Chief Investment Office PWM | 26 May, 2020
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Memorial Day honors the men and women who have died while serving in the military. Without them, we would be unable to enjoy all things that we do and have. We thank all those that have served or are serving on Memorial Day as we do every day. The origin of Memorial Day dates back to the Civil War, (it was originally called Decoration Day), but it was not until 1971 that Memorial Day became a national holiday!

Lots of Bad Economic News. All of it Expected.
We've all seen the headlines, over and over again.

> **"The unemployment rate is the highest since the Great Depression."**
> **"Manufacturing dropped the most since 2008."**
> **"The Leading Economic Index plunged the most on record."**
> **"Earnings estimates have been revised down at a record rate."**

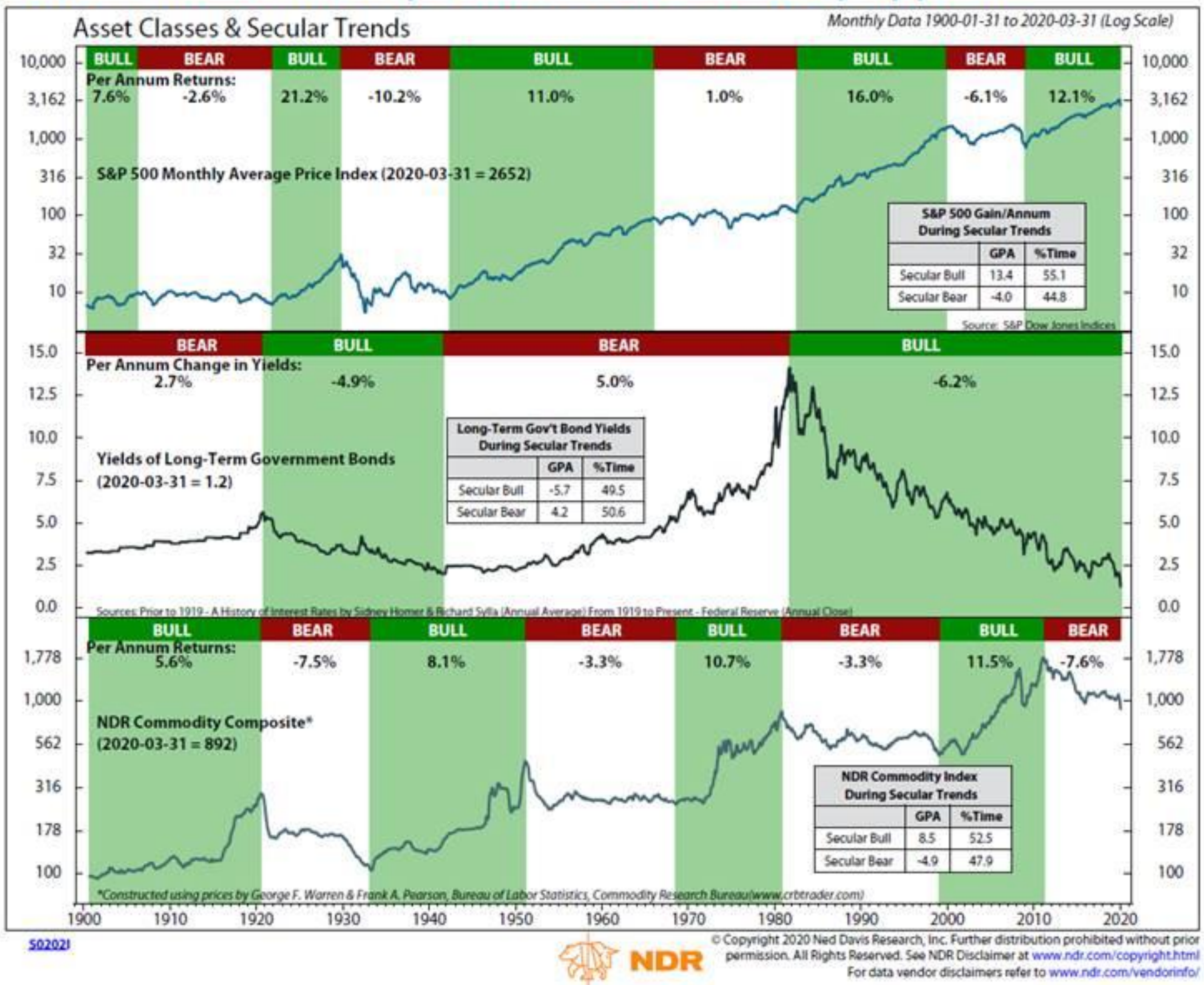
Yet the market continues to climb. Here are PWM's latest thoughts:

Economy: When this pandemic first got started, we warned against watching too much media. It is not good for the soul or for the mind. The media likes headlines, and anything that can keep a reader/watcher's attention. The headlines above appear shocking, unless you were aware that we were closing down a large swath of the economy. In that case, the headlines are 100% expected. If they were anything else, they wouldn't be believable. The same is true when comparing today to the Great Depression of the 1930's. Again, as we said weeks ago, this is self-inflicted, but it is temporary. The FED (Federal Reserve) and government have made it very clear, to the extent they can, that there will be money around to see us through this closure. The interview with Federal Reserve Chairman Powell last Sunday made that absolutely clear.

Allocation: For diversified portfolios, the primary driver of investment returns is asset allocation. That is why we are so particular about our allocation. It is a well-diversified allocation and as a result it doesn't vary dramatically, but we are always aware that it needs to be adjusted occasionally. As we have said before, we don't expect that coming out of this closure is going to be easy. Aside from the basic problems of getting the government money into the right hands, we also must control the re-emergence of infections as the economy re-opens. Neither will be easy, and as a result, we have every expectation that there will be bumps along the way, but we don't see anything that requires a major adjustment to basic portfolio allocations.

It might sound a little bit odd that allocations don't change much, but it makes sense and here's why. At the top of the following chart we have stocks, in the middle we have long term Treasuries, and on the bottom, we have commodities. The green shaded areas are long term bull markets and the white areas are bear markets. For the well-diversified portfolio, one of the asset classes is almost always in a bull market, and more than 50% of the time, two of the three are in a bull market. Over time, that makes for strong returns with less portfolio risk, which is precisely what we seek.

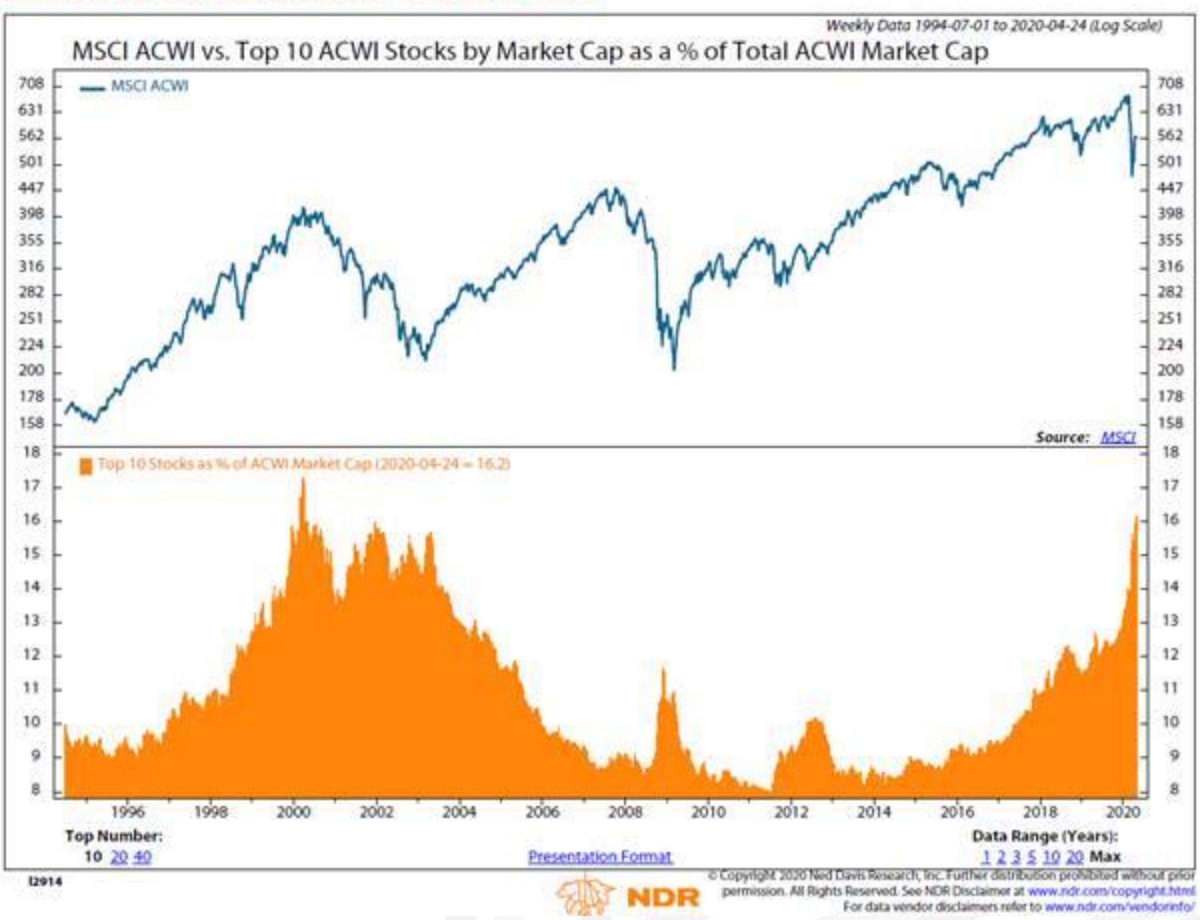
Stock and commodity secular trends usually opposite



