

First Quarter 2020

Economic and Market Commentary

His friends called him “Double D,” an affectionate nickname given to him by classmates years before. That made sense, since his given names were David Donald. Just over six feet tall and solidly built, Double D had an affable smile, a sharp mind and a can do attitude. With his one gold bar and star neatly pinned to each shoulder board, 22-year-old Ensign Lent (my paternal grandfather) was ready to go to war.

America had entered World War I a little more than a year earlier, April 6, 1917. It was now June of 1918, and Lent had just received his commission weeks before and wanted to be part of the “War to end all wars.” But, as it turned out, the government had different plans for him. He wasn’t “going over there” because his deployment papers told him to report to the Brooklyn Navy Yard, just a few miles from where he grew up.

The Brooklyn Navy Yard was the first navy yard the United States ever commissioned. It opened in 1801 on a sprawling 220-acre site at a bend in the East River called Wallabout Bay. Known later as the “Can Do Shipyard,” thousands of wooden ships were built there through the 1870s. By the 1880s, they had switched from wood to steel. They built much of the fleet for the Spanish- American War, including the Maine, whose sinking was the trigger to that War when she was destroyed in Havana Harbor in 1898. Perhaps the most famous ship built at the Yard was the Florida-class battleship, the USS Arizona. She was built in 1915 and now rests on the floor of Pearl Harbor.

It would be a little more than four months from the time David was stationed at the old yard that World War I would be over. A generation lost at the cost of well over 20 million lives, 116,708 of them American. Two thirds of those American deaths occurred in the last six months of the War for reasons you might not suspect.

The Unseen World War

Unbeknownst to the world, a new World War was brewing that spring, one that would prove to be far deadlier than the one that was winding down. This time the enemy was unseen, and the foe was not a nation but mother nature herself, and Ensign Lent was soon to find himself on the front lines.

Round One

Several months prior to Lent’s posting at The Yard, a young army cook named Albert Gitchell, stationed at Fort Riley, Kansas, reported in sick with flu-like symptoms. That was on March 4, 1918. Within the next several days, an additional 521 soldiers reported in sick. Just one week later, March 11, 1918, the first case of what soon became known as the Spanish Flu showed up in Queens, New York, 10 miles from the Brooklyn Navy Yard.

Most people recovered well from this first wave of flu, but it was its return in August that proved

so deadly. Many US troops started returning home that summer infected with an avian form of virus that later proved to be the H1N1 virus which is still around today. Stuck in trenches for months, at a time both the infected and the healthy soldiers lived in close proximity. When their time came to head home, they got on crowded trains to then be shipped home in even tighter quarters on ships.

A critical reader might say, “Wait a minute, Ray, I thought you just said the first case of Spanish flu started in Kansas and now you’re talking about troops returning from Europe. What gives?” The truth is that nobody knows where this pandemic actually started. The world had been at war for four years. Yellow fever and diphtheria were already rampant throughout the world. As early as 1917, British troops at a staging site in Etaples, France, were coming down with similar symptoms. Both the Germans and the allies suppressed as much information as possible from the world. They already had enough on their plates. It took the press in Spain, a neutral country, to get the word out. Now you know how that pandemic got the name “Spanish Flu” because it was the Spaniards that broke the story.

Like today, New York found itself at the epicenter of the pandemic here in the United States. That summer, Lent was assigned to assist in the maritime quarantine that was put in place. This quarantine was land based for those arriving by ship from Europe whether they were civilian or military.

As Quickly As it Came

The second bout of the Spanish flu passed through region to region rather quickly, never seeming to linger for more than a few months before it mutated to a less deadly strain. But what a toll was paid. That October of 1918, more than 185,000 Americans died from the virus, almost 20,000 of them right there in New York where Lent was stationed. In all, more than 650,000 Americans lost their lives to the pandemic, a country with a population of just over 100 million at the time. No region was immune, no region was spared. Right here in San Rafael, City Sheriff Keaton succumbed to the illness just days after contracting it. In all, the pandemic of 1918/'19 took somewhere in the neighborhood of 50 million lives worldwide.

It’s been a hundred years since the world has had to bear and combat the devastation of a pandemic, “An epidemic that has gone worldwide.” No place to run, no place to hide. The Spanish flu epidemic of 1918/'19 was certainly not the first global pandemic, and as we ourselves tragically bear witness to today, it certainly wasn’t the last. What’s changed is how little time it takes to cover the globe. A stark reminder of how fast the world now travels.

It took almost 300 years for the Black Plague to make its way around the known world starting in the 14th century. Back then, almost 60% of those who contracted it died. Two hundred years later, smallpox went around the world, not once but twice, killing roughly 30% of those who contracted it. By the time Europeans came to North America, it took less than 200 years for measles to kill 90% of Native Americans. The list goes on.

Fast Forward

In the last 60 days, we've learned terms like "Shelter in Place," Social Distancing," and "Covid-19." Was it really so long ago that our biggest disappointment was the 49ers not winning their sixth Superbowl? The reality is our country is now at war. In fact, the whole world is at war, not with each other, but with an unseen killer born from the might of mother nature.

We find ourselves in a period like no other in our lifetimes. Whether young or old, it's a period that requires resolve, thoughtfulness, creativity and common sense. It also requires working together. It makes my blood boil when I think of Congressman Thomas Massie from Kentucky who demanded a voice vote on the first phase of the bailout bill. The hubris of Massie to force so many Congressmen to travel at a time like this is inconceivable: numerous members of both the House and Senate had already come down with the virus. It was shameful and dangerous and the antithesis of what it will take to come out of this with the least loss of life possible, stronger and better prepared for the next challenge.

Flattening the Curve

Yet another new term to enter into the American lexicon. By flattening the curve, scientists are saying we avoid an otherwise inevitable spike in the infection rate. This spike would overload our hospitals and medical capabilities ultimately resulting in a far higher mortality rate. What we need to do is stay smart and not spread the virus. This will dramatically speed up the return to normalcy and renewed growth and prosperity. To try and irresponsibly speed up the process will only fuel more infections and more deaths and take the economy a lot longer to recover.

We're in "Shelter in Place" right now. No bars, no restaurant visits, no theaters, and no baseball just to name a few of the restrictions that have happened. Muni and Caltrans all but shut down recently, so it only stands to reason that the economy will be off for several more quarters at least. Being the news junkie that I am, I heard an interview with Bill Gates the other day, a man I respect for his genius, insight and philanthropy. During the interview, he was asked, "How long do you think it will be before you and your family might be resuming somewhat normal activities?" His answer: "If all goes well and we contain the virus growth, I would say at least 10 weeks."

Remember, that was assuming we're doing all the right things and containing the virus, something that's in our power if we're smart. Back on November 12, 1942, Kaiser shipyards launched the Liberty Ship, the SS Robert E. Perry, in less than five days. That's a reminder of just how important it is for us to pull together and use all of our resources.

It's shameful to me that all of our hospital and medical personnel are risking their lives daily while lacking equipment as basic as masks, gowns, testing kits and beds. My hat is off to companies like Brooks Brothers, America's oldest retailer, to take it upon themselves to make 25,000 surgical-grade masks per day, or Leonardo, the scuba company, to start making respirators instead of waiting for ridiculously delayed federal powers to be invoked so that our industries can retool as needed when we are dealing with a time of crisis. Let's not kid ourselves: this is war, and we need to use every tool at our disposal whether it be cutting edge, common sense or tried and true. You know, they are experimenting right now with a plasma type therapy that was first used successfully against malaria more than a hundred years ago.

Usually, around this time of year, companies are reporting earnings and are giving out guidance on the upcoming quarters. This year, they are not. Why? Because many companies' earnings will look horrible. So has that fact been completely baked into the sell off in the equities market? Maybe, maybe not completely. The extreme volatility of the market demonstrates the uncertainty. The good part, where we start to see a prospering economy, prolonged growth and a release of pent-up demand, won't start until after the curve has flattened and people are moving around again living their lives.

