July 20, 2020

"Well, what if there is no tomorrow? There wasn't one today."

– Bill Murray as Phil Connors in Groundhog Day

Dear Client,

There is not much new to say since we last wrote to you on April 30, 2020. This might seem odd given the significant amount of changed patterns and uncertainty in our daily lives. Though, if you think back, both the new patterns and heightened uncertainty were well established by the end of April. Perhaps "nothing new" makes perfect sense given the "Groundhog Day" feelings engendered by the new pandemic economy and lifestyle.

Either way, in the following short prose, we will revisit the primary themes in our last letter. Uncertainty remains extremely high regarding: the direction of the virus and medical countermeasures, the medium-term impact on the US and global economies, the impact and progression (trillions more?) of government programs, and the financial market reaction to all of the above. Let's start with some backward-looking speculation on the narratives that drove the market volatility over the past two quarters to help frame where we are today.

Narrative Economics

Robert Shiller put his latest theory, narrative economics, to work in a July 7 essay titled "Understanding the Pandemic Stock Market."[1] The key to his analysis, which runs quite contrary to conventional financial market theory[2], is that market trends take time to develop and they do so via storytelling. Individuals are not able to sufficiently process new scientific and economic data so they rely on others. Thus, "stock-market movements are driven largely by investors' assessments of other investors' evolving reaction to the news, rather than the news itself."

[1] https://www.project-syndicate.org/commentary/understanding-us-pandemic-stock-market-by-robert-j-shiller-2020-07

[2] The backbone of modern finance is the Efficient Market Hypothesis (EMH) which posits that market prices instantly reflect all available information. As a pioneer of the "behavior finance" field (incorporating psychology and sociology into the study of financial price movements) Shiller has been a longstanding critic of EMH.

What narratives led the US equity market higher during much of February? Remember the S&P 500 went up 3% "after the World Health Organization declared coronavirus 'a public health emergency of international concern' on January 30." Shiller's theory: everyone lacked a relevant data point to create a baseline. The only comparison was a century old: the 1918-20 Spanish flu. We would add that our own reference points of SARS and MERS actually supported the calm initial reaction. While much deadlier than Covid-19, neither virus caused significant global economic damage.

Then, the second phase commenced. From February 19 through March 23, the S&P 500 fell 34%. A March 23 article in the Wall Street Journal led with: "Markets have never unraveled as quickly as they did in the past month."[3] Shiller explains: The media began amplifying "vivid stories" of the health impacts and lockdowns in China and Italy. "In Italy, there were stories of medical workers in overwhelmed hospitals being forced to choose which patients would receive treatment. Narratives about the Great Depression of the 1930s flourished." And then the economic lockdowns started in the US.

Regarding the rapid selloff, we would again add some additional color: market structure has changed significantly in the past two decades. The rise of passive investing and simultaneously high-frequency trading (HFT) leads to two seemingly contradictory phenomena: First, in normal times, there is a continual bid for financial assets (mostly equities) regardless of price or fundamentals. This relentlessly pushes asset prices higher. Second, during periods of uncertainty and dislocation, there is now a much smaller consortium of liquidity providers ready to step in to buy and slow a sell off. As a smaller share of the overall market, active managers, who often profit by acting as liquidity providers, no longer have the relative firepower they once did, and thus are less able to function as market stabilizers. Further, many market makers have been replaced with HFT operations that have no stated obligation to "make a market" and provide liquidity. The result is long periods of very low volatility and higher and higher prices, punctuated with short periods of extreme volatility.

So what triggered the rebound that began on March 24 and continues as we write? Government interventions, that were multiples of the actions taken in 2008, occurred almost immediately rather than a year into the crisis. Investors had a clear reference point and it signaled higher stock prices. As Shiller writes, both the monetary measures from the Federal Reserve and the $2 trillion CARES Act from Congress "were described as resembling the actions taken to counter the 2008-09 Great Recession, which was followed by a gradual but ultimately huge increase in stock prices." A portion of that $2 trillion CARES Act went to providing a $600 per week Federal unemployment supplement. In a two-person household, this alone matches the median US household income. And, it's on top of traditional state-run unemployment

[3] https://www.wsj.com/articles/stock-market-meltdowns-historic-velocity-bruises-investors-11584955800

insurance. This and the other CARES Act programs have gone a long way to stabilize personal income and consumption (for now). It did not take long for FOMO (fear of missing out) to begin to drive the market higher still and for the first market structure phenomenon we describe above to kick back in. Regarding FOMO, note that the Robinhood trading platform added 3 million accounts year-to-date through May. The underlying facts regarding the virus, the government reaction in terms of lockdowns, and the incredible fundamental strain on small and large businesses alike seemingly ceased to matter.

