AMB Wealth Management

2nd Quarter 2020 Newsletter

April 9th, 2020

First and foremost, all of us at AMB would like to thank you for your support and commitment as we navigate through these difficult times. Most of us, like you, are working from home and sheltering in place. While inconvenient, we are hopeful that doing our part will help to flatten the curve of this horrible virus. We hope you and your families are in good health.

We are sure that all of you are tuned into the news every day as the global pandemic from COVID-19 continues to bare down on us all. There is no question that the events witnessed in the first quarter of this year would be characterized as a black swan event. A black swan is defined as an event, or series of events, that comes as a complete surprise, has a major impact on markets, and is often inappropriately rationalized in hindsight. To be sure, analysts and pundits will look back at this quarter and “see” many signs of how and why markets reacted this way. However, few of those same pundits were as accurate in their analyses at the beginning of this quarter.

In our opinion, the biggest surprise of this black swan is the extensiveness of the engineered shutdown of the global economy. As an example, the U.S. service industry had been, by far, the strongest part of our economy and it has now been crippled to the point of a standstill. There is no longer a question of if the U.S. will go into a recession this year but what the severity and duration will be.

Monetary & Fiscal Stimulus

With much of the economy coming to a halt, the longest U.S. economic expansion in history has also ended. However, the monetary and fiscal reactions to this crisis, when compared to the 2007/2008 financial crisis, are much different. During the last crisis, the Federal Reserve took months before introducing a monetary package to help shore up financial markets; comparatively, their response to this crisis only took days. Similarly, fiscal policy was also swiftly introduced with the passing of the largest stimulus bill in U.S. history.

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Monetary & Fiscal Stimulus (continued)

To try and soften the economic fallout, the Fed has lowered short term rates to a range of 0.00 – 0.25% and stated that they intend to keep those levels until they are confident the economy has weathered the recent events. In our view, this means we will see lower-bound rates throughout the rest of this year and probably next year as well. Their biggest concern, and the one they have addressed most strongly, is the worry of dollar shortages which could lead to credit drying up. In an effort to calm the markets, they implemented a full range of liquidity programs under the Federal Reserve Act. These are the same initiatives we saw during the great financial crisis of 2008. In a sense, the Fed has depleted all their available tools. If the crisis worsens, Congress does have the authority to allow the Fed to expand the array of assets that can be purchased. Doing so would be similar to Japan's strategy and the actions the Bank of Japan have already been doing for several years. Uncertain times are ahead, but the Federal Reserve has acted quickly and efficiently to get ahead of the economic shock that is bound to hit the U.S.

With monetary policy depleting its available tools, we have to look to fiscal stimulus for further assistance. This aid has come in the form of a $2 trillion stimulus package that was voted on by the House and signed by the President earlier this month. This will not stop a recession from happening, but it should lessen the blow and help spur the economic recovery later in the year. If the impact from this shutdown continues to worsen, we expect to see more stimulus packages from Congress. However, with the election looming, political posturing may worsen and slow down the process.

Economic Outlook

Our overall outlook for GDP in the U.S. is negative but the severity is unknown. Everything depends on the containment of the virus and an end to the economic lockdown. Economists often discuss recoveries by assigning "shapes" to them. For example, a V-shaped recovery is characterized by a sharp downturn, followed by a sharp uptick. Another recovery shape would be a U-shaped recovery. This is similar to a V-shaped recovery, but the economy is depressed longer before strengthening. While we hope for a V-shaped recovery and swift return to normal, the longer the lockdown lasts, the longer it will take to restart the economy and the odds are raised of experiencing a U-shaped recovery. Above all else, let us hope we do not see the dreaded L-shape!

Economic Outlook (continued)

Under more normal circumstances, first quarter's price digression in energy markets would have been of higher consequence for discussion. Now, it has been relegated to little more than a footnote, although we still believe it is important to remember. In early March, Saudi Arabia and Russia failed to agree on oil production cuts. This disharmony led to a glut in oil supply, and when combined with lower demand, oil prices were reduced to levels not seen since 2001. Oil production remains a large part of the U.S. economy, but current prices are lower than the cost to produce for many companies. If oil prices remain depressed, we could begin to see bankruptcies in the energy sector which would further weaken the economy. A stabilization or recovery in the price of oil will go a long way in shortening this economic downturn and seeing a recovery in the overall markets.

Equities Outlook

Equities have been under pressure since the middle of February. In recessionary scenarios, one would expect quality companies with strong cash flows to outperform, but we have witnessed the exact opposite. So far during this sell-off, higher quality (i.e. low leverage, high cash flows) has trailed lower quality (i.e. high leverage, low cash flows) by a large margin. We expect this will change in the coming quarters.

It is also our belief that the low volatility/high momentum trade is overcrowded and in need of a major pull back. Defensive stocks are currently at some of their richest valuations in history. Relatively, cyclical stocks are trading cheap to historical valuations, and we believe a rotation into these stocks as this cycle plays out will be seen. Going forward, our strategy will be to look for opportunities on both the buying and selling side in order to take advantage of dislocated valuations in an anticipation of this expected rotation. We remain aware that this pandemic can cause rapid changes within the markets, therefore we strive to be flexible in executing our portfolio strategy.

Fixed Income Outlook

Fixed income markets saw more volatility than their equity counterparts. Spreads across all asset classes dramatically increased as liquidity became a real concern in the middle of March. It was not until the Federal Reserve stepped in to backstop both commercial paper and the municipal markets that we saw some return to normalcy.

Fixed Income Outlook (continued)

Going forward, we remain duration neutral to the intermediate area of the curve and are negative on the longer end. We look favorably at investment grade credit and municipals as we believe the damage has been done, and we may have seen the widest levels in spreads already play out. Once again, like with the equity markets, this is an ever-evolving situation. We are in unprecedented times, and we will be updating our thoughts as data flows in and markets react.

Conclusion

If there is one positive takeaway from this market, it is that the economic shutdown has been purposely engineered in an effort to combat the spread of COVID-19. While we have no precedent for this type of market, we hope the economy can be restarted as quickly as it stopped. Worldwide fiscal and monetary stimulus has been extraordinary as nations try to lessen the damage caused by shutdowns. However, the longer the shutdowns last, the higher the probability that stimulus will be inadequate to keep the economies afloat.

Sir John Templeton famously stated that the four most expensive words in the English language are “this time it’s different.” We tend to agree with Templeton, although the circumstances around this shutdown are incredibly unique. Still, as we look back on past crises, we see that financial markets have always recovered. We expect that investment disciplines that were profitable during those times (prudent asset allocation, quality business ownership, and disciplined purchases and sales) will remain profitable through this crisis as well.

We are honored to serve as your financial advisors through these uncertain times. Please reach out with any questions you may have.

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