April 30, 2020

> *"You shall make the fiftieth year holy, and proclaim liberty throughout the land to all its inhabitants. It shall be a jubilee to you; and each of you shall return to his own property, and each of you shall return to his family. That fiftieth year shall be a jubilee to you. In it you shall not sow, neither reap that which grows of itself, nor gather from the undressed vines. For it is a jubilee; it shall be holy to you. You shall eat of its increase out of the field. In this Year of Jubilee each of you shall return to his property."*
>
> – Leviticus 25:10-13

> ***Knightian Uncertainty: "****In economics, Knightian uncertainty is a lack of any quantifiable knowledge about some possible occurrence, as opposed to the presence of quantifiable risk. The concept acknowledges some fundamental degree of ignorance, a limit to knowledge, and an essential unpredictability of future events."*
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> – Wikipedia[1]

Dear Client,

The last few months have been a whirlwind for everyone. We provided a brief update on our initial thinking regarding the Covid-19 pandemic in early March. Quite a bit has happened since then in the world and within our client portfolios. We know more today than we did in early March, but in some areas not that much more. Below we discuss our performance, our thinking across multiple relevant areas from the virus to the economy to financial markets. Finally, we describe how we are currently positioned for the future and why we believe a conservative posture is warranted today.

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[1] More from Wikipedia: Knightian uncertainty is named after University of Chicago economist Frank Knight (1885–1972), who distinguished risk and uncertainty in his 1921 work Risk, Uncertainty, and Profit: "Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated.... The essential fact is that 'risk' means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; and there are far-reaching and crucial differences in the bearings of the phenomena depending on which of the two is really present and operating.... It will appear that a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all."

Portfolio Performance & Structure

Grey Owl "growth" accounts finished the first quarter of 2020 down approximately 20%; in line with the S&P 500. Going into the Covid-19 pandemic, our portfolio had significant exposure to travel and hospitality businesses and financial services. Some of the hardest hit sectors, these positions negatively impacted performance relative to indices. While modest, our energy exposure hurt too. On the positive side, our focus on maintaining an "all-weather" structure helped as long-dated Treasury bonds and gold rallied during this period. Balanced and fixed income accounts performed much better, though those accounts incurred drawdowns as well.

When we became convinced the economic fallout from the pandemic and associated government reaction was likely to be as negative as anything we have experienced in our lifetime, we began a process of lightening equity exposure. Today, some of these sales look well timed. Others appear quite poorly timed. In truth, it is too early to pass useful judgement. Markets rarely (never) correct in a straight line. As liquidity constraints were relieved and the initial fear related to the virus passed, a reflex rally was inevitable. Technical analysts believe rallies recovering between 50-62% of the decline are "normal" in the context of a bear market. That is about where we find the market today.

Even if the stock market never revisits the March lows, there is still an argument for precautionary portfolio positioning. Yet, this goes against the grain. It is standard operating procedure in the value investing community during significant economic contractions and stock market corrections to point out that that these events have always proven temporary. Similarly, the "buy and hold" crowd loves to highlight that if you miss the biggest up days your performance significantly suffers. (They fail to point out the biggest up days almost all follow even bigger down days.) In other words, just "stay the course" and everything will be fine.

While there is certainly some logic to these ideas, they ignore the way compounding works. If you are down 20%, you need a 25% gain to recover. If you are down 35%, you need a 54% gain to recover. If you are down 50%, you need a 100% gain to recover. From a psychological perspective, it gets harder to stay the course as the drawdown increases. Protecting the downside is incredibly important. In the current environment of Knightian uncertainty, the opportunity cost of missed short-term rallies and even missed sustainable gains seems reasonable to us in order to protect from further losses.

The Virus & Government Reaction – Do Medicine & Politics Make Good Bedfellows?

Despite massive fiscal stimulus and monetary interventions, the economy is still a mess. The United States shutdown that was originally implemented as a two- or three-week affair is now

entering week seven. Maybe (maybe) a seamless restart was possible after three weeks, but does it really seem likely after seven or more weeks of increasing layoffs, stretched working capital, and fraying nerves?

