PERSPECTIVES

The December 2018 downturn of between 15%-20% in global equity markets did not challenge the near-universal thesis of investors that policymakers, particularly central bankers, "have their backs," and that nothing really stressful would be "allowed" to happen to their hard-earned (actually not) persistent one-way returns in stock and bond markets. Actually, December 2018 was a kind of Perils of Pauline (look it up) moment, where a downturn in overpriced and overleveraged stock and bond prices, purportedly triggered by modest rises in very low short-term interest rates, was quickly reversed when the head of the Fed, bowing and scraping, basically promised never to do such a dastardly thing (raising interest rates) again. No recession or financial crisis ensued, and a resumption of the stock and bond market levitation left the "new era of low risk and inexorable returns" belief intact.

In contrast, the financial market swoon from February 20th to March 23rd this year has provided a heavy bookend to 12 years of basically nonstop positive returns in global stocks, bonds and real estate. It has also provided a persuasive retort to the "stocks can't go down, and if they do, then buying the dips will always work" mantra. We would say that minus 36% top to bottom (so far) in the S&P 500 (and similar declines in other global stock markets) in a little more than four weeks provides a decent platform for 5, 10, 15, and 20-year performance comparison analyses among different investment asset classes and money managers. These periods now include at least one "full cycle," and also provide at least a cautionary subtlety to the previous certainty that stocks either could be bought at any price without fear or that a 20% downturn delivers good-old-fashioned proper bargains. But markets do not kowtow to anyone's script (except sometimes to those of the Fed Chair or POTUS), and so after blowing through the minus 20% bargain basement last month, they went straight through to minus 36%, then straight up 21% eight days later to the end of the month. Let's put it this way: Six trading days before the end of March, the S&P was down 26%, but it closed the month down only 13%. As this report is written, the U.S. stock market has rallied 31% from the March 23 low, which still leaves it down 16% from the high of February 19 and down 12% year-to-date.

What is truly interesting about long term performance comparisons at present is two bits of data: (1) the 20-year performance of stocks is notable because the return for the first 10 of those 20 years was *negative;* stockholders *lost money* for the period 4/1/00 to 4/1/10; and (2) in those 20 years, bonds made a higher return than stocks.

While it is near-universally believed that the global, particularly the American, economy was humming on all cylinders before being slugged flat by the virus, we believed that the pre-virus financial assets landscape was toward the high end of the riskiness scale. The record-high global leverage, the record-low government-manipulated interest rates, the $20 trillion of purchased bonds and stocks still on the books of the major central banks from the non-stop emergency policies pursued for 10 years after the emergency was over, presented a highly risky and unsound picture. It is on that terrain that the virus landed.

The global economy is currently experiencing the deepest and quickest downturn in history (including the 1930s). Among the most surprising aspects of this situation is that most investors, Wall Street economists and strategists, business executives and governments were exceedingly slow in identifying that a deep recession and vast economic shutdown was underway. The path to restarting the global economy will be a labyrinth, with no clear guidelines, and with different localities opening on different schedules based on different data, theories and policy approaches. A great deal of damage, some of it irreparable, is being done to the global economy. More below on all of these topics.

As this is written, there is no way of telling whether the minus 36% stock market waterfall decline is "enough," and whether the subsequent sharp rally signals "*fini*" to the crash (the decline was sharp enough, with several days comparable to the 1929 crash, to justify the "crash" label). Since the actual economic downturn is exceeding in depth and impact – and probably will exceed in length – the 2008 experience, our gut tells us that a 50% or deeper decline from the February top might be the ultimate path of global stock markets. However, public policy has been marshalled with all its strength to do battle with a resumption of the market decline. Our job, and style, is not to pick tops and bottoms with precision (actually, not to pick them at all), but to have a portfolio that can make some money in normal times and *keep it* when the music stops for any reason, the timing of which is always a surprise even if you keep a sharp eye on the disc jockey.

Many investors feel that a surfeit of bargains has already emerged in the downturn, and they are busily deploying capital into these (perceived) bargain stocks and bonds. We certainly observe the price concessions, as well as the kind of illiquidity that enhances the ability of buyers to buy at what they consider to be sufficient discounts. But here is one measure of "value" which is pretty sobering: The price/sales ratio of the S&P 500 at the end of September 2007 was 1.64. At the end of March 2009, it was 0.82. At the end of March 2020, it was 1.86, down from 2.32 at the end of December 2019!

