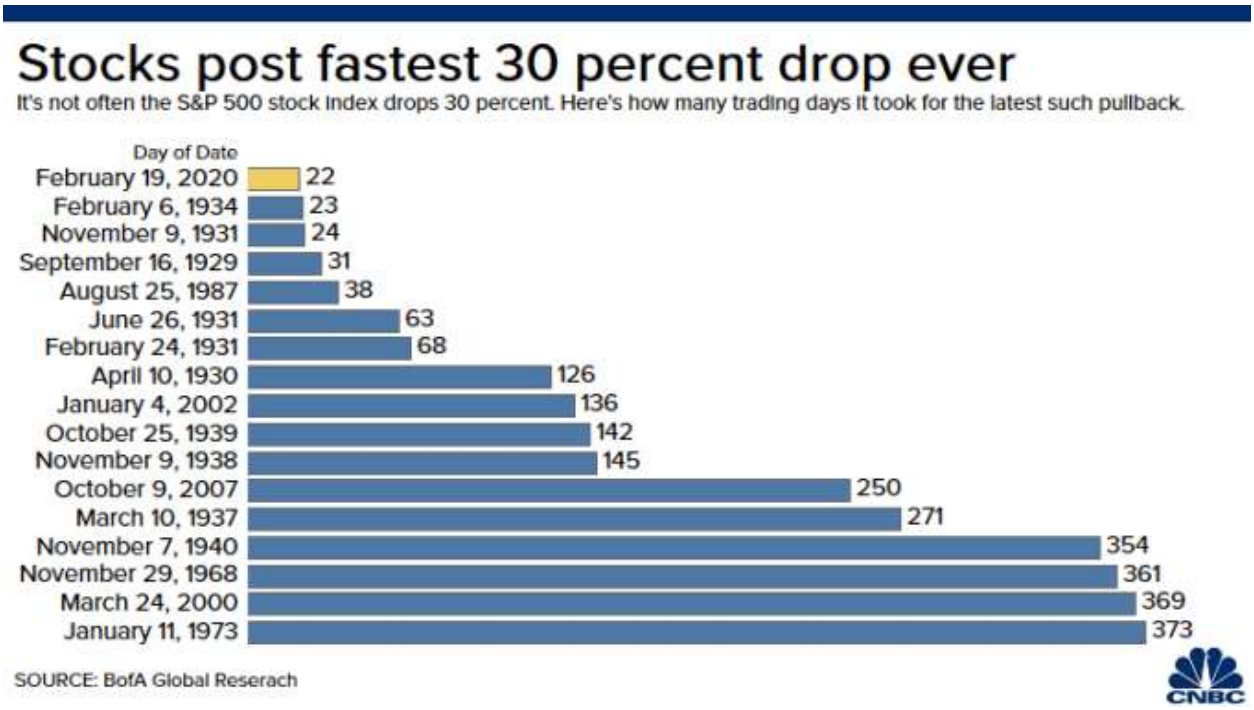
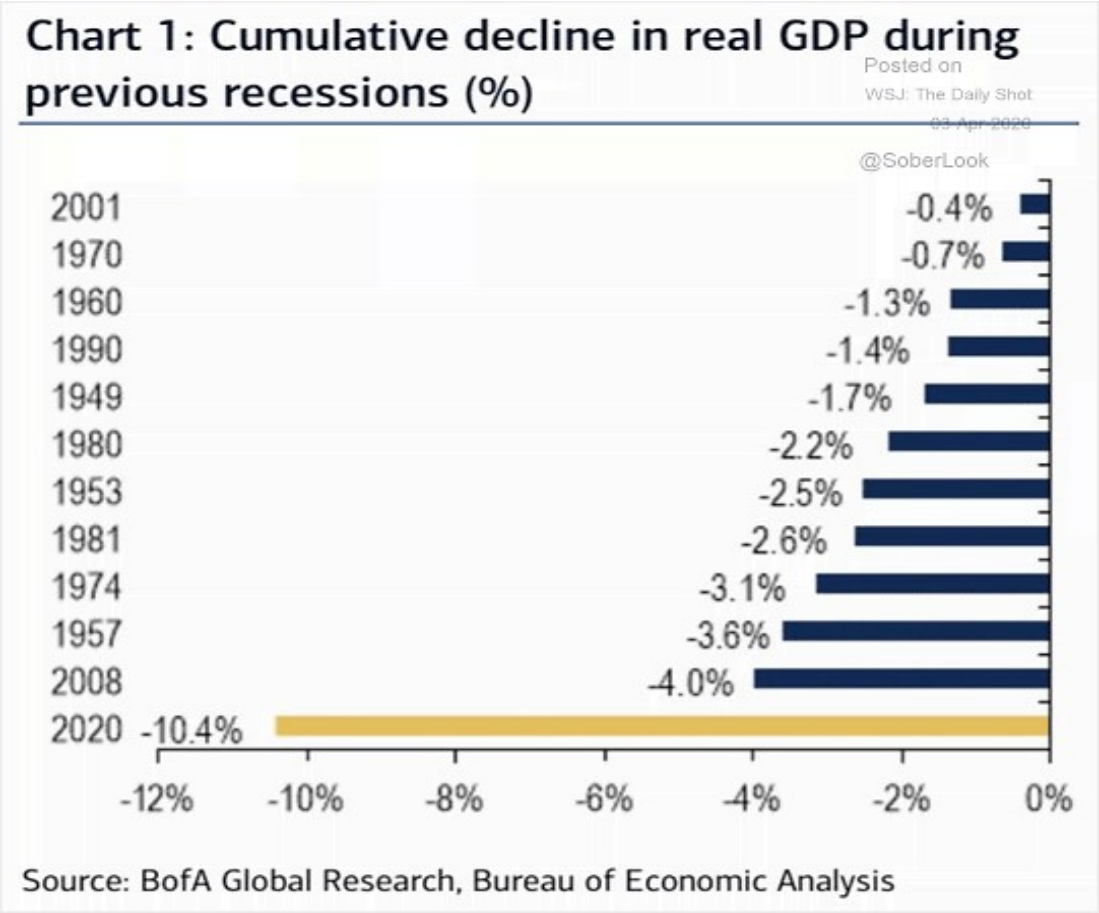
Everything Is Awful. So, Why Is the Stock Market Booming?

