MORGIA WEALTH MANAGEMENT™

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A New Normal

We penned our last update six years ago… oh wait… no… it was ***six months*** ago. It just feels like six years ago. Things are different now – much different. We have new normals, we have social distancing, we have takeout food, we have Dr. Fauci. We *wish* we had more toilet paper and Clorox and baseball – heck even a live JV softball game would be wonderful!

We had the fastest 35% drop in stock market history. The pace of the "waterfall" decline, as this type of crash is called, was so steep that it approached an annualized pace of -100%. All this was then quickly followed by one of the fastest and most powerful upward rallies in the last one hundred years.

Our hearts go out to those families affected by the virus. The kind of toll the world has paid in both mortality and suffering has not been seen for many years. The corporate toll ran along similar lines. As we all know by now, the pandemic mostly affected the elderly. Similarly, in corporate America, elderly *companies* with elderly business models did not fare so well. I can think of a few hundred-year-old companies like legacy automakers or broad diversified manufacturing firms that struggled mightily during this downdraft.

It wasn't just the elderly that were affected. Companies with pre-existing conditions struggled as well. Afflictions related to compromised balance sheets such as elevated debt loads and/or low cash reserves were the primary cause of much corporate pain and suffering. The crisis obviously struck the travel-related companies and the transportation companies the hardest. Oil itself had a double dose of trouble. Demand literally stopped cold at the same time that an excess supply problem was raging. Russia and Saudi Arabia apparently decided that it would be a great time to play a game of chicken and see who would blink (cut production) first. For a few crazy days back in April, oil prices for current month delivery actually went negative as storage capacity was maxed out and no one needed or wanted any more of that commodity.

The young and strong did much better: Stocks of the established technology giants initially fell much less than average, then remarkably, regained their old high prices in short order. Many of the healthcare stocks dispensed with the crash altogether and actually gained ground right from the start of the outbreak.

Some investors found out the hard way that they were being too aggressive pre-crisis. They found out that their risk tolerance was not as high as they thought it was. What all investors should have also learned is that no matter how good things may appear, it is unwise to be without a well-thought-out contingency plan just in case the unexpected happens.

Hint: The unexpected *always* happens.

The 2,000 Pound Straw

It is our strong belief, that **if** our country and our companies and the citizenry all had low debt levels and a surplus of cash in the bank (as we advise our clients), then this virus-related pause in business activity would be just that – a pause. Sure, it would be a painful loss of current cash flow, but that is exactly what emergency cash reserves are designed to backstop. Sadly, debt never stops working. Interest payments (costs) never stop accruing. Debt does not care how bad the economy gets.

We have all heard of the proverbial straw that broke the camel's back. The straw was the COVID-19 economic shut-off. Even though the U.S. "camel" was experiencing a very good economy, it had been straining mightily from years of debt burden and a decade of average annual deficits close to a trillion dollars. Any added "straw" might do the trick. COVID-19 unfortunately was anything but your run of the mill straw. It was a 2,000 lb. straw that landed squarely on the poor camel's back and did some very serious damage. To push the analogy to the Nth degree (as I have been known to do), the massive amount of money printed over the last few months by the Federal Reserve was like an emergency morphine injection into our camel. So far it has worked, and hopefully it will be enough to bridge the gap until the economy gets moving again and true healing can begin. The systemic issues were **not** even marginally addressed however, and the long-term effects of patchwork fixes have yet to be seen. For the past 20 years, the Federal Reserve has not been shy about coming to the rescue with ever more "help" in the form of these "morphine injections." We would dare to say that the camel is now addicted to this "help."

Well That Was Fast

In our last update we outlined multiple factors and strategies that we believed would become extremely important for investors to understand and adopt over the coming years. What we did not expect, however, was that it would be necessary to implement so many of these considerations immediately. We were thinking in terms of years – COVID-19 changed that to weeks. We list them here again to emphasize their importance over the coming decade.

