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2nd Quarter Update

First off, I hope you are continuing to stay healthy and sane. I am going to do something different to open this report. Why not? It's 2020 after all. I want to answer the single most asked question by an exponential factor from clients, prospects and the media. Why have stocks been rallying with the economy collapsing amidst a global pandemic? If you are nodding your head in agreement, you are in good company. Although I will go into details later in this report, the short answer is two-fold.

First, stocks trade on economic activity 3-6 months down the road, not what is currently happening. Rallies are forecasting what is supposedly going to happen. Second, and perhaps more importantly, liquidity usually trumps all. That is the amount of money in the system ready to be put to work. Once the Fed pivoted with their arsenal of nuclear bombs in early April, they literally ran over almost every market issue, dislocation, lack of liquidity, etc. They weren't taking a laissez faire approach like 1929 and they weren't taking a measured, incremental tact like 2008. They went all in, right way, in an unprecedented, epic fashion. They took a page from former European Central Bank chief, Mario Draghi's, playbook to do "whatever it takes" to save the economy and markets.

As I mentioned three months ago, every single quarterly update since 2016 began had a common theme of Donald Trump, either as a candidate or president. That theme was both direct and indirect as well as positive and negative. It literally took a global pandemic to shake that theme. But now that we have a new global theme of COVID-19 entrenched, it is going to be difficult to crack its stranglehold for a while, even with the election in roughly 100 days.

Q2 2020 was definitely an historic, precedent setting period on an economic, political and financial market front. That's both on the good and bad side, something that you will find throughout this update. The four main topics to be discussed are the economy, Federal Reserve and government response, financial markets and our strategies. For the first time in years, geopolitics will be deemphasized, but not eliminated.

As the novel Coronavirus obviously dominated every news cycle, new words and phrases were added to our lexicon. "Shelter in place", "PPE" and "flatten the curve" became "social distancing", "wear your masks", "herd immunity" and "contactless pick-up and delivery". And speaking of flattening the curve, something we heard about all day, every day in March, I felt like this was similar to winning the 2003 "war" in Iraq without a plan for the peace that would follow. We had a definite plan to space out the number of positive COVID cases over months instead of weeks, but no plan once the curve was flattened and the healthcare community caught up. It wasn't like anyone ever discussed and debated how to safely reopen the economy.

Coming out of Q1, everyone knew the economic data was going to completely collapse like had never been seen before, only the magnitude was and is still in question. I saw GDP contraction for Q2 range from a relatively "mild" -10% to an horrific -50% and everywhere in between. The first look at the number will be released in July, but I would be absolutely shocked if the Armageddon crowd was even remotely correct.

We know that the economy has lost more than 22M jobs since the crisis began (more than all of the jobs created since 2009) with unemployment spiking to somewhere around 15%. However, to almost everyone's shock, the economy added more than 3M jobs in May and almost 5M in June. Both the losses and gains are record numbers.

May and June also saw other historic surges in the economy. Industrial Production was up 1.4% in May and 5.4% in June. Manufacturing Output was up 3.8% in May and 7.2% in June. Retail Sales was up 17.7% in May and 7.5% in June. Consumer Confidence rose to 85.9 in May and 98.1 in June. I listed the various reports which may have caused some eye glaze to show you that I was not cherry picking select reports to support a conclusion. The economy has clearly strengthened from its depressionary levels of March and April.

Probably the worst part of the economic collapse was seen in those who could least afford to lose their jobs. Barrons reported that 40% of all job losses were from workers making less than $40,000 per year. In other words, the group that could least afford to be unemployed suddenly lost their jobs and didn't have savings to fall back on until they secured another job. And many of these people are in areas that are likely to be impacted for years to come, like restaurants, travel, entertainment and retail.

This brings us to the government's response which will segue into the Federal Reserve's. Most people were impacted by the virus through no fault of their own, not that it makes it any easier to swallow, whereas so much of the financial crisis resulted from pervasive bad behavior among financial firms, some of their corporate partners and many individuals. In late March and April my constant message when interviewed in the media was that the government needed an unfathomable response, something absolutely and totally unthinkable. And whatever response they came up, I said it needed to be bigger without even knowing what it was.