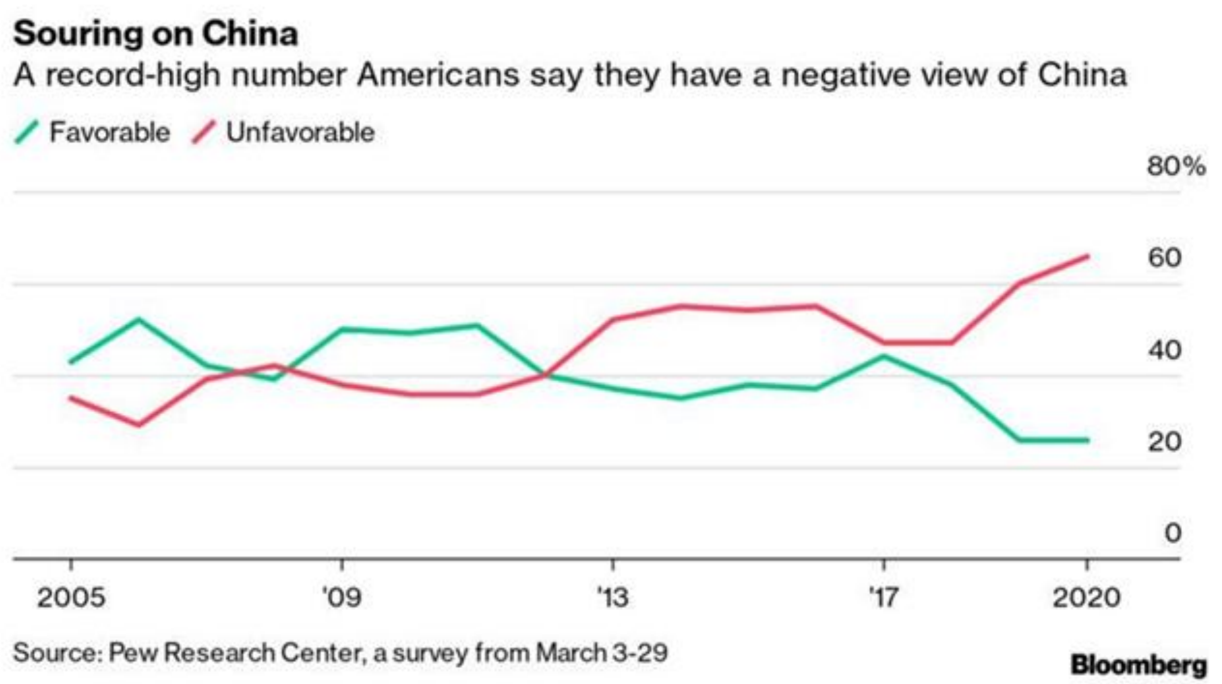
Fixed Income: For a long time now, this has been the easy part of the allocation. We were in a long-term trend of falling interest rates, which drove bond prices higher and allowed us to use bonds as buffers for equity dislocations. Rates have now reached a point where that will be increasingly difficult to duplicate, unless we believe that interest rates, even long-term rates, can go negative. We expect the Federal Reserve will resist that, but stay tuned. In our mind, markets remain unsettled enough to prefer investment grade bonds over high yield bonds, but the overall credit quality of investment grade bonds has deteriorated to a point where they do not appear all that attractive either.

