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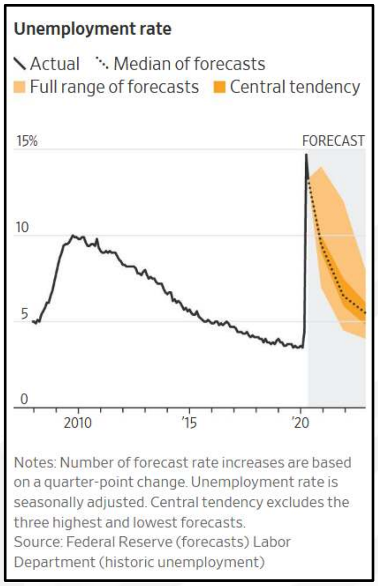
The FED Roils the Stock Market

The Federal Reserve made it very clear on Wednesday that it intends to keep its foot on the monetary gas. Fed Chairman Powell stated "We are strongly committed to using our tools to do whatever we can and for as long as it takes to provide some relief and stability".

What that means more specifically is **short term rates, which are currently near zero, are likely to stay there into 2022 (see FED projections in the chart below), but that is a two-edged sword**. The good news, which the market ignored late this week, is that the FED will continue to inject money into the financial system.



More specifically, **the FED now intends to buy at least $80 billion in Treasury securities and $40 billion in mortgage securities, net of maturing bonds, each month**, ending the gradual reductions of treasury and mortgage security purchases that had been ongoing. As we have noted several times over the last few months, Fed purchases of securities inject money into the economy and this has served as fuel for financial market advances. Since the initial surge of liquidity in response to COVID, the FED had been gradually reducing that flow of fuel, so this implies a bit more fuel to keep markets in the green.

The bad news is that **if the FED feels the need to make these changes, they are apparently less sanguine about the recovery than the stock anticipated**, and that sentiment took center stage this week as after the Fed comments, the stock market reacted violently. In his comments, Chairman Powell said the strong employment report last week was "a welcome surprise", but then added "I think we have to be honest, that it's a long road". That is evident in the unemployment projections (shown above) where it takes until 2023 to get unemployment back down to 5%. In short, **the FED was very clear that it expects a long and protracted recovery from the COVID pandemic.** The violence and destruction related to the George Floyd protests only makes recovery that much more difficult.

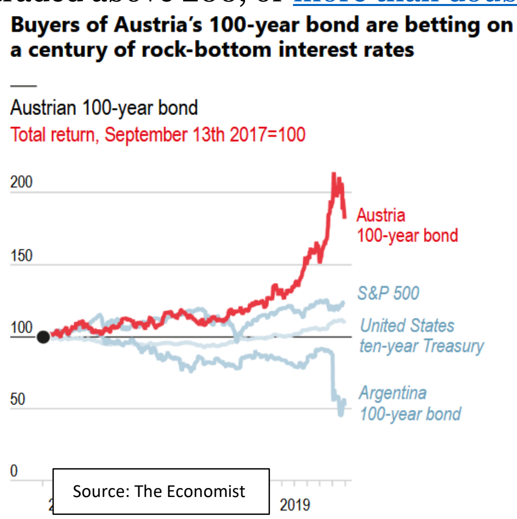
Final Market Note: Last week we discussed how retail investors were piling into the market and referenced Bob Farrell's Rule #5: The public buys the most at the top and the least at the bottom. **After this week we can confirm that Rule #5 still holds.**

Why own Bonds?

Back in simpler times, the basic investment theory was that you buy stocks for capital gains and you buy bonds for income. Of course, those were times when bonds were actually able to provide a meaningful income stream. With bonds not providing much income these days, **we have seen an increasing number of equity managers on the financial news decrying that investors would be so illogical as to buy a 30-year Treasury bond with a remarkably low yield**. They reason that surely inflation will be greater than current 1.59% yield over that time frame and owning such a bond is likely to be a very costly error in judgement.

