Talbot Asset Management Quarterly Report

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This Time It Was Different...

I mentioned in my last newsletter that John Templeton taught me that the most dangerous words in the English language was "This time it's different." With the coronavirus, this time was truly different. I thought that in my 39 years in the business, I had seen it all. Market crashes, market meltdowns, market melt ups, 21% interest rates, 0% interest rates, Y2K, 9-11, the 2008 financial crisis, multiple recessions, etc. etc. etc. I wasn't' prepared, nor expecting, a black swan event or an alien invasion. By definition, a black swan event is "an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences." Black Swan events are characterized by their extreme rarity and severe impact. So, for the first time in my career, this is truly a black swan event.

According to Hersh Shelton, a behavioral finance economist at Santa Clara University, the virus has "wrecked people's illusion of control, which triggers the amygdala, a part of the brain that's activated by fear, sending a rush of adrenaline that can create a high that is manifested in the comraderies among early social distancing in the grocery store. But the body starts pumping cortisol if the threat continues-and that tends to diminish people's ability to engage in rational thought-creating panic." The "new normal" could bring about a new fiscal conservatism as consumers, companies, and governments recalibrate for a post virus world.

Consumers: After the Great Depression, personal saving rates exploded from almost zero to a peak of 28% of income in 1944 (source: Bureau of Economic Statistics). I have had many clients over the years who grew up during that time frame. Almost all of them had significant amounts of money. Yet, if you knew them, you would think they were on their last dime. The shock of this will undoubtedly push consumers to increase savings and reduce (or eliminate) debt. The other side of the coin will be consumer spending. There will be definitely a thought process of "do I really need this?" prior to hitting the "buy" button on your Amazon order.

The virus has taken people out of their normal routines and created new habits. Socializing online via services like Zoom or Skype have made sheltering in place a little more doable. People are working from home which will revolutionize the workforce and become a dominant trend in commercial real estate and reassess the need for business travel.

This makes the need for and the demand of technology infrastructure more likely. Faster and more secure digital networks will be here sooner than later as will be the development of "5G" wireless technology.

The number one thing consumers want after this pandemic is to go back out to eat. I guess you can only eat so many peanut butter sandwiches before you want a great meal. The virus will force restaurants to reduce capacity to create distancing between customers. This will lessen their need for as many employees, but force them to raise prices. Leisure will become more expensive.

This will happen in airlines as well. After 2008, airlines reduced capacity by cutting unprofitable routes, raised prices and instituted the highly profitable (but unpopular) bag fees. Airlines will do the same thing again. As an example, I have owned a timeshare in St. Maarten for over 30 years. I have been there 25-30 times. It normally costs $600 per person round trip. For giggles, I thought I would go ahead and book the ticket for next January thinking I would get a great deal. I recently went to Delta.com and found the cost at $2400 per person. Needless to say, I decided to wait a bit.

Corporations: Companies will find that cash is king. For the last twelve years, companies have borrowed money because interest rates were so low. It made sense and interest rates were very low and they could borrow on their assets with historically low rates. Disney offered 30 years bonds at 2.5 percent. Financing theme parks at 2.5% interest made sense. However, multiple companies borrowed money for purposes that weren't necessarily for asset development or asset purchases. Instead, they used the borrowings for stock buybacks or other forms of compensation. Some increased dividends, but due to the double taxation of dividends in today's current tax code, most companies opted for buying back their own stock to increase shareholder value. The practice of using corporate cash for stock buy backs has now developed into a bullseye on its back. Companies will most likely discontinue issuing debt and becoming more leveraged for purposes of stock buybacks. They will still use debt for acquisitions while rates are low. In fact, you will probably see many companies get acquired over the next few years as larger companies with tons of cash make acquisitions. However, the most likely trend is companies maintaining their cash and returning more cash to investors via dividends rather than the political target of stock buybacks.

Companies have found during this virus that their supply chains have been disrupted, especially in pharmaceuticals and medical supplies. Companies were already starting to move their factories out of China due to the tariffs enacted by President Trump. However, this has made them realize that going to the low-cost producer is not always the best alternative (I will discuss this later). Regionalization will be the trend. Globalization, as noted in my prior newsletter, is probably going to take a big hit. Automation and robotics will also be a huge part of this supply chain restructuring.

I firmly believe that companies will also be more inclusive in how they grow the company. What I mean by that is that being a shareholder in the company will include communities, employees, as well as shareholders. Companies will find the most brand loyalty when they combine all three attributes. They will make more employees shareholders as well as spending more of their resources in helping their local communities. Shareholders will be an important part of the loyalty factor too as companies will want investors who firmly believe in their mission. I would love to get back to where companies like Carnival Cruise would give discounts to shareholders and Disney would give you discounts to the theme parks. It's possible…..