What on earth is the stock market doing?



In April, the stock market had its best month since 1987. And the economy had one of its worst months ever. How is this possible?

Death and despair are all around. The number of people filing for unemployment benefits each of the last two weeks was about 10 times the previous record — and vast swaths of American business are shuttered indefinitely. The first two quarters of 2020 are expected to be the worst ones since WWII.

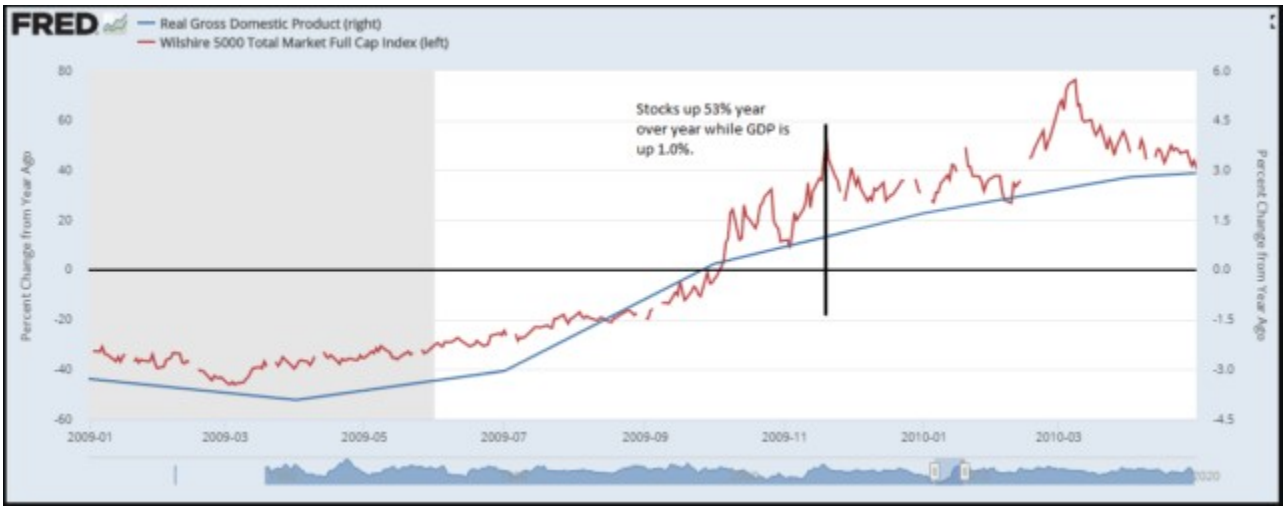


According to all forecasts, the US economy is already in deep recession, with Q1 GDP down over 10% and expected to post the deepest quarterly decline ever during Q2/2020. Overall, the 2020 global recession may be like nothing we have ever seen before.

Yet the S&P 500 has made up 60% of the losses it incurred in February and March. It was down only about 14 percent from the February high — and is nearly up year over year. Everything about this crisis has been incredibly fast, with the economy going from full health to devastating recession within weeks and the stock markets tumbling right along with the economy until the stimulus package was enacted.

Is the April rally a flip-flopping of perception from "the sky is falling" in March, to a glimpse of light at the end of the tunnel today? We can only hope that stock investors know something that thousands of people coping with the coronavirus or facing a catastrophic economic situation do not.

To better understand how the current stock market operates let's review the 2009 recovery. In November of 2009, the economic picture remained bleak. The headlines were downright grim, but the stock market was up 53% year over year.



The stock market anticipates a recovery well ahead of the current economic picture.

The stock market is forward looking. So, while we saw everything in real time, the stock market was already envisioning what was likely to be the result of the 2008 stimulus package and other market reviving measures.

The stock market's fluctuations are a series of guesses about future outcomes. Warren Buffett's mentor Ben Graham always describes "Mr. Market", as a manic character who is in a constant bi-polar state but never in doubt about the direction it is going.

Today we have two powerful forces that are pushing in opposite directions. It's a battle between a collapsing economy and the desperate measures in force to prop it up. The result is that the Fed's balance sheet is exploding like nothing ever seen in history.