Although I am a frequent critic of our elected folks in DC who mostly work for their own interests instead of ours, I must give credit where it is due. In true bipartisan spirit, the Treasury and Congress worked together and then passed a number of bills aimed directly at the economy and those most impacted. The CARES Act was the biggest bill of all to date and that targeted an extra $600 per week in unemployment benefits, loans and grants to businesses like the Paycheck Protection Program, $1200 stimulus checks to those in lower to mid-income brackets, waiving the 10% penalty for early retirement plan withdrawals as well as allowing those mandated to take RMDs from having to withdraw those funds from retirement plans in 2020. Obviously, there was more, but those are the highlights. It needed to be gargantuan and it was. More will be coming regardless of politics.

One of the unintended benefits of these massive rescue programs was that the savings rate in the country spiked up. The pandemic shook people so much to their core that they actually started saving money. Recall that in 2006, the U.S. had a large negative savings rate and many families were living on borrowed funds until that party abruptly ended. If memory serves me correctly, I believe that families making less than $100,000 a year were spending $106 for every $100 they earned. Saving money seems like a great idea intuitively. However, our economy is not structured for people to save money. It's a consumption economy that absolutely needs the consumer to spend.

Jay Powell and the Federal Reserve went even bigger than the government. This crisis was not 2007-2009 and it certainly was not 1929-1932. In both those cases, rolling financial crisis roiled and collapsed the economy over time. 90 years ago, the government and Fed did almost nothing at first and hoped that the weakness would make its way through the system quickly. On top of that, the government passed very protectionist legislation that helped create the single worst sovereign debt crisis the world has ever seen. In 2008 the powers that be were quicker to respond, but it was still way too late in the making. They waited until banks were technically insolvent and in jeopardy of failing before taking massive action.

In 2020, the Fed went "all in" right away by immediately taking interest rates essentially back to 0%. While they knew banks had plenty of capital and would not fail, they attacked the bigger issue of liquidity. As they did too late in 2008, Powell and Company unleashed their nuclear bomb of programs aimed at keeping the wheels of the financial system greased and functioning with efforts in money markets, commercial paper, marked to market pricing, municipal, mortgage and corporate bonds, currency swap lines with central banks around the world to prevent a shortage of dollars and much, much more.

While the Fed initially launched Quantitative Easing IV with the purchase of Treasury and agency bonds, that essentially morphed into QE Unlimited as well as adding all kinds of corporate bonds to the list, including high yield or junk bonds. This is the only area where I vehemently disagreed with Powell and the Fed. In fact, I was more than loud and vociferous in the media about it. The Fed should never, ever get into bailing out those who take risk, including me.

There is a reason investors get paid what they do for buying junk bonds; there is more risk to one's principal. For the Fed to be buying junk bond ETFs and now individual bonds allows them to pick winners and losers in the markets and economy. It's wrong. It's irresponsible. And it paves the way for the Fed to behave even worse by buying stocks at some point down the road. To be clear, one of our strategies was a big beneficiary of the Fed's foray, so it's not like I can complain across the board. Of course, in another strategy, there was a trade of the decade setting up for conservative investors if the Fed would have just let the market take care of itself.

I am going to pivot and discuss where things are heading. While I am certainly no epidemiologist nor virologist, it seems as though the Coronavirus will be with us for at least the rest of 2020 and into 2021, vaccine or no. Most of the markets are certainly pricing in vaccines being available in the next 6-12 months as well as dozens of new therapeutics. The questions remain which company or companies will have a vaccine; how will it be distributed and how many people decide to take it early on? We know from history that there will be unintended consequences, but the economy and markets are banking on success.

Economically, my thoughts remain the same. I certainly do not see a "V" shaped recovery. That's a pipedream. However, I also do not see an "L", "U" nor a "W", but if I had to choose one letter, it would be a "W". My favored recovery scenario would look like the left-hand side of a "V" which we have already seen. That would be followed by a strong bounce in the economy which regained 50-75% of what was lost in GDP output. From there, the economy would stall or pull back a bit later this year or in 2021. Much better and more consistent growth would return at some point in 2022.

Besides the obvious economic challenges ahead, there are also some macro ones as well. Perhaps the one least mentioned could offer a big opportunity. That is the mass migration out of the major metropolitan areas and back to the suburbs and rural areas like we saw after 9-11. While revisionist history is powerful, let's not forget that "no one" wanted to live in New York City after 9-11. And no one wanted to fly, rent space in skyscrapers nor live on high floors. I still remember all those city folks buying properties in New England to escape the big city. There was a major behavioral change in America that lasted five years before being unwound.

