April 3, 2020

THE BULL MARKET ENDS

Dear Investor:

I hope to hear that you and your family are doing well as we face an unprecedented crisis brought on by the coronavirus. At this time, it looks like we will be living with social distancing and many other changes in our daily routines for at least the month of April, and perhaps longer. As I'm sure you are following the situation through several news sources, I will do my best to keep the focus of our letter on the economy and the markets.

As the title states, the bull market is over. I don't think there's any room for doubt on that. The bull market lasted 11 years, give or take a few days, and has been considered the longest in our history by many. We all knew it would end, but no one predicted that a health crisis would be the thing that caused it. The data during January and February showed that the US economy was on track and doing fine. There was some weakness, but generally, it looked like the Fed rate cuts in 2019 had been able to keep us moving forward. Things changed very fast, and some of the smartest money managers in the world have stated they did not see it coming. In less than a month, from the middle of February to mid-March, we have been plunged into a bear market, generally considered a drop of over 20%.

The current situation we are facing looks like it could be bigger than the financial crisis of 2008 and 2009. It's substantially different and is like comparing apples and oranges. The hallmark of the Great Recession was the massive over extension of credit to people for mortgages they could not afford. You may recall that many of these loans were based on aggressive ARM's, exotic mortgage terms, no income documentation, overvalued appraisals, and several other gimmicks. This enormous increase in lending caused real estate prices to appreciate rapidly in many markets. This led to the concept of many people using their homes as ATM'S. The idea was to borrow as much as you could against your house to have a good time, because it would keep climbing in value. There was plenty of blame to go around, as much of this was predatory lending by some banks and other lenders who knew these were very risky loans at best, and totally fraudulent at worst. Naturally, this couldn't continue forever, and the house of cards came crashing down. There was bad debt everywhere and it caused the credit markets to seize up. Many banks were weak, and the bad loans still on their books put them under. Thus, the essence of the Great Recession was a credit crisis based on an enormous amount of bad mortgage loans.

Our problems today are completely different. We are currently in a major health crisis. What we are doing now is trying to defeat the coronavirus by physically keeping people away from each other to slow the spread. From everything I've read, this appears to make a very significant difference, and should help us to eventually get past this. However, as I'm sure you're well aware, this has led to a dramatic “pause” in the economy. When I say this could be bigger than the Great Recession, I’m thinking of the potential numbers of unemployed and the loss of earnings by businesses of every size. This will also lead to large drops in tax revenue to governments at every level all around our country and the world. We are facing very substantial financial losses on every front. It’s a pretty grim picture. The big difference from the last recession is that this has not been caused by “bad behavior”. It’s a health crisis, and if workers are asked to stay home by the government, it’s certainly not their fault. I happen to be reading a book on George Washington right now, and I was somewhat amazed at the severe outbreaks of smallpox in the US and Europe during the time of the Revolutionary War. The towns and cities were small, but it was not uncommon to lose 15% - 20% of a local population to the outbreak. I sincerely hope that all the steps being taken now will drastically reduce the loss of life from this virus.

We know that the Fed and the Trump administration have both sprung into action to fight back against this pandemic. The Fed immediately cut short term rates back to essentially zero and has resumed the quantitative easing (QE) used in the Great Recession. They have also opened up many other programs to help with the management of credit and money markets. These are already having a big effect on the credit markets and the stock market. The administration, working with Congress, has passed a very large $2 trillion-dollar economic relief package, and there may be more to come. I don’t want to get into a discussion at this point about the pros and cons of QE or these relief programs. I’m sure that debate will go on for many years to come. The realities of the world we live in demand that our leaders take action when we are confronted with these extreme situations.

Looking forward, what might the road to recovery look like? Virtually everyone in the financial world knows that there will be a large drop in GDP and company earnings in the second quarter. The range of estimates is currently down between -16% to -30%. Goldman Sachs is currently predicting -24% and that seems quite possible. Most of the major firms are optimistic and expect positive growth again of 12% on average in the third quarter, with further improvement going into year end. Obviously, this is not guaranteed, and the positive 12% would be nowhere near recovering the losses if it happens. Our GDP at the end of 2019 was over $21 trillion. The losses we are talking about here will be in the trillions, even with the relief packages. How long it will take to recover will be first and foremost determined by the peak in the virus epidemic. At this time, that’s a moving target which keeps moving further out. Until the authorities are satisfied that we are well past the peak, I don’t expect any change in policy on social distancing. There’s no way significant growth can resume before that time. The recovery could take the shape of a **V**, a **U**, or an **L**. A **V** would be a fast bounce back to where we were at the beginning of the year. Some people think this will happen, but I’m not one of them. A **U**-shaped recovery would be more gradual, but not real slow. Perhaps over the course of the next year. I think that could be possible, and it’s a more realistic best-case scenario in my opinion. The reason I think that’s more likely is the economic damage from this will be very widespread and also deep in many situations. An **L** shape recovery would indicate a pathway back of several years. Two or three years, maybe longer. I think we have to realize this is also a very distinct possibility. I certainly hope that’s not the case. In either scenario, people are not going to be spending as freely as before all this happened, and unfortunately, many are going to have less money to spend. It will take time to rebuild consumer confidence and incomes. It’s also pretty clear our industries will come back up to speed on different timetables, depending on how hard they were hit by this.

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In conclusion, I don't think we should let our optimism run away with us. At the beginning of the selloff, the market was clearly starting to price in the very real possibility of a depression. The very strong action by the Fed and the Administration seemed to convince investors that a depression would be avoided, and it recovered some of the lost ground. These current programs are much larger than what was done in 2008. The Fed's balance sheet has already climbed to $5.3 trillion, and many economists expect it to go much higher before this is over. Some have put the number at $10 trillion. We can also plainly see that our budget deficit is going to explode and could easily hit $2 trillion or more, with no end in sight. We also know that state budgets are being decimated and they are going to be asking for a lot more help. It's not my intention here to enter into the debate of financial costs versus the loss of human life. As I mentioned at the beginning, I'm trying to limit this to economics and the market. The reality is that this is a big hit to our economic well-being, and we will be bearing these costs for a long time. All of this will have an effect on the soundness of the dollar in the years ahead. I will likely talk more about that in future letters. At this time, we all have to do our part to help slow the spread of the virus so that we can resume our "normal" lives as soon as possible.

Please feel free to contact me anytime to discuss your portfolio or the current situation.

Sincerely,

David Keim

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