Perhaps in assessing the opportunity set we are too influenced by the 2008 decline and by our belief that bargains must exceed in attractiveness the wild underpricing of stocks and bonds that existed in late November and December 2008. However, there does yet not appear to be serious undervaluation (by our definition) in any meaningful size, and we recall (vividly) that *after* prices in 2008 got to *ridiculous* levels, *they proceeded to further collapse to insanely low levels* (and that is before taking into account the probability that the current recession significantly exceeds, in severity and possibly in length and impact, the 2008-2009 episode).

The potential opportunity set is primarily in credit. Of course, equities that have fallen 20%, 30% or 50% in a very short time can provide substantial upside, but in periods like this one, we prefer the additional downside protection of carefully researched debt. The Holy Grail (which presented itself in size in 2008) is to have credit positions in which we have so much confidence and which have so much convexity (asymmetric return profiles; much more upside than downside) that hedges are either not needed or can be relatively small. A great example was auto finance unsecured debt in 2008, which at the bottom was trading at levels that anticipated many more defaults than at any time in history. Such credit positions fell in price to many points below our "scientifically derived" bedrock-bottom prices, but we had a lot of confidence in the ultimate repayment of the debt.

In contrast, currently, despite the massive stimulus moves around the world and the unimaginably large new rounds of money printing, there is substantial uncertainty about the future viability of a large range of businesses. Which businesses will eventually emerge stronger than ever, which will come back more or less as they were, and which will require very substantial changes to their business model in order to maintain some profitability (or even to survive)? It is very difficult to make a careful and realistic assessment of the timing and shape of the restoration of the global economy, the future financial condition of the companies whose securities appear to be bargains and the possible further downside of those securities. We are currently in the process of sorting through it.

THE VIRUS

First, and before all else, we must recognize that this calamity has brought about ongoing widespread misery and tragedy and imposed a heavy psychological toll on humanity. Many people around the world are suddenly without jobs and any means of support, and are experiencing or witnessing sickness and death from the disease the understanding of which is just being painfully learned. It is within this highly fragile new reality that everyone is living – and, crucially, in which decision-makers must choose and shape the path out of this dark situation.

In terms of markets, we have said, more than once, that there are consequences, and not just positive ones, that come with the increasing complexity and interconnectivity of the world. Rising debt and gigantic amounts of derivatives, which are contracts referencing and betting on the prices of assets; the global transportation system; the internet; the electric grid; and the supply chain, have all become more interconnected and complex. Each has its own set of implications of the first order, and then cascades of second-order, third-order and deeper effects.

For example, advances in air transportation have opened up the world to most of the global population for travel, business and networking, but they have also ensured that something like the current pandemic can spread across the globe in hours, not months, and outrun efforts to contain it.

Another example is the electric grid, which has literally created modern society but which is highly vulnerable. Perhaps its most dangerous vulnerability is to EMP, or electromagnetic pulse, which could be caused naturally or by humans. In 1859, an EMP episode (called the Carrington Event) caused by a solar flare caused disruptions to the global electric grid, but that grid was very rudimentary at the time, so there was not much disruption to global life. If that exact event (which is by no means at the outer limits of the potential severity of such events) recurred today, the impact would be extremely painful, as the world's functioning depends upon a working electric system.

Serious interference with the proper operation of the internet, either accidently or intentionally by a hostile power, would have unimaginably negative consequences.

Just-in-time inventory practices work perfectly when things … work perfectly, but stumble in periods like the present, during which supply chains are distorted and breaking. Disruptions are cascading around the world, and their impact is accentuated by the lack of cushion and inventory. Also, supply chains for many items necessary for our national military or health security have become concentrated and risky, as for example the world's reliance on China for pharmaceuticals and rare metals. These factors will lead to significant re-thinking by many businesses and governments about their supply chains when the current crisis ends.

Health care systems throughout the developed world are hampered by the lack of redundancy and spare capacity, because those emergency preparations have been deemed too expensive as well as unnecessary. The world has been lulled into complacency by extended periods of normal or close-to-normal functioning, notwithstanding that serious health emergencies have emerged regularly throughout history and have periodically exacted an enormous cost from society.

The points are that complexity and interconnectivity cause brittleness, and people have short memories. Long-term vision is rare, and decades of smooth functioning encourage people to reduce cushion, eliminate spare capacity, increase leverage, rely on unsound and fragile structures (both physical and organizational), and neglect preparation for real adversity and volatility.

The virus pandemic is essentially shutting down the global economy. Policy responses across the world – both those oriented toward limiting the spread of the virus and those intended to mitigate the economic effects – have been spotty, highly variant, largely panicked and only partially effective. They are large, but at this point nobody can know whether they are large enough. "Whatever it takes" is quite a brazen statement, but it is partly a demonstration of power and partly a bluff. Even more obscured from view are the second- and third-order effects of the policy actions.