Will going BIG with trillions of dollars from the Treasury and the Fed pre-emptively prevent the Coronavirus from doing lasting economic damage in the US?

Source: Wall Street Journal

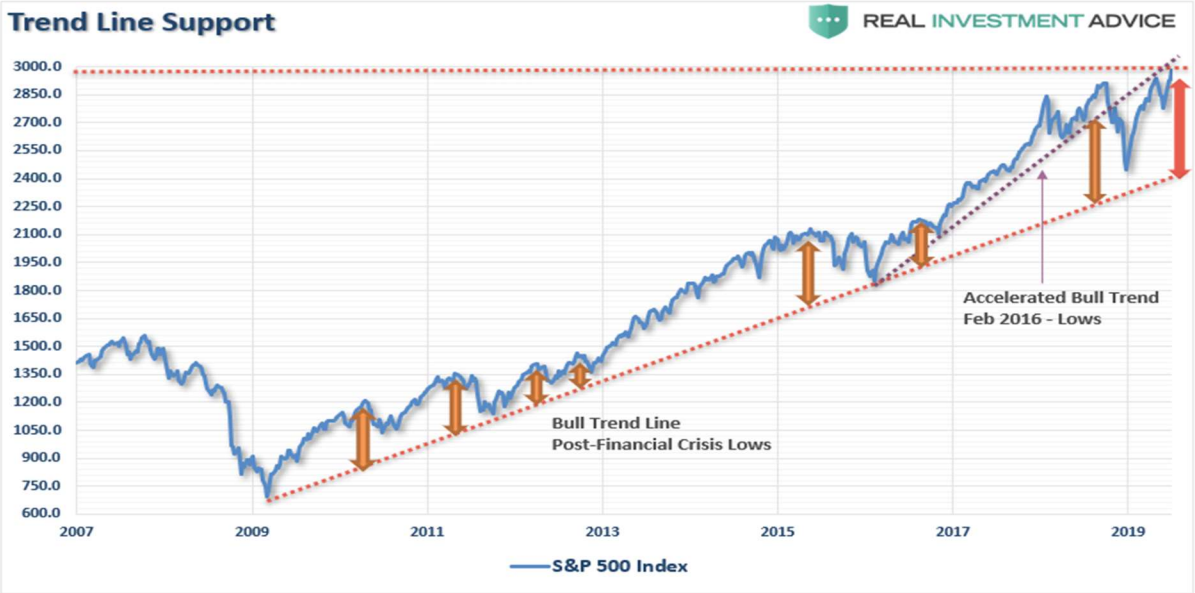
The Fed (monetary policy) and the US Congress (fiscal policy) are pouring trillions of US Dollars into the system to provide liquidity. The Federal Reserve is now buying bonds at a pace of over $1m per SECOND!

Commerce is being disrupted to an extent that seemed impossible just weeks ago. But simultaneously, stock investors seem to be betting that the powerful Washington interventions— including what has by the end of April, become $7 Trillion from the Federal Reserve (projected to go as high as $9 Trillion)— will be enough to enable major companies to emerge with little damage to their long-term profitability.

"If this doesn't go on much longer than expected, it really is a three- to six-month event from the time we turned the switch on the economy off to when we turn it on, then perhaps markets have already accounted for that and are looking ahead," said Jim Paulsen, chief investment strategist for the Leuthold Group.

Some analysts who project corporate earnings are, in the aggregate, forecasting a relatively mild hit. They expect the companies that make up the S&P 500 to experience only an -8.5 percent decline in earnings in 2020, with revenue falling a small amount, according to FactSet.

"What is happening here is a flip-flopping of perception from the 'sky is falling' for the majority of March, to being able to glimpse a light at the end of the tunnel today" according to Jason Pride, chief investment officer of private wealth at Glenmede.



It should be noted that *at the worst point* (**2200**) the S&P 500 index dropped to a point just below the bull market trendline indicated by the lower dotted line on the chart above, and it quickly recovered. Currently it is sitting just above 2900 and far above the lower trendline giving some support to the notion that this bear market is manageable.

