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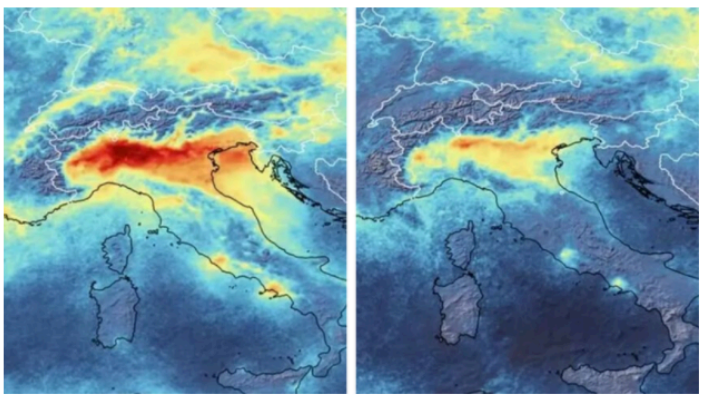
A New World



When I last wrote, a Swedish teenager had politicians and central bankers struggling to demonstrate that they were taking climate change seriously. All that noise and now this! Commutes to and from our city centers have collapsed and so has air travel. Industrial output and related pollution is sharply receding—take a look at the change in NO2 emissions over Lombardy, Italy's industrial heartland, during the past two months. The impact in places like Germany or China is as dramatic and far more impactful. I suspect that for the next many years, politicians will desperately try to resuscitate the world's key industrial centers.

Meanwhile, Angel Hernandezcinto of Orlando, Florida has been arrested for allegedly stealing 66 rolls of toilet paper, valued at 99 cents each, from a hotel. Local media outlets report that he faces up to five years in prison. At a food market in rural Michigan, a stranger handed Julie Huguelet an envelope with a hundred ten-dollar bills, instructing her to divide the money among the exhausted staff. Such are today's news stories.

BBC News - Home

- Coronavirus: Italy's death toll overtakes China's
- Coronavirus: Queen urges UK to 'work as one' in message to nation
- US jails begin releasing prisoners to stem Covid-19 infections
- Coronavirus: Trump blames media for virus spread
- Coronavirus and how it's changed our world
- Coronavirus: UK interest rates slashed to lowest level ever
- 'India must prepare for a tsunami of coronavirus cases'
- Coronavirus: Asian nations face second wave of imported cases
- WHO head tells Africa to 'wake up' to coronavirus threat
- Coronavirus: EasyJet staff may no longer be given food on shifts

Even the stately BBC has succumbed to virus mania. Depriving us of titillating stories about Harvey Weinstein, the late Jeffrey Epstein or royal indiscretions, the network's "top-ten world news stories" have, since March 19, almost exclusively been about the COVID-19 topic (see the table on the left).

The bottom-line: the world is a new place. Not just "out there", but in our homes and workplaces. From here on, we'll be doing many things differently, maybe for a few months and maybe for decades to come. Our feelings have changed too. Stress and anxiety rank more prominently in our emotions, but we're also learning a lot about our capacity to cope with adversity and help others.

A Catalyst, Not the Cause

Let's talk about how we got here. Yes, as governments, central bankers, the corporate elites and investment professionals tell you, all this commotion is being caused by the virus. Yet that is only half the story. The other half is that while the coronavirus is a potent catalyst for change, it is not the cause for the numerous dislocations that are underway. So dysfunctional was the policy construct that existed prior to the virus' arrival that any number of problems would have derailed the status quo. A total reset of existing policies was urgently required because, in very simple terms, nothing worked any longer.

Consider a few of the key problems of recent years:

> -Economic growth has only been possible with ever larger liquidity creation by the world's central banks.
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> -Debt levels in most developed nations were at astronomical levels—at the government, corporate and individual level.
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> -Few large corporations have been spending money on productive capacity; the vast majority used capital to buy back shares and reward their top executives.
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> -The result has been an ever greater increase in wealth disparity, most noticeably in the United States.
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> -I can't think of handful of policy platforms that were not utterly mismanaged. Whether we look at health, education, agricultural, industrial or environmental policy, the direction we were going in was utterly unsustainable.

I imagine that most of our clients fiercely believe in free enterprise and dislike socialism, yet I'd also take a bet that many of you feel badly let down by what capitalism has become. Well, what we're now getting is the most comprehensive reset since the Great Depression.

What's important to understand is that the huge fiscal stimulus that is being applied by governments everywhere may relieve immediate virus related pressures, but will not remedy the countless problems that have been allowed to build over the past many years. If we are to actually 'fix' things, almost everything has to be re-thought and rebuilt—most tragically, by the same sad crew that let things deteriorate to such an extent. Moreover, there is also the possibility that other catalysts may come into play and complicate things further. A serious wobble of the technology platforms on which virtually everything is based comes to my mind first, especially in view of a supply chain that's very dependent on China and a service capacity that resides primarily in India. Let's hope we can avoid that.