Equities: With the market having recovered a substantial part of the initial decline, it is certainly possible that the next big move could be lower, but we have no special conviction in that thought. Although the risk of an economic re-opening not going exactly as expected is high, fighting the Federal Reserve and the trillions of new dollars entering the economy has usually been unsuccessful. The one trend that remains unbroken since the Housing Crisis in 2009? Global Financial Crisis (GFC) is the thirst for growth. It has been a growth-starved world for the last 12 years and growth stocks continue to attract buyers. Much of this is centered in the technology sector.
This trend seems perfectly logical and reasonable, but like every trend, it can go to extremes and it appears it might have again. The chart below shows the MSCI All Country World Index (ACWI) at the top and in orange below it shows the percentage allocation of the top ten stocks in the ACWI, which is currently above 16% and nearing the high of late 1999 just before the technology stock bubble burst. While this can certainly go higher, it is not a healthy situation for the stock market. Markets are strongest when there is broad participation in the advance of the index, i.e. when the "top ten stock" percentage is much lower within the index. When market performance becomes concentrated in a few stocks, or in one sector, it is generally a sign of weakness. Big name growth stocks can continue to lead the market higher, but a lasting market recovery requires participation from a broad set of markets and sectors.

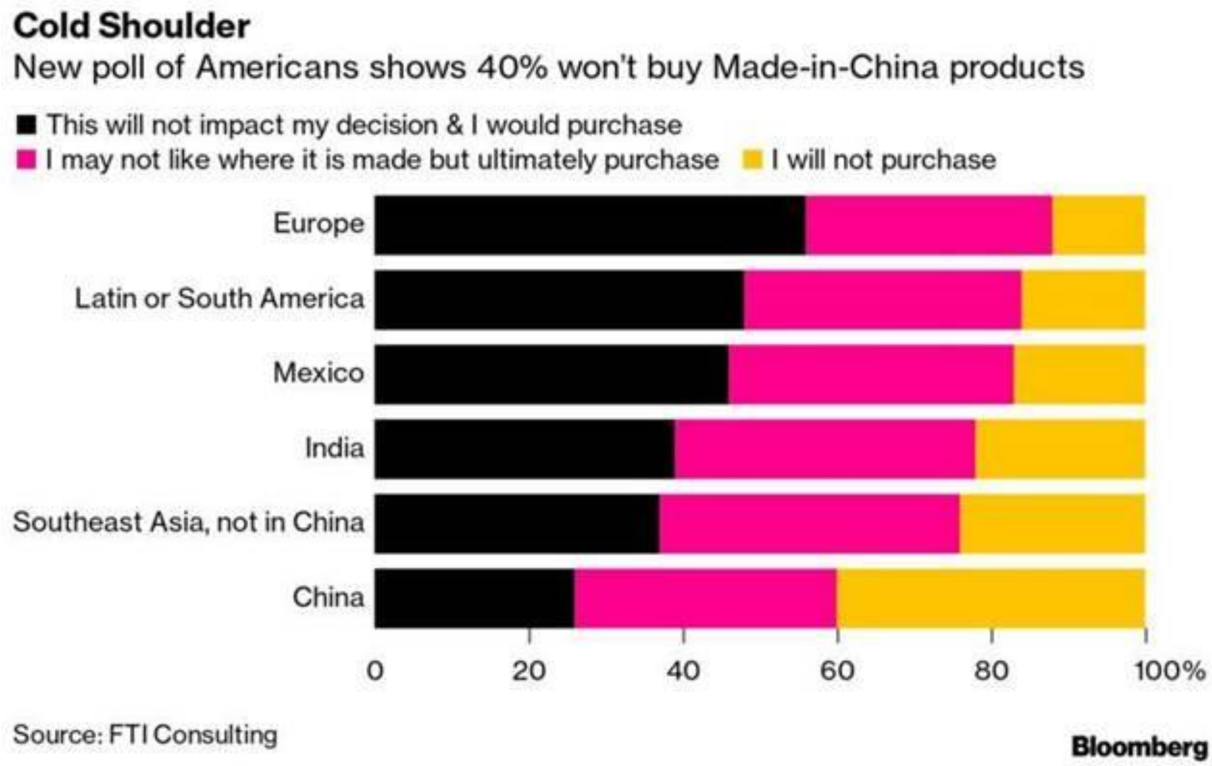
Most concentration since 2000



U.S. - China Relations on the Watch List
With all the news on COVID, the shrinking economy statistics and the re-opening fears, a very important story that will affect the future is being largely ignored – U.S. China relations, or more accurately the [deterioration of relations] with the Chinese Government.
Trade, while currently on the back burner, is a critical issue for both the U.S. and China. COVID has complicated that discussion enormously. We hear increasing rhetoric that the virus was created and released (accidently or not) in China with many Western countries are joining the U.S. in calling for an investigation. The Chinese is hitting back with an aggressiveness that is historically unusual.
From the beginning we believed that this pandemic would have a significant influence on supply chains globally, and in particular, in the U.S. The 'discovery' that we relied on China for the bulk of our protective equipment and some 80% of our key drugs was undoubtedly a shock to the average American and the impact on attitudes toward China have been felt quickly.
A record high number of Americans (about 2/3) now have a negative view of China. See chart below.