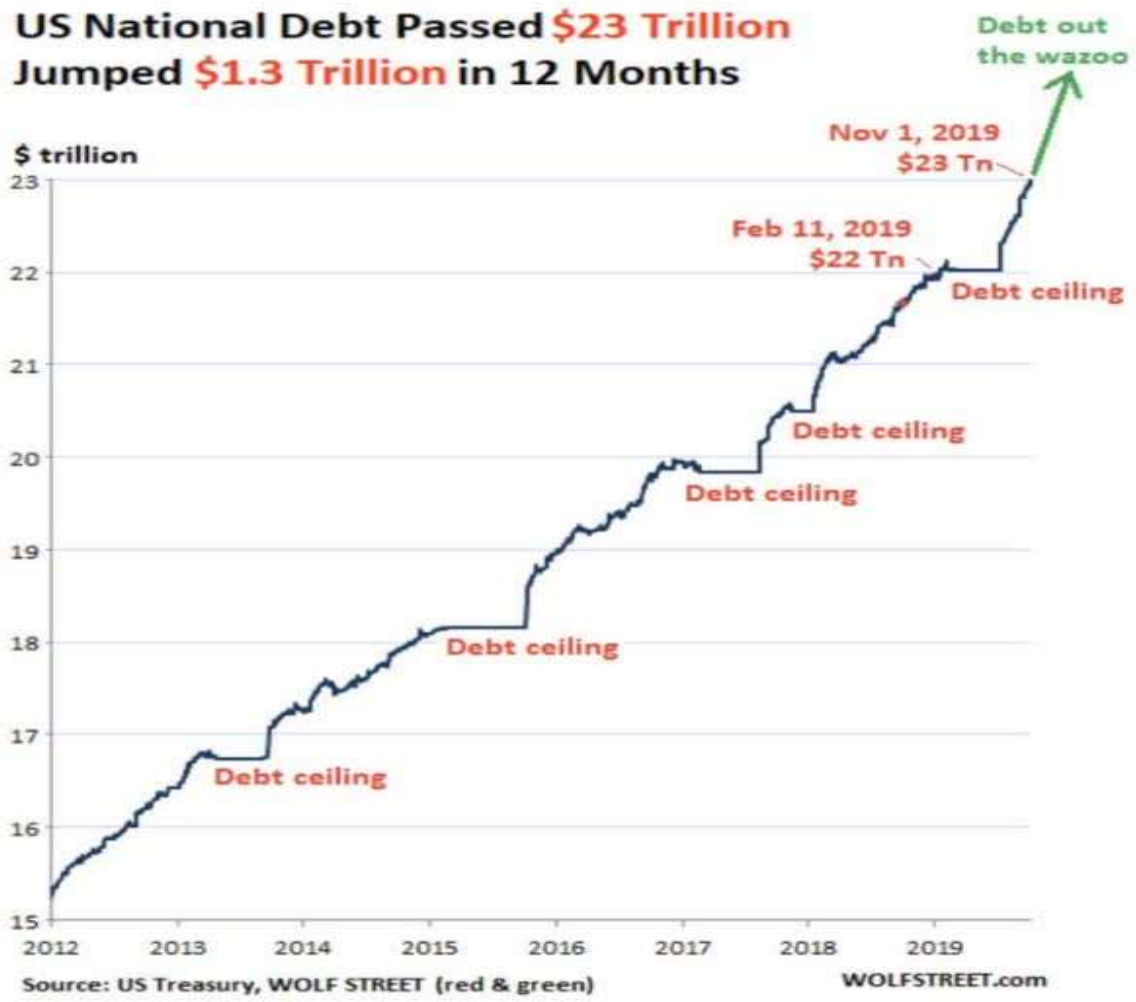
On the one hand, we have the potential for an unprecedented slowdown in the economy. Investment will collapse. Savings will spike. Dividends and buybacks may be cut in half. But then you have the Granddaddy of all spending packages from the government sector.

There's a saying in the market, **"Don't fight the Fed."** While we believe that government interference with the natural and logical flow of market cycles does more harm than good, we have also observed that when the government opens the monetary flood gates the corporate ships have invariably risen.

A mathematical equation defines the relationship between government budget deficits and corporate profits. It's credited to Michal Kalecki, a Polish economist who was a contemporary of John Maynard Keynes:

Profits = Investment - Household Savings - Government Savings - Foreign Savings + Dividends

Don't worry, we are not going to try to explain the equation. But a few prominent economists including John Hussman and James Montier say the "*Kalecki Profit Equation*" shows that deficits and corporate profits move in tandem.



