LEWIS WEALTH MANAGEMENT

Newsletter

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Executive Summary

There was a dismal jobs report last week. Investors want to know if we are heading into another Great Depression and why markets went up after this terrible news.

While our unemployment rate may hit 20% (and that has not happened since the Great Depression), we are likely not heading into a depression.

The Great Depression was a credit and banking crisis that was exacerbated by catastrophic policy decisions by the Federal Reserve and the Hoover administration.

This is a global pandemic – it's different. The better analogy is the 1918 Spanish flu pandemic. Back in 1918, we did not shut down our economy and 675,000 people died in the U.S. (up to 50 million globally). This time around, we shut down our economy to save lives and that decision has a cost – right or wrong.

The market has priced in a slow and steady economic recovery with employees being rehired in the next two quarters and a vaccine available early next year. The market also knows that trillions of stimulus dollars have just arrived in business and consumer bank accounts. That is why markets are up.

Of course, the market may be wrong and there are many unknowns. It's time to stay disciplined and diversified.

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Historical Perspective

A dismal jobs report came out last week, and this has highlighted two important questions.

First: Are we heading into a depression?

Second: How can the stock market go up with all this bad economic news?

Are We Heading into a Depression?

No, I don't think so.

In the mainstream media, there has been a focus on the unemployment rate, which rose from 3.5% to 15% in less than two months. Payrolls in April dropped by 20.5 million, shattering the previous record of 800,000 in October 2009. Don't be surprised if the unemployment rate eventually exceeds 20%.

When I watch the news, interviewers pose questions to experts such as, ***"The last time unemployment was this high was the Great Depression, so we are heading for a depression, right?"*** The experts all say, "I don't think so," but they are given only five seconds to tell you why not, which leaves the question hanging. You feel terrified. Cue the commercial.

Not so fast. While the media targets our greatest fears, ***the Great Depression was an entirely different event with much different causes. This is not a credit and banking crisis – this is a global pandemic. It's different.***

We are experiencing these shocking job losses because we intentionally shut down our economy to fight the COVID-19 virus and save lives. ***If any comparisons are to be made, I think the better analogy is the 1918 Spanish flu pandemic.*** Let's compare.

The Great Depression

The Great Depression lasted from 1929 to 1941. It was a devastating economic event. Unemployment approached 25%. The Great

Depression lasted 12 long, bitter years. An overheated, overleveraged economy led to a sudden decline in stock prices, which led to a full-blown credit and banking crisis that was greatly exacerbated by deeply flawed fiscal and monetary policy in response to that crisis.

Here is a review of the causes of the Great Depression and why things are different this time around.

A Speculative, Leveraged Stock Market

The Great Depression began when the stock market crashed in October 1929. It was the end of the Roaring Twenties. The market was extremely speculative, and many investors borrowed great sums of money to buy stock that was overvalued many times over. When the market went down, they had to sell all their stocks to repay their loans. This sent prices down even further.

Today, we have margin requirements that have created a safer way to borrow against investments.

Banking Panics and Closures

During the Great Depression, thousands of banks failed, and millions of people lost their savings.

Today, we have more robust deposit insurance, bank regulation, and capital requirements. There are no bank runs.

The Federal Reserve Did the Exact Wrong Thing at the Wrong Time for the Wrong Reason

During the Great Depression, the Federal Reserve contracted (not expanded) the money supply because it was worried about maintaining the gold standard. This contraction had a catastrophic effect on the economy.

Today, the gold standard is a thing of the past and the Federal Reserve is doing the exact opposite of what it did in the 1930s. ***The Fed has intervened in a huge way to help support markets over the past few weeks, and this has made a big difference in the capital markets.***

No Fiscal Help, a Harmful Trade Policy, and the Dust Bowl

During the Great Depression, there was no fiscal help, only pain. The Hoover administration and Congress did not use their powers to help citizens deal with the financial burden of the economic downturn. Instead, they raised taxes and passed the Smoot-Hawley Tariff Act in 1930 that imposed steep tariffs on imported goods, which provoked retaliatory measures by other countries. Trade and economic activity suffered at just the wrong time. Exacerbating the situation was a devastating drought and the resultant Dust Bowl.

Today, Congress recently passed a very robust series of direct emergency fiscal assistance measures for people and businesses. ***No, they're not perfect, but trillions of dollars have just arrived in bank accounts all over the country. This should have a positive impact in the months ahead.*** As for trade policy, this is the one item that does seem similar to that of the Great Depression.

If you want to find an event like the Great Depression, you need look no further than the financial crisis in 2008-09 and the Great Recession that followed. ***The Great Recession could have actually been the Great Depression Part 2.*** The Great Recession was a devastating credit and banking crisis. Fortunately, our policymakers handled it differently than their counterparts did in 1930.

When Ben Bernanke was asked how he decided what to do during the financial crisis in 2008, he said that he would do the exact opposite of what the Fed did in 1930 and do it as quickly as possible. Thanks to our policymakers, the financial crisis was a deep recession, but not another depression.

This Pandemic Is More Like the 1918 Spanish Flu Pandemic Than the Great Depression

The 1918 Spanish flu pandemic lasted from the spring of 1918 through the early summer of 1919. It occurred at the end of World War I as infected soldiers from European battlefields took trains and ships back home.

The Spanish flu infected about one-third of the global population and killed somewhere between 20 million and 50 million people worldwide. The virus killed 675,000 people here in the U.S. (the equivalent of 2.1 million people today). There were four waves: The initial wave came in the spring; a second, deadlier wave in the fall; and there were two smaller subsequent waves.

At that time, there were no antibiotics to treat secondary bacterial infections, no therapeutic drugs, and no vaccine. It took public health efforts and herd immunity to finally end the pandemic. Most of it was over in about a year.

