asset management associates

First Quarter 2020

Written by John R. Ruocco

assetmanagementassociates.com
jrock1400@cox.net

800-208-8588
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The Black Swan

The first quarter of 2020 started out with a continuation of a fourth quarter rally that was propelling stocks to new highs. The biggest concern was the upcoming presidential election and the impact elections would have on the markets as the year wore on. Most investors felt that something would come up that would act as a catalyst for a market correction.

In February we began hearing more about a virus in China. We had seen several of these before over the past decades and none of them materialized to any extent in the United States. I polled several of my clients and most were not concerned. The odds of anything happening seemed remote. Then, in late February, the Dow took a 1,000 point dive and that signaled that something was up.

Still, most people felt this was a much deserved market correction or a panic induced by a hyped up media. It was like The Weather Channel telling us about a devastating hurricane that would end up going out to sea.

With the virus spreading in Italy, the Federal Reserve stepped in on March 3rd and cut interest rates by 1/2%. This was the first emergency cut since '08. When it did this, the market was initially up some 300 points. Investors were shrugging off Italy, but the sudden off schedule cut in rates spooked investors. The stock rally quickly reversed and sent the Dow down 1,300 points. Many of my clients were asking me why investors were panicking. Very few saw any need for concern and still felt the media was hyping things up. Most individual investors were complacent.

The following Sunday the Fed brought rates to zero. This did not help reassure the markets. Then, a few days later, on the 12th, the country went into lockdown mode. This was the day that every major league sports team cancelled games and all concerts and events were cancelled across the board. Many states limited formal gatherings to less than 100. Then, within a week, restaurants and non-essential retailers

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A black swan is so rare that most don't believe it exists.

New Rules for 2020?

Tax deadline extended to July 15th.

IRA 2019 contributions are due on July 15th.

SEP IRA 2019 contributions due at time of filing or, if on extension, October 15th of 2020.

Penalties waived for premature IRA or 401k distributions (still with some restrictions).

Required minimum distribution for those over 70 1/2 are not mandatory for 2020. Direct disbursements to charities are still allowed.

Relief checks for a maximum of $1,200 will be disbursed electronically to all eligible citizens. This is a little fuzzy but the following are income guidelines:

- **Married Filing Jointly:** (max $2,400) Income must be under $150,000 to get maximum payout of $1,200 per person and $500 per dependent child. The maximum payout is reduced by $50 per $1,000 of income over $150,000 up to $198,000.
- **Single:** (max $1,200) Max income $75,000 for full amount reducing by same as above up to $99,000. $500 per child with reductions based on income.

There are a host of provisions for small business loans and grants and the unemployed. It is too much to summarize here but I will do my best to help get this information out.

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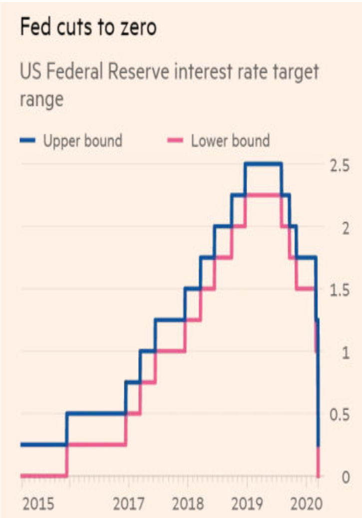

Fed Funds Lowest since last Recession

were ordered to close. A good number of restaurants have remained open for take-out but, for most, take-out is a fraction of their overall business.

So, the revenue stream to a large swath of corporate America was being slashed without any warning. As I mentioned in my newsletters over the past several years, corporate debt was (and is) at record levels, varying widely in credit quality. But even the highest rated and most secure firms were seeing their revenue streams evaporating. For this reason it became impossible for investors to value the debt they were trading just a day ago. So traders hesitated buying buckets of high quality bonds. This hesitation caused bond prices to sink like stones.

What was most unusual and unexpected about this market meltdown was that many historically stable, solid and conservative investments, those that pay consistent interest or dividends, dropped more than some tech stocks that most would have been labeled as aggressive. This indicated that, behind the scenes, markets were coming apart. Bonds and utilities tend to go up in price when interest rates drop. Instead they collapsed.