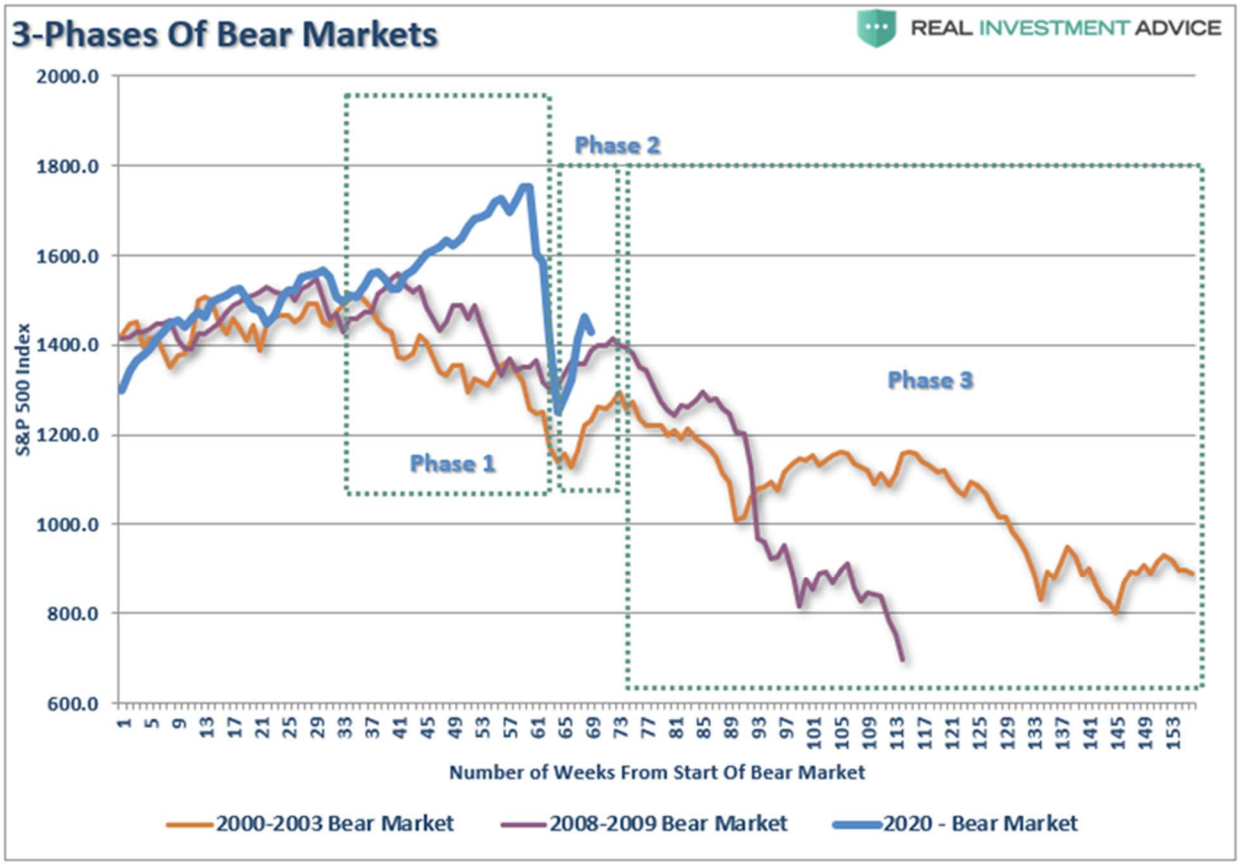
Can global financial markets and the global economy be healed by pouring lighter fluid on an already raging fire? Can too much debt be cured by the issuance of even more debt? --Stay Tuned

Some people don't seem to understand how big this unprecedented cash flow is to corporate America. No matter to whom the money has been given, much of it ends up in the hands of the corporations. To put things into perspective, net investment, dividends/buybacks, household savings and other saving all added up to $4.7 trillion in 2019. The government is going to generate 100% of that in 2020 **ALL BY ITSELF** according to Cullen Roche of the Orcum Financial Group.

We are taught to believe that shrinking the deficit would be good for corporate profits and stock prices but in fact, that has not been the case. The longest period of recent deficit reduction occurred during the Clinton administration and the economy went into a bear market according to economist Stephanie Kelton an expert in the mechanics of modern money flow operations at the University of Missouri at Kansas City.

So, it's not that the stock market recovery won't be about death, business closings, job losses and devastation; it simply gets down to the expectation that whatever happens, an unprecedented amount of government stimulus is going to flow through to corporations that are too big to fail.

The current pricing assumes that a cascading series of failures will not happen; that widespread job losses and drops in income won't cause the mass closure of businesses: and that people will have a job to go back to and will be willing to spend when the Coronavirus crisis ebbs.

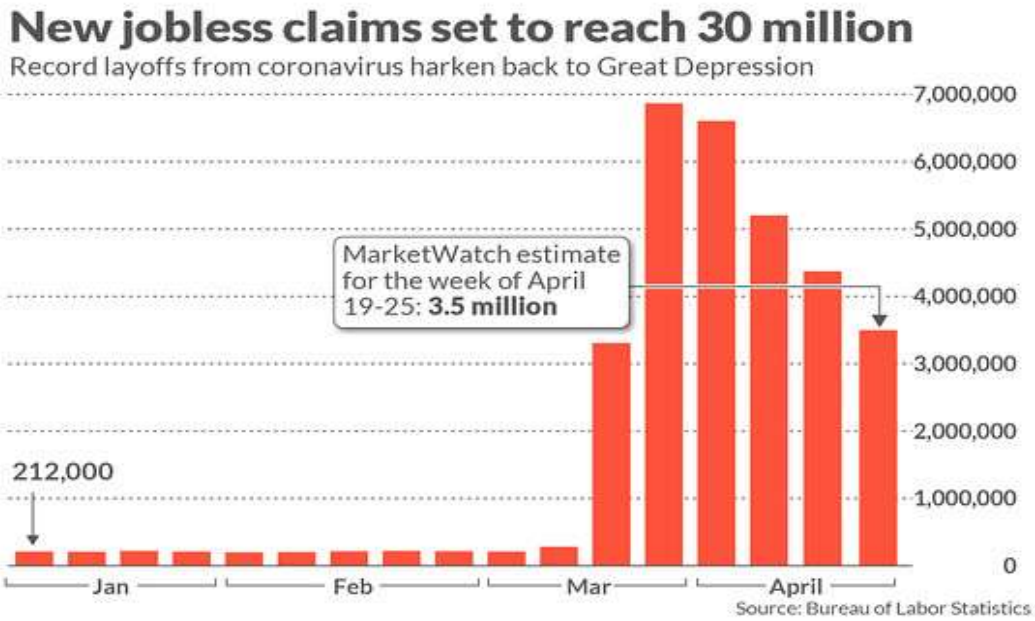


The lessons from past bear markets include the observation that there are often enticing rallies which can be *bear market traps* – such as the rebounds that occurred in 2000 and again in 2008 (See Phase 2 on the chart above).

