19 is going to be a larger problem than originally thought. On March 3rd the house passed a 7.8 billion emergency spending bill to deal with the crisis, and no that wasn't to deal with Jamie Dimon's emergency heart surgery around the same time. By mid-month the President restricted travel from the EU for 30 days, but the UK and Ireland were excluded… And like dominos starting with California, states started to lock down their respective citizens and "non-essential" business

over the last week in March as the Covid cases topped 82k. As of the time of this write up we are over a million confirmed cases and **with about 1.8% of the population being tested.** And not to be undone the Government finally passed its own $2.3 Trillion fiscal stimulus package on 03/25/20. The grand total of stimulus is about 21% of our 2019 GDP, and I don't think we will stop there.

International Observations

January's US airstrike of Qassem Soleimani, the Iraqi military general, and the Iranian response of firing more than a dozen missiles at a joint US-Iraqi airbase is all a distant memory. But Iraqi high-speed boats still like to hassle US warship in the Persian Gulf. But is Iran worse than Saudi Arabi, who is sending tanker upon tanker of oil to US shores after their dispute with Russia has pushed oil into negative territory and storage capacity to the brim? In other Iranian news, they shot down a 737 on 01/08/20 killing 176 people. At first, they denied it, but after the videos of missiles being shot from the ground surfaced, they later recanted. After over a year of the China/US trade war the US took China off the list of currency manipulators a day before they signed phase one of trade deal. Light on details, China has continued to implement it during strained relations of the Covid-19 outbreak, buying US agriculture products and removing restrictions on foreign companies in their domestic financial markets. In late January, as if to stoke his US counterparts, Phil Hogan the EU Trade Commissioner, said he would take the case to the WTO if the China/US trade deal isn't compatible with the WTO rules. On 01/21/20 China started reporting cases of Covid-19 respiratory disease… and then stopped counting around the beginning of March. China locked down the city of Wuhan and most of the province of Hubei, an industrial hub, and important sector to their belt and road plan on during the end of January. Confirmed cases and deaths rapidly rose within one month's time. Allegedly topping out at just over 83k… while other countries like Iran, Turkey, the UK Germany, Italy, Spain and the US have easily eclipsed those numbers. In finance we have often taken Chinese economic data with a grain of salt, as most planned economies suffer from data manipulation in some shape or form. But as China tries to evolve from an export driven economy to a domestic consumption economy, it is one thing to lie to the world but an entirely different thing to lie to your own people. By the end of January, the WHO had declared a global health emergency, only nine days after the first reports. Eclipsed by Covid-19 news, the United Kingdom officially left the European Union on 01/31/20 after over three and a half years since the referendum. In February the two largest Swiss banks, Credit Suisse and UBS replaced their CEOs, Tidjane Thiam and Sergio Ermotti, with Urs Rohner and Ralph Hamers respectively. In other banking news HSBC decided to cut 35k employees and take a 7.3 billion in charges, refocusing in Asia while downsizing Europe and the US. By the beginning of March worldwide "reported" Covid-19 cases topped 90k. After OPEC couldn't come to a supply reduction agreement Saudi Arabia started offering its Asian and European customers steep discounts in the price of oil, dropping the price of oil by over 30%. By March 10th Italy was reporting large amounts of report Covid-19 cases and deaths and put the entire country on lockdown. A day later the Bank of England cut interest rates by 50 bps, and like the Fed offered a substantial monetary package close to 20% of its 2019 GDP (The next highest monetary package is Sweden around 17% of GDP, then the US around

11%). On 03/12/20 China declares that the outbreak in China is over. The ECB, Denmark, Switzerland, Sweden and Japan all have central bank interest rates less than zero, while the US and UK hold at or near zero. 10 years and we are right back where we started.