Despite actual virus statistics developing more favorably than the worst models predicted, significant uncertainty about the virus remains. Is the infection fatality rate much lower than we thought, but the transmittal rate much higher? Are the better outcomes due to a less deadly virus or only to repressed transmittal stemming from aggressive social distancing via lockdowns?

Pundits are now talking about a vaccine in 18 or fewer months. But, wait. The fastest vaccine ever developed (for mumps) took four years. This is critical in the context of a shifting lockdown goal. Originally, the stated objective was to “flatten the curve” until enough personal protective equipment could be manufactured, and hospital infrastructure could be scaled to deal with a surging influx of sick patients. Today, some government leaders and pundits are urging the shutdowns to continue until a vaccine is available for mass inoculation.

Facts, still very hard to come by, may matter less as we move closer to a “madness of crowds” scenario where citizens have taken to informing on their neighbors who are gathering closer than six feet in community parks. At the same time, groups are beginning to actively resist the lockdown. It seems likely the lockdowns will begin to lift in the next few weeks, but it remains unclear to what degree and if they will return.

The Economy – Red Light… Green Light… Red Light?

The core of the near-term bullish argument has three parts. First, unlike in a war, no physical or knowledge capital has been destroyed. Second, when society returns to work, the highest value employees will be the ones engaged from day one and thus businesses will be more productive; i.e. able to resume close to full production quickly and initially more profitably given the lower cost structure. Finally, this scenario assumes the federal government has effectively plugged income holes via the multiple sources of fiscal stimulus and liquidity holes via the Federal Reserve’s multiple monetary interventions. A related belief is that other national governments and central banks have succeeded in similar efforts with the United States’ major trade partners. For the bullish thesis to prevail, the system must be kept spinning at the necessary rate to prevent breakage of any critical interconnections.

While this optimistic argument is plausible and should be considered, the bearish argument seems more probable. Unemployment is nearing record highs. Production has collapsed. Supply chains are discombobulated. Toilet paper is scarce, and farmers are dumping milk and potatoes into fields. A meat shortage appears possible (likely) given the very recent shut down of mid-

Western processing plants. According to *The Washington Post*, daily cattle slaughter fell 24% for the week of April 13. From credit card data, we know certain industries (travel and hospitality) sales were down 90% year over year by the end of March. Across the board, consumer spending was down 30%. And, this was just a few weeks after the March 13 declaration of a national emergency; i.e. before everyone had time to react and rein in spending. We are already seeing increases in consumer credit card delinquencies and corporate debt delinquencies.

Further, it is already clear the government interventions have serious side effects. Significant numbers of small businesses directly impacted by the shutdowns were crowded out of the first round of paycheck protection program (PPP) stimulus. And, there is already evidence from some businesses who received PPP loans that efforts to rehire employees have failed because the new unemployment assistance pays more.

JP Morgan writes in their April 27, weekly Global Data Watch that US gross domestic product (GDP) will likely drop 10% in Q1 2020 and 22% in Q2. Remember, the worst quarter in 2008 during the great financial crisis saw GDP drop 8.4% and the stock market fell 58% peak to trough and the market did not bottom until March 2009.

Changing Behavior – Permanently?

The Covid-19 pandemic hit the world after several decades of "McKinseyfication."[2] The McKinseyized world means just in time inventory (no back stock), optimal sourcing (production in the cheapest location - e.g. China), capital structures altered to take on as much debt as possible to get just on the edge of junk and in order to jack up return on equity as high as possible, operating businesses split from property to increase the sum-of-the-parts valuation. The system has removed redundancies and any margin-of-safety.

There is a flaw though. It is only perfectly optimized for profit in the "normal" environment. It is not robust. For a time, during long stretches of stability, it works perfectly and looks smart (and anyone who tries to do it differently looks dumb). BUT, it ONLY works if the world spins at exactly the right speed. Today, the world is the 6' man crossing a river with an average depth of 5' 10" and he just hit the big hole in the middle.

