MALLARD Financial Partners INC

MALLARD MARKET ALERT – 3/17/2020

It's Time to Talk about a Recession

We prepared a whiz-bang Market Alert over the weekend, but Monday's news and market actions made it out of date. It is time to talk about the likely recession which should officially begin on April 1st (a recession is officially a decrease in the economy, as measured by the GDP, for two successive calendar quarters). The impact of the coronavirus in our country is expected to have serious, measurable effect by the 2nd quarter, and continue at least through the 3rd quarter, hence we now expect a recession.

Obviously, this recession was predominantly caused by the global coronavirus pandemic, however an oil price war between Saudi Arabia and Russia joined in to seal the deal. US stock markets were making record highs last month, but **almost every investment is down sharply in the past month**. US markets are down from 29 to 38% (small caps and value stocks have been hardest hit) and foreign stocks are down 26 to 33% (with emerging market stocks falling the least). While Government bonds have done well (especially long-term government). Quality corporate bonds are mixed, with short-term down 1½%, intermediate term actually up almost 1%, but long-term down 3½%. Municipal bonds are down 1½% to 4½%, with shorter-term ones down the least and long-term down the most. Opportunity bonds are down more, with multi-sector bonds down 7%, municipal high-yield down 5¼%, and corporate high-yields down almost 12½%. It isn't inappropriate to use the term 'panic' to describe the markets recently.

The most important question at this time is not will there be a recession, or even how deep and long will it be, but **is the recession already priced into the market?** Those other two questions are important, but pale in comparison to the last question. The challenge when answering the question is that it relies on confidence in the unknown. When the US invaded Kuwait and Iraq, we didn't know how that would go. The same was true after the terrorist attacks on 9/11, the dot-com blow up, and the 2008-2009 financial crisis. This appears to be the worst pandemic in a century, and pandemic paths come with a wide range of outcomes. Furthermore, with pandemics the impact (the spread) occurs at a literally exponential pace for a time period, and thus **estimates and projections are outdated as soon as they are made** (hence our worthless Market Alert draft from this weekend).

We know this. Stocks are down about 30% (or more). Lacking a time-travel machine, that is painfully behind us. Our task is to make the best investment decisions, with the S&P 500 down 30%, foreign MSCI ACWI stock index down 28%, with 10-year US treasury bonds yielding ¾%, 10-year municipal (tax-free) bonds yielding 1¾%, and corporate high-yield bonds offering over 8%. In past financial crises (whether spawned by a financial sector meltdown, tech bubble, or external event), safety investments such as cash and government bonds have provided awful results once the panic begins to dissipate. Furthermore, as painful as it is, the investments which dropped 20% or more provided very strong results, again, once the panic recedes.

If you invested in US stocks at the peak of the market in October 2007, you would have lost 57% by March 2009, and it would have taken three years for you to be back at your previous peak level. But let's consider transporting you back to October 2008, with markets down 40% or so. If you were considering 'going to cash', you would have missed the final 17% or so decline (a very good thing, which would have felt great), however you would have missed the steady recovery which by the summer of 2009, and would have left you well ahead by year-end if you had stayed in stocks in late 2008.

We cannot escape the 30% decline of the past 30 days, focusing on it is analogous to driving your car while staring out the rear view mirror. **Investors have very serious decisions to make, and this requires focus on what is beyond the windshield.** The US economy is very likely entering a recession. There is likely to be a global recession. It is quite possible that this likelihood is already priced into the market. Recessions end, and with them, economic activity increases. Similarly, companies' profits fall during recessions, and rebound afterwards. Since stocks are measures of investors' confidence in **future** profits, stock prices typically fall before earnings fall. That is certainly the case now. Similarly, stock prices rise when there is an expectation of earnings rising, well before earnings actually rise.

The economy (and company profits) is expected to fall for two or more quarters, to have shrunk for all of 2020, have a modest recovery in 2021 and a stronger recovery during 2022. While these are pretty current expectations, they simply guesses. Once investors conclude that we will eventually come out of this, stocks should stabilize, and investors should make more economic-driven rather than emotion-driven decisions. It could take a while until that comes to pass.