Government: Unfortunately, borrowing money to get out of a crisis is not a sound long term economic policy. Borrowing money for consumption by state or local governments is a recipe for future problems. The Federal Government has the ability of printing money that the states don't have. In this environment, they print money to pay back their borrowing. This historically causes inflation and usually causes bond investors to lose purchasing power as they get their principal back but their money doesn't go as far. States don't have the luxury of printing money. This virus has created a very bad scenario for high debt states with large government employee pension plans. Illinois is a perfect example as they have incredibly high pension costs for government employees. However, I'll use the City of Winter Garden (where I live) as an example. For years, they have had an actuarial assumption of 7% rate of return for their employee's pension plan. This means they assume they will earn a rate of 7% on the return in the pension plan. If they don't meet this return, the city has to put in money to make up for the short fall in the returns. With the stock market declining and interest rates at next to zero, several cities and states will be forced to increase their funding into these plans or become "unfunded". By having "unfunded pensions", it creates a problem where cities will have to hope for increased returns or have to raise taxes to meet those obligations…..good luck with that. Thus, right now the tax-free municipal bond market is very dicey as the stronger states and cities with lower liabilities will win out while the ones with large amounts of debt will have problems.

Regulations are going to be a huge topic of discussion going forward, both at the federal and state levels. On one hand, the Federal government has been lowering most regulations super-fast while certain states have been raising regulations. The advancement of drugs during this crisis has taken front and center stage. A cure or a vaccine for the disease would have taken five to ten years in past environments due to the regulations. Now, it could take 3 -18 months for that to occur. Ladies and gentlemen, that is historic. On the other hand, governors have stepped into the arena and made certain promising treatments such as hydroxychloroquine off limits. The ability of governors to also limit religion (such as arresting people or giving tickets to church goers who remain in their cars) has pointed out the high probability of various freedoms being restricted going forward depending on where you live. I believe there will also be TONS of lawsuits from business owners towards various states or cities where they have unilaterally forced businesses to close (and maybe go out of business) where they had little to no exposure or could have adapted accordingly. As an example, let's say you had a machine shop working 9-5 with 30 employees. Why couldn't that business owner make the decision to have 3 eight hour shifts of 10 people with social distancing as opposed to outright closing the business? There are lots of Constitutional questions that will be debated for years to come.

Futuristic Thoughts: Undoubtedly, this virus will reshape the landscape going forward and have lasting impacts on multiple fronts. I'm going to take a stab about futuristic thoughts and the changes that could be on the horizon. These are various thoughts in no specific order. These are all my opinions and could change rapidly depending on how things evolve.

The Stock Market: In my prior newsletter, I felt that buying quality blue chip stocks in companies with good balance sheets and good dividends was a good scenario. Unfortunately, the historic volatility in the market on a daily basis has made it seem like going to Las Vegas without the free drinks. Most investment research is worthless right now as every company has no idea what their revenues or earnings may be (with a few exceptions). I'm not sure when a final bottom will be made (although March 23rd does look like it may have occurred but we won't know for sure for another few months). I still believe buying high quality dividend paying blue chip stocks makes sense for the long term as this will now also become a big source of investment income going forward.

Made in the USA: I have heard from several sources that companies are preparing to move their manufacturing and supply chains back to the US or at least North America. They were already doing that prior to the virus due to the tariffs as companies realized their products were outsourced to a very unreliable producer. Companies feel that the consumer is now willing to pay 10-15% more for the "Made in USA" label. This is "Made in USA" investment theme could include everything from steel, lumber, concrete, industrial suppliers, railroads, trucking, automation, robotics, etc. etc. I am pretty convinced this will occur and am preparing various "Made in USA" investment portfolios.

As I mentioned in my last newsletter, this moving of manufacturing in China will come at an economic cost to them and has a risk of de-stabilizing the Communist Party in China. There have already been videos coming out of China showing various crowds of citizens getting restless. According to CNBC in a recent report, the Communist Party has been going to companies with manufacturing there giving them concessions to stay. This is interesting as that has never occurred as the Chinese always made stringent demands and now, they are offering concessions. There are several state-owned enterprises that could collapse, if we decide we don't want the "Made in China" label any more. In fact, I am convinced that a majority of consumers will most likely not want to buy anything with that label going forward.

If the "Made in USA" label does come to fruition, the country could emerge in even a better place than we were before but that will be months down the road.