As the stock and bond markets continued to drop, with no bottom to be found, the Federal Reserve entered the markets, similar to its actions of 2008, but with much more force. Some called it nuclear! The Fed began to buy not only mortgage and Federal government issued securities, but also expanded the purchases to include corporate bonds and municipal securities. It indicated firmly that there was no limit to how much the Fed could buy and it would do whatever was necessary to stabilize the markets. The Fed also opened operations to lend directly to businesses. All of these actions combined dwarfed the operations of the last recession. The Fed pulled out the playbook it wrote in 2008 and added several new chapters.

Meanwhile, Congress was debating a relief bill to help small and medium businesses. Many small business owners did not know if they should lay off employees or wait until Congress made up its mind. Rumors flew and it wasn't taking long for the ripples to show up. Businesses did not have income: Cheesecake Factory announced that it would not be able to pay rent on April 1st, Ford cut its dividend to zero. Owners of commercial property instantly saw stress when tenants of malls, shopping centers and business parks lost revenue and their ability to pay rent.

Relief from Congress

Days after the Fed began its salvo of missiles, the House and Senate finally overcame some of their political motivations and moved to pass a 2 trillion dollar relief package. This is designed to shore up businesses and 6.6 million workers displaced by the shutdown so far. It is a massive financial package but the impact of this borrowing is yet to be seen. Consider the following:

- **The Federal Debt** prior to going into this situation was about 22 trillion dollars. This is up from about 7 trillion going into the last crisis. Since ‘08, the debt has steadily increased in what has been labeled a good economy.
- **The deficit** (Federal spending minus tax inflow) over the past year has been just under 1 trillion a year.
- **Tax revenues** this year (2020) will be lower due to the current situation—maybe considerably lower - so, for that reason alone, the deficit this year will be higher.
- The **2 trillion** just borrowed in the **relief package (above)** will tack on another 2 trillion to the deficit.
- **If we add up the above,** we have well over 3 trillion to be added to our current debt that could move the total debt from 22 trillion to well over 25 trillion ...and another package is already being considered.

In addition to that, or as a part of that, the Federal Reserve just added some **2 trillion** to its **balance sheet,** which is already holding 4 trillion in debt from 2008. With this round of Quantitative Easing (QE or bond purchases) the Federal Reserve Bank will be holding over 6 trillion in bonds and this number is climbing. Also, a good hunk of the 6 trillion the Fed holds is a piece of the 22 trillion debt the government borrowed. So the government is sort of financing itself....LOL. You have to say LOL because if an economics student proposed this scenario in 1990, they

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Drop in Oil Prices Puts Pressure on U.S. Producers

would have flunked the class. The treasury issues bonds and because there is no demand, the Federal Reserve buys them!

When this virus draws to a close, it is not over. The Treasury will have to continue to issue bonds to finance the increased Federal debt until we establish enough economic growth to pay off these loans via tax revenues. Currently a 10 year Treasury is paying around .65% per year. Selling treasury bonds (debt) at these rates to the public could be rough so some feel they may have to raise the interest rates to attract buyers. Maybe, these rates that to us appear extremely low are actually high when compared to a German 10 year at minus 3/4%. But at this point, it is too far into the future to figure out the other side of the COVID-19 recession. We have a lot of ground to cover over the next several weeks.

It is not all bad because the Fed, in conjunction with Congress, does have a strategy. [Hard to believe]. They want to create a tremendous amount of excess cash in the economy when the "recession" ends so businesses and individuals will be able to pick up that cash real cheap and run with it. This will jump start the economy. The Fed is trying hard to be ahead of the curve. It is doing a great job—but in the days ahead, we will continually ask: Is it enough?

Oil

While all this was going on, a price war between Saudi Arabia and Russia was developing. The initial target may have been U.S. shale producers but the situation spun out of control. The U.S., via its shale production, had become an exporter of oil and one of the largest producers of oil in the world. Unfortunately, the cost of producing shale oil in the U.S. is much higher than what is produced by Russia or Saudi Arabia. The Saudis, via a weakened OPEC, and the Russians had a somewhat loose arrangement to support each others price by controlling their production. This time when the Saudis wanted to cut production to hold down supply to support prices, the Russians refused to co-operate. So, the combination of the virus shutting down airline and auto travel, along with Russia and the Saudis continuing to pump at prior levels, resulted in the price of oil plummeting from over $60 per barrel in January to $20 as of this writing. This is the lowest it has been since the beginning of this century.

