

April 2020

Today I write this quarterly client letter in the midst of a recession, one that three months ago I did not see coming. As noted in our January letter (and even italicized): *We cannot predict the future*. I suspect we have proved that by now. Successful long-term investing does not depend on successful forecasts of the future (which is impossible), but on accurate analyses of the present (which is possible). What we have before us, as described by Jim Bullard, president of the St. Louis Federal Reserve Bank, is a government-induced recession. Why would the government induce a recession? Don't governments obsess over preventing recessions? Democratic governments must face the voters every few years. Recessions don't usually lead to election victories. Even autocratic governments worry about legitimacy and the potential for revolution; they don't want recessions either.

A government-induced recession does seem like an oxymoron, until one observes the unique threat that a highly contagious pandemic represents. Our leaders, with surprising unanimity, determined that shutting down the economy, by forcing us to shelter at home, was a preferable outcome to the potential deaths of hundreds of thousands of citizens and overwhelming the health care system. People will second-guess those decisions for generations, but that is the hand we're dealt. We will leave it to others to assess the wisdom of policymakers' decisions as we must invest according to the world that is, not in the world we would want.

This is a recession unlike any that we have experienced or studied. In searching for analogs, we find two other types of historical economic events to be instructive. The first is that of a mass-mobilization war, such as World War II. In that event, the government needed to redirect the productive power of the economy toward a purpose greater than normal business: winning a world-wide conflict. The government quite literally told American businesses to stop what they were doing and do something else. Auto manufacturers were told to stop making cars and trucks and start making tanks, troop carriers, and even airplanes. Consumers were told to stop normal behavior. "Stop buying tires and silk stockings, the government needs the rubber and silk; stop your usual jobs, join the military or go to work producing military equipment." Normal economic activity was stopped by the government, while new economic activity (of the military kind) was created by the government.

Now imagine what would happen if the government told us to stop normal economic activity, but then didn't create any new economic activity to replace it. That is what we have lived with for about five weeks in late February through late March. Government instructions to combat the coronavirus halted economic activity, but we didn't get any action from the government to "fill the gap" until March 24. That is why the market fell 35% over the preceding five weeks (basis the S&P 500). (In fairness, one arm of the government, the Federal Reserve, has provided extraordinarily positive support to the financial system. We give them an A+.) Since then, the government has made several sizeable actions to fill the

gap, and the stock market has responded positively. I've taken many questions about the market in the last few months, and my response has been largely the same: a cyclical low and recovery in the market will require two things – a peaking of infections and a massive response from the government to support the economy.

Mistakes by policymakers have been made and will be made. This is normal. The market will respond, not so much to the mistakes but to the effort. Since this recession was largely induced by government action (a reaction to the pandemic), honest and substantial efforts by the government to support the economy will be appreciated by investors. Thus, I believe it's probable that the March 23 low in the market will hold. As an older (and wiser) friend and market analyst once told me, the stock market will always bottom at the point of *maximum fear*. On that fourth Monday in March, we were staring at an exploding health crisis while Congress dithered. Fear maxed out. When Congress got its act together in the next 24 hours, fear abated. That 35% decline in stock prices over five weeks was the fastest such decline on record, but the size of the sell-off was typical for a recession. We still can't predict the future, but if progress is made going forward against the coronavirus *and* the government doesn't ignore the economy, then we should work our way back.

I mentioned above that this unique recession is analogous to two historical economic events. In addition to a mass-mobilization war, this event is reminiscent of the effects of a natural disaster, such as a major hurricane or tornado. The difference is that a hurricane is regional, while this disaster is global. Hurricanes are devastating to the regions affected, but they have a conclusion, after which reconstruction begins. While this crisis doesn't have the crisp endpoint of a weather disaster, it will end. And when it does end, we expect the American people will quickly go back to work to repair the damage just like they do after a tornado. Such relief and recovery usually require government assistance and support, and this disaster will be no different. But anyone who has seen a community rebuild after a hurricane or tornado has been impressed by the American spirit, and by how quickly the effects of the disaster are erased. I don't doubt that the recovery from this disaster will be similarly impressive.

We appreciate your confidence in us.

Gratefully,

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CEO and Chief Investment Officer

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