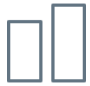

PENSION & WEALTH MANAGEMENT ADVISORS

May Bulletin

BY GEORGE P. WEBB

SCIENCE DRIVEN EQUITY MARKETS

The market has moved from being EARNINGS DRIVEN to GOVERNMENT DRIVEN to SCIENCE DRIVEN. Our government moved swiftly with fiscal and monetary policy to support the proper functioning of the economy and the financial markets. The results have been positive in the short term and taken the worst case scenario off the table, however, we all need the real economy to re-open to keep the system working. Our best hope for a full recovery is to find a way to put COVID-19 behind as possible. That will only happen with good science in the form of therapies, vaccines, prevention, and herd immunity over time. The market has reacted positively because we have made progress globally across all of those areas. There are no less than 100 different vaccines and therapies that are showing promise, and we have a “Manhattan Project” like research and production effort in place. We have already begun manufacturing large quantities of “at risk” vaccines which means some of those molecules may not get final safety approval – but we want to be able to immunize millions of people the moment one is approved.

It would not make economic sense for any company to do this – but the government can accelerate these efforts along with logistical support to rapidly immunize our population. In the interim, the economic numbers are stunningly negative as the 2Q GDP number is expected to be -38% and unemployment of over 26 million people. A recession is considered two consecutive quarters of negative GDP growth – and the market usually convulses with even a -1% contraction. How can the market be so disconnected from the fundamentals? The reason appears to be that equity investors understand that this crisis has an expiration date – we will get past it – and then it will take some time before we make new highs again. .There is also the support of the government expanding the balance sheet to support asset prices and perhaps pushing us into higher P/E ratios than what we have had historically. The chart below was published today by Fidelity Investments this week and speaks to our headline from our last bulletin. When the government expands quantitative easing – and there is no real growth in the economy – the resulting P/E expansion is asset inflation.

International equities on the other hand remain problematic as many governments around the globe acted far less swiftly and with far less force to support their economies. Their recovery will take longer and many that were already at stall speed GDP will take longer to repair. The valuations, however, remain interesting from a historical perspective and continue to have a place in our globally diversified portfolios accessed through active managers.

BANKRUPTCY DRIVEN BOND MARKETS

Bonds are usually the “canary in the coal mine” with financial crises: usually the first to crumble and tend to repair in half the time that stocks usually take to recover. This time, it has been very different with the equity markets recovering 80% of the drawdown, and bonds only about 40% of the way back from the spread widening.
High yield spreads remain elevated at 7.5% above treasuries. That is why the government has started buying corporate bonds and EFT’s for the first time in an effort to provide much needed liquidity back to the markets. The reason that spreads remain high is that we are entering the BANKRUPTCY PHASE of the crisis. Much of the issuance of corporate and high
yield bonds came in retail, energy and travel sectors. As a result, many familiar names are entering bankruptcy – Neiman Marcus, Williams Companies, JC Penny, Diamond Offshore Drilling, Golds Gym, Frontier Communications, J. Crew, True Religion Apparel, Virgin Australia and many others on the verge of insolvency like Hertz, Mohegan Gaming, Lord & Taylor. Leveraged companies, as well as well managed companies, typically do not have a lot of cash on the balance sheet (why keep it in cash if you can invest it in the business to grow or return it in the form of a dividend to investors). Well capitalized companies can usually bridge a downturn with other lines of credit – whereas highly indebted companies run out of life lines after 60-90 days. That is what is happening now – and why there is a wave of bankruptcies. It is also why the economy needs to open up – because if this goes on long enough – even well capitalized companies will run out of life lines if they have no revenue. It all comes back to the science - the risk to these weakened companies now is an unexpected second round of COVID-19 as we open up. So we remain cautious in corporate debt across the credit spectrum.

Ironically – one of the most risky securities in our opinion is the 10 year treasury. With a small yields of just .71% and a 10 year duration. If the economy heals as expected – and rates go back to HALF of what they were before crisis – to just 1.71% - the bond will loose 10% of its value rather quickly.

WHAT DID WE LEARN FROM 2008 ABOUT INVESTING?

One of the key takeaways for companies and investment managers in the 2008 crisis was that they did not model in what would happen to their investments if 30% of their businesses went away. Many found that their business models were broken - and some went out of business. The survivors then game planned for another similar recession in the future - just like generals tend to plans for the last war.