We Get it Now

We were slow to recognize the pandemic threat and slow to respond to it. Scientists have warned us for more than 15 years of the imminent danger of a global pandemic and how we will be unprepared for it. We've had our warnings over the years. Remember Legionnaire's Disease, Ebola, West Nile, or how about the H1n1 virus that infected more than 60 million Americans back in 2009/'10 yet killing less than 13,000 (Americans having developed some immunity and advancements in vaccines since it first appeared as the "Spanish Flu" 90 years before were the main reasons it was so much less deadly when it returned).

It is Absolutely Not All Doom And Gloom

To begin with, although very contagious, the Covid-19 virus has a very low mortality rate. Most individuals are now practicing social distancing, sheltering in place, avoiding unnecessary travel and crowded spaces. This will greatly speed up our recovery on all fronts.

There will be tremendous amounts of money from the federal government spent (hopefully wisely) in backing up businesses and workers. I'm hoping much of the money spent will go to people flat out of luck: the gig workers, and people who work in restaurants, nail salons and gyms. You'd be amazed at how many households live one or two paychecks from homelessness. I also hope the aid goes to small and medium sized businesses so they can still be around when this is over. It's these same businesses that employ 70% of America.

It is my true belief that we will be far greater prepared for the next challenge and hopefully a bit kinder and more helpful toward each other when this is over.

Let Me Bring it Home

Think of it this way: Two months ago, most people you'd talk to couldn't even point on a map to where Wuhan Province was or what they did there. People looking at American business felt pretty darn good. Productivity and profits were strong, wages relatively low, interest rates low, inflation low and energy costs pretty low. Technology was helping in every industry. Stock market prices, although a bit "frothy," were nowhere near the ridiculous levels of P/E multiples of previous busts but were actually much closer to the 60-odd-year averages.

The fundamentals are all still pretty much in place, and when we finish our war with this unseen killer, the market should ultimately grow robust. Good companies that had good business models

and modest debt will do great over time. Those companies that operated with loads of cheap borrowed debt will probably be acquired, merged or just plain gone.

Through active management, we've always endeavored to put a high emphasis on a company's capital structure (debt to equity) when picking our securities. We manage our equity portfolios so that, although not immune from a pandemic's financial backlash, by and large, they have held up very respectably, particularly against the major averages. Between a very strong third and fourth quarter of 2019 and the carnage of first quarter 2020, our rolling 12-month numbers have left most portfolios relatively flat, leaving us poised for what we predict will be strong positive results in the upcoming 18-36-month period ahead.

Obviously, nothing happens on auto pilot. Back in early February, when the cruise ship, the Diamond Princess, was first quarantined in Yokohama, Japan, we immediately began reviewing each and every client's portfolio, removing all cruise ship lines and international air carriers along with most emerging market ETFs.

For those clients with holdings in variable annuity sub accounts, company 401(k) plans, 403(b) plans and the like, we looked at the underlying holdings inside the funds and endeavored to do the same screening. Clients with variable annuities in their portfolio enjoy holdings that provide that incredible safety net of guaranteed income for life no matter what might happen in the markets. In your case, your portfolio holds variable contracts that provide that incredible safety protection of guaranteed income for life no matter what might happen in the markets.

We are treating this market as an opportunity to continue to consolidate our positions to those companies exhibiting foresight and strong management focused toward the future, It would be a time to avoid excessive discretionary spending so as not to have to sell, unnecessarily, securities at bargain prices.

Having grown up in Manhattan, call me biased to have followed New York's plight with deep sympathy and keen interest. In a recent daily briefing, Governor Andrew Cuomo laid it out quite succinctly when he said: "There is no on/off switch. There is no short-term point to declare it's over. There are points of resolution over time." To paraphrase, they are:

- We are controlling the spread
- Universal testing is conducted to both determine if people have the virus, and equally importantly, if they had the virus and recovered
- The worst is over
- We are starting on the way back to normalcy
- Some businesses are opening
- We have a medical treatment for those who become ill, and ultimately,
- We have a vaccine.

Until then, I want to remind you that we are all well, working very efficiently, principally from remote locations.

Right now you need to stay safe and do the right things. You don't want to be a statistic because

of your own foolishness. Rather you want to be a survivor who is around to enjoy the recovery—when it comes.

I look forward to the end of social distancing and our next visit. Until, then, just call if you need anything.

With Warm Regards,

Ray Lent
RLL/dot
Enclosures