This puts enormous pressure on the debt laden fracking industry. If this debt can not be repaid, it will put immediate pressure on many banks and lenders. This was a big part of the liquidity problems in the bond market described earlier.

It should be noted that oil has gone through many boom-bust cycles. But normally, when oil prices drop and the oil industry gets wiped out, the rest of the country benefits from low oil prices, which translates into more spending and helps to offset the economic damage. But this economy is not normal. The virus is controlling our behavior, not the price of oil, so there is little upside to this situation.

Opportunity

What is saving us from complete disaster today is technology. Many companies and individuals are operating remotely due to the technology at hand. We are extremely lucky to have this. We have known for quite some time that in the future we would rely more and more heavily on video conferencing, robotics and artificial intelligence. That future is suddenly here.

History has illustrated that in past world wars there were many rapid advances in the technologies at hand. Jet aircraft and rockets, which led to spacecraft, were created at the end of WWII. The most remarkable was the development of the nuclear bomb. Although a horrible weapon, this pushed us into a new nuclear age. War

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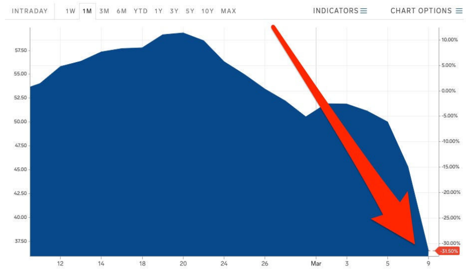

forced us to push the envelope.

Today's war against a virus will do the same. We will be pushed to use remote technologies and create a world of automation and artificial intelligence that we may not have seen for well over a decade. Teachers are being forced to learn, overnight, how to teach students from a home laptop. These systems existed but were underutilized. Now it's being used across the country, transforming the pen and paper age into a much more robust technological classroom. Although we hope they don't forget the pen and paper, the future of learning is changing. The cost of transporting students and teachers to a central location every day is tremendous. That could be reduced to a few days a week for labs and study groups. It will become a better mousetrap.

The same is happening on the corporate level. Large corporations have been allowing more and more of its employees to work offsite. This event will push even more employees into a home office, saving on real estate and overhead. There is a lot to be said about the comradery gained by working under one roof, but again, it does not have to be every day. 5G communications will be pushed to the forefront. In Europe, Netflix was forced to reduce its video quality because it jammed current bandwidth. We have all this technology at our fingertips. This virus will force us to utilize it at a much more rapid rate.

Conclusion

The situation at hand is like nothing we have ever experienced. It is not like any other major bear market in history. At this time, most professionals feel this will be a short term situation where this virus will peak in several weeks and then begin to subside. If this is the case, the Federal Reserve and the U.S. Government can afford to dump trillions of dollars into the economy to carry it for 30 or maybe 60 days.

If we could see some daylight within that timeframe we may be able to experience a relatively quick recovery. If, however, this goes much beyond that without seeing an end, we can easily end up in a deep recession that will take many years to get out of. Keep in mind, the market looks six months ahead, so stocks will begin some form of recovery long before the economy comes back and before the virus has dissipated. At the same time, for the market to actually get past this, we need an economy on a solid footing.

The bottom line is that no amount of money can solve this problem. The only way we get out of this is for the virus to either dissipate based on its own natural course, or for medical experts to come up with drugs that can mitigate its spread and provide relief to those afflicted. It seems as if there has already been a beginning and end to the cycle in China and South Korea. That news is very positive. Developments in the medical field also show that rapid progress is being made. There is reason to be optimistic.

Meanwhile, like it or not, this Black Swan may be the catalyst for a historic transformation of our economy from bricks and mortar to much more sophisticated technologies. There will be a lot of opportunities in a variety of areas as these doors open. And, if we keep some cash on hand, we will be in a position to take advantage of those opportunities as they arise. We have been in some real tough spots in the past and this will just be another one to add to the list. I will keep you posted in this fast paced environment.

John R. Ruocco