Bear markets accompanied by recessions often go through the three phases pictured above. First, markets sell off ahead of the recession, next, they partially recover, and finally, they sell off again in phase 3 as the force of the recession hits the economy.

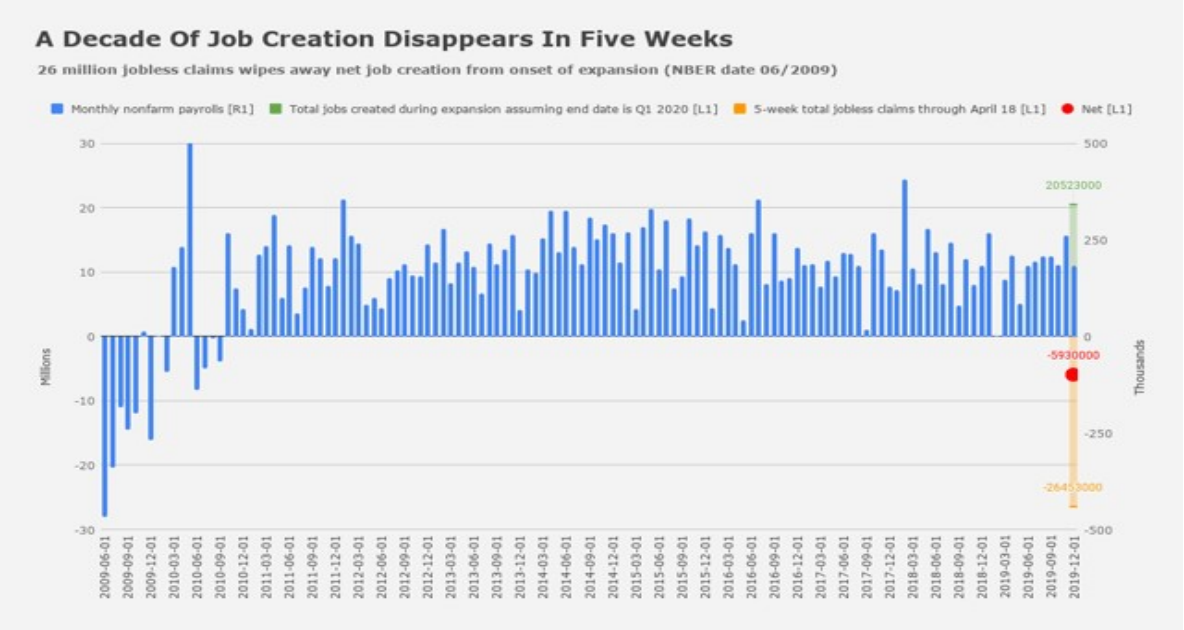
According to *MarketWatch*, Bespoke Investment Group research data indicates that since 1928, the S&P has experienced 25 bear markets (when the market price dropped 20% or more). They found that **60%** of the time, after a subsequent rally, the initial bear market plunge was followed by another that took the index to lower lows.

There are powerful arguments to suggest the third phase is yet to come.



U.S. unemployment rate estimated to have surged 15%

The flood of Americans seeking unemployment benefits after losing their jobs in the coronavirus pandemic is slowing, but enough Americans probably filed jobless claims to bump the total to almost 30 million in the last week of April according to economists polled by MarketWatch.



Between June of 2009 and Q1 of 2020, the US created around 20.5 million jobs over the longest expansion in history according to the National Bureau of Economic Research (NBER) data. In the past five weeks all that job creation was wiped out. The red dot on the chart indicates where net loss begins.

Currently, an explosion in debt is happening in the US corporate market.