[2] McKinsey is the premier consulting firm in the world. Its employees are some of the smartest and most creative thinkers. But, there is some argument its process often over-emphasizes optimization of the wrong variables: easy to measure profitability, at the expense of robustness.

Over the past few months, the world has changed daily behavior at a rapid pace. Travel, restaurant dining, and large-group entertainment (sports & music) have all ground to a halt. Work and school have both changed too.

As the current lockdowns slowly lift, countries and geographies within countries are restarting at different times. Given the perceived dangers of the virus, the unknowns, and the fear formed over weeks of lockdown a rapid return to 100% capacity in airlines, sports stadiums, etc. is almost certainly months, quarters, maybe years away. If the virus spread increases once lockdowns lift, how quickly will we see rolling lockdowns resume in affected regions? As dramatic as it has been, the government programs do not likely provide stability for more than a few months. Many incentives to restart are misaligned (e.g. unemployment insurance). It seems highly probable the economic gears will grind.

We think it is important to consider the potential for longer-lasting changes in consumer and corporate behavior. Increased savings. Local sourcing. Less borrowing, more retained earnings, and greater liquidity. Weeks or months of inventory, rather than just in time. Lower profits today in exchange for long-term robustness. More equity capital and less debt. Very little in share buybacks.

Financial Markets – Data Out of Sample; Failure to Compute

The speed of the equity market rally since March 23 is very difficult to understand intellectually given the picture we paint above. In a Bloomberg interview, Mohammed El-Erian argues that analysts and investors just can't process the magnitude of the sales destruction and job losses we are seeing across the economy. These buyers just see a win/win set up where we either get a perfect, V-shaped recovery or things are really bad and the Fed backstops all financial assets.

For our part, we see three high-probability developments as the world comes to terms with the magnitude of what has happened. And, these economic dislocations meet the structural issues inherent to a world where global debt to gross domestic product has grown over the past 75 years to a level greater than 320%.

1. Corporate borrowing to buy back stock will decrease significantly if it doesn't come to a complete halt. "In the decade through 2019, S&P 500 companies poured $5.29 trillion into buyback programs."[3] If that buyer disappears, does it put pressure on equity valuations?

2. If revenues stay lower beyond the current (and anticipated to end momentarily) lockdown period, will the $3 trillion in corporate debt rated BBB come under downgrade

[3] https://www.wsj.com/articles/if-companies-arent-buying-their-own-stock-who-is-11586079000

pressure? The Federal Reserve must have been concerned about this exact issue when they announced a program in early April to buy corporate debt (even some junk rated issues). But, Fed buying in the secondary market will not stop defaults. Many institutions (e.g. pension funds) can't own junk rated debt. What happens to the system if the junk category becomes flooded with downgrades?

3. Outside the US, corporations owe approximately $13 trillion in dollar-denominated debt. Those corporations need global trade to flow in order to earn the US dollars to pay interest on that debt. What if global trade remains stagnant and oil (the premier dollar-denominated global commodity) remains priced below $25/barrel? Perhaps the dollar can remain strong against other fiat currencies.

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We are cautious today. This is a unique period of Knightian uncertainty. In a world of unbounded unknowns, protecting capital is paramount. However, the environment is in a state of flux and new information is developing at a rapid pace. We are very open to new information and altering our outlook and position.

We own some equities whose businesses will do well in a challenging economic environment. We also hold modest equity positions in excellent companies whose businesses have been hit directly by the lockdowns, but have staying power, and would be worth significantly more in a full recovery. We continue to own long-dated US Treasury bonds that should do well in a world where everyone is scrambling for dollars in the short-term. Gold remains a core holding and should perform well in an eventual modern debt jubilee where the Federal Reserve (and other central banks) retire the excess debt via even more extreme quantitative easing. Finally, we hold a significant amount of cash as a source of stability and optionality.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,
Grey Owl Capital Management
Grey Owl Capital Management, LLC

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