PCM
PEAK CAPITAL MANAGEMENT

Trickle Down Economics

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Trickle Down Economics was a much-debated economic construct in the 1980's and the driving force behind Reagan's Supply Side Economics. The theory states that high income earners receiving tax incentives will put more capital to work and the benefits trickle down to middle- and lower-income earners in employment opportunities. This debate is still prevalent in economic discussions today, but we are currently experiencing a different type of "trickle down economics" as a result of COVID-19 or the coronavirus.

While the spread of the deadly virus outside of China has remained mostly contained, notwithstanding the sudden outbreak in N. Italy and South Korea in late February, the impact is going to be felt globally. The trickle-down impact of the virus is likely to reduce global growth significantly. The financial markets oddly ignored the impact of COVID-19 for nearly 2 weeks before deciding to price in elevated risk starting February 24th when the Dow lost more than 1,000 points in a day and the market suffered back-to-back 3% down days.

The question astute investors are asking themselves today is "will the coronavirus result in a global recession?" How you answer that question determines the appropriate portfolio allocation. I believe the impact on supply chains will force the Fed, BOJ, and ECB to cut rates (likely 50 basis points) and initiate QE4. When announced, I expect a V-shaped recovery from initial market losses making this a non-event for investors if a recession is avoided. No posturing from Central Banks, however, will prohibit a steep sell-off if we experience a global recession.

The spread to Italy and resulting cancellation of public events like Carnival is distressing and will lower growth. The most concerning article I read was from the World Health Organization (WHO) that stated that there are cases with no known epidemiological link. If true, this would differentiate COVID-19 from SARS and make a devastating spread more likely.

The closest comparison we have is the SARS outbreak in 2002-2003 that also originated in China. The difference today is that China only represented 4% of the global economy in 2002 but represents 18% today. When factoring supply chain disruption, China directly influences roughly 30% of global economic activity according to some measures.

Context for COVID-19 is difficult. "Official" numbers on the virus are 80,000 cases and 3,000 deaths (WHO, at the time this was written). Any loss of life is tragic, but according to WHO figures, in the 2019-2020 flu season in the United States there were 15 million cases of the flu, 140,000 hospitalizations, and 82,000 deaths (U.S. only figures). We also live in a very different world than in 2002 when SARS occurred. It took 20 months to get a vaccine in phase I trials for SARS but it has taken only 3 months to achieve the same benchmark with COVID-19. It is likely a vaccine will be available this summer for coronavirus.

> **This outbreak will almost certainly result in an acceleration of plans to move jobs back to the U.S., resulting in higher domestic economic growth in the future.**

The velocity of money has dropped dramatically. Germany and Japan are likely already in recession given their negative growth in Q4. 18% of German auto exports are to China and the Chinese are not going to be buying as many cars in 2020 (UBS). The SME sector is the largest in China and most firms have reduced workforce by 20% and forced a 30% pay cut to the remaining employees (WSJ). China's economy could slip to below 3% growth, or less than half of previous forecasts.

Growth in the U.S. appears to be far more resilient. I was forecasting 2% growth for Q1 and it looks like it will only be necessary to drop that forecast to 1.8%. I expect Q2 to be hit the hardest, where growth could drop to below 1% before recovering in the second half of 2020.

There is a "silver lining" for the U.S. economy, at the risk of sounding callous given the suffering around the world. The Trump tariffs were already causing many companies to re-think supply chains and manufacturing and bring more of that economic activity back to the U.S. This outbreak will almost certainly result in an acceleration of plans to move jobs back to the U.S., resulting in higher domestic economic growth in the future.

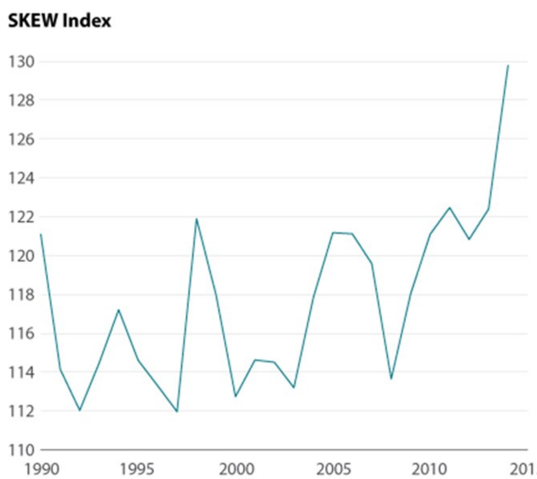
The current flight to safety has been unprecedented, even if it began later than expected. The 10-year Treasury hit all-time lows just 10 days after the S&P 500 hit an all-time high, a feat that that most portfolio managers, me included, could not have imagined. This has made Treasuries a great hedge against equity risk. We are vigilant in controlling volatility and will continue to do so in our portfolios.