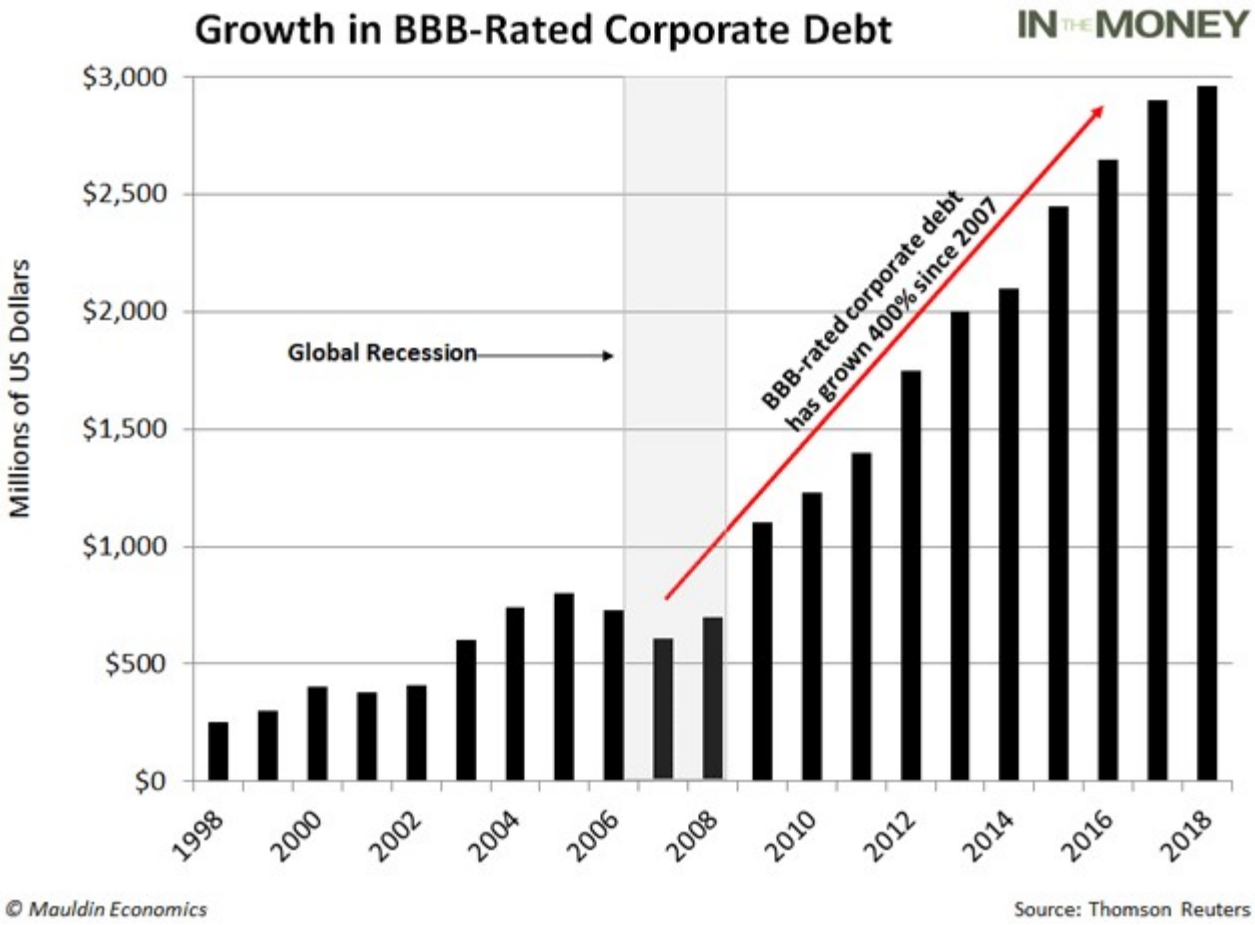
Of greatest concern is the amount of low-quality debt.

There is a reason BBB-rated debt is so plentiful. Ultra-low interest rates that followed the Great Recession in 2008, seduced companies to pile into the bond market. Corporate debt has surged to heights last seen in the global financial crisis of 2008.

If there is a massive downgrading of these low quality bonds to junk status, as the result of the pandemic, many institutions, pensions, and mutual funds, (which are required to hold *"investment grade"* bonds) will be forced to dump them on the market.

Keep in mind, the sub-prime mortgage crisis, and the ensuing financial crisis in 2008 was sparked by investor concerns about defaults and resulting losses.

When there are no bond buyers, we have a liquidity problem that could cause the markets to collapse. That is why the Fed recently announced that they will be buying corporate bonds for the first time in order to stem the expected massive defaults in the private sector.



In just the last 10 years, the triple-B bond market has exploded from $686 billion to $2.5 trillion—an all-time high.

In October, The Wall Street Journal published an article with troubling implications: *"Bond Ratings Firms Go Easy on Some Heavily Indebted Companies."* The amount of debt rated triple-B — one rung above junk — has tripled over the past decade to $3.7 trillion. There was clearly skepticism about the credibility of many of those BBB ratings from the ratings agencies.

According to the Journal roughly $100 billion of BBB bonds currently trade with yields more common to junk bonds. (Bonds rated lower than BBB are not considered to be "investment grade" in the industry they are termed "junk bonds.)" If 50% of those BBB-rated bonds were to get downgraded, it would entail a shift of $1.30 trillion in bonds to junk status.

Joseph Otting, who heads the U.S. Office of the Comptroller of the Currency, said in written testimony to the Senate Banking Committee that underwriting standards have declined on these loans. In the event of widespread defaults look for big investor losses.

To put this into perspective, the entire junk market today is around $1.25 trillion, and the sub-prime mortgage market that caused so many problems in 2008 peaked at $1.30 trillion. Since 2014, junk bond trading volumes have diminished by 80% and the bond market is dangerously illiquid these days. Each of the last three economic cycles exhibited debt trends similar to the one we are now experiencing.