The Next Narrative

It is one thing to recognize that narratives exist and play some role in driving financial market prices. And further, to be able to retroactively establish a credible storyline. But what about going forward? Obviously, that is much more difficult. From an investing perspective, the goals should be: First, protect capital; always a goal, but even more so when “Knightian uncertainty”[4] abounds. Second, overweight the likely narrative(s) that are not priced in. With US equity markets near all-time highs is anything other than a full and rapid economic and corporate profit recovery considered?

The virus continues to spread throughout the US. The precise dangers of the virus, as well as, the need for and the cost/benefit of lockdowns are certainly debatable, and more so as we collect additional data about the impact of the virus. However, the reality is the lockdown mentality does not appear to be waning. California just reinstated bans on indoor dining this week.[5] That is the economic reality we must incorporate into our portfolio structure.

With a large percentage of the small business loans spent, consumer loan (mortgage, auto, and credit card) forbearance ending, pandemic unemployment insurance set to roll off (in late July), and an already staggering $2.7 trillion budget deficit[6] at least somewhat moderating an ability to add more stimulus, the government support that bridged the gap from March through July is set to come off.

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[4] 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."

[5] https://www.cnbc.com/2020/07/13/california-to-close-indoor-restaurants-movie-theaters-and-bars-statewide-as-coronavirus-cases-rise.html

[6] $2.7 trillion is for just the first 9 months of the fiscal year: https://www.cbo.gov/publication/56458

It seems highly probable that the next few months will be a difficult time for the economy and corporate cash flow. At the end of May, the National Bureau of Economic Research published a working paper titled "Covid-19 is Also a Reallocation Shock."[7] The paper details a likely reallocation of jobs due to three factors: demand shifts between industries (more streaming movies, fewer movie theaters), the death of marginal firms (e.g. Hertz), and an intra-industry shift (restaurants that offer delivery at the expense of those that do not). The conclusion is that 42% of the current unemployed will likely be permanent job losses. There is a lot of debate about the true number of unemployed, but even if we use the 17.8 million number from the June BLS report[8], that leaves 7.5 million people looking for new jobs. The job losses were almost instantaneous. Unfortunately, the paper demonstrates that historically new job creation takes a long time: 1-2 years.

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We are as cautious today as we were at the end of April. We continue to own equities whose businesses we believe can do well in a challenging economic environment. We still hold modest 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 made some changes to our equity exposure in the second quarter: trimming some positions and adding exposure in more defensive areas and sectors that could more easily navigate inflationary pressure. We added a "hedged" exposure to equity via the Hussman Strategic Growth Fund (HSGFX). This vehicle is designed to gain some upside exposure should equity markets continue to rally, while offering significant downside protection.

Speaking of inflation, we are slowly adding additional exposure designed to protect against nominal price increases that erode purchasing power. A weak dollar, rising commodity prices, and a continual bid for gold all corroborate the idea that the federal deficit ($2.7 trillion dollars in the first nine months of fiscal 2020[9]) will result in a currency that loses value. We recently initiated a position in IVOL. This security bundles a portfolio of Treasury Inflation Protected Securities (TIPS) with options that would benefit from increased inflation expectations. Look for us to opportunistically add commodities and emerging market equities in the weeks and months ahead.

We continue to hold "safe-haven" assets in the form of long-dated US Treasury bonds that should do well in a world where everyone is scrambling for dollars. They should also provide a positive return if the additional economic contraction we think possible develops. Gold, another

[7] https://www.nber.org/papers/w27137
[8] https://www.bls.gov/news.release/pdf/empsit.pdf
[9] https://www.cbo.gov/publication/56458

"safe-haven" asset, 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 still 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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