Warren Buffet on Dogs

Warren Buffett, the Sage of Omaha, released his annual letter to shareholders discussing prior year results and espousing his views on the economy and financial markets. Buffett often utilizes this letter, read by millions, to discuss pet peeves and injustices he believes negatively impact the investor class. Buffett takes on the issue of corporate boards and the inherent conflicts of interest that exist. Buffett opines that CEOs prefer Cocker Spaniels to Pit Bulls when it comes to selecting board members. Pit Bulls are aggressive and will not relent until they achieve their objective. CEOs, often bent on questionable acquisitions and absurd compensation packages, prefer a breed more in line with "man's best friend." We salute Warren for his willingness to take on this issue as shareholders would be better served if more Pit Bulls occupied corporate boards.

- Berkshire Hathaway set record share buybacks in 2019 as they again had difficulty finding companies with compelling valuations to acquire. In just Q4 they purchased $2.2 billion of their stock, bringing the total to $5 billion for the year.
- For 2019 the company earned $81.4 billion, but only $24 billion was from operating earnings. The rest was the result of new accounting rules requiring them to book $3.7 billion of realized capital gains and $53.7 billion of unrealized gains.
- Berkshire continues to sit on a pile of cash totaling $128 billion as they wait for the right opportunities based on their view of trustworthy company management, compelling valuation, and strong earnings from net tangible capital.

Revisiting the Fat Tail

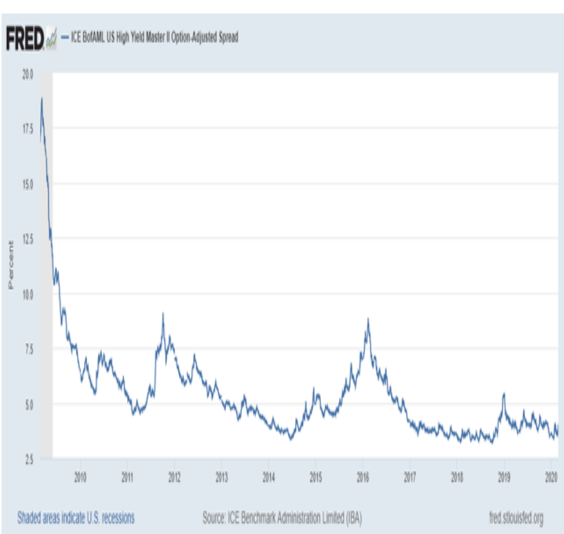


NOTE: An index of skewness in returns on the S&P 500 for 1990-2014, constructed using option prices.
SOURCE: Chicago Board Options Exchange.

The fat tail events surrounding the great recession have recently moved from the back of our minds to the front of our minds. The St. Louis Fed has recently produced great research to shed light on the impact fat tail risk has on investors' approach toward potential fat tail risk in the current market. The Chicago Board Options Exchange has quantified tail risk with the SKEW Index. The chart below shows the SKEW Index, demonstrating that the index has increased since the great recession. Investors' awareness of the potential for black swan events has increased. As of February 26th, the SKEW Index was 130.65, showing a spike above the 200 day rolling average (CBOE).

- Awareness of the potential for tail risk has been indicated by an increase in google searches on topics such as "economic crisis" and "financial crisis" since the great recession (St Louis Federal Reserve).
- The CBOE SKEW Index chart shows investors may become complacent prior to market corrections depicted by the index approaching a low prior to the 2008 recession.
- Google trends of searches related to risk have remained elevated since the great recession (Source: Google Trends).