In addition, a poll conducted in May 12-14 found that 40% would not buy products made in China. By comparison, 22% said they would not buy from India, 17% would not buy from Mexico and 12% would not buy from Europe.



Other poll conclusions included these:

- 55% don't think China can be trusted to follow through on its trade-deal commitments signed in January to buy more U.S. products
- 78% percent said they'd be willing to pay more for products if the company that made them moved manufacturing out of China
- 66% said they favor raising import restrictions over the pursuit of free-trade deals as a better way to boost the U.S. economy

This increasingly negative sentiment towards China in the U.S. is giving the president room to be more aggressive in negotiations (we use the term loosely) with China. Almost lost in the Pandemic news was a decision by the Administration to block foreign chip makers using U.S. software and technology from shipping products to Huawei without a license. This is clearly designed to prevent Huawei from maintaining its current network as well as limit their capabilities in 5G. As the WSJ points out, a complete shutdown of business to Huawei is difficult to enforce in this mobile, complex world, but it is another, more decisive push by the administration against China. China will continue to fight for Huawei, as it continues on a path toward technology self-sufficiency.

Later in the week, China signaled it will impose new national-security laws on Hong Kong, which became a special administrative region in 1997 when the U.K. returned the colony to China. The 1997 agreement was that Hong Kong would maintain a separate government and economic system from Mainland China. This latest move by the Chinese means that, contrary to the 'Handover Agreement', Mainland China would have the authority to intervene in Hong Kong if events threatened Chinese security. It has been mostly lost in the COVID news, but prior to COVID, there had been massive protests in Hong Kong due to a proposal that would allow extradition to mainland China in some circumstances, rather than processing in the Hong Kong legal system, a clear encroachment on the rights of Hong Kong citizens. The proposal was withdrawn, but the protests did not stop.

This new national security proposal goes a step further and would allow China to directly intervene in Hong Kong if events threatened the security of China. This is sure to set off a new wave of protest. The U.S. administration has responded by calling the proposal a ‘death knell’ for Hong Kong autonomy.

The very clear movement is toward an economic and political de-coupling of the U.S. from China. That will not be easy, but with the realization that supply chains are significantly less resilient than previously thought, along with changing public attitudes, that result currently seems inevitable, and that would likely be a best-case scenario. The worst case would be to have hostilities break out between the U.S. and China, which is not out of the question as China increases military spending, the U.S. administration continues to send the fleet through the South China Sea and becomes more open in its support of the Taiwanese government.

The implications for U.S. industry are significant. Supply chains can, over time be altered, and likely will be altered to reduce reliance on China, but what cannot be altered is the desire of U.S. companies to have access to the massive Chinese market. Their participation in the Chinese market has been hindered by numerous restrictions and requirements for joint ventures with Chinese companies, but the Chinese market is so large, they dare not complain too much. If this escalation of tensions continues, it will surely become more difficult for U.S. companies to access Chinese markets, which would not be good for U.S. multi-nationals and certainly not good for the stock market. Likewise, it is not good for China, which has pulled itself from an agrarian economy to an industrialized economy with extraordinary speed by becoming manufacturer to the world. Supply chains pulling out of China will serve to make the countries growth goals that much harder to achieve. That, of course, risks social unrest and threatens the power of the Xi regime. It would appear that the U.S.-China relationship is likely to become increasingly tense and a driver of news and markets once the Pandemic eventually recedes.

Moderna Vaccine Trial Results

Early this week Moderna released the results of the first COVID vaccine to be tested in humans, which were taken as very encouraging early in the week, but came under some criticism later in the week. We’d like to hopefully add some clarity to what’s going on. First, as we have seen quite often lately, if an expert says something, it is not difficult to find another expert that will disagree. The point is that this type of controversy is normal when dealing with new technology. The second point is that our scientific resources tell us that the results were indeed very encouraging, but generally not for the reasons you saw in the newspapers. As we understand it, this virus has some similarities to the dengue fever virus. That has created scientific concern that a vaccine could produce an enhancing effect, which means that the vaccine actually promotes a worse case of the disease, rather than a better case, which is the reason for a failed vaccine for

Dengue Fever. Although we are able to accelerate vaccine development in general, a similar problem with COVID could set back the time-line for a vaccine substantially. Although the Moderna trial was only 8 individuals, the key finding was that the vaccine did NOT produce enhancement and was safe in all 8 patients in the trial. That is indeed good news.