This time – many companies never expected 90% of their revenues to go away over night(airlines, restaurants, cruise lines) . I am not sure that many companies can sustain that kind of a shock for very long – but I do think that companies and investors will run smarter – perhaps even "fortress balance sheets" going forward to ensure long term survival of other crises that will undoubtedly happen over time. What impact will that have on their growth rates, ROI and long term P/E's remain to be seen.

MORE STIMULUS & HOW CAN WE PAY FOR THIS?

The government is considering new rounds of financial support – including payroll tax suspension, reduction of capital gains taxes to promote free flow of capital, and other incentives to support the economy through the storm. We will keep you posted on any additional legislation. Several clients have asked how we will pay for all of this? There are three possible ways 1) issue more debt and pay it down over time with a higher growth rate in the economy 2) issue more debt and raise taxes to pay for it 3) monetize it – or essentially inflate our way out of it. The likely outcome is a combination of higher inflation, a national sales tax rather than income tax so that everyone contributes, and issuing more debt. There are many things we can do to navigate those different situations, but the days of having a portfolio that you set and forget are unlikely to be successful going forward.

YOUR PORTFOLIO

Our investment committee remains fairly neutral on equities as we look for a clear path toward the final stage of recovery. The markets have rebounded far more quickly than anticipated, so we remain patient and will continue to rebalance on any meaningful pullbacks. Our themes across portfolios:

- Rebalanced from a slight underweight in equities to a slight overweight as we added based on valuation through the downturn.
- Overweight to US Equities vs International
- Overweight Small Cap Equities
- Overweight US Min Vol
- We continue to be highly selective on credit
- given the economic growth uncertainty post crisis.
- We have trimmed international equities due to a much slower response by non-US governments to their local economies to the crisis.

Themes under consideration by the investment committee include: tilting toward more active international equity management, trimming higher quality bonds, evaluating an potential opportunity in convertible securities.

MORTGAGE & STUDENT LOAN REFINANCING

Several of our clients have refinanced their mortgages, so we encourage you to continue to work that side of your balance sheet. Here is a link to the most recent published rates: https://www.bankrate.com/mortgages/refinance-rates/. Our younger clients have also been able to consolidated and refinance their student loans at much more favorable rates.

Please let us know if you need a contact and we can connect you to a quality mortgage specialist or direct you to banks for student loans.

GREEN SHOOTS

It is said that you never end a journey the way you began – the experience always changes you. The same will be the experience that we all have from this COVID-19 crisis. So we will leave you with a few thoughts on how things will likely be different going forward:

- We will be less dependent on others. Supply chain dependency on China will be replaced by disbursed trade arrangements with countries that are more aligned with our interests and security. Critical manufacturing like drugs and certain technologies will be on-shored - and is already happening by executive order.

- We will be more efficient. Across industries there will be a lower need to commute to work as technology has forced all of us to reconsider the way we have been working. There will be substantial adoption and productivity gains in telemedicine, logistics, teleconferencing and education.

- We will be more cautious. Companies will run more efficiently and likely be less capital market dependent going forward in anticipation of future downturns.

- We will be stronger. The economy will be stronger due to more efficiency, less dependency and better prepared for the next contagion. Just like after 911 – our airline security was greatly enhanced and the same will happen for future pathogen protocols.

- We will be more appreciative. Of our simple freedoms to travel and to go to dinner with friends and family.

We still have a way to go until we are done with this crisis – but there are significant opportunities and reason for optimism on the other side.

We look forward to checking in again as things continue evolve - so please do not hesitate to call with any questions - we are here for you.

All of us here at the firm wish you a happy and healthy holiday weekend!

George & Team

We remain fully functional for our clients and are happy to report that our business continuity plans have worked exceptionally well. As always, please do not hesitate to contact us as we move through the next several weeks of what we expect will be continued volatility.

*Investment advisory services offered through Pension & Wealth Management Advisors, Inc. The firm is a Registered Investment Advisor with the United States Securities and Exchange Commission (SEC). The team of advisor representatives operating as Pension & Wealth Management Advisors have been in business for over 35 years. Principal Office: 800 South Street, Suite 160, Waltham, MA 02453. E-mail: info@pensionwealth.com.