R Thoughts – Market Update #3 – March 25, 2020

We felt it would be helpful to review recent events in the financial markets and our response and actions in the accounts we manage on your behalf.

We certainly do not think it is a time to panic with your financial assets and thankfully, I can speak for all of us, we have not seen much of this from our clients and for that – thank you.

With a world in lockdown and nothing else to do, at times we may be more tuned in to the media through various mediums than we otherwise might be. This has led to a viscous cycle with fear and hysteria running very high.

We do not believe and feel very strongly that this is NOT the beginning of a Depression. Far from it, in our view. What we do believe is this is the start of a U.S. and global recession and that is nothing to fear at this point. Recessions are simply part of the normal business cycle and we believe that this recession will be short.

The financial markets are discounting machines. They process information looking into the future and adjust current pricing accordingly. What has happened in the past few weeks is, due to a variety of issues, the markets have now adjusted to the realization of a recession and adjusted prices around 30% lower from the highs in mid-February. (1)

Although I (Jim Kniffin) wasn't alive in 1929, I was alive and working in the industry in 1987 and I think this is much more reminiscent of '87 when stock markets corrected very sharply and quickly then proceed upward over time. The speed in which the economy is now moving from expansion to recession and the markets' reaction to it is the fastest in history. (2)

Also, a very much overlooked event – the oil price war between Russia and Saudi Arabia – which quickly cratered energy prices, has had a dramatic effect on the pricing in the overall credit/bond markets. There has been tremendous dislocations in the price of any fixed income security - except for the shortest of U.S. Treasury issues. Due to the Federal Reserves' massive interventions the past few weeks these markets are beginning to stabilize but currently are still far from normal.

According to Morgan Stanley's Chief Equity Strategist Mike Wilson, he believes the table has been set for a recession for a few years and the average stock has been in a "bear market" for more than two years. Mike believes, and we concur, the recession marks the "end" of the bear market and that we have been going through one somewhat stealthy for a while now. (2) We believe the Coronavirus was simply an accelerant in adjusting financial market pricing downward. The markets are now, in our view, beginning to discount an end to this recession over the next six months or so. That is a good thing.

It is also true the U.S. Federal Reserve Bank and other Central Banks around the globe are doing whatever necessary to offset the "demand shock" which has all but halted economic activity worldwide.

These actions have – at least through today, March 25th - seem to have calmed the markets and more rational pricing has been noted by us.

We believe price matters and think that pricing in the equity markets is much better today than it was just five weeks ago. There has been tremendous dislocations in the financial markets but with this we think there are tremendous opportunities out into the future for those with discipline and a strategy.

So with that as a basis, here is how we at the Diamond Peak Group envision the near-term future in the financial markets and our response to that vision.

First, WE HAVE NO IDEA IF WE ARE AT OR CLOSE TO A MARKET BOTTOM in equity prices. Things certainly "feel better" the past few days, however, in our years of experience, normal market bottoms usually take months to form and one only knows a true market bottom is in place in hindsight. That often occurs with an exhaustion of selling.

We do know recessions usher in new business cycles and the new cycle will likely look nothing like the prior market cycle.

The prior market cycle owned the market via passive strategies – the "indexing" model which, in our observations, has dominated investors' preferences for the past 10 years or so. The passive strategies of indexing has also often led to 100% downside capture – meaning these strategies have declined as much as the indexes they mirror – or an average of a 30% decline from the market highs last month. (3)

Our job as your asset managers is to look through to the other side of this recession to a new business cycle and the old business cycle – U.S., Large Company, Passive, Growth strategies – is not likely to be the new business cycle, in our view. The old business cycle model greatly depended on low interest rates and basically "free money" which the Federal Reserve provided with abundance over the past number of years.

Given the policy and monetary response to this crisis – and we do believe it is the proper response – the Fed's policy levers will be gone for quite some time. The Fed has proven they are the buyers of last resort and they have been buying every asset class in huge size this week and will continue to into the future. U.S. debt will likely be more than 100% of GDP as we move forward. (2)

The natural result of this – in our opinion – will be higher inflation and higher interest rates. We believe the U.S. dollar needs to and will decline relative to other currencies. There has been a tremendous rush to own U.S. dollars during the crisis as a flight to quality. (1)

We are encouraged and proud of the way our Tactical Growth accounts have held up against the overall market in the past five weeks. Overall we feel they have done exactly what we hoped they would do in limiting the amount of declines in asset values as the equity and credit markets have been under extreme pressure.

We have been slowly, …very, very slowly, increasing our net equity exposure over the past week in our Tactical Growth accounts. Remember, we believe the bottoming process in the equity and credit

markets here in the U.S. and worldwide is just that – a process – and will likely take several months before the "all clear" sign might be hung out again.

As a colleague said to me today, "I've been through several of these rodeos in the past thirty years but this rodeo has been different than all the rest." I've (Jim Kniffin) been at this since March of 1981 and I'd say pretty much the same thing; it has been frightening, at times breathtaking and certainly stressful. But this is precisely why we manage assets the way we do. We have said many times that if we manage the risk in portfolios we believe the returns will take care of themselves. We have been defensive in our Tactical Growth accounts and now have cash in which we can deploy over time and in a disciplined manner allowing us to potentially take advantage of the many "fat pitches" which we think are developing in many asset classes.

In closing, we wish you and those you love and care about safety and health. Though we are all working remotely at present, we are able to answer any questions or concerns you might have. Please do not hesitate to reach out to one of us if needed. Be well.

The Diamond Peak Group at Morgan Stanley

Written May 25, 2020

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Links to our Recent Written Newsletters and Updates:
R Thoughts – Winter 2020
R Thoughts – Market Update – February 27, 2020
R Thoughts – Market Update #2 – March 12, 2020

Sources and Footnotes

1) ThomsonOne Market Monitor, March 25, 2020
2) Mike Wilson, Chief Equity Strategist, Morgan Stanley, Client Conference Call, March 25, 2020.
3) Definition of Index Fund, Wikipedia

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CRC# 3013197 03/2020