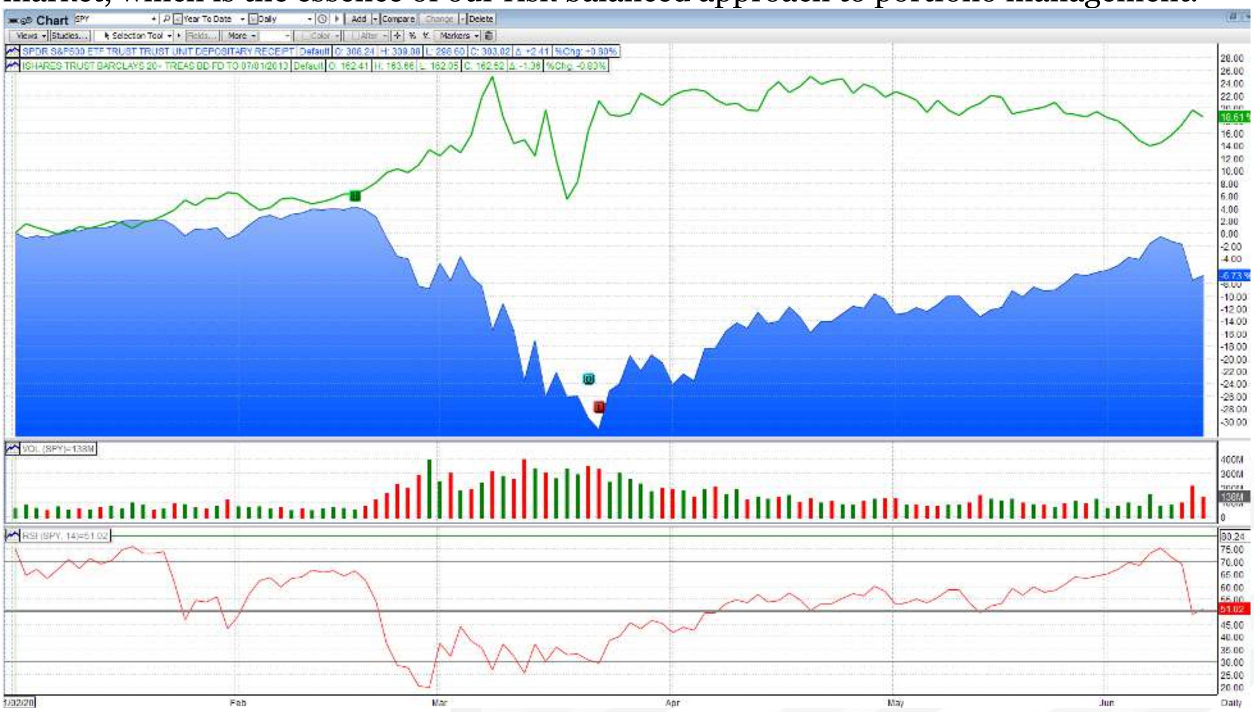
Fortunately, we don't listen to equity managers when they talk about bonds - here's why. Back in 2017, Austria sold a 100-year bond with a paltry 2.1% coupon. Surely buying that bond must have been a crazy idea. How could anyone possibly project that inflation would be tame for the next 100 years?

We argue that **the real answer depends on why you own the bonds in the first place.** Take the example of that 100-year Austrian bond. By mid-2019, that bond briefly traded above 200, or more than double the original price of the bond.



If you bought the Austrian bond for the income, yes, it was probably an error, however, if you bought that bond for a capital gain when interest rates declined, you look like a genius. The point is that you need to understand why you own bonds in your portfolio. **At PWM, our portfolio philosophy is based on owning uncorrelated assets over the long term and allowing them to compound. When structured properly, this has historically produced very competitive returns over the long term** with substantially reduced year to year volatility in the overall portfolio value, of course, past performance does not assure future results. From our perspective, that is the proper methodology to grow your assets and always be in a position to 'stay in the game' when difficult times arise.

The COVID-driven economic and market collapse is a perfect example of why we own bonds, despite the very low yields. When the stock market gets edgy, investors scramble to the exit and they need a place to go, typically, the safe haven asset of U.S. Treasuries. The buying pressure in bonds drives prices up and yields down and serves to partially offset that decline in the stock market. **As shown in the year to date chart below, while the S&P 500 was retreating from mid-February into mid-March (blue line), The 20+ Year Treasury ETF, (symbol TLT, red line) was rallying, and countering stock market declines.** There were some scary moments when both were declining hard and correlations were high, but over the course of the event, the lack of correlation came though and did its job. So, we don't mind holding low yielding bonds as they can potentially provide the needed capital gains to offset a weak stock market, which is the essence of our risk balanced approach to portfolio management.



It's Official – Recession Declared

The official declaration from the National Bureau of Economic Research came much more rapidly that usual, but was hardly a surprise. Nonetheless, it does mark **the end of the longest expansion on record (128 months) in records going back to 1854.** While the expansion was long, it was also quite feeble compared to other expansions. We suspect the declaration came quickly because 1) it was so obvious, and 2) as the economy begins to recover, we are likely to come out of the recession quickly too. **We would not be at all surprised by headlines in coming weeks touting the fastest recovery on record. Don't misunderstand, that does not mean we'd expect the economy to get back to where it was quickly, however, after a very sharp decline in GDP, it simply does not take much to show rapid growth.** The Atlanta FED's GDP NOW tool is projecting a roughly 35% decline in GDP in the second quarter. If, for example, GDP were to grow 20% in the third quarter, it would be historically very rapid growth, but would not come close to fully recovering. **Bottom line, we advise caution when reading the economic headlines in the months ahead.**

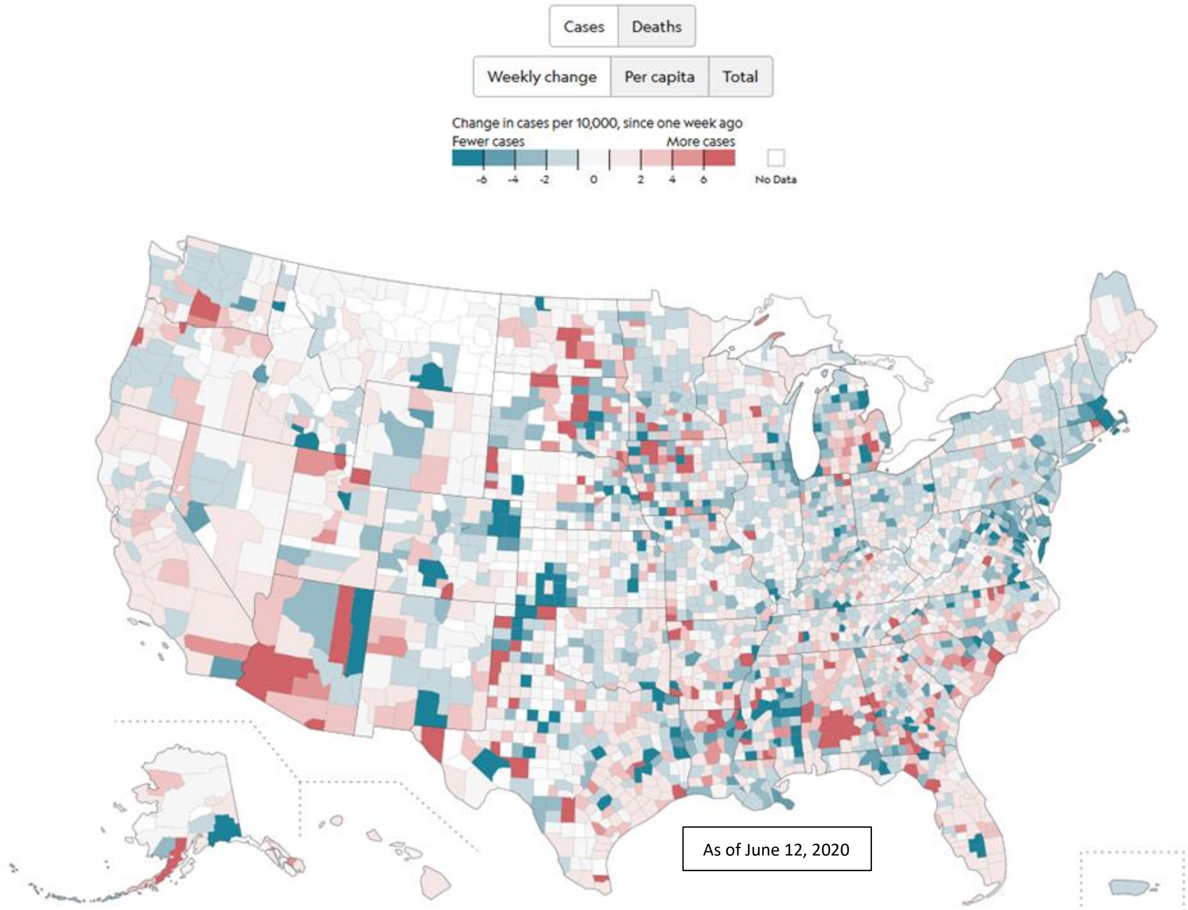
That expansion cannot come fast enough for President Trump. Looking at elections **since 1900, only once has a president gained re-election when there was a recession during the two years before the election.** The other four occasions, the incumbent lost. The winner was William McKinley, although the point can be argued, as he was assassinated less than a year later. The losers were William Taft, Herbert Hoover, Jimmy Carter and George H.W. Bush. The wild card here is that the 2020 recession was not accidental, and not policy related, so the President can legitimately argue that it was not his fault and that it would have happened no matter who was President. In any case, you can bet that this will be a point of contention, among many others, as the election nears.

