BFSG, LLC March 5, 2020 Conference Call

Summary of March 2020 Conference Call

It has been a rocky and volatile road in the markets for the past two weeks. At one point, the Dow Jones Industrial Average was down over 13% from its peak almost 3 weeks ago. Since then, the markets have been seesawing up and down, presumably because of the coronavirus epidemic. While this is partially true, the U.S. stock market has also declined because the stock market smelled out a Bernie Sanders move towards the democratic nomination. Putting politics aside, Sanders is market-unfriendly and the market figured that out. Remember, investors vote with their feet, not their ideologic thinking. To make matters more interesting, the Chinese stock market has held up extremely well considering that China is the epicenter of the COVID-19 virus.

Tonight, we will talk about our perspective and that is obviously from a financial point of view, not a medical one. We don't profess to be medical experts, but we do have a good handle on financial markets and human behavior when it comes to markets.

The truth of the matter is that this virus is so different from past incidences like SARS, MERS, Swine Flu and the 1918 Influenza. Nobody knows, with certainty, how much it will spread. While a Spanish Flu scenario cannot be ruled out, it is unlikely. However, we do know this, that the number of new cases in China has been steadily declining as the Chinese Government enacts draconian measures to contain the virus, something we probably would never be able to do in this country. The number of new cases in South Korea have fallen to 2,166 on March 4th from 2,410 on March 3rd. In Hubei Province, China, only 42 new cases have been reported. Researchers in Peking University in China have discovered 2 strains of the COVID-19 virus. Strains L and S of which strain L is more virulent and aggressive. However, strain L has been less common since January 4th.

What does this mean to the investor? In the news, the press has referred to the supply chain, which is the manufacturer of parts and products that are shipped to the United States to assemble phones, toys, furniture, and other consumable items. With so many Chinese workers quarantined, the supply chain was greatly affected. Global companies depend on an uninterrupted supply chain to furnish parts "Just-In-Time". It is rare that companies keep a warehouse of parts waiting to be used. Instead, companies who manufacture or assemble goods, order parts and supplies to use them exactly when the product is made. This process, called "Just-In-Time" inventory, saves worldwide companies massive amounts of money. However, there is a dark side and that is the supply chain can be interrupted when there is a trade war, military war, embargo or coronavirus epidemic. There is no doubt that the supply chain has been affected, but there is not a clear idea of how much. Apparently, the Chinese workers have slowly been going back to work. For example, Apple reported that their main parts supplier, Foxconn, has been operating at 80% of capacity. This is certainly good news. I suspect that the supply chain should be fully restored by the second quarter or third quarter this year at the latest.

We believe the COVID-19 outbreak is key to the 2020 stock market outlook. If the uptick in cases outside the U.S. continue to dramatically increase, the likelihood of a recession in 2020 is more likely. That scenario would not be good for stocks, nor the re-election prospects of President Trump. Chinese growth in Q1 will be close to zero and global growth most likely will be chopped down to less than 1%. If a recession does occur and there is no guarantee that it will, we believe it will be fleeting and short. A global recession is likely a low probability event. Epidemics and natural disasters may stop economic activity for a while, but they also create pent-up demand that boost economic growth in the subsequent quarters. Even if COVID-19 cases don’t spike, consumer confidence has been impacted. There are signs of consumers cancelling trips, conventions being cancelled, and workers being told to stay home. In Los Angeles, customers at Chinese and Korean restaurants has declined by 60% in the past three weeks. Is this a microcosm or is it a sign of something bigger? Only time will tell.

Although cases are popping up throughout the United States, particularly in California and Washington, it is too soon to tell how bad it might become. I suspect that this crisis could be over by summer if it follows the SARS, MERