the Connection

A Quarterly Review

2nd Quarter 2020

STRANGER THINGS

Let us just preface this document with “Wow, what just happened?” This has been the most bizarre quarter of our firm. And personally, we think probably the weirdest six months most of us have ever seen. Our prognostication is dry. We don’t know what is going to happen in terms of markets or virus spirals, but we do have a good idea as to why markets reacted the way they did. We also have some opinions on the Fed and the Treasury, and why there is not going to be inflation anytime soon.

Starting with market panic, and ending with euphoria, what is going on with the stock market? There is a big difference between the NASDAQ and the Dow Jones. The NASDAQ was up double digits through the first six months of the year, and the Dow was down double digits through the first six months.

Covid-19 sparked a sea of change that was going to happen anyway. Our baseline forward thesis was that over the next ten years, adoption of cloud services and the ability for employees to be productive from anywhere was going to happen slowly. If people aren’t required to be at a certain place for work, then all of the retail and dining that was built around work locations (including gyms and recreation areas) was going to be less profitable.

We thought that transformation was going to happen over a prolonged period of time, giving businesses and consumers the time to make appropriate decisions to adapt. Covid-19 gave no time to adapt. The companies that were moving that way moved faster, and companies that were not prepared immediately for that development are on the skids. The winners in this light speed adoption are – Cloud companies, consumer electronics, software, healthcare technology and data infrastructure - All industries that we liked longer term. Companies that saw their ten year plan vanish – retail, restaurants, leisure and travel, industrial production, fossil fuels, hospitals, insurance and banking, are the losers. That explains the massive disparity between the NASDAQ, which is technology and biotechnology, and the Dow, which represents finance, industrials and to a much lesser extent technology.

The only reason stocks are benefitting at all is related to something we wrote about in January. There are no opportunities anywhere else. High grade bonds yield next to nothing so conservative investors are forced into equities. Historically professionals typically made their living finding impaired companies and changing the direction to better unlock value and thereby increasing stock price. Covid-19 just blew all those models up. What use is a gas pipeline, and managing the cost structure of it when no one is driving? Does it matter that Macy’s has fewer employees and a better supply chain when no one shops on location? Today successful investors are understanding that accounting and modelling does an investor no good if the historical assumptions are no longer relevant.

The best defense in hard times is growth. During the Great Recession companies that couldn’t grow revenue were crushed. Companies that couldn’t control costs got crushed. They never really recovered compared to their less leveraged and stronger revenue peers. Dryships went from a massive multinational to a bankrupt shipping company while Netflix ended up more valuable during the recession. The paradigm shift has already cemented itself. Defensive companies are now established technology and infrastructure companies (including healthcare technology). The cyclicals are now financials, utilities, energy companies, telecom, insurance and other companies that cannot control costs.

As Gencap cautiously looks to put capital back to work where we have built cash, we will be looking very specifically at technology infrastructure. The only clarity that we have today is that if these trends of a productivity diaspora continue, the globe will need more infrastructure to handle the data and communications necessary to be productive from anywhere. That means more silicon, more fiber optics, more remote testing and automation, and more satellites.

Moving on to why stocks are up in the first place, we will tackle the Fed and Treasury response. Again, currently a lot of professionals are on the wrong end of this idea. The common logic is that the Fed response of increased money supply and deficit spending will cause inflation. That is true in a vacuum, but it turns out everything is relative (Einstein would have made a great economist).

The U.S. treasury is printing money at an astounding rate, but we don’t foresee inflation. How can that be? Supply side economics says increase supply, demand stays the same, and value goes down – inflation. Where inflation hawks get it wrong though, is that demand for the dollar is going up, matching the supply increase. There are no other central banks in the world that compete with the Fed today. The global currency for trade and savings is the U.S. Dollar. That is why the U.S. treasury can print with impunity. When 100 million citizens from India and China and Indonesia become middle class, those countries can’t necessarily increase money

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supply without spurring inflation. They don't have the global confidence that the U.S. dollar has. The Euro could have stepped in and competed against the dollar, but too many conflicting ideologies and economies make the Euro a decentralized organization. So the U.S. is left printing the currency of trade to accommodate money supply issues across the globe.

We think the Fed and the United States is in the cat bird's seat right now. The United States has the only centralized response that can print money with full faith globally. Even if we run up a 15 trillion dollar tab that needs to be paid back in thirty years, we think the Fed should do it. There is no inflation problem today. There is no cost of capital problem today. Borrow away and spend on infrastructure and jobs. If inflation rears its head in ten years, then that 15 trillion dollar deficit that is coming due in 30 years will be easier to pay off.

That unlimited Fed response is also pushing stocks. The risk denominator right now is zero. And if you divide anything by zero, you get infinity. That is why traditional measures of risk and opportunity costs are out the window. Stocks that pay dividends are the new bonds, stocks that don't pay dividends but earn money are the new value stocks. And stocks that won't earn money for five years are the new growth stocks. We will be leery of equity markets when we can earn more than 2% in a ten year treasury. Don't expect any protracted bear market until there is something else to do with investor cash.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks
www.sfmfoodbank.org
www.shfb.org
www.foodbankccs.org
www.refb.org

Bloom Marin
www.bloom.org

Maya's Music Therapy
www.mayasmusic.org

Frien*ds of the Urban Forest*
www.fuf.net

Guide Dogs for *the Blind*
www.guidedogs.com

Doctors without Borders
www.doctorswithoutborders.org

The Nature *Conservancy*
www.nature.org

Nationa*l Kidney Foundation*
www.kidney.org

Guide Dogs of America
www.guidedogsofamerica.com

Golden Gate National Parks Conservancy
www.parkconservancy.org

Fine Arts Museums of San Francisco
www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Whistlestop
www.whistlestop.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.nothernsierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

Marin Agricultural Land Trust
www.malt.org

Walk to End Alzheimer's – San Francisco, CA
www.act.alz.org/sanfrancisco2019

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