Spread Compression

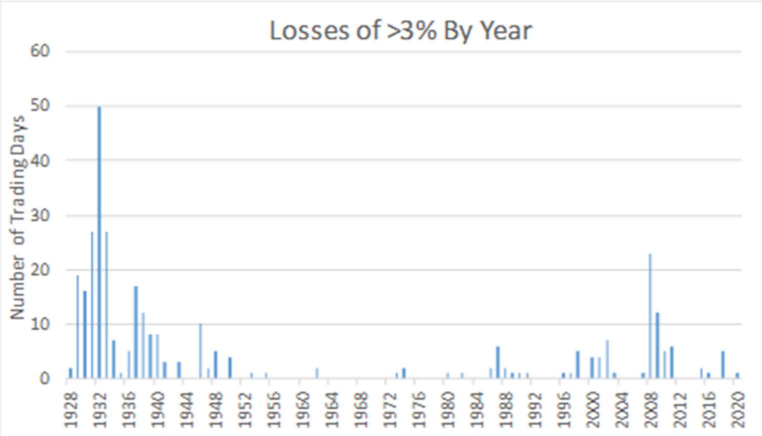


A common debate among investors and economists today concerns valuations in the high-yield bond market. With spreads, or the difference in yield, between bonds issued by companies with below investment-grade ratings and government Treasuries is fairly compressed. Historically, the yield on so-called junk bonds had to be sufficiently higher than the corresponding yield on Treasuries to entice investors. The high-yield premium had to compensate investors for the risk of default and loss of principal. But since the Great Recession of 2008-2009, the high-yield spread has come in substantially, which has raised concerns about an overvalued market.

- Based on current readings of the ICE BofA Merrill Lynch High Yield OAS Index (see chart), the current high-yield spread of 4.0% is slightly below the long-term median level of 4.8% going back to 1997, suggesting that the market might be somewhat overvalued. Given our low interest rate environment, and the overall reach for yield, there's ample support for this argument. How much further can spreads narrow, considering that high-yield bonds returned 14% last year?
- However, the overall composition of the high yield bond market has changed since the start of the Great Recession roughly 10 year ago. Based on data from the Barclay's High Yield Corporate Bond Index, the exposure to BB rated bonds is higher today, while exposure to CCC rated bonds is lower. Overall, the quality breakdown of the high-yield index is more favorable today.

Macro View – Drawdown Dialogue

February provided a wakeup call for investors with two consecutive days of over a 3% drop in the Dow and the S&P 500. According to Seeking Alpha, approximately 99% of trading days are above a -3% return dating back to 1928. In a standard normal curve, this type of correction occurs about 3 times per year. The chart below shows that sharp drawdowns occur more frequently during economic contraction. The chart also shows that downward trending momentum can persist in periods of economic weakness. It is notable that periods of low volatility can persist — for example, from 1951 to 1972. 2012-2014, 2017, and 2019 did not see a single trading day fall below 3% (Seeking Alpha). One could conclude that the drawdowns could be one of the canaries in the coal mine warning of future recession and correction.

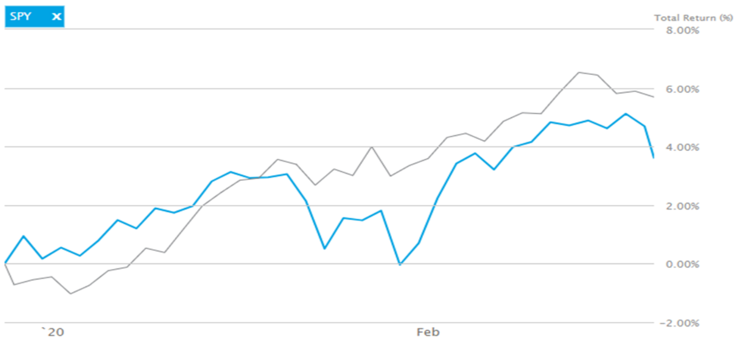


Source: Seeking Alpha

Taking Stock – Safe Haven

In February, the PCM Dynamic Risk Hedged US Growth Strategy over weighted low volatility companies versus other factors. The chart below shows the YTD performance of low volatility companies reflected through the Invesco ETF, SPLV, versus the S&P 500 ETF, SPY. As of February 24, 2020, SPLV is up just under 6%, while SPY is up just under 4%. Over 60% of SPLV is made up of financials, real estate, and utilities, followed by consumer staples companies and industrials. Not surprising that utilities and consumer staples are often heralded as defensive sectors. From February 14 through February 21, 2020, SPLV added $1.21 billion in assets, more than any other ETF for the same time period (ETF.com). The SEC 30 Day Yield is 2.32% (Invesco) offering the benefit of cash flow and income.