Back in 1918, U.S. cities and regions handled the crisis differently. Schools and churches were closed, but not businesses. It looks like people kept working and the economy was not shut down. Some communities that took little or no preventive measures saw much higher death rates than other communities that practiced social distancing and contact tracing.

Although there is not much economic data from that period, it looks like the unemployment rate doubled from about 5% to 10%. The stock market was up by over 18% in both 1918 and 1919. ***The 1918 pandemic did not cause a depression (or even a recession), but the loss of life was staggering.*** In the U.S., our life expectancy came down by 12 years.

Epidemiologists have always said that when the next global pandemic hit, they would handle things differently than in 1918. And that is what is happening now.

During the current pandemic, we made the decision to shut down the economy to avoid the huge loss of life that occurred in 1918. And now we are paying the economic price for that painful decision – right or wrong. If trends hold true, we will suffer a lot fewer deaths than in 1918, but the economic costs to achieve that goal will be high.

We know the virus will be with us for some time, but we reasonably hope that a vaccine will finally end the pandemic sometime early next year.

This leads me into the second question.

Why Is the Stock Market Up with All This Bad Economic News?

The market is climbing the classic “Wall of Worry,” which Investopedia defines as follows:

> ***Wall of worry is the financial markets’ periodic tendency to surmount a host of negative factors and keep ascending.*** Wall of worry is generally used in connection with the stock markets, referring to their resilience when running into a temporary stumbling block rather than a permanent impediment to a market advance.

This is not the first time markets have advanced in the face of bad economic news. The markets ascended a huge wall of worry after the financial crisis in 2008.

Here are some of the potential reasons markets have recently surged.

First, don't forget the market lost about one-third of its value in about two weeks in March. While the recent surge in April is impressive, most of the market still sits about 10% lower than it did at the beginning of the year. The markets **<u>may</u>** have initially overreacted to the current crisis.

Second, the market has priced in the enormous fiscal and monetary stimulus provided by Congress and the Federal Reserve. Trillions of dollars in stimulus money are sitting in business and consumer bank accounts. Eventually, that money will start to be spent.

Third, the market is counting on certain assumptions as we recover from this pandemic, which include but are not limited to: 1) the economy slowly coming back online, 2) the rehiring of employees, 3) consumers having enough confidence to slowly begin spending again, and 4) the pandemic finally ending when we get an effective vaccine early next year.

Fourth, remember that the market is always forward-looking. That means that market analysts are looking at revenues and earnings over the next several quarters. Those numbers are expected to improve. The market was already expecting last week's jobs report and believes unemployment will top out at about 20%. Markets have also priced in a lot of bankruptcies (many of which will be restructuring under Chapter 11), foreclosures, and workout deals.

As investors, we should be cautious. The markets may react negatively if the assumptions above prove to be incorrect, if we have a resurgence or a larger wave of the virus this fall, if a vaccine proves elusive, or if there are unexpected challenges to the recovery. There are a lot of unknowns.

<u>Recommendations</u>

I think that investors are coming to realize that the coronavirus pandemic is going to require patience, perseverance, and inner strength. It looks like we are in about the third inning. We have a long way to go, but we can and will get to the end of the game.

Turbulent markets and fears about COVID-19 can make us emotional investors, which reminds me of one of my favorite Nick Murray quotes:

> ***The world does not end. People just fear that it's ending.*** In part, this is because people fear loss much more than they hope for gain. Therefore, they react much more emotionally to declining markets than to rising ones.[1]

We are not out of the emotional woods – not even close. The recovery will not likely be V-shaped. It will likely be a lumpy swoosh. The economy will come back online, but it will do so slowly and unevenly. There may be increases in cases as we reopen, and we will have to learn how to better deal with outbreaks.

From an investment standpoint, the most important thing to do is focus on rebalancing your asset allocation back to your risk tolerance. Remain disciplined and diversified.

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[1] Murray, Nick, *Simple Wealth, Inevitable Wealth* (2008) at p. 79 (emphasis added).

As for your individual investments, consider using the core and satellite approach in your portfolio.

On the stock side, hold at least half your portfolio in diversified core indexes, such as the S&P 500 or the Russell 3000. On the international side, the MSCI EAFE Index is a useful choice. As for the rest of your stock portfolio, you can explore satellite strategies such as dividend-paying stocks, lower-volatility stocks, and large-growth stocks.

Stop trying to guess what is going to happen and when. Stop trying to pick winners and losers. You could invest in individual names that are currently performing well in the stay-at-home economy, names like Amazon, Apple, Netflix, Google, Facebook, Walmart, and Target. But I would caution against placing too many bets here, as the market has already priced these stocks for perfection. Eventually, small and value stocks, which have been beaten down considerably, will stage a comeback, and valuations of these larger names may come back down.

On the bond side, at least half your bond portfolio should be invested in conservative, highly rated government and corporate bonds with short to medium durations. Capital preservation is more important than yield right now. You can explore satellite strategies such as mortgage and high-yield bonds, but I would be very cautious here. If the markets plunge, only the most conservative bonds will hold their value.

Recently, the Fed jumped into the bond market by buying junk bonds and even certain bond ETFs, and some investors are trying to take advantage of this situation by buying those same bonds. This seems speculative. If markets plunge again, you would be relying on another Fed bailout. That may prove correct, but you never know.

Overall, keep your eye on the marketability of all your investments. Stay away from thinly traded, exotic, or complex investments that are difficult to sell when markets are under stress.

If you can, make sure your cash needs are met for the next 12 months. Be humble. Don’t overreact to negative news, which will remain so for some time. Be prepared for volatility.

I hope this newsletter finds you safe and well. Please reach out with your investment questions and concerns.

Thank you.

D. Austin Lewis