Deglobalization: Without a doubt, this will drive a stake in the "We are the World" movement. Borders will matter.

.European Union: Speaking of borders, when Britain wanted out of the European Union, Italy also made overtures. Italy's case was more complex because they were part of the Euro. Britain never integrated their currency like the rest of the European Union. Thus, in theory, it was somewhat easier for Britain to exit the European Union. After this virus runs its course, I wouldn't be surprised if Italy also says, "we want our borders back". Spain could also fall into that category as well.

Gold: If Italy and/or the European Union becomes less unified, gold will be a beneficiary of that. Investors will use gold (and maybe the dollar) as a currency option as the Euro goes through a disruption. As the US also goes through this borrowing spree with future potential inflation on the horizon, gold also makes sense. If the economy also gets even worse, gold may provide a hedge. It's been shown that if you had 5 percent in your assets in gold during the Depression and lost every thing else, you would not have lost money. I am liking the gold option, but not to the 5% allocation-yet. If you are making money on gold, you could be losing it on everything else. The wild card right now is that almost every gold mine in the world has been shut down due to the virus, causing supply disruptions. Gold is the ultimate supply and demand investment. So, you could have lots of people selling their excess gold at the same time you have supply disruptions.

Airlines: One of the industries impacted the most from this demand destruction as been airlines. Who wants to fly when everything is shut down? Airlines are VERY difficult to trade. You almost have to buy them when everyone thinks they are going out of business and sell them when they are making money hand over fist. Now is one of those times when some airlines could go out of business. I pointed out earlier how they never let a crisis go to waste and they will justify higher fares. The surviving airlines will probably create a "take or leave it" model as they raise their capital structures for the next crisis.

Cruise Lines: I admit I liked cruise line stocks and it hurt me here in the short run. I believed the demographics were outstanding for the industry. Plus, it takes one or two billion dollars to build a new cruise ship at the same time ship building yards were at full capacity with other vessels. No new supply while demand was outstanding…..The virus caused demand destruction for this industry and the stocks have been punished. The cruise companies have reported that 2021 demand has shown improvement at the same time the Saudi Arabian Sovereign Wealth Fund took an 8 Percent position in Carnival Cruises Lines. I don't see demand roaring back anytime soon but the probability of dirt-cheap cruises is in the cards.

Employment: We had the lowest employment in over fifty years—until the end of February. The virus destroyed years' worth of employment gains. The longer these shut downs go, the more likely that small businesses never come back. First Trust is predicting that if things open back by May 1, 93% of businesses will return. If we wait until June 1, they believe only 80-85% will return. If the Made in USA theme comes true, then that will bring employment back in certain areas. However, since most businesses will experience restructurings, they will rehire only their A or B list employees and therefore, not all employees will be brought back.

Bonds and Interest Rates: Interest rates on Treasury Bills recently went to NEGATIVE interest rates for the first time ever. This means if you buy Treasury Bills, instead of earning interest on your investment, you will have to PAY the government for the luxury of you having a "safe investment". I know, it doesn't make any sense to me either. Interest rates on CDs and money market funds will be coming back to zero in the next month or so.

There could be opportunities in some high-quality corporate bonds or high- quality tax free municipal bonds but there are still lots of invisible land mines out there. And I mentioned many times in these newsletters that you can lose money on bonds if interest rates go up. So, I'm treading carefully in the fixed income space until things have more clarity.

Working from home: The virus has causes millions of people to work from home. Internet providers and video conferencing companies have seen unprecedented demand. The ease and simplicity of this has shown that companies don't need those high- priced real estate offices in major cities. If you have 20 floors of a commercial building and realize that 80 percent of your employees can work remotely, then you may only need 3 floors. Commercial real estate in major cities could be a land mine and a place to probably avoid. Thus, internet providers will win while commercial real estate could lose.

The "Amazon" Economy: The virus will expand shopping from home exponentially. As we all realize, Amazon will benefit from that, but major delivery companies will also benefit. Other online companies will also benefit and are currently exploding. Privately owned Omaha Steaks is an example. They have had a 1200% increase in business, started a second shift and expanded their call centers (with people working from home). Their motto right now is "If you can't go to the Steakhouse, let us bring the steakhouse to you". Winners: Online shopping and delivery companies. Losers: Brick and mortar companies that do not adapt to this new environment.

Housing: I have heard several comments from people about how they would love to be out of the city and have a small house in Americana. Working from home will accomplish that. In my opinion, this could cause a significant decline in home values in places like New York City or San Francisco. In some faster growing states such as Texas or Florida, you could even see faster building as the price of lumber has dropped over 30% in the last two months at the same time mortgage rates have dropped to 3-3 ½% interest rates. If you have a high mortgage rate, you should see if refinancing makes sense for you.