While there is much that is still not known about the virus, what seems clear is that it spreads easily from person to person, that it is contagious from people who have no or limited symptoms and that it has a significantly higher death rate than "regular" flu. It is said that outcomes are worse for old people and those with pre-existing conditions. Unfortunately, many young people, reading about the enhanced vulnerability of people more than 60 years old, interpret that as a "get out of jail free card" for younger people and an excuse to go about their lives in a pre-virus manner.

There is evidence that the virus may not like the extra ultraviolet light present in longer daylight hours and may diminish in the spring and summer, but spring in the northern latitudes is autumn in the southern. Until effective therapeutics are developed (hopefully in a few months) and/or a vaccine is developed (probably no less than 18 months), the virus will likely go coursing around the world for at least a couple of seasonal cycles until the world's population develops something like "herd immunity." The Spanish flu, which killed an estimated 50 million people worldwide, went through three definable cycles starting in the spring of 1918. While everyone – policymakers, citizens and investors – is looking for guidance on the science and on the data, one of the key factors in this situation is that the data (like everything else nowadays) is highly politicized. It is hard to separate the politics from the "truth" with regard to any particular expert, any particular slant on the situation and any particular recommended policy response.

There is substantial disagreement over whether the global economy should be shut down for a period of months in order to bring down the death rates and keep the global health care system from being overwhelmed (with the drawback of delaying the development of herd immunity by critical masses of people), or whether only more modest precautions (e.g., encouraging "social distancing" and other precautionary measures) are called for in an effort to keep the global economy functioning and allow herd immunity to develop somewhat faster. The second course implies more near-term deaths (potentially at catastrophic levels), but possibly a shorter time to the end of the critical phases of the crisis. Only when targeted therapeutics and vaccines are developed and distributed will the crisis will be on a path to ending. Until then, it will be stop/start, where declines from peak numbers of cases give people hope, but then partial re-openings start new waves of disease before immunity is widespread enough to allow the disease to peter out.

One of the major questions that is impossible to answer at this point is how the social-distancing policies that have been put into place will unwind. Our guess is that restarting the global economy will be a patchwork of actions and edicts, occurring on timelines that elicit endless controversy, by policymakers and by the judgment of employers and workers, based on the evolving situation on the ground in different locations. Supply chains will probably come back much more slowly (and in an altered form) than anticipated because of the different policies of governments throughout the world. Our further guess is that the recovery (in the economy, not necessarily in financial markets) will not be steep and sharp, and may take many months or even years to get the wheels turning to a "new normal."

ECONOMIC POLICY RESPONSES

Millions of Americans, and hundreds of millions of people globally, are suddenly out of work through no fault of their own. Most of them have little or no reserves and need immediate cash aid. Some governments are understanding that, and are quickly shoveling out cash. Regardless of the economic system (capitalism, socialism, authoritarianism, whateverism), this need is an urgent priority.

In addition to simply writing out checks to people who have been losing their jobs, other policies aim to alleviate cash burdens. These policies include moratoria on some mortgage payments and loans, and formal or informal forbearance policies on some rent or utility payments.

These policies are quite a bit more complicated than simply sending people money, the risks of which are diffuse, and will likely have many unanticipated consequences. By telling people they don't have to make mortgage, utility or rent payments, policymakers are reducing the revenues of mortgage servicers and lenders, landlords, electric utilities and other consumer-facing businesses. Most large providers of such services can lobby for government loans, guarantees or grants, but many medium and small businesses cannot.

In addition to the budgetary impact of grant programs (the amounts involved are simply gargantuan), there is also the issue of cronyism and governments picking winners and losers in the various forbearance permission programs. The immediate effect of the aid policy programs will seem helpful, but in the medium term there will be significant political impact as fights develop about inconsistencies and windfall gains and losses.

In the case of small landlords, mortgage servicers and lenders, and utilities, forbearance may turn into financial distress and bankruptcy as revenues are capped or truncated but costs march inexorably onward. Which brings us to the hundreds of thousands of small businesses (such as restaurants, bars, hair salons, shops) that temporarily will go out of business as revenues disappear in the lockdown periods. Some such businesses will be saved by policy moves, but many will disappear. These are truly uncharted waters, but our judgment is that the widespread notion of a V-shaped recovery is highly fanciful. It seems more likely to be a Q-shaped recovery.

