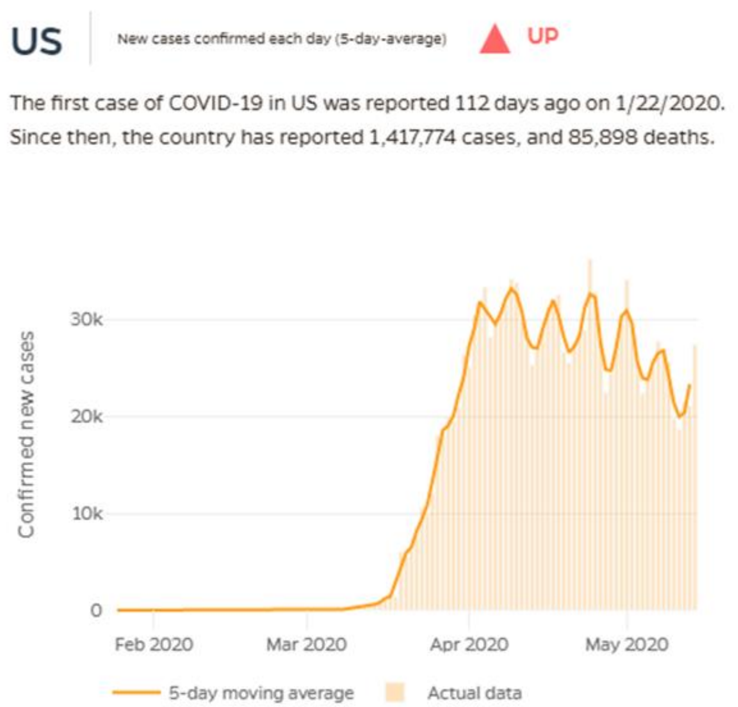
May 15, 2020

4.4 million coronavirus cases worldwide (+1.1M & 33% from 2 wks ago)
303,825 deaths (+30% from 2 wks ago)
1.4 million US cases (+29% vs 2 wks ago)
86,000 US deaths (+36% vs 2 wks ago)
10.3 million tests in US (6.2M vs 2 wks ago)



Dear Clients and Friends,

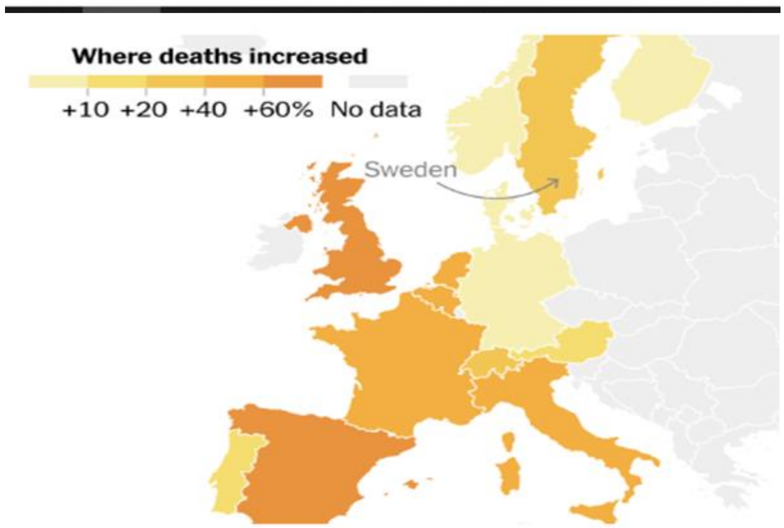
Two weeks since my last note. What has changed? In our last letter the theme was re-opening. Logic tells us that there would likely be an increase in cases as we re-open, and it appears that there is. But the trend is falling from early April.

You have probably heard about the Swedish approach, which was not to completely shut down their economy. Two articles today in the NY Times caught my attention. The first seems to argue that Sweden experienced a worse result by remaining, more or less, open.

Sweden Stayed Open. A Deadly Month Shows the Risks.

While Sweden has avoided Europe's worst outbreaks, seen in Britain, Italy and Spain, it has also experienced an extraordinary increase in deaths, mortality data shows.

1h ago



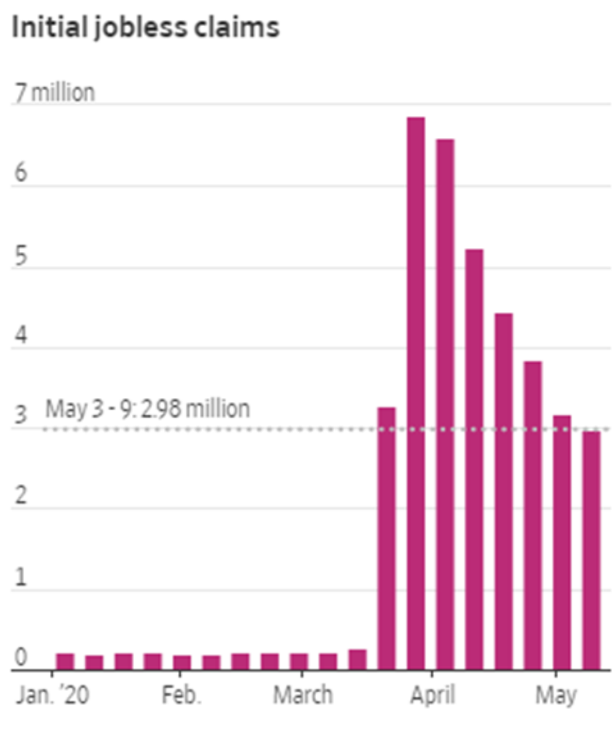
But the second is in the Opinion section and is titled: "I live in Sweden. I'm Not Panicking."
https://www.nytimes.com/2020/05/15/opinion/sweden-coronavirus.html?action=click&module=Opinion&pgtype=Homepage

I would encourage you to read it. The author writes, “our country has opted for a more measured approach”, and “the idea is to slow the spread of the virus enough to avoid overwhelming the country’s health care system and to mitigate the effects on the economy and people’s lives”. In the debate about re-opening, I think this point has been lost. The primary reason for shutting everything down was to make sure the healthcare system didn’t get overwhelmed. In many places that goal has been accomplished.