First, we thought that investors would not be lucky enough to make it through another ten years without a major problem or as we call them "Big Mistakes." We said:

1) We do not think the 2020's will be able to compare [to last decade]. Much of the fuel that has propelled this current bull market is unlikely to repeat. ✓

And

2) We will want to be more flexible. Stocks are unlikely to go straight up, so having a sound sell-discipline will be important. We may need to be more opportunistic, locking in shorter-term profits when they arise and then holding cash until we find another bargain. ✓

There is nothing quite like a global pandemic to demonstrate the need for flexibility – and speed for that matter. There was very little time to sit and ponder the full effect that slamming the brakes on the economy would have on certain industries or the market as a whole. Even during World Wars I and II, we did not dead-stop major portions of the economy. So far in 2020, you either had a game plan and a disciplined strategy or you were relying on hope as tactic and winging it.

Toward the end of March, things were looking rather bleak, but as we wrote back in our January letter, investors had a guardian angel of sorts should problems arise. We said:

3) Some investors actually believe that the world governments, especially the United States, cannot allow interest rates to rise nor allow stocks to fall. They feel that our highly indebted country is quite economically vulnerable to any kind of shock. They further think that the powers-that-be will do whatever it takes to keep up the status quo. ✓

"Whatever it takes" was *exactly* the policy adopted this year by the Federal Reserve. They moved even faster than they did in the 2008 Financial Crisis. Fed Chairman Jay Powell effectively printed 3 trillion dollars and injected it straight into the economy! He cut rates to 0%, restarted quantitative easing (buying up assets), and created different lending facilities to quell any worries of institutional insolvency. We continued:

4) They might play a new game called Modern Monetary Theory (MMT)... That game's premise is that since the government can print money at will – let's just do that... Then, one way or the other, let's give that money to the people. ✓

With the PPP and CARES Act both doling out literal free money, this is precisely what has happened. We didn't like the MMT "game" six months ago and we still don't like it today – but when a country has already painted itself into a financial corner, sometimes a bad strategy is temporarily necessary when all the other choices are worse.

And when money starts getting printed – asset prices usually start to move up.

Many investors, amateur and professional alike, found it too difficult to believe that the stock market could rebound quickly from a shock such as a pandemic shutdown of the economy. Many were expecting at least a couple attempts at "testing the low," whereby the market tries in vain to rally upwards but eventually gets dragged back down once or twice before any real recovery begins. Historical precedent was strongly *against* a so-called "V" shaped recovery for either the stock market or the economy itself. A "V" recovery is just what it looks like – a straight down drop in stocks (and/or the economy) followed by a sharp reversal and an uninterrupted rise all the way back to the starting point. It seemed both fundamentally and psychologically impossible for stocks to "forgive and forget" and head straight back upward.

But that is exactly what happened. Many of our clients were asking, "With all this bad news, how is it possible for the value of stocks to be going up??" We recommend an alternative vantage point. Better to ask, "How is it possible for the value of cash to go down?" That's easier to answer - when supply goes up, price goes down. It's Economics 101. So, when the Fed creates new cash to the tune of $3,000,000,000,000 (that's 3 trillion dollars) the value of cash can go down - a lot. So, it might not be that stocks are rising as much as it is the value of cash is falling.

The market is a schizophrenic beast in the short-term, chasing its own tail with glee one moment (February), then panicking and running off a cliff with the lemmings the next moment (March). That's because it's based on human emotion and human herd mentality in the short run. Investing is also quite prone to groupthink, when one's reference point is days or weeks or months. Truth be told, the market can be irrational for even a few years. But eventually, longer term, it is highly sane and sensible. It is that difference between the emotion of the short-term and the rationality of the long-term where investors can profit. Profit, that is, IF they can replace emotional reaction with disciplined strategy.

Here are a few of the other predictions from our last letter.

5) There is a chance that the already low U.S. bond interest rates could follow the Japanese and European rates down to sub-zero%. ✓

On March 16th the Fed took a dramatic step and lowered the Fed Funds rate to 0%. True, the rate did not go negative yet, but the decade is still young. Since I am my own referee, I am calling it close-enough.

6) Eventually market participants might get sick of printed money policies and shun financial assets altogether. We might need to lean more towards real and tangible investments like gold, commodities, or real estate. ✓ ✗✗

Well, so far only one out of three of those worked.

7) The technology revolution will be with us for some time... the productivity boom that is happening because of technology will still be a substantial driving force for many investment trends. ✓

Technology investments, especially the tech giants, seem to have barely felt this downdraft. As it stands presently, they have mostly hit new all-time highs, even elevating above their pre-crash levels. That is both amazing and worrisome at the same time. Yes, they are great companies, and we are glad they are up, but we need to be a little cautious here - but hey, we are not complaining!