This provides us with an apparent opportunity, a significant one. US stocks haven't been this cheap for seven years, and were never this cheap for the twenty years between 1997 and 2007. Foreign stocks are yielding almost 4½%. High yield bonds are yielding over 8%. Just rebalancing portfolios to long-term target levels of stock should be very financially beneficial over the next five to ten years. Even simply holding on to what you have today in stocks should be extremely superior to cashing out.

At Mallard we have been through many painful crises. None have been like any past one, and this is certainly not an exception. However, in each case, history has shown us the likely pattern, the panic and over-reaction in the decline, the inability to see it coming, or identify the bottom. It has also shown us that **once a downturn has begun, investors are best-off holding-on**, or even boosting their stock levels, painful as it feels at the time.

Drop & Give Me Five™ (D&GM5) is one of the two unique investing strategies we designed for clients. It is designed to enable clients to 'buy dips' which might otherwise be unavailable when their portfolio is rebalanced once every three months. It permits a 'snap-rebalance' 'out-of-cycle.' Some of our clients have opted-into this program, and each of them had their D&GM5

order fire during this market turmoil. We do not, however, immediately enter a new D&GM5 order once one fires, as not all declines are dips, and we have not received our clients' approval to execute one D&GM5 order after another, as markets fall and fall, as they have been doing. Only one D&GM5 order is entered in between quarterly rebalances.

Firewall Investing™ is our second unique investing strategy. We developed it in very early 2009, during the financial crisis. It is not designed to maximize investment results; it is designed to avoid costly financial mistakes. Historically, one of the worst financial mistake is to sell stocks as they are falling or once they have fallen. In early 2009, the anxiety level of our clients was very high, and there were many who were considering cutting back their stocks after they had fallen 25% or more.

For the second time this month, Mallard's Investment Committee discussed whether to implement **Firewall Investing™** last Thursday. We unanimously agreed to **not** do so on a firm wide basis (as we had done in 2009). The reason was two-fold: **Firewall Investing™** will most likely produce weaker investment results than if it is not used (as it prohibits purchasing more stocks at the current, apparently cheap, levels), and we have found that few of our clients are expressing a high level of anxiety over the stock market decline. We cannot be certain, but we would like to believe that this low level of stated anxiety is due to the success of our emphasis over many years on long-term, patient, disciplined investing.

<u>If you are very worried about your portfolio</u>, and are tempted to ask us to cut your stocks, we encourage you to take one or more of the following steps. Recognize that the market has already cut your stock level, as a natural result of a stock market decline. Reach out to us by phone or email, and share your concerns. Give us an opportunity to address your concerns. If you remain certain that you would like to take a step to control the risk in your portfolio, contact us and direct us to apply **Firewall Investing™** to your portfolio. While we are not doing this for all of our clients, as we did in 2009, we are willing to do this for clients who opt-in, who request it. If you still feel that you must direct us to sell some of your stocks, please phone or email us and we will determine the amount you want us to sell and we will do so.

<u>What if you see this time as an opportunity?</u> If you share our view that, despite the substantial uncertainty on the world's path with the Coronavirus, today's prices have left stocks cheap, the simplest thing to do is nothing. We rebalance all ongoing clients' portfolios every three months, and at the current market levels, this should result in substantial purchases of stocks. As I (Paul, as a Mallard client) noted on Thursday's conference call, I took a further step and requested that Mallard raise our stock target level from 65% to 80%, and requested this be executed as soon as practical.

While we typically rebalance a third of our clients' portfolios each month, given the sharp decline in stock values, **we are striving to increase the pace of rebalancing**, and thus be able to start the April and the May rebalancing well ahead of schedule. Our new reporting format and procedures have improved our efficiency and enabled us to speed this up. As is always the case, we are also working on technology upgrades. Specifically to integrate new software to further improve our trading efficiency. Our emphasis on tax-efficient investing adds much complexity to this project, however complexity is never something we have shied away from.

In our conference call last week we noted that we have promoted Joe to serve as Mallard's CEO, Chief Executive Officer (in addition to continuing his role in the Investments Department). He noted that, in light of the best practice of social distancing, and in preparation for possible mandated quarantining, Mallard is testing out working-from-home for all of our employees. We tested this Monday the 16th, to see how well the systems, including the phones, work when we are working from our homes. We want our work for our clients to be as unaffected as possible should work-from-home be mandated in coming days and weeks. Our accessibility to you is extremely important to us, especially during difficult times.

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