This is the first modern, truly global and interconnected crisis since World War II (surpassing even the 2008 crisis in scope), and although there is no blueprint to help guide our understanding of it, we tentatively wonder whether it would be useful to think of the economic and financial policy responses to this crisis as if they were occurring within the paradigm of a “planned economy” (Soviet Russia in the 1950s and 1960s? Mao’s Great Leap Forward?) that suddenly runs into unexpected conditions, with all the resulting disruption, waste, poverty, corruption and misallocation of resources that such conditions entail. Furthermore, when the immediate effects of this crisis are over and the global economy is more or less working again, how quickly will the political classes be eager to extend parts of the new stimulus package(s) with the encouragement of newly created special interest groups? Every new special interest (especially corporate interests) that is created by the various stimulus programs will represent a new vein of ore for politicians to mine for gold and silver.

One thing is for sure: The global economy coming out of the virus situation will be more indebted and more dependent than ever before upon “free money,” QE/MMT (Quantitative Easing and Modern Monetary Theory, meaning massive asset-buying by central banks and unlimited fiscal spending financed by central banks in their own currencies, respectively) and higher deficits in order to function.

WAITING FOR GOOD-DOUGH

In the play “Waiting for Godot” by Samuel Beckett, which premiered in 1953, two characters wait for the arrival of someone named Godot, who never arrives. In our version, Good-Dough is sound money, and its chance of arriving is just about as slim.

The reason that we have been harping on the failure of central banks to normalize monetary policy these past 10 years is that we were highly concerned about entering the next financial crisis/bear market/recession (whenever it might arrive) without the fluff, detritus and litter of the previous crisis having been cleaned up and scrubbed clear. To have the curtain go up for the “next show” on a stage where the stagehands are caught in the floodlights holding $20 trillion dollars of bonds and stocks purchased under the one-size-fits-all monetary flood period, with interest rates at, near, and most significantly below, zero, is to start the next thrilling show deeply unprepared. The world’s major central banks continued emergency policies for 10 years after the emergency was over, with no theoretical or empirical support for doing so. Those policies resulted in a gradual slow-growth recovery coupled with dramatically rising securities and asset prices.

The reason this is important is that QE, ZIRP and NIRP are deeply unsound policies, and rely for their magical-seeming efficacy on naïve faith by citizens, investors and businesses that paper money is trustworthy no matter how much of it is whisked into being, and no matter what the return (or literal cost in the case of NIRP!) is from holding claims on it. Like any compelling “serial” on TV, we will start with a reprise of the highlights from the previous exciting episode: 2008. Too much debt, unsound financial institutions, oblivious corporate executives, and arrogant and clueless central bankers brought the world to the brink of financial extinction in 2008. Then, so the story goes, these same central bankers morphed into heroes and saved the world with their monetary fire hose on "full crowd control" and "confetti" settings. That tsunami of newly printed free money lifted securities prices, deepened inequality and unleashed the political testiness that comes along with such a novel and distorted recovery, and it tested and kept testing the willingness of people to accept cotton-candy money at full value.

Sadly, when people (including those who should know better) do something stupid and reckless and are not punished, it is human nature that, far from thinking that they were lucky to have gotten away with something, they are encouraged to keep doing the stupid thing, keep believing the unbelievable and keep assuming that they were just plain wrong to be concerned about "old-fashioned" restraints (like sound money: Good-Dough). As we have pointed out *ad nauseam et beyondum*, doubling down on unsound policy just raises the stakes and the intensity of the future "payback."

Inflation is generally rising price levels. Inflation can be caused by supply issues or blockages, excess demand, wars or various versions of money printing. It is normally hard to convince people to accept paper money (backed by nothing) that is being debased, and human history is full of examples of currencies that were debased and then fell precipitously in value. Debasement is not novel; it is a timeless way for sovereigns to attempt to pay less, or far less, on the obligations they have incurred. Usually it does not "work," in the sense of permanently fooling people, because at some point people front-run the debasement, which turns into a tail-chasing episode that can, and frequently does, destroy people's savings and make them really angry, in contrast to the desired result of fooling people into passively accepting the erasure of their assets (the governments' obligations).

In the case of the post-2008 debasement, a combination of technological change, globalization and the use of the newly printed money to buy bonds has kept reported consumer price inflation in bounds and fed the narrative that monetary radicalism is really a panacea without risks and side effects. The inflation instead has gone into stock, bond, real estate and art prices and has exacerbated inequality. It actually has created more financial engineering than economic growth, but the sheer size of it ($20 trillion of bond and stock purchases and zero percent and below interest rates) brought the global economy close to appearing to return to normal after 2009, albeit growing more slowly than before.