Finally, we ended our previous letter on:

8) just between us... you might want to buy a little gold. ✓✓

Gold was one of the few asset classes that held-up during this crash. It is up rather nicely for the year and we are glad we did not procrastinate in this area.

The Great Toilet Paper Bubble

Over the last year or so, we have been hinting at revealing our once-a-decade prediction. Every ten years for the past fifty years we have made an attempt to identify what we call the "Big Mistake" for the period. As we are just barely into the 2020s, we *thought* we had plenty of time to make that call. We now think differently. What we *think* is that we had better hurry up and get on with it.

For reference, in the late 1990s we told clients that the technology stocks were defying the laws of gravity and were likely in a bubble. We thought that they would be that decade's big mistake. In 2005 we wrote that the Big Mistake for that period would be the real estate bubble – that one turned out even worse than we expected. In 2015 we said that "predicting a Big Mistake" - and thus being too cautious - would be the "Big Mistake" for the decade of the 2010s.

This time, for the 2020s, we see a lot of potential problems but have narrowed it down to one major idea. A recent occurrence has ironically served as a foreshadowing of sorts. Allow us to elaborate.

We are quite sure that for the rest of our lives none of us will ever forget **the great toilet paper bubble of 2020**. It all started innocently enough, when some unknown person, in some unknown city got a very troubling thought lodged in their mind:

"What if I run out a toilet paper during the pandemic!?"

True enough, it was a terrifying thought! It quickly spread faster than COVID-19 itself. Before long we were *all* searching for and stockpiling and hoarding this paper. Supplies initially started to dwindle and demand went through the roof … but then… quite rapidly… the papermakers started making and making and making. Before long there was so much paper stockpiled that no one wanted any more of it – in fact, as a society, we probably have got our fill of the stuff for the foreseeable future. The paper that was once so precious had now become…

… worth less (granted, that's better than worthless.)

Now, if you could, please do me a favor and go back and read that last paragraph over again, but this time, imagine that I was talking about paper money instead of toilet paper – because I was.

We think the “Big Mistake” of the 2020s will be paper money.

The implications could be very broad and very deep. We have not witnessed dollar erosion or real inflation for many years, and it seems so unlikely today with the world stuck in an induced economic coma. But there is so much debt building up throughout our country and in the world and in the state capitals and in the corporations and student loans and auto loans and credit card debt, that we feel the piper will finally need to be paid. Investors have been fretting about this for far too long. And being *early* on an investment prediction is indistinguishable from being *wrong*. So, we have waited a very long time to make the call. Until now.

So just how does an investor, or a citizen in general, protect themselves from the erosion of the monetary base? The main problem with any currency is always the **stock to flow ratio**.

<u>Quick Finance Lesson:</u> The Stock to Flow Ratio

Throughout history there have been many forms of money from seashells to glass beads to silver, gold and today’s paper money (which is more electronic debits and credits than something physical). Pretty much anything *could* be used for money but what makes a *good* money is the feature of <u>limited</u> supply. How large is the current **stockpile** of what you think of as “money,” and how much can that stockpile be increased (the **flow**) in a given year? *Note that for ease of conceptualization we will be viewing this ratio in reverse by dividing the annual flow (or change) by the current stockpile. This will express the outcome as a percentage.*

Obviously, a money is no good if it can be created easily. Think about the trillions of new U.S. dollars that were recently “created” to help the populous though the current crisis. Just where did that money come from? Let’s think about it this way: suppose the government just decides one day to double the amount of money in existence. All that would really happen is that the price of everything “real” would effectively double as well. Nothing new was actually created in this example. It was just that the so-called “pie” was sliced in twice as many pieces with each slice now being worth half the original amount. In 2020, the U.S. government just did a sophisticated version of the old Roman Emperors’ trick of shaving off the edges of their gold coins in circulation. The Federal Reserve used a different method, but the impact is the same – they just took some of your money.

“Well that’s not fair!” said the person who had been working and saving.

Too bad. When voters run low on cash flow and state pension funds start to have trouble making payments, politicians do not *care* about what is fair. They only care about not letting the system crash on their watch (which is a more noble sounding way to say that they don't want to get blamed for wrecking the economy and wasting all your money). So, as we have said many times, the easiest way out of a national cash-flow and debt problem is to *print* more money if possible. And it is *always* very possible, if not probable, when your currency is paper (or electronic entries). Politicians and government officials will always be loath to fix the problem the hard way – through work and austerity. Short cuts and band-aids, however, often result in a cure that is worse than the disease.

So as investors and savers, we will most likely want and need some form of "hard" currency over the next decade. This is why we have bought gold in client accounts over the past two years.

For some context on the **stock to flow ratio**, consider the following: For the 25 years from 1990 through 2015, the annual increase in the U.S. money supply was about 5.45%. Remember, if you own dollars, you do NOT want a high percentage of new money being created as it will dilute your savings. Compare the U.S. figure of 5.45% with 10.41% for Canada, and a lofty 20.56% for China. Is it any wonder that those currencies have been historically weak? Increasing the supply of anything reduces its value. Consider two of the more responsible countries: Switzerland only grew their money supply by 4.88%, while in Japan growth was a mere 1.91%.[1] By the way, in the 30 years prior to these examples (1960-1990), the yearly increase in money for all these countries was even worse. The scary part is that today, especially after the COVID-19 crisis, the money printing is picking up steam again. And the rate of increase is rather alarming.

Now consider gold. Over the long run, the *real* long run (as in 1,000 years or more), gold miners have only been able to increase the stockpile of gold by approximately 1.5% per year (gold has a very favorable stock to flow ratio). It didn't matter how much pressure politicians came under to dole out more "benefits" to the citizenry – if a country's currency was backed by gold, the government was forced to spend within its means. Well that was no fun! So, in August of 1971 President Nixon decided that… actually, no…sorry… we would not redeem the U.S. dollar for gold anymore. Over the following three years the price of that precious metal jumped from $38.90 per ounce to $106.48 and eventually topped out over $800 about ten years later.[2] On the bright side however, most countries could get as much U.S. paper money as they wanted (to be read with ample sarcasm). Oh, I forgot to mention, prices of everything went up - a lot.

If so-called fiat money, like the dollar, euro, yen, etc, end up losing their value to some degree, then real goods could end up increasing in price. Prices for commodities, gold, and agricultural goods might rise. Stock prices of high-quality, stable, dividend paying companies could also attract buyers. We think that the innovators, companies that constantly invent new products and make new markets will also continue to do well. However, if interest rates rise with inflation, and money ceases to be "free," those marginal technology companies that generate negative cash-flow could see their free-pass status on Wall Street revoked. Also, if the U.S. dollar comes under pressure against currencies of better managed countries (Switzerland, Norway, Australia, for example) foreign stocks might begin to reverse their trend of multi-year underperformance. As you can see, a declining dollar could open up opportunities as well as pose risks.

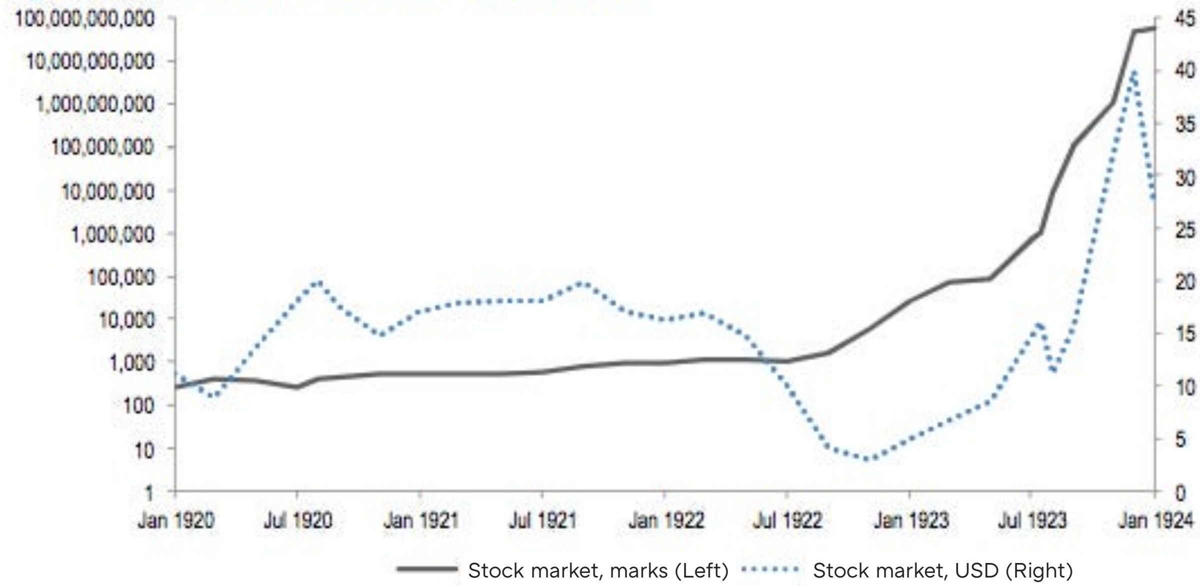
Our style over the last 53 years in business has always been one of avoiding extreme thinking and extreme predictions. We don't get too bullish and we don't get too bearish – we stay disciplined and we stay careful. Occasionally however, we will run some disaster planning scenarios based on historical extremes in order to study the tactics that would be necessary to make it through such storms.

We recently re-studied one of the worst currency debasements in history – the Weimar Republic era in Germany. No… actually… we did NOT have anything better to do. We were quarantined for three months for heaven's sake! We were running out of binge-worthy Netflix shows. But we digress. At some future date we may delve deeper into the Weimar crisis but for now we will keep it brief. Let's start by saying that we do **not** think the U.S. dollar will go the way of German currency circa 1920. Nevertheless, it is an illustrative example of what extreme money printing can do to one's investment portfolio.

After racking up far too much governmental debt in order to pay their war debts, the German government started massively overprinting their currency, the Deutschmark (the mark) in order to make it easier to meet those obligations.

Cutting straight to the chase, the result of all this new money creation was that the currency lost ***all*** its value over a four-year period. Government bonds (based on that currency) also lost ***all*** value. Counterintuitively, the German stock market survived and then thrived. From the perspective of the Germans, their stocks went from a starting point of 500 marks up to 50 billion marks! However, that is nowhere near as amazing as it might appear. Remember that *anything* more real than paper money (such as food, land, or stocks) made a similar run up in price. To get a more realistic picture of what happened to the true *value* of the German stock market we can view the period through the eyes of a U.S. investor (the blue dotted line on the graph below – scaled on the right). A starting amount of $10,000 dollars invested in 1920 on the Berlin stock exchange went up to $20,000 in six months, stayed right there for a year and a half and then promptly crashed back down to $3,000 by the end of year three. The fourth year (1923) saved the day and stock prices flew upwards. The original $10,000 investment was then worth $40,000! Not bad for a time when money itself (the mark) had lost **all** its value.

Figure 20: German stock market: in marks and USD



Source: J.P. Morgan estimates, "The Economics of Inflation", by Constantino Bresciani-Turroni

Our point is simply that risks are sometimes hidden. We all think of cash as safe and stocks as risky but that's not always been the case. Exactly how the excess U.S. dollar printing will play out is anyone's guess. All we can do is to be watchful and have a game plan formulated **ahead of time** in case quick action is necessary. We will do what we can to position portfolios to preserve capital.

For long-term investors, our final risk-control mechanism is always *patience*. When dealing with market risk, our *first* order of business is to mitigate damage. Then we try to mitigate some more. Next, a little *more* mitigation should be employed... and then, finally, after all that, we advise clients to ride out the storm. Ride it out until we, as a nation, find a way to fix things. And although that seems like a tough ask in today's environment, a brief look at history will reveal many unnerving storms that our country has survived. So far, our nation has made it through each and every one of them… just not painlessly. Yet, as painful as it is – this too will pass.

We wish everyone good health and safe passage and a pleasant summer. Hopefully our "camel" can hold its own, but just in case…

…you might want to hold on to your gold!

…and buy a bit more.

The best way out is always through.
Robert Frost

Feel free to check out our video library on our website (morgiawm.com) or our YouTube channel or follow Morgia Wealth Management on LinkedIn. As always, please call or email with any questions and/or comments. On behalf of Tony, P.J. and the rest of Morgia Wealth Management, thank you for your continued confidence.

Sincerely,

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