The speed of recovery will also play a role here and that will be tied to both the election and the COVID re-opening. **Although we are among the majority that believe that it will take a couple of years to get back to 'normal', growth from a low base can be substantial, and that could provide a tail wind for the President, if the growth appears fast enough and any COVID relapse can be contained.**

Post-election, there is a divide in the corporate tax policy of each candidate. A Biden victory would likely mean in increase in the corporate tax rate, and therefore lower corporate profits, which would certainly be a headwind for the stock market and potentially of the economy, depending on how it is structured. Needless to say, there are more variables than usual this election cycle, and it will soon be time to buckle-in for the presidential dog fight of 2020.

Speaking of COVID

Most of the country has now re-opened to some degree and much of it has been re-opened for several weeks. **This is the time to start watching the numbers again. Are the number of cases building? If so, where?** What will the response be if it happens? Simple mathematics suggests that re-opening will produce more cases, the unanswerable question is whether that increase can be kept below the point of exponential growth, and with the stock market largely recovered, that is major concern. If the re-opening does not go well, it is hard to imagine that the market can continue to do well. **The National Geographic map below shows the weekly changes in cases reported with green indicating fewer cases and red indicating more cases. Use this link to access this map in the weeks and months ahead.** We note that if you scroll down from the map, you can access details by state and county.



From the "You Can't Make This Stuff Up" Department
We will allow the first several sentences from the Wall Street Journal to speak for themselves. You can find the entire story here. Note that a WSJ subscription is required.
"Hertz Global Holdings Inc. hopes to raise up to $1 billion in new equity from a counterintuitive stock rally while under severe financial strain, a seemingly unprecedented move from a large bankrupt company eager to capitalize on market anomalies."
"Bankruptcy experts said the planned stock sale raises questions about whether a company under chapter 11 protection can exploit equity markets for financing when the value of its shares, as with nearly all bankrupt issuers, is at significant risk of being wiped out."
Conclusion

There are many articles that we are reading detailing why the economy will recover slowly and/or why the economy will recover quickly. Every one of these articles makes some sense, and at the same time, be really confusing. I believe in life you should keep things SIMPLE. Albert Einstein said, **"If you can't explain it simply, you don't understand it well enough".** The BOTTOM LINE, as it relates to the economy recovering, comes down to the **success of reopening**. As mentioned in this commentary, if infections rise again exponentially, this recovery will take multiple years to get back to where we were pre-COVID, and vice versa, if infections are contained, we can recover quicker than people think. We can all prognosticate about this outcome, but in the end, nobody knows.

This is precisely why we believe in taking a balanced approach to investing versus betting on one outcome over another and shifting your portfolio based on that view. That is a very dangerous proposition, that if you are wrong, it can take multiple years to make your money back. Stay **BALANCED and REBALANCE** when there are dislocations in the market. Over-time, you will do very well.

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