But the failure to normalize monetary policy prior to the next crisis (which is now hard upon us) ensured that the next crisis would bring the unsound (and experimental) monetary policy to even greater uncharted heights (depths?) of unsoundness. Prior to 2008, central bank balance sheets were clean and interest rates were sort of low but normal. In contrast, just prior to the virus a couple of months ago, $20 trillion of purchased stocks and bonds were still on central bank balance sheets, and Japan, Europe and Switzerland had policy interest rates below zero.

One can only imagine what is going to happen to central bank balance sheets and global interest rates now, given that the global economy is screeching to a halt. Is the $20 trillion of central bank securities holdings going to rise to $30 trillion? Almost assuredly yes. How about $40 trillion? $50 trillion? Who knows? Are short-term policy rates going to be negative everywhere? Is all this going to matter? Will there be a serious deflationary period that will cause governments to pour even more fuel on the fire? Following a brief deflationary period, is the even-more-radical monetary flood going to create a tipping point following after which fiat money is rejected and hyperinflation begins, a process which could be self-reinforcing and serve to wipe out the real value of global savings and send consumer prices, commodity prices and real estate prices to the moon?

Even if that is the path that governments are following (wipeout of savings, attempted wipeout of debt), and you try to align your businesses and assets on that path, things will be much more complicated than you think. Take real estate, for example. Of course it is "real," and you might think that it is a slam-dunk to preserve value in a serious inflation. But commercial real estate is a peculiar asset. It looks real because kicking it can break your toes, but it is generally highly leveraged and depends upon the relationship between rents and costs. If there are rent controls or moratoria, formal or forced by circumstances, and no controls on costs, commercial real estate can produce rapid insolvencies. A little thought will reveal many more examples of the complexities involved in a period of monetary destruction such as the one that is possible in the near future.

In addition to the monetary excesses, almost all developed countries are growing their debt and their unfunded future promises (retirement, health care and other obligations) to record amounts. Currently, to fight the deepening recession, not only are central banks restarting QE without limit, they are also cutting already-low rates, and their governments are cranking up massive deficit-spending plans.

There are many times in a long investing career that one hears, "Where will this all end?" We never thought that was a good question, because there is no "end," just a succession of real-world events and market actions stimulating policy reactions. Politicians love markets going up, and if there are no countervailing considerations, like rapid consumer price inflation, then they will try to keep markets high and rising and interest rates low forever.

The world is currently in a deep recession from which it will be complicated to recover. Emergency policy is appropriate. Deficit spending and massive monetary expansion are called for to prevent total collapse. Holes in people's basic ability to feed themselves must be filled with alacrity. However, the new fiscal and monetary policies currently underway are the largest peacetime policies of their type ever enacted, and when piled on top of the existing, pre-virus, central bank policies, the top of the pile of debt will likely reach the heavens. We have a hard time imagining what will occur in policymakers' minds post-COVID-19 to make them responsible stewards of monetary soundness, but monetary soundness is the key to financial system soundness, confidence in economic stewardship and fiat money, and the inauguration of a new period of sound, non-inflationary growth.

They got away with unsound policy for 12 years. Now they think they have the magic formula, the one-size-fits-all nostrum that enables them to control the yield curve and to promise and deliver unlimited amounts of money without cost and without risk. They are wrong. They are just as wrong as when they said that recessions and financial crises are things of the past.

The new element in the equation of the forces which will shape inflation and deflation in the near future is supply-chain blockages. Prior to the virus, sluggish growth plus globalization and technological change, together with bond-buying by central banks, kept producer and consumer prices calm. It gradually led to a widespread (crazy) belief that inflation is an historical artifact, not a modern possibility. In the current situation, the global economy is plunging in activity, and this would normally be sharply deflationary in terms of producer and consumer prices. However, several factors might change the equation, probably when the economy bottoms but possibly prior to that time. One factor would be very significant supply blockages all through the global supply chain. Additionally, the global supply chain is likely to undergo dramatic changes (as companies and governments recognize the national security as well as economic risks of sole-source or limited-source critical products and services) that will generally increase the cost of goods to the consumer. Other very important factors are that the existing already-radical monetary policies have been dramatically ramped up, and fiscal policies have now gone full MMT with the new huge stimulus bills (which passed without even a discussion of how to "pay" for it). "Paying" for things with "real" money is now a quaint, outdated concept.

Money is going to hell. Good-Dough is not coming. As usual, timing and shape TBD. Stay tuned for the next exciting chapters in this serial.

MEMORIES

Human memory is interesting. In times like these, the shortness of our memories becomes readily apparent. The events and patterns of the past glitter with many important analogues and lessons, but most people, including people in positions of influence or power, don't care to mine the collective memory. Below are some illustrative nuggets on this topic.