Education: A popular saying is "When the tide goes out, you'll know who is wearing a swimsuit." With secondary education, the virus has definitely exposed who is wearing the swimsuits. Student debt was already becoming a political topic even before the virus arrived. In 2008, the Obama administration took over the financial backing of student loans, and in the process they eliminated most underwriting requirements to get the loans. If you were a student….you could get a loan. Due to the ease of getting a loan, colleges began to raise tuition much faster than inflation or any other realistic valuation. They also luxuries you were a student….you could get a loan. Due to the ease of getting a loan, colleges began to raise tuition much faster than inflation or any other realistic valuation. They also created luxuries that are usually found at all inclusive resorts. From lazy rivers where you could inner tube to rock climbing walls, these universities sometimes were resorts for students. With this came inflated salaries for professors or administrators. It was widely known that Elizabeth Warren earned $400,000 for teaching ONE class. It is not widely reported how Ron Guenther, the former athletic director at the University of Illinois, is receiving over $473,000 in an ANNUAL pension from the State of Illinois University Retirement System.

The tide has probably turned now and we'll see who took their snorkeling gear with them. There was already a movement in place to take online courses from some of the best instructors in the US. I have mentioned before how if you could take engineering courses from MIT online, why go to Eastern Illinois University? The rapid closing of universities and putting their courses online has exposed the reality of how online learning can be used to drive down costs. Upper class courses should continue to be live and interactive, but should English 101 or College Algebra? It would not be surprising to see the business models of universities change dramatically. Remember, they are essentially businesses. I originally thought that 10-20 percent of universities could go out of business in 10-15 years. This could speed it up to 5 years. The student loan free lunch has probably come to an end. I tell students that if you live like a professional while a student, you'll probably be living like a student when you are a professional due to the loan debt. This crisis could make college more affordable and you won't need millions of dollars in a 529 plan.

<u>Biotech and Pharmaceuticals:</u> This crisis has shown how biotechnology, DNA sequencing, genomics and the advancement in medicine can move rapidly if government just gets out of the way. Look for incredible advances coming to market much more rapidly than ever before.

<u>Telemedicine:</u> This trend will also explode. I had a telemedicine appointment with my doctor recently. I could even send him an EKG off of my Apple watch if needed. This movement in wearable medical devices and telemedicine will also evolve rapidly.

<u>Staycations:</u> The Made in USA movement will also cause an increase in the Stay in USA movement.

<u>Movie Theatres:</u> Regretfully, this has probably started the decline in movie theatres. Disney, Comcast, and Netflix have already created streaming video services where you could have movie studios bring their product straight to your home (maybe on a pay per view basis). As people want to stay in and continue distancing, people would rather pay money and watch it from their living room than head to the movie theatre. AMC theatres has already announced they are near bankruptcy.

ZOOM meetings now available: With video conferencing become more popular, I do have the ability now to have zoom meetings with you from the office. Let us know if you would like a zoom conference in the future and we will set it up. Over the next few years, we will probably work on having several reviews through Zoom or other video conferencing means. I haven't set up an office video studio yet…but you never know….

Notes from Nancy:

Cares Act updates:

- IRS postpones 2019 tax filing deadline to July 15, 2020
- IRS waives Required Minimum Distributions for 2020
- IRS waives premature distribution penalty for certain Coronavirus related distributions

⇒ A coronavirus-related distribution (CRD) is defined as any distribution made on or after January 1, 2020, and before December 31, 2020, to a qualified individual, defined as an individual (or the spouse or a dependent of that individual) who is diagnosed with COVID-19 or SARS-CoV-2 in an approved test; or an individual who suffers related adverse financial consequences, or suffers from other factors as determined by the Secretary of the Treasury.

⇒ Up to $100,000 in coronavirus-related distributions (CRDs) can be withdrawn by an individual from eligible retirement plans. These distributions will be exempt from the 10 percent early distribution penalty tax.

⇒ There will be a three-year repayment period beginning the day after distribution, during which one or more repayments may be made, not to exceed, in aggregate, the amount distributed. Taxpayers can recontribute these amounts to an eligible retirement plan or IRA.

⇒ CRDs that are recontributed within the three-year period will be treated as having satisfied the general 60-day rollover requirement.

⇒ CRDs will be taxed ratably over a three-year period, unless an individual elects otherwise.

As always, please consult your accountant or tax advisor regarding these changes.