The fiscal and monetary packages have been many across the countries with the average total package around 10% of the respective countries GDP for the top 20 largest confirmed covid-19 case countries. The last time the Federal reserve and congress acted like this was during the Global Financial Crisis. The Fed was blamed for putting wall street ahead of main street last time, for creating moral hazard, and inflating asset and real estate prices (which could have been tied to them prior to 2008). This time around they took it a step further in the types of assets they are buying into TALF, with literally no regard for companies that may be too levered to begin with. Keeping interest rates low have enabled corporations and our governments to increase and extend large debt levels to non-war time levels. I flatly believe this is wrong and way out of bounds of their mandate. And we have seen the Fed's reluctant to reduce its balance sheet as the security markets and thus the retail and institutional investor refused to by quantity of these instruments at those prices. The Fed stopped the reduction in balance sheet and started to drop interest rates last year, with inflation targets and unemployment rates at rock bottom rates. Modern Monetary Theory (MMT) is literally snake oil for the masses that believe long term deficit spending to create full employment has literally no lasting effect on the economy, (e.g no crowding out effect), but like it or not we have been lulled into this over the past decade. Who cares about credit analysis anymore, when the Fed is ALWAYS there to buy EVERYTHING when the economy sneezes? And as I write this the Treasury Secretary is weighing buying equity stakes in U.S. energy companies.

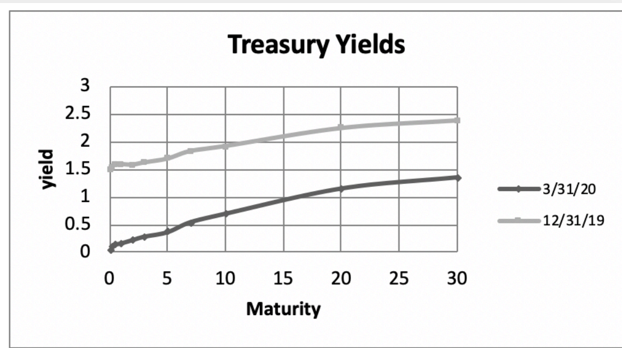
Interest Rates

As previously mentioned, the Fed cut rates again to the range of 0.00% to 0.25%, what is called the zero lower bond, in March in response to the Covid-19 pandemic, among a myriad of other plans to reduce or remove any mitigants to liquidity in the US financial markets. I believe they have opened another of Pandora's boxes and won't be able to close this one either. This will simply exacerbate what I believe is systemic leverage problem and over valuation of many financial and real assets in the marketplace. If the Fed can't simply take a look at the run up of the S&P 500 pre 2008-2009, and then the Everest like mountain that occurred afterwards and not be held responsible I don't know who can. The Feds three mandates which really were brought about in the 1970s (think stagflation, high inflation, high unemployment) of maximum employment, stable prices and moderate long-term interest rates seem beyond dated at this point and almost irrelevant. If inflation was low, prices stable, and firms profitable, and long-term interest rates more than moderate, what were they doing cutting rates last year? And now despite the $2.3 Trillion they have made available to the market; they have zero control over the unemployment. You can't simply replace wages and earnings with more currency?!?! You sure can prop-up values of stocks and bonds that should be cratering given people and firms can't work, but this is synthetic and cannot

persist for long. The King seriously doesn't have any clothes on and everyone in the court is remarking how good he looks.

The curve unsurprisingly fell on average 1.30 bps across the curve, which with CPI's most recent print of 1.52% annualized, there is zero or negative real returns in anything that has a T in front of it.   Shockingly pushing everyone into credit assets when we are about to see 15-20% unemployment in less than a week.

Years	3/31/20	12/31/19	Difference
0.08	0.05	1.48	-1.43
0.24	0.11	1.55	-1.44
0.5	0.15	1.6	-1.45
1	0.17	1.59	-1.42
2	0.23	1.58	-1.35
3	0.29	1.62	-1.33
5	0.37	1.69	-1.32
7	0.55	1.83	-1.28
10	0.7	1.92	-1.22
20	1.15	2.25	-1.1
30	1.35	2.39	-1.04



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage fell to 3.5% at the end of March from 3.74% in December. As of the time of this report it continued to decline to 3.33%. 15-Conforming balance loans also fell from 3.19% in December to 2.92% in March, and 2.86% as of the time of this write up.