The Carrington Event was in 1859. The Spanish Flu was in 1918-1920, causing about 50 million global deaths. World War II ended in 1945. Krakatoa blew up in 1883, with tremendous global effects on the climate. Another volcano, Tambora, erupted in 1815, causing 1816 to be the "year without a summer." These were all highly impactful events at the time, but similar events now would be so much more impactful due to the increased interconnectedness of the modern world.

The above events occurred a long time ago, but the Global Financial Crisis (GFC) occurred in 2008, only 12 years ago, and the only fix that has taken place to avoid a recurrence is the improved capitalization of global banks. It is good that the big banks are much sounder than before, but in just about every other respect, the highly accessible historical lessons of markets, debt, money, inflation and economic systems have been stubbornly ignored post-GFC. The GFC-style fixes (free money and massive money printing) are firmly currently underway in much larger size than the policies which addressed the GFC, with policymakers projecting the aura (real or feigned) that these policies will "work" as they purportedly did post-GFC, with no discernible "side effects," because policymakers think the GFC fixes performed well. There is no way of telling when a massive amount of unjustified confidence in something will break. However, we do believe that when it breaks, it will happen all at once, and the consequences will be significant.

INFLATION

An important part of the policy response to the virus is asset-buying by central banks (with newly printed money). It is not only government bonds, but also corporate bonds and equities that are being purchased in very large size in Japan, the U.S. (so far not buying equities, but reportedly buying junk bonds) and Europe. This asset-buying and associated yield curve control is known as financial repression. Despite all the central bank buying, bonds will not hold up near 0% yield if inflation starts accelerating and rises from 2% to 3% to 4% or higher. Most readers will say, “How can inflation possibly move up? It is a depression out there.” As a first-order effect, we mostly agree with that, but there are aspects of this peculiar crisis that could produce upside inflation surprises. There are significant disruptions in the global food supply chain, and those disruptions (which could include or produce export controls, labor disputes and outages, border issues preventing labor workers from harvesting crops and other disruptions) could cause significant pockets of high food price inflation and limited availability, which in turn could cause social unrest and further disruption. Nobody is prepared for this kind of inflation, and if it develops, financial repression is not going to hold bond prices up at the stupid yields currently prevailing.

Under such conditions, people may not want to hold money, and the system could go towards barter. This would be very inefficient, because you would have to find somebody to do a deal with. Extreme monetary policy is the correct move today in the midst of the emergency, but it will not be the correct move a year or two from now. Ten years ago, policymakers liked monetary extremism so much that they kept going with it and even accelerated it after the emergency. The result last time was not hyperinflation, obviously. But hyperinflation, a rejection of fake money and fake-knowledgeable central bankers, is possibly lurking just out of sight.

Central banks have been very focused on preventing credit collapse and deflation these last 12 years. We never thought that deflation was a realistic possibility, and we railed against the continuation, long after the emergency was over, of emergency monetary policy. Now there is a new emergency, and at this moment, emergency monetary policy is completely appropriate. But we want to remind people of a few truths. On form, we think it is very unlikely that central bankers will move to normalize monetary policy after the current emergency is over. They did not normalize last time, and the world has moved demonstrably closer to a tipping point after which money printing, prices and the growth of debt are in an upward spiral that the monetary authorities realize cannot be broken except at the cost of a deep recession and credit collapse. The point worth making is that credit collapse, although terrible, is not as terrible as hyperinflation in terms of destruction wrought upon societies. Capitalism, which is economic freedom, can survive a credit crisis. We don’t think it can survive hyperinflation. We think that there are a number of really good reasons to stringently try to protect the purchasing power and trustworthiness of fiat money, especially the primary reserve currency: the almighty dollar. But chief among those reasons is to keep a good distance away from the tipping point in which confidence is destroyed.

GOLD

This is a perfect environment for gold to take center stage. Fanatical debasement of money by all of the world’s central banks, super-low interest rates and gold mine operation and extraction issues (to a large extent related to the pandemic) should create a fertile ground for this most basic of all money and stores of value to reach its fair value, which we believe is literally multiples of its current price. In recent months, gold has gone up in price to some degree, but we think that it is one of the most undervalued investable assets existing today. There is nothing else that has its historical and fundamental characteristics, and we think that it is only beginning its inexorable, but impossible to time and place boundaries around, uptrend. The fact that it is so under-owned by institutional investors is astonishing to us in light of the obsessively inflationary policies being pursued by central banks around the world.

