February 28, 2020

Re: <u>BFSG Conference Call March 5, 2020 at 6:30 P.M.</u>

Dear client,

It seems that U.S. investors and speculators are driving down the U.S. stock market in a panicky fashion with the S&P 500 declining roughly 10% in the six days prior to February 28th. This represents the fastest correction in history. In my opinion, this downdraft is due in part to an overreaction to the Coronavirus and also due to Bernie Sanders taking the lead for the democratic nomination. Like Bernie Sanders or not (no opinion here), he is viewed as market unfriendly.

We have been cautious for the past month, not because we suspected that the Coronavirus would become a worldwide health issue, but because we felt that market valuations were stretched. When you see stocks like Tesla and Virgin Galactic have meteoric rise and falls, you know something is wrong.

John Maynard Keynes, the famed economist, once told a story about a beauty contest in which he asked his friend which contestant would be picked as the winner. Keynes' friend answered with this: "the woman who was most beautiful would win." Keynes replied, "no it is the one who others think is beautiful." There is a valuable lesson to be learned from this story. I may think that it would be best to not sell any stocks, but if the rest of the market thinks otherwise, then I may be right in the long-term, but wrong in the short term. Of course, Keynes also said, "in the long term we are all dead."

The truth is nobody really knows how bad this epidemic can be and its effect on the global supply chain and the world economy. We have read reports coming from China that many workers are going back to work and some areas have had their quarantines lifted. Certainly, the number of new Coronavirus cases in China has been dropping which means that it will be most likely contained in China. However, it is the rest of the world where there is a problem, particularly in Iran and Italy, and potentially California. We have had other "flu" type viruses in the past such as swine flu, SARS, and MERS. The swine flu seemed to be a lot worse than the Coronavirus, but it seems that people are panicking more.

In one of my "Coffee with Dr. Steve" sessions, I talked about a black swan event. A black swan event is one that has a low probability of happening and the Coronavirus is such an event. The problem is when a black swan event is mixed with an overvalued stock market that makes a toxic brew and this is the situation we are in today.

I think we have managed the risk well with our mix of gold, bonds, and stocks. This combo has not prevented a decline in prices, but it has kept the portfolios from experiencing large losses. It is a hard decision to balance short term risks with long term goals. I have no idea where the market is headed, but I suspect in a contentious election year, regardless of the Coronavirus, the road will not be smooth. Looking back at December 2018 when the market went down 13%, I held fast and did not sell because I felt there was nothing structurally wrong with the market or the economy. As it turns out, we were right in this decision to stick it out and the results turned out very well.

However, the situation may be different this time. If this Coronavirus disrupts supply chains, global workforces, and transportation, the economy could go in a recession. Truthfully, we don't really know, and I don't think anyone else does either.

For the past 35 years, I have had what I think is a successful investment process. I wish I could claim that I invented it, but I lay in comfort knowing that Benjamin Graham came up with his investment ideas in 1934 after he got wiped out in 1931. To take some credit, I had the opportunity to refine Graham's methodology when I was a Visiting Scholar at UCLA in 1994 through 1997. I am grateful to Professors Rubinstein, Andrews and Titman for helping me understand behavioral economics, risk and return, and portfolio construction. Most importantly, I learned about an investment process and discipline.

At this point, we are not selling out the entire stock portfolio. We are not panicking because to do so would turn an advantage into a disadvantage. Again, I'm sticking to my discipline, but my investment process allows me to make the necessary changes when we have to. We are simply trimming a few stocks here and there to bring the asset allocation down. We most likely would have trimmed regardless of the Coronavirus because we believed that the stock market was overvalued. The next dose of turbulence will come from election year rhetoric from all sides of the party lines, so I think it is a good idea to take some chips off the table.

Please keep up with the latest developments by watching Coffee with Dr. Steve. Katie sends out an email blast every Friday and you simply just click on the link.

We invite you to tune into our next conference call on **Thursday, March 5, 2020 at 6:30 p.m**. To join the conference call, **please dial the toll-free number: 1-800-914-8405. Once prompted, enter the access code: 5486434, followed by the # button**.

Please see enclosed special report from our partners at BCA Research regarding the Coronavirus outbreak and China's response that I think you might find insightful.

Thank you for your patience and confidence in us.

All the best,

Steven Yamshon
Managing Partner

Special Alert: BCA Research

BCA's Global Investment Strategy has been flagging the near term risk to global equities, including last Friday's prescient "Markets Too Complacent About the Coronavirus" report, dated 21Feb20. Since then, global equities have shed -13% and the S&P500 is down -15%. While the worst-case global pandemic scenario remains a risk that would tip the global economy into recession, it would likely be brief. Economic imbalances (cyclical spending as a share of potential GDP) are not elevated, and monetary policy remains highly accommodative. Credit spreads and equity valuations now support upgrading the 3-month horizon recommendation on global equities and credit-sensitive fixed income back to overweight relative to government bonds.

As global financial markets buckle under fear that the coronavirus will grind global commerce to a halt long enough to cause lasting impairment to global growth and thus corporate earnings, BCA's China strategists examine the evolution of Chinese policymakers' response to the crisis – "China: Back to Its Old Economic Playbook?" (China Investment Strategy 26Feb20). Leadership is pivoting away from the deleveraging ethos driving their long term structural reform agenda, toward a more aggressive stance on stimulus – fiscal and monetary, to support rapid recovery in the face of this negative shock:

Key Takeaways:

1) Chinese policymakers' response to this unprecedented public health crisis over the next 6-12 months is now likely to match or even surpass the thrust of the stimulus deployed to counter the 2015/16 downturn. Policy focus has shifted from "financial de-risking" to "mitigating economic damage to shocks at all costs", per several high profile policy announcements. Moreover, China's economy was healthier going into the outbreak than it was in 2015/16.

2) While production had ground to a halt in many regions, top manufacturers just surveyed indicate a slow return to work, and gradual resumption of production, albeit business is still operating well below capacity. Aggressive containment measures have been effective in stemming the spread of the virus within China, while the world is mostly fixated now on the spread outside the country. The tradeoff between growth and health remains the critical arbiter of how lasting the disruption will be.

3) Another reflationary cycle in China will ultimately revive demand for resources, global business sentiment, and China-geared investment plays.

Bottom line/Context:

After this week's global market rout, equities now discount a lot of bad news. Even though neither fiscal nor monetary stimulus can address the supply shocks to growth emanating from the virus now, both can help jumpstart growth once businesses resume activity. After downgrading the tactical (3 month) view on global equities from overweight to neutral on January 10th, BCA's Global Investment Strategy team now recommends reinitiating an overweight position on global equities and spread product relative to government bonds.

<u>Source</u>: BCA Research Inc.