Today, I see what happened post-9-11 as a model for what to expect now. In other words, a massive exodus from the big cities to the suburbs and rural areas. Think of that 2001 and 2002 move on steroids for what appears to be happening today. Just that grand behavioral change alone will cause some economic dislocations and supply chain interruptions, not to mention what will occur in the real estate markets. On a very small scale, think of your local healthcare provider suddenly getting a surge of new patients and what they would do to the practice. However, like almost everything else in our history, Americans have an unusual ability to adapt and adjust to changing times. I have no doubt that will be the case here as well.

It's not just the real estate market that is changing. Regulations will likely increase to protect against future pandemics. Companies with deeper pockets and strong balance sheets will likely be able to withstand the added expenses. More leveraged companies and small businesses will struggle. There will be new sanitizing procedures and an array of new products and services. With millions effectively quarantined for months, I would all but guarantee that a flood of new companies, new ideas and new technologies will have been born in 2020. Who knows; maybe the next Facebook or Google is out there?

I read a great report by bond market guru, Jim Bianco, which was predicated on the economy regaining 90% of what it lost across the board. That sounds very appealing and acceptable on the surface. To support that, Jim assumed that all "have" sectors of the economy recovered 100% this year, not exactly unreasonable. The ones least affected by COVID. Jim then analyzed the impact on the "have not" sectors which are the areas of the economy most impacted by the virus. Airlines, hotels, casinos, restaurants, venues, amusement parks, retail and even dry cleaners, etc.

The impact on the "have nots" is severe no matter how you slice it and it's very unlikely they will even recover to 75% of where they were pre-crisis in 2020. Jim showed through hard data that losing 10% of our overall output for an extended period prevents the economy from fully recovering for a longer period of time. 22 million jobs were lost, and we can assume that some percent of those businesses are not going be in existence. And given the high number of jobs in the service industry, it won't be easy nor fast for those folks to quickly find new jobs and recover without job training. Remember, 40% of the jobs lost came from those making less than $40,000 a year. As such I believe there are now systemic challenges in the employment market and I will go on record stating that the generational low in unemployment we saw in February will not be seen again for decades to come. In summary, the economy is wounded, and time is needed for healing.

Longtime clients know that I haven't written about inflation being a problem since well before the financial crisis. In fact, I have been on the polar opposite side, worrying about disinflation or deflation. Deflation is when prices actually fall, and that is much more dangerous than rising prices. With deflation, a dollar is worth more in the future than in the present, so consumers save more and are reluctant to spend. Deflation is often referred to as a black hole or spiral which is very hard to break while inflation is more easily cured with higher interest rates. Consumers can also often substitute goods which have become too costly.

I believe the deflation/inflation tide is finally about to turn, but perhaps not for the reasons you would think. I absolutely do not think it is because the Fed and government created and/or borrowed many trillions of dollars. That's a fool's errand. Whatever the Fed and government do won't nearly replace what was lost during the pandemic. My data look like there is risk for old fashioned commodity inflation, starting with the food complex. The next three to five years or more could see higher prices resulting from climate change, supply chain disruptions or geopolitics. If that scenario plays out, the next few years could see substandard economic growth with higher inflation. Some would call that stagflation.

The risk with stagflation is that the economy is worse than forecast and it tips back into recession in 2021, also known as a double dip. The other risk factor next year is that a vaccine either isn't successful enough or is delayed in distribution. That could also cause the economy to double dip. At this point, I do not rate either scenario as the most likely.

Both the Fed and the government are nowhere done with their response from a fiscal and monetary perspective. I always laughed when pundits claimed the Fed was "out of bullets" or they were "pushing on a string". One thing we have learned from the modern-day Federal Reserve is that you cannot win a fight with the people who control the printing presses. While they sometimes may be late, their resources are endless, and they will adopt a "whatever it takes" approach.

Given my less than rosy economic outlook, one would conclude that I believe the financial markets are also in for a period of struggle. That's not exactly the case. As I have written about on the blog and in email updates, a new bull market began on March 23rd. It was probably the least recognized in modern history as it did not conform to any of the usual markers until well after it launched. And that's the main reason I did not give it enough credit early on. I have been comparing the price action since March 23rd to what we saw when the last bull market began on March 6, 2009. You can find the posts on the blog. Ignoring the environment and news, the price paths are very, very similar. Of course, at some point this analog will break down, but it does point to generally higher prices the rest of this year.

Between now and the election, I see a broad trading range, bound by the February highs and just below the June lows. In other words, no huge move. The weaker the stock market, the more likely there is a change of power in The White House. Looking out to 2021, I think there is a scenario where the major stocks market indices soar during the first half of the year as the U.S. dollar bottoms and capital flows surge back in the U.S. If that's the case, I won't be surprised to see the S&P 500 run towards 4000 and the Dow well into the 30,000s with a possible shot at 40,000 during the next president's term. Lots can and will happen along the way, but that's my long-term view right now.

If the economy rolled over again in 2020 and the Fed's and the government's measures did not support the capital markets, I would definitely rethink my outlook for 2021. While I do not rate that as a likely scenario, I will discuss that further if the data start to move in that direction. Right now, the economy looks to be bouncing back and although the markets are not 100% in sync, I don't see a large downside unless something comes totally out of the blue. In fact, in a very counterintuitive way, I am beginning to think that news that a vaccine has passed and will be available to the public could be a sign that stocks will peak. More on that notion another time.

Before pivoting to our strategies, I want to reiterate a topic I have briefly written about before, but one I have discussed with many clients over the past few years. It’s the barbell approach to investing in our strategies. If you picture a barbell from the gym, there is a long, thin bar with big weights on both ends. Think of those weights as our conservative strategies and aggressive ones, the exact proportions do not matter yet.

In theory, your money would have higher weights to conservative and aggressive strategies, especially if you are in or very close to retirement, and lower allocations to the middle of the road strategies. Certainly, over the past few years, our conservative and aggressive strategies have performed better than the middle of the road ones. This barbell approach has also worked very well with monies being transferred in from 401K and 403b plans as those pre-packaged plans rely heavily on bonds for the more conservative approach and do not account for interest rates rising. Additionally, their aggressive choices do not usually reward the risk taken. If you would like to learn more about the barbell approach, we can set up a call, Skype or Zoom.

Q2 was very much the opposite of Q1 regarding asset prices. Most asset classes rallied sharply in April and May. June saw a euphoric peak on the 8th, where most assets saw their highs. From that date until quarter-end, all of the major stock market indices, except the NASDAQ 100, quietly declined mid-single digits. Our 15 strategies fared well overall in Q2 although I was not pleased with every single one. I am thrilled to report that a good number of our strategies hit all-time highs in Q2.

Here is the link to our disclosure documents including our privacy policy as well as our ADV Part 2A & 2B. https://investfortomorrow.com/disclosures/

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Although not as deep nor long as 2000-2002 and 2007-2009, the financial markets certainly experienced another scary period that was made worse by a global health crisis, the likes of which has not been seen in the modern era. Every crisis is different, and Americans are great at solving the last crisis instead of anticipating a new one. Some things are evergreen. Having an emergency fund to tide you over and increasing savings will only help during these periods. Right now, with mortgage rates at all-time lows, most should consider refinancing to shorten duration loans.

Protests, riots, economic disparity and social injustice are all making headlines today. The Coronavirus rages on, still in the first wave. Even trade tensions with China have resurfaced. Yet, the financial markets, especially the stock market, have been nonplussed since Q2 began, and performing very well. This is another great example of being able to adapt, adjust and price in what is generally known. Remember my career long adage. It's not what the actual news is, but rather how markets react. The masses read too much into the headlines and ignored what the markets have been saying. Not a single investor has been successful betting against the U.S. economy over the long-term and that's not about to change.

While we are always very appreciative of your support and loyalty, we are especially so right now. Although we can only meet via Skype, Zoom or the phone, we are happy to schedule meetings most days of the week. Please continue to share your feedback, positive and negative. Investing is a marathon not a sprint and the long-term future continues to look very, very bright. We look forward to sharing that with you over the coming years. Again, here is the link to my calendar to schedule a call, Zoom meeting or Skype. **https://schedulewithpaul.as.me/**

Thank you for the privilege of serving as your investment adviser! Please stay healthy and sane!!

To Your Financial Success,

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