From the world Gold Council: "Gold is the only reserve asset that bears no political or credit risk, nor can it be devalued by the printing presses or extraordinary monetary policy measures. The yellow metal is insulated from income inequality, polarization of political parties, trade disputes, deteriorating government budgets, rapidly aging populations, massive growth in unfunded liabilities and counterparty risk."

Emerging and developing economies hold only 5% of their total reserves in gold, compared to a 16% share held by the developed world. The share of gold in total global reserves has fallen from 13.5% to 10.6% over the last 20 years. Institutional investors around the world own basically zero gold.

Gold today, despite its modest run up in recent months, is the answer to the question: Is there an asset or asset class which is undervalued, underowned, would preserve its value in a severe inflation, and is not adversely affected by COVID-19 or the destruction of business value that is being caused by the virus?

CHINA

In a breathtakingly short period of time, the global perception of China has morphed to a significant degree. Just a few months ago, concerns about China centered on bad debt, corruption, IP theft, a slowdown in its rate of growth, and unfair trade practices. The U.S. had engaged in a kind of trade war with China, and the sporadic and evolving nature of that "war" created waves of optimistic and then pessimistic views in the West about the medium- and long-term relationship with China, the terms of trade, and China's long-term geopolitical ambitions.

In just the last few weeks, these concerns have shifted to add an entirely new set of concerns, principally about the truth concerning the scope of the virus in China, the prospects of China re-opening parts of its economy, and the shape of the relationship between China and the rest of the world post-virus.

Whether or not a significant number of Chinese factories and businesses will come back on line in the next few weeks, a major question faces every non-Chinese business that has done business with China, has located in China, is supplied with cheap goods from China, or relies on China for part of or a significant part of its supply chain: Should we go back to China, build plants in China, depend on China as primary or sole supplier? The answer to these questions is not straightforward and may depend on governmental actions in the West and on the risk assessments of Western businessfolks. Questions about partnering with or doing business with China were seriously debated before the virus, and they are even more relevant in light of the virus and the damage it is causing. The virus and the questions about doing business with China could do to international trade what tariffs could only have dreamed of doing.

THIS IS MONEY MANAGEMENT?

We will repeat our prior expressed view that index investing is not managing money at all. Failing to select particular assets, companies and managements, and delegating all decisions to the index constructors and unaccountable academics rather than to money managers, is something that "investors" get away with as long as the asset classes rise obediently (and higher and faster than pitiable "actively-selected" assets) on their tether to central bankers.

So who is "managing" your money? Can investors please commit to remembering this period (as well as the period just a few days before quarter-end when the stock markets were down 33% YTD, not 20%) when they are thinking about whether they need to be broadening their focus beyond the comforting assumptions of the halcyon days of the Fed-fueled pre-virus period these last 10 years?

When you are managing money that way, you are heavily exposed to the periods when correlations go to 1.000 and diversification disappears. What other realm of human life has such a gigantic amount of income, salaries, money flow – and so little value – as herded and benchmarked money management in times of crisis? What is the value of all of the parts of the money-management ecosystem when the value of portfolios plunge 20%, or 36%, or another bigger number?

The virus was "unpredictable" and would have caused serious damage even to a low leverage economic system with conservative management by moderately competent policymakers. However, when an economic system piles together kindling, combustible materials (record leverage), very high asset values, careless investors and uninformed politicians, and then a spark is lit, is the enormous economic damage that follows really "unpredictable?" We think not.

This needs to be savored: In a *March 26th* interview on NBC's "Today" show, current Fed Chair Powell said, "We may well be in a recession," but "there's nothing fundamentally wrong with our economy," he added. "People are being asked to step back from economic activity … so in principle if we get the virus spread under control fairly quickly then economic activity can resume." On March 26, we *"may well be"* in a recession??

The fact is that the steepest and deepest recession since the 1930s is underway, and because of cascading destructive effects, the global economy will take months if not years to restart and return to anything like a "new" normal. The Fed and other central bankers are just pouring liquidity on the compost heap, hoping it will work. Whether it works or not, they will (on form) claim victory if financial markets go up for a while.

There is "active" money management, and a bunch of that is sticking close enough to the indices that "underperformance" won't prod impatient investors to "save the fees" by going "full Monty index." Then there is "*really* active money management" which actually represents trying to make money in a different way, by attempts at clever combinations of securities, by influencing outcomes, by combining disparate bodies of knowledge, by manual efforts. Isn't it a precious resource to be attempting to create value in a different way rather than being at the mercy of market changes, rule changes and the whims and fears of central bankers? Shouldn't such efforts be applauded, nurtured, placed into portfolios like heirloom objects in contrast to "regular," indexed, benchmarked, tightly competitive, running-scared investing? Our answer is yes.