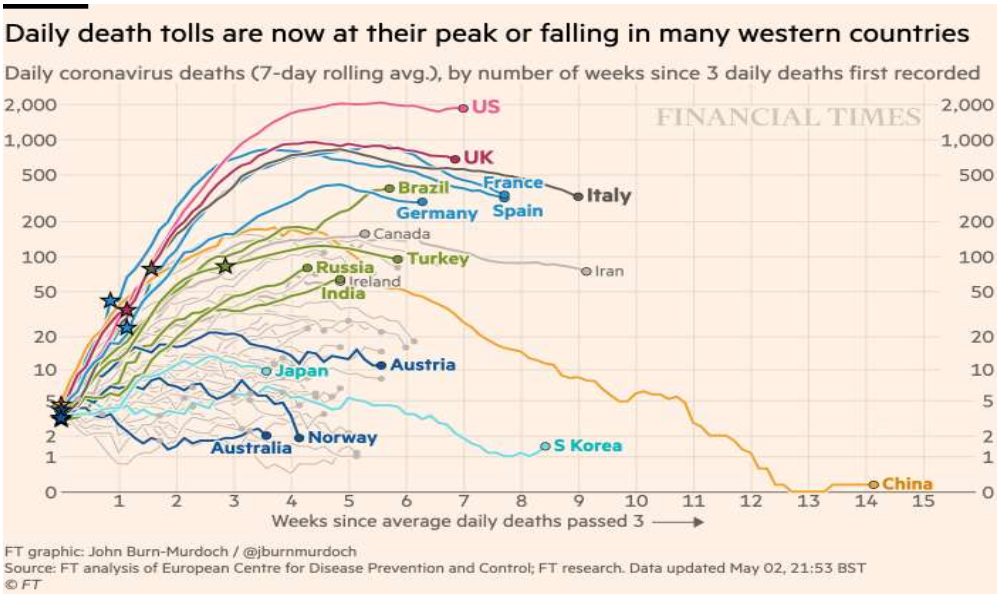
Excessive speculation and increased levels of debt peaked with this end of the expansion. Bond market liquidity evaporated during the sell-off, playing a large part in triggering the Fed's emergency actions. If the current stress in the financial system cannot be overcome with monetary and fiscal stimulus, it could lead to significant deleveraging, more market losses, and a deepening of the recession.

Last fall, the International Monetary Fund (IMF) warned that as much as $19 trillion in global corporate debt — or roughly 40% of borrowings by companies in the U.S., China, and some European economies — are at risk of default in the event of a severe economic slowdown.

Many mutual funds and exchange traded bond funds promise investors "daily liquidity" while holding what may become relatively illiquid assets. "The risk is that losses could cascade through the banking and non-banking financial sectors, amplifying the shock of any downturn," wrote the IMF. Global bond funds holding assets worth $1.7 trillion could face difficulties in repaying investors promptly if a wave of debt downgrades forces bond funds to sell junk at the same time bond investors start seeking redemptions. A devastating liquidity crisis could result.

Now, with global markets reeling, the question becomes: How vulnerable are bond and stock markets to a simultaneous spike in defaults, ratings downgrades, and corporate belt tightening?

Coronavirus Update –The Financial Times May 2, 2020



The World Health Organization reports the outbreak has spread to more than 190 countries around the world. The US accounts for more than one-third of global daily deaths according to the Financial Times. New confirmed case counts in some European countries and U.S. states have begun to plateau, and in Italy they are starting to fall.

Summary

The Fed rate cutting encouragements that began a year ago– and other incentives that unnecessarily and unnaturally extended the bull market, encouraged an unusually high level of investment in the stock market. Most notable were the normally reticent individuals who were lured into the markets last year by the fear of missing out.

Many investors believe that the monetary and fiscal stimulus could be a sufficient cocktail to help ward off a revisit to the depths of March. Even without a vaccine, the economy might return to normal relatively quickly if effective treatments can be swiftly implemented.

Scientists will know a lot more about our microscopic invader in a few months. With the virus now racing across the U.S., American researchers will have direct access to data and patients, rather than having to rely only on Chinese data. Only after the invasion is beaten back will it be possible to put a price tag on the economic cataclysm it left in its wake.

But, absent widespread testing and a clear sense of what will constitute "normal" going forward, it will be difficult to persuade businesses to invest and hire, especially when they are anticipating higher tax bills as the result of runaway spending when this is all over.

Economic reports point to the shocking deterioration in activity compared with just a couple of months ago. There is little commerce currently taking place in all major western nations. The manufacturing sector hasn't completely failed, but the services sector hardly exists at the end of April. Main Street isn't just hurting, much of it may disappear in a very literal sense.

As Atlanta Fed Governor Raphael Bostic warned in April:

"May is going to loom large, in terms of the transition of concern from this being a liquidity issue… to this perhaps translating and transferring into a solvency issue, and whether companies can exist at all."

Portfolio Review

While in retrospect, we would have liked to have been even more preemptive, we converted a lot of gains into profits and we raised a lot of cash in 2019 and 2020. Many of our TIAA retirement accounts were out of the stock markets well ahead of the bear market and all accounts are holding record amounts of cash and short-term bonds.

Today, we believe the odds remain greater that this bear market has further to run as the economy comes under increasing pressure. As we wait for the eventual

bottoming out, our large cash position is exactly where we need to be in such a dangerous bear market. Our portfolios are well positioned to take advantage of the low-risk buying opportunities that will ultimately ensue as the markets shake out and the bullish trend is re-established.

We have added a few positions over the last few weeks to some of our stock portfolios and have our eyes on a few other stocks that we believe will hold up regardless of what the overall market does. We also added to our market sector plays, focusing on the Technology and Healthcare sectors. Even with the additions we've made, we're still holding large amounts of cash and remain defensively positioned. When our indicators improve and we see more positive signals, which could be next week, month, or year, then it will be time to start aggressively increasing exposure to equity risk as the bullish trend is re-established.

DISCLOSURE