The Consequences

No one knows how long the coronavirus crisis will last or how many lives it will claim, but some of the social, economic and political consequences are becoming increasingly clear. "Social distancing", a misnomer if there ever was one, may have created more physical space between us, but it's brought people together on a much deeper level. Let's hope that lasts. An equally weighty change has been brought on by mandatory working from home. The affected managers, insurance and banking operatives, travel agents and accountants I've talked to seem to enjoy not having to drive, bus or train-ride to their customary downtown towers, while feeling they can do as good a job at home. As importantly, employers appear surprised by the ease with which the transition has unfolded. Given the huge cost companies have historically incurred on office space and equipment, I'd be surprised if we ever reverted to the *status quo ante*. (Or, put differently, I'd hate to be invested in anything related to commercial real estate).

I'm also convinced that consumer spending, by far the largest portion of America's GDP, is going to collapse. When I first arrived in North America in 1972, the concept of "charging it" was new to me. During the past 50 years consumerism has not only reached unimaginable heights, but also resulted in unsustainable indebtedness. The $2 trillion U.S. bailout package that will bail out corporations and helicopter $1,200 into the pocket of every adult and $500 of every child will not make much difference. The culture of consuming today at the expense of tomorrow is in critical care and unlikely to survive.

Then there is "the emperor without clothes" factor. In the United States, the shortcomings of a woefully underfunded health system and a self-serving medical-pharmaceutical complex have now been widely exposed. (What, the nation that spends more than $800 billion on senseless and invariably doomed military adventures turns out to have been one of the least prepared for this crisis?) In Europe, COVID-19 has made the incompetence of bloated, centralistic bureaucracies visible like nothing else could have. (Imagine, Italy getting help from Russia, China and Cuba, but not from Germany or the EU).

Holding on to Power

Indications are that the corporate class and its faithful servants in politics, the central banks and the media won't likely submit to the outcome I suggest. The creative destruction of a system that has been dysfunctional for some time is not an option for them, primarily because it's their system. Throughout history, control structures have desperately clung to power at any expense, at least as long as the people let them. So, in the end, the most important question centers on the socio-political outcome.

My impression is that millions of people sidelined from their usual pursuit realize they've been badly led for a long, long time. Will they rise and demand change, or will they do what they almost always did—follow the pied piper into the realm of new, unfulfillable promises? Or will the now desperate elites go in a wholly different direction and create an external enemy that will unite the frightened masses behind them? I don't know which it will be, but all three are scenarios I'd rather not contemplate.

How We've Fared

In a meltdown like the one we're experiencing, everyone loses. Fear and paralysis are followed by mass liquidation of anything that is, well, liquid. Stocks were first, then bonds and even gold were tossed overboard as the financial crisis unfolded. Less liquid assets will be next—real estate comes to mind first. Think asset meltdown, income loss and unemployment, delinquencies and foreclosures.

As our clients and readers know, we've been extraordinarily cautious. After 2016-2018, when cumulative appreciation totalled 52%, we turned defensive in 2019, reducing our equity exposure to 48%. The remainder was held in cash and gold. Gold, despite intermittent sell-offs, has been the best-performing asset during the past few months. Our overall performance so far in 2020 is negative, but far less so than benchmark portfolios. Asset values have dropped by just under 6% during the first quarter, compared to a decline of 20.6% in the S&P 500. And that is what really matters: in a downturn, the key objective is to lose a lot less than what others lose.

The question of the moment is whether we should further adjust our portfolio balance. To answer that, we need to revisit the merits of every asset class. Let's take a closer look:

Bonds:

Arguably the worst asset class at the moment is that of bonds. To begin with, let's remember that a bond is nothing more than a promise to repay a principal at maturity and, in the interim, pay an interest. A bond is a word of honour and, in my case, I can't get myself to trust the word of most bond issuers. How will they honour their obligation? With new money minted out of nothing? By taking on even more debt? If so, what does that tell us about the future value of money? We're avoiding bonds.

	Dow Jones Industrial Average Decline
1929	-89%
1937	-53%
1973	-48%
2000	-48%
2007	-56%

Stocks:

Equities represent a participation in an active enterprise. We're stakeholders rather than creditors. For the past two years, we've focused on companies that have manageable debt, generate strong cash flow and pay a sustainable, attractive dividend. More recently, we also made sure our picks were in sectors which had limited exposure to the "de-globalization" dynamic, getting rid of companies that were threatened by tariffs. On balance, our stock selections have done better than the indices, but they've still suffered considerable setbacks. Should we add to them now, while Wall Street calls them cheap? In the current context, is anyone's judgment of what is expensive or inexpensive of use?

We feel extreme caution is still in order. One reason is that there is little indication that the news-flow regarding COVID-19 will soon turn more positive, especially in cities like New York and Chicago. We're also deeply concerned that the actions taken by government won't be sufficient to stabilize the economy. We'll stay put until there are clear signs that the virus threat subsides and the economic backdrop improves.

Cash and Gold:

During the past several years we've emphasized that cash is an important and widely underappreciated asset class. Gold, meanwhile, is a potent hedge and the only globally accepted, highly liquid asset that isn't someone else's liability. We continue to hold our prominent positions in both cash and gold, confident that we'll eventually convert a significant part of them into deeply discounted financial or real assets.

Thank you for you continued trust. Please let me know if you have questions or concerns.

Peter Cavelti