OBLIVIOUS

How did the world's financial markets miss the slowest-moving black swan in history? Mid-February was really, really late to be bulling stock markets up to the highest prices (and close to the highest valuations) in history. This thing (the virus and attendant disruption) was coming down the pike hard and fast, even if its ultimate shape was not in sight. We have made plenty of mistakes, including in the last few months, but we think we are right to use the word "oblivious" to describe this lack of awareness. Markets have been seemingly shortening their prediction cycles to the period just right in front of investors' noses. Most investors seem to have said (in their portfolio allocations) that as long as the Fed has our backs, everything will be fine. The virus was ignored for quite a while after it was obviously a mega-event. What has happened in the last 20 years to cause markets to lose predictive value? Maybe at least a partial answer is the rise of benchmarking and tight short-term performance requirements. When the clients define the shortfall of hedge fund performance below the performance of a runaway 12-year stock bull market as "poor performance," you know that the table has been set for counterproductive portfolio construction in different kinds of market environments.

Twenty or thirty years ago, most investors thought a lot about the future prospects of individual companies and businesses, with some thinking about macro conditions as well. Had those investor attitudes existed today, it is likely that many investors would have understood in December or early January that the virus was going to have major effects on the prices of their holdings, and the general market would probably have quickly reacted negatively to the developments in China, and certainly would have done so sooner than the end of February. But now everything is an asset class, a theory, an algorithm. Companies in China, Argentina, and South Africa are inserted into mainstream indices, without any regard to the rule of law and the nature of ownership in these places, and voila, millions of investors have to buy them regardless of whether they want to or not!

Is the only time that good hedge funds (that make money in a different way, with lower variability of return) are appreciated is when global stock markets are beating investors down?

Imagine a hypothetical hedge fund on December 31, 2019 that has a good chance, through whatever combination of strategies, of making "only" a 6% forward net annualized rate of return over full cycles, with 1/3 the volatility of the stock market. We think that is actually pretty good (although at our particular fund we hope to do a bunch better than that), but our guess is that such a profile would be waved off as inadequate. Yet what do institutions think the forward rate of return in stocks will be from current levels? Can it actually be more than 6%-8% compounded? Unlikely, in our view. Thus, the 6% return with 1/3 of the volatility of the stock market to be generated by our hypothetical hedge fund example sounds pretty good, particularly with the high-quality fixed income alternatives yielding a whopping 1% annually. It is a good time in the capital markets cycle to be closely examining investment goals, assumptions, practicalities and the choices available to investors. We surmise that the overwhelming bulk of investors have basically the same portfolio: long positions in global leveraged (or heavily leveraged, or double leveraged by margin debt or private equity capital structures) equities, listed and to-be-listed.

SURPRISE

Should it be a surprise that stocks go straight up and then crash straight down? Which part of "record prices, record valuations, record leverage, record derivatives trading and record complexity" should investors be excused from understanding? Any outright long investor who is not waking up in the middle of the night sweating and worrying whether there will be a next leg of the bear market (despite the desperate and gigantic policy moves) is either Cool Hand Luke or oblivious.

We are not in the business of calling market turns. Why did most managers, economists, strategists and policymakers miss it? Certainly as the virus was getting underway, advisors should have been incorporating it into their thinking. Certainly as the global economy started shutting down, advisors should not have been upgrading their recession probability forecasts "from 20% to 25%" and modestly downgrading their Chinese growth forecasts "from 6.1% to 5.6%." Maybe investors DIDN'T miss it. Maybe they actually thought that no matter what happens, the authorities want stocks to go up, and that is all you need to know.

The central bankers, particularly at the Fed, should be ashamed of themselves for fostering that belief, and for allowing the policy mix to be so skewed toward free and (overly) plentiful money. The solution is now pouring unlimited money into the boiling cauldron. MMT has come along just in time to justify everything. Not in productive ways, not in the building of useful infrastructure, not doing a better job of educating our workforce so we can grow like crazy, but just to save the screwed-up system that we have, just to hold things together. Helicopter money has made the job of active investing harder, and the suppression of interest rates by central bankers lowers the forward rates of return for everyone. You might say, "But it has enhanced the to-date rate of return." We would retort, "That is true, but despite the artificially enhanced to-date rates of return in bonds and stocks, net debt has skyrocketed, pension plans are universally underfunded and developed world infrastructure is oriented toward political pet projects and is inadequate to support needed economic growth going forward."

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