March 2020

A Time Forgotten!

Attention Kmart Shoppers, We Have A Flashing Blue Light Special in Aisle 8!

I remember shopping with my parents as a kid at Kmart and hearing that announcement. It was like a parade of shoppers heading to the sales in aisle 8. For what, a flash discount on already discounted merchandise?

So, what has changed? A lot apparently. Okay, there is no rush to aisle 8 right now as the market goes. One day there is a sale in aisle 8 and the next day it is off. But wait, it's back on again! Why? Likely because most of the world was "all in" drinking the Kool-Aid being served up at the top of the market. We all knew something had to give at some point and that the economic cycle was real. Those who said central banks could float asset prices forever are now reviewing their models in the face of virus uncertainty.

The FED and the Bank of Canada have both acted by lowering benchmark rates by 50 basis points and it's kind of ho hum…

The fear in the markets holds great opportunities for us! It is the most difficult thing in the world to buy ugly but as one successful real estate investor once said to me, "You make money when you buy, not when you sell." Meaning, if you buy cheap or smart, the world normalizes, and you make a profit. You take advantage of the fearful crowd.

That opportunity to buy is shortly upon us. By shortly, it could mean another quarter or two.

Consider that pipeline stocks were down about 10% in the sell-off period. Fundamentally, nothing has changed with their businesses. These assets in some cases are yielding 7% and 8%.

In 2008, when the global credit crisis hit, markets recovered. It took some time, but after the storm there was recovery. The same will happen this time. The nature of the storm is always worse than anyone thinks it will be.

We have generally taken a balanced approach to portfolio management and have prudently raised cash levels. We have also maintained positions in dividend-yielding companies that have little to zero exposure to China and/or the current state of the Coronavirus.

At the end of the day, the flashing blue light special may last a bit longer than we all feel comfortable with, but remember, this is when money is made… longer-term.

When will this stop and where will the market settle?

We have a theory on this that may fly in the face of some of the bigger voices out there. We think the first stop should be 10% lower! When you think of fear you must measure it quantitatively to have some sort of rationale behind your thinking. Being really scared usually does not cut it. Let's look at this numerically. The world typically operates within 2 standard deviations of the mean. The mean of the S&P 500 is currently around 3000 points. Negative 2 standard deviations would move the S&P 500 down near 2700 points or 10% lower. There's no magic here, just numbers.

Now a word of caution, the pendulum typically swings equally both ways. Meaning, we were trading above 2 standard deviations for a couple of months and at times we were almost 3 standard deviations above the market mean. So, there is some probability that we could swing below negative two standard deviations. The chart below illustrates those ranges over the past couple of years.

Chart Source: Thomson Reuters

At the end of 2018, the FED provided a stimulus for the market and a rally ensued. Today, March 3, the Fed cut the Fed Funds rate by 50 basis points. The market, as we type, is not drinking the Kool-Aid! WHY? Maybe they have just had enough or maybe they will come back tomorrow?

Playbook

We continue to seek out opportunities to right-size risk and improve quality opportunities. Acting in the eye of the storm usually leads us to become speculators versus acting on actual data. One final data point we will leave you with is an on the ground view of what is happening in China today. The chart below shows the average road congestion in 100 cities across China. It tells a story of a slow recovery back to normal. For what it is worth, it is important to realize that China is getting back to normal at a slow rate but heading in the right direction.

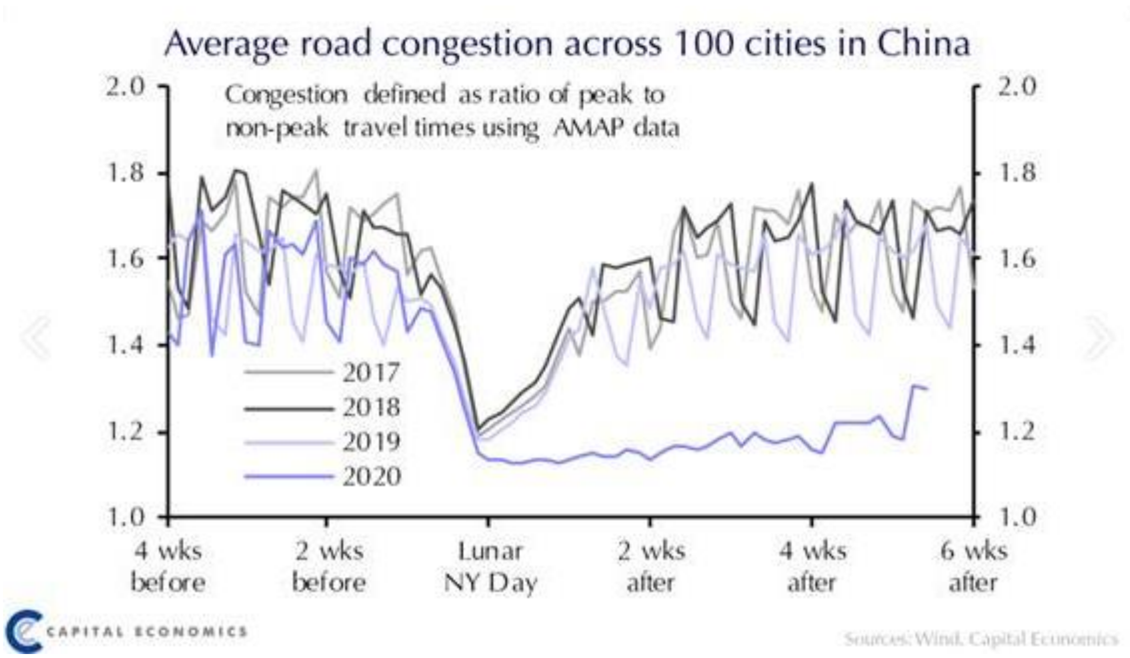

Chart source: Capital Economics

In the graphic above, you can see that traffic is moving in the right direction in China but there is still a gap to normalcy. The spread outside of China is likely to have more impact. If we see any sort of spike of diagnoses in the US, markets should remain volatile.

Final Thought

As the blue light special flashes on and off, we will selectively right-size risk. This means at times we will protect capital and at other times we will employ capital. It should be noted that this is not an all-in or an all-out event, but a measured approach to noise and data.

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