The Mortgage Bankers Association information as of 04/22/2020 showed 30-Year conforming balance FRM down from 3.81% with .28 in points to 3.45% with .29 points. Jumbo loans were also down 3.97% with .24 to 3.815 with 0.34 in points. 15-year conforming balance FRMs were also down slightly from 3.24% with .22 points to 3.03% with 0.33 in points.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 104.2, a significant drop from February's 111.7, and haven't been this low since July 2017 right after they re-scaled, and the largest decline in 60 years. The largest negative contributors to the LEI were unemployment insurance claims and stock prices. Seven out of the ten indicators were negative and two of the three positive indicators were statistical imputation.   We should see worse print in April as eight out of ten of the indicators should be negative, with Stock Prices and Interest rate spreads the

only positive indicators. With the recent bounce in stock prices and the widening in spread between the ten-year treasury and the federal funds, which is now at zero, these should be the only indicators that are positive. Average workweek, production workers, unemployment claims, new orders, building permits, credit index and consumer expectations for business should all be substantially lower in April. I had already had doubts that 2020 was going to be a strong year, and lockdown has essentially assured it.

Jobs

At the time of this write up, **nonfarm payrolls** posted a **decrease of 701,000 jobs for March.** As we all know from the claims data that has been coming out throughout April, this is the tip of the iceberg and we will see jobs down in the ten to twenty million range next month. This will push the unemployment rate into the teens if not low twenties in a couple of weeks, and although the rhetoric from the Treasury Secretary is for a summer Q3 snap back, I doubt it. If the last recession was any kind of indicator, jobs will be phased out or replaced, or simply not hired back without a substantial increase in revenue. Non-residential fixed investment will be substantially lower, and thus firms new hiring freezes will persist throughout the rest of the year. **Temporary services** were also down 1.68% for the month, and again I think this will be markedly lower in April. As so many new people flowed into the unemployed category, this created a perverse effect on **Median duration of unemployment, which actually dropped two months from 9.1 to 7.0**, as this is a weighted average and thus having so many new people come into the statistic, greatly reduced this number. For some perspective the highest median duration in the 52 years it has been tracked was 25.2 in June 2010. It seems like our labor force will have to change again, and adapt to a different world, something that takes time, and thus that number will begin to extend starting April. The **Civilian Labor force participation rate retreated from 63.4 in February to 62.7**, and again I think this number will be much lower in April and stay way for much longer this time. Some context here again is needed; the maximum participation rate over the past 72 years was 67.3 in 2000. For much of the post WWII period our participation rate didn't touch the 60s until December of 1955. I believe we will drop into the 50s and stay there for an extended period of time as the labor forced changes yet again in response to our latest crisis.

Industrial production

Q1 IP was down 5.43% for Q1 2020, reversing all gains for the past two years, which was mainly obtained through a 2.39% increase in Q4 2017. With the closing of all nonessential businesses, most manufacturing facilities shuttered, some even by police force. **Manufacturing output fell 6.3%,** and as with other numbers this will be eclipsed in April and May, and maybe beyond. This is the largest decline since 1946, while capacity utilization also fell 4.3 percentage points, with the long-term trend declining since the inception of statistic in the 1960s. What happens to the transportation sector after this? Will we as a society truly travel less, in planes and trains, take the subway less or even think twice about getting into a taxi or uber? What happens to the production of those vehicles, those

firms, and jobs? Like the banking sector, will the US force manufacturing into domestic supply channels, possibly increasing production, in area's deemed vital or "essential" to the economy or country as a whole?

Housing

New home sales for March fell to 627k per year, in sharp contrast to the 777 and 741 of January and February, and reversal of 2019 recovery spawned by the Fed lower interest rates. Mortgage rates have fallen for the entire quarter down around 25 bps with the exception of 5/1 Arms that only fell about 10 bps. **Existing home sales fell to 5.270mm** from February's all time high of 5.760mm. The national association of realtors understood this number would fall with social distancing rules in affect. They stated that while sales have declined prices are holding up, with median existing home prices was $280,600 up 8% since March 2019 which marks 97 straight months for price increases. They also stated that inventory at the end of march was 1.5mm units up 2.7% from February but down 10.2% from last year at this time. Virtual tours and e-signings have helped the industry, as we are complying with new regulations. As cities have been hardest hit with the virus, and populations were already declining, this might actually help the migration into the suburbs and into houses, by many in the younger generations out of the market.

The Consumer

The conference Board's consumer confidence index stood at 120 down 12.6 points from February, and the lowest reading since July of 2017. The **University of Michigan's Consumer Sentiment April number was 71.8**, down from 89.1 in February and 101 in January, a level not seen since December 2011. For the first time in a while I agree with Richard Curtin's comments in the survey when he states that there are disproportional risks to the consumer reaction to relaxing restrictions. He states that if the opening goes badly then the "necessity to reimpose restrictions could cause a deeper and more lasting pessimism across all consumers, even those in states that did not relax their restrictions." From a reluctance to dine out, to travel or even commute using mass transit, the economic damage could be long lasting until a vaccine is viable. The consumer is not in a good place at the end of Q1, with consumer spending down 7.5% in March, unemployment claims averaging 5 million per week in April, and personal income down 2% in March, with wages and salaries down 3.1%. The savings rate now stands at 13.1%, a number I would normally be cheering, but not for the reason it climbed, which is a result of forced less spending. The consumer is in rough shape; rent, mortgages, credit cards and auto loans are not going to get paid, as consumers hoard cash until the unemployment rate starts to descend again. This would normally not bode well for securities backed by these assets, but in comes the Fed with TALF 2.0 to rescue and spreads tightened. QE infinity.

Inflation

As of March, **CPI was up 1.52% and PCE was 1.32% year over year. A considerable drop off from the December's revised 2.32% and 1.81% respectively.** Energy across the board was down as oil prices sank to multi year lows down 5.7% for the last twelve months. Core inflation (less food and energy) was up 2.1% but this number won't stay there for long. Investment banks are already looking at inflation to drop to 0.5% and could go negative because of continued drops in the energy sector as tanker after tanker anchor off the shores and US storage capacity is at or close to its max. As people began eating more at home the price of food at home climbed 0.5% in March, and 1.1% for the last twelve months. Going forward the results should be mixed for this area, as farmers are forced to dump milk and eggs and plow under their fields because demand has dropped off a cliff. **Health insurance ending 03/31/20 was up 20.6% on an unadjusted basis over the last twelve months.** Where do you think that is going to go after Covid-19? Health insurance only representing just over 1% of the total CPI, the larger area of Medical Care Services (7.2% of the CPI) was up 5.5% over the same time period, unadjusted for seasonality.

In Closing

The expansion has ended at 128 months, the longest in history. Everything is pointing south, there is zero chance you can forcibly close the economy and expect anything else. Any hope or attempt to return to a normal functioning financial market is gone. The Fed has effectively propped up the market with a balance sheet of one trillion in 2008 to over four trillion by 2015 and **as of today close to six and half trillion dollars**, creating money via a balance sheet entry and have allowed bond and stock prices to hold completely unrealistic levels given the underlying economic activity. Make no mistake this money is not trickling down, it is holding asset prices, securities and real estate steady, not creating or defending jobs, while the fiscal response has been to go deeper into debt not seen since the end of WWII at 106%, and estimates are that it will rise to 126% over the next several years. **Interest rates have been cut to zero and the Fed has injected $2.3 trillion into the banks, while congress has injected another $2.8 trillion** into small business, health facilities and into people's pockets. I don't think it will be enough and throwing money at trying to find a viable vaccine may or may not work. **We lost about 700k jobs in March in the nonfarm payroll survey, but this will be eclipsed in April.** The virus should resurface as lockdowns are eased and the consumer will not be kind, behavior will change how we shop, consume, commute and work. **Industrial production was down 5.43 for Q1 2020**, and it will have a tough couple of months ahead of us as durables should fall off in line with unemployment, and the lack of fixed nonresidential investment. The summer is typically the time when auto manufacturers pause and lay off workers, and if demand continues to wane, will it behoove them to reopen? The consumer is in a really bad place now, discretionary spending will disappear from a large portion of our population as the huge swaths of jobless will be concerned with just feeding their families.

As of this write up my model is only calling for a 22% of a recession, but that will immediately rise as of next Friday when employment comes out. We are in a contraction; the worst one we have ever seen. After the Fed enacted their programs, I exited both equity and fixed income holding in mid-April. Spread on bonds are simply too tight and yield levels too low for the risk even for prime names. Across the platform we are down around 11% for the year and holding there. Equity markets have since rebounded about 3% but for those of you who think the worst is over, dust off your copy of Manias, Panics and Crashes.