YTD Return (%) SPY (Blue) vs SPLV (Gray)

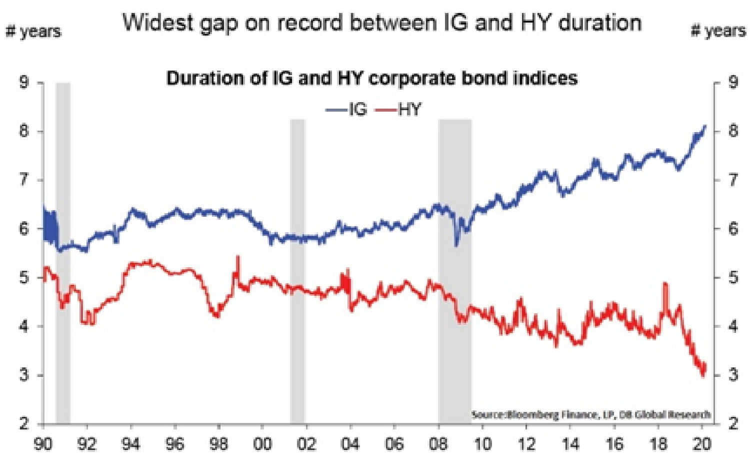


As of February 24, 2020

Source: ETF.com

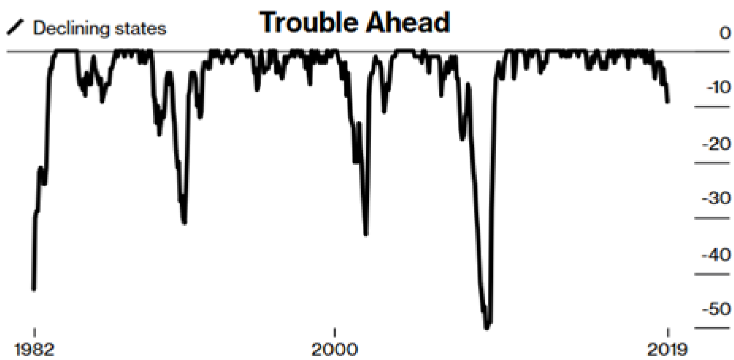
Fixed Income - Risk Off in Disguise

Equity markets hit all-time highs in February, making it is easy to assume we have been living in a risk-on world until panic over the COVID-19 showed up. The bond market has been flashing an early warning sign for more than a year as evidenced by the chart below. The two most common measures of risk with fixed income are credit quality (default risk) and duration. The longer the duration, the more uncertainty investors are subjected to. Investment-grade companies with low default risk have been taking advantage of historically low rates to lock in long-term durations. The market's pricing of risk for high yield companies is driving durations lower, to the lowest level in 30 years. The duration spread between IG and HY is now the widest on record at 5 years after averaging just 2 years for more than 20 years.



Technical - Warning Signs from States

One of the most accurate predictors of a recession in the United States is the relative level of economic activity on a state-by-state basis. The U.S. economy is nothing more than the sum of each of the 50 states' economic activity. History has suggested that when too many states experience negative economic growth, the nation's economy will ultimately follow. Over the last 30 years, whenever more than 30 individual states experienced economic contraction a recession followed. As we near the end of Q1, the number of states with contracting economies is right at the threshold of signaling a tipping of the economy into recession. This would suggest even a modest slowdown from COVID-19, particularly in states that benefit from exports to China, could become the tipping point to a U.S. recession. No indicator or trend is fool-proof, but we are watching this closely for signs of contraction.