It seems to me the government should set out a few principles to provide guidance. Mine would be:

1. Slow the spread of the virus so our health care system is not overwhelmed.
2. Provide the equipment necessary so our health care workers are safe and can do their job.
3. Protect the most vulnerable.
4. Invest in massive testing.
    a. Quarantine the sick. Let the healthy go to work.
    b. React quickly to flare-ups.
5. Make clear recommendations on hygiene and social distancing. Be strict but fair.

Sweden is a small wealthy country. They subsidize their healthcare system and have a generous social safety net. Their population is more homogenous and generally healthier than ours, so we can’t be just like the Swedes. But having 36 million people out of work is not sustainable. We do need to re-open the economy, and soon. We have to learn to live with this virus for a year or two until a vaccine comes along. A more measured and reasonable approach is needed, and maybe we can learn something from others.



This week had a drumbeat of bad economic news:

- 2.98 million Americans filed for unemployment bringing the total to 36.5 million in eight weeks
- Goldman Sachs estimates the unemployment rate could reach 25%
- The Fed Chairman, Jerome Powell, gave a speech indicating the recovery may come more slowly than we would like, and urged the White House and Congress to provide more stimulus.
- US Industrial production fell 11% in April
- US retail sales fell 16% in April
    - Furniture down 59%
    - Electronics down 60%
    - Clothing down 79%

However, the outlook did not change much. The recovery is still expected to be sharp and begin in the second half of the year. If you haven’t followed the alphabet soup discussion of the economic recovery, it has gone from expecting a V to a U to an L to a W. The current thinking is it will be a Nike swoosh.

After falling over 30% from late-February to late-March, stocks rebounded 30% from their lows through late-April (unfortunately, after a drop of 30% you need a 43% increase to get back to even). We are still

15% below the highs, but it feels a whole lot better than it did in March. The market has been trending sideways for a few weeks as shown in this chart:

This gets people worried again, understandably. The pain is fresh from the big drop. But seriously, should we expect the market to recover to its old highs in a matter of weeks when the economy is still in a deep recession? Of course not. We are at the bottom (we hope) of the Nike economic swoosh. We need to begin seeing the rebound. There are a few signs, but they are weak and early. From a technical viewpoint, there is often a 50% retracement, after a move up like the one we have seen. That would suggest the market might fall back to about 2,600 on the S&P 500. That's about 9% from where we are today. There are a couple of other technical factors worth mentioning and being prepared for. One, is that declines tend to happen faster than rallies. A 9% drop could happen in a matter of days. And second, the worst day of a pullback is often the last day and the bottom of the decline, although it usually isn't obvious until sometime afterwards. Understanding these patterns doesn't make it any easier to trade on them, but it makes it easier to not over-react. We will not try to time these moves. The market is acting rationally now. The economic and earnings recovery will dictate how fast the market returns to the old highs.

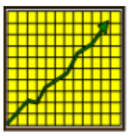
Another question we often hear is "Why is the market doing so much better than the economy? I don't expect the economy to get better for a long time". I've tried to address this before by pointing out the stock market is not the economy, and the economy is not the stock market. Much of the difference lies in the makeup of each. Technology and healthcare stocks represent a much larger percentage of the stock market than what we see in our daily lives, and many of these companies are doing quite well during the COVID crisis.

The most striking example of this are the FANMAG stocks (Facebook, Amazon, Netflix, Microsoft, Apple, and Google). These six companies now account for 22% of the S&P 500's market-cap. These companies are loved by investors, perhaps too much. But, over the last four quarters they have increased sales at 15% on average and have 56% gross profit margins, and 18% net margins. They deserve the outperformance they have received; however, this type of concentration in the market is neither healthy nor sustainable. It will end. In our individual stock portfolios, we invest in five of the six – only Netflix is excluded. We know the companies well and we do not see signs of deceleration in their outlooks yet, but we are on the watch.

Our portfolio strategies have changed little. Our tactical portfolios are underweight equities, but not extremely so (about 80% of normal). Our strategic portfolios are being rebalanced this month. The equity targets are very near the long-term target. Alternatives are being reduced and we are holding some cash, and a short-term treasury bond fund. Given clearer signs of recovery, or a selloff creating more attractive value, we would like to allocate another 2% - 5% to equities. As we said in a previous note, the return on stocks after a Bear market is higher than average but, getting the timing right is hard.

There is still an election ahead, and it is likely to be mean and nasty and divisive. Stay healthy and stay calm. There is still turbulence ahead, but as Warren Buffett likes to say, “Don’t bet against America”. It may take a while, but we will find a vaccine. Airlines will fly again, and restaurants will open. Five years from now, things might be different, but they might not. I’m pretty sure my wife wants to go back to Italy as soon as it feels safe, and my friend, Fabrizzio, who owns a Taverna in Orbetello, says they will go back to work next Monday.

Take care,



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