Source: Federal Reserve Bank of Philadelphia

Interest Rates Reach New Lows

Clint Pekrul, CFA

It wasn't long after the Great Recession back in 2009 and the peak of quantitative easing from the Federal Reserve in 2011 that the headline story was how interest rates were destined to rise. The consequences of such unprecedented quantitative easing would certainly lead to inflation and ultimately higher long-term interest rates. Anyone with bond portfolios that held long-duration maturities (e.g. fixed income securities with maturity dates beyond seven years) was at great risk of principal losses, as higher rates would send bond prices lower. The correct way to position portfolios was with TIPs, which have coupons that adjust with changes in the Consumer Price Index, and variable, floating-rate bonds that would shorten duration.

Indeed, higher interest rates and inflation might ultimately be the path forward over the next decade or so, and holding securities such as TIPs and floating-rate bonds might prove to be the correct portfolio allocation decision. But as of February 25th, 2020, the yield on the benchmark 10-year U.S. Treasury reached an all-time low of 1.31%. Over the past decade, the Barclay's 20+ Year Treasury Index is higher by roughly 120% on a cumulative basis, compared to a corresponding gain of roughly 44% for the Barclay's Aggregate Bond Index. Holding long duration has been the better investment. We've provided two charts to illustrate the more recent moves in yields over the past 10 years (Chart 1) and the longer-term change in yields (Chart 2).

Chart 1

Chart 2

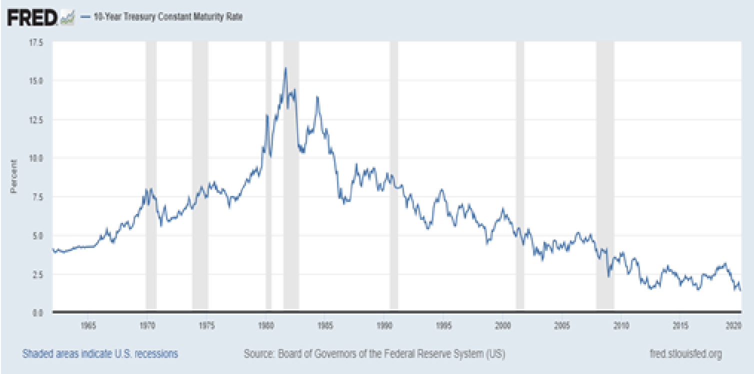


Chart 1 begins in 2010 when the Fed was aggressively pursuing quantitative easing and operation twist to inject liquidity into the market. The 10-year yield began at roughly 4% and proceeded to collapse to roughly 1.5% in 2012 amid the Eurozone debt crisis. Then Fed chairman Bernenke made comments in 2013 that the central bank might taper their quantitative easing programs (the so-called "taper tantrum"), and yields soared back to 3%, but then subsided to new lows in 2016 as energy prices collapsed and market participants began questioning global growth potential.

Then, president Trump got the nomination on a platform of tax cuts and infrastructure spending, which sent rates higher based on inflation expectations. Fed Chairman Powell took a tightening stance and raised short-term rates. The 10-year ultimately rose to roughly 3.2% in 2018, but when market volatility hit, the Fed pivoted on policy and began lowering rates in 2019. Now, with the threat of the coronavirus and an economic slowdown in China, the 10-year sits at an all-time low. Chart 2 provides a longer-term view of the 10-year yield. Structurally, the benchmark rate has trended lower since the inflationary periods of the early 1980s, dropping from an all-time high of roughly 16% to 1.3% today.

Earlier this year, former Fed chairman Bernanke suggested that the central bank should not rule ***out*** using below-negative interest rates combined with direct asset purchases to combat the next financial crisis. This would suggest using a policy of keeping short-term rates at the lower ***end*** bound with longer-term rates near zero or negative. Another former Fed chairman, Alan Greenspan, commented that it's only a matter of time before we experience negative rates in the U.S. Current chairman Powell, however, has stated he would prefer to use direct asset purchases and forward guidance, but not negative rates. The bottom line is that rates seem to be on the "lower for longer" path, at least until the uncertainty of the coronavirus impact and the upcoming presidential election abates.

Q: What do you expect the market impact to be if Bernie Sanders moves closer to the Democratic nomination?

I believe the impact would be a skyrocketing of real estate prices in Puerto Rico as demand from high net worth families from the mainland relocate to the island territory of the United States with its unique tax benefits. Being forced to deal with an occasional hurricane and power outages might look attractive compared to planning around confiscatory wealth and income taxes. While the curmudgeonly Vermont Senator has risen to the top of the Democratic primaries, his socialist views and confiscatory tax policies have not been market moving. I think it is because most investors do not expect a socialist would defeat Trump and his business-friendly policies even if he won the nomination.

The establishment Democrats were relying on former NYC mayor Michael Bloomberg, who is self-financing his campaign, to be the solution to defeat Trump in November (note, Bloomberg does not own or publish the PCM Report). Who better to beat a billionaire businessman in his 70's than an even richer billionaire in his 70's? Sadly, or not, Bloomberg has instead only competed for the title of most gaffe-prone with Biden (a difficult title to wrest from the former VP).

Well, at this point, it looks like the nomination is Bernie's to lose. My initial stance was that the Democratic establishment would do everything they could to prevent a Bernie ticket, but if he pulls through super Tuesday in good shape, there's not much the establishment can do to stop him, in my opinion. Michael Bloomberg's showing in the Nevada debate was not all that inspiring, and at this point the chances of him overtaking Sanders seem fairly slim. For now, it doesn't seem like any of the other candidates are willing to bow out, but that will likely change after super Tuesday when a third of the delegates will be rewarded. Then we could see a narrowed field and a possible brokered convention this summer. But for now, it seems like Bernie has all the momentum.

What does this mean for the market? I don't think Bernie can win in November. But if circumstances change between now and the election, the prospects of a Sanders administration would be less favorable for the market than another four years under Trump. But even so, I don't place a high probability on his administration actually passing many of his major initiatives. So, the market reaction to a Sanders presidency might not be as dire as some might think.

Q: How does the oil drop below $50/barrel impact the markets?

Answering this question has become far more complex than just 10 or 15 year ago. In the past, low oil and gas prices were the equivalent of a tax cut for consumers and resulted in higher consumer confidence and spending driving GDP higher. With the advent of fracking and other technological advancements on drilling leading to U.S. energy independence, the impact is far different today. Yes, low gas prices do lead to more discretionary income for Americans, but a rather large and growing percentage of our economy is energy production.

West Texas crude below $50/barrel is likely to result in a reduction in well count and lower spending among oil service companies in states like Texas and Oklahoma. Layoffs and lower wages in the sector will negatively impact the economy and offset the benefits of higher discretionary income in other sectors of the economy. The result remains a net positive for consumers at a national level but also raises the risk that lower oil production will lead to more energy imports in the future.

A quick look at the S&P 500 Energy sector returns will tell you how difficult the market has been. So far this year, the sector is down about -18%, and has lagged the broader market for the past decade. To some, the fall in the price of oil is seen as a signal of weakening global aggregate demand. The assumption is that falling oil prices could correlate with declining equity prices, since weaker overall demand will hurt bottom line earnings. If you look at the more recent past, particularly in 2015 and 2018, decreases in oil prices as measured by West Texas Intermediate corresponded with declining equity prices. However, if you look at 2015, the year began with a fairly substantial collapse in WTI from roughly $105 per barrel down to about $30 by the end of the year. That decline of approximately -70% didn't coincide with a recession. Part of the reason is that the energy sector as a percentage of the overall economy isn't close to what it was back in 2007, just prior to the Great Recession. So, while the price of oil is worth watching and markets will respond in the short run, I'm not sure its importance is quite as meaningful as it once was.

All weights as of March 1, 2020

Income	
Mortgage Backed Bond	46.27%
Investment Grade Credit	20.27%
High Yield Bonds	9.95%
Preferred Stock	10.72%
US Dividend Equities	5.89%
US REITs	6.89%

Balanced Income	
US Dividend Equities	17.49%
International Dividend Equities	15.50%
US REITs	12.75%
High Yield Bonds	24.27%
Long Term Treasuries	29.98%

US Growth	
Low Volatility Factor	14.99%
High Quality Factor	11.98%
Small Cap Factor	10.96%
Value Factor	13.78%
Momentum Factor	10.56%
Long Term Treasuries	37.71%

Global Growth	
Low Volatility Factor	9.09%
High Quality Factor	5.48%
Small Cap Factor	5.54%
Value Factor	6.66%
Momentum Factor	5.32%
Developed Market Equity	15.52%
Emerging Market Equity	13.48%
Long Term Treasuries	38.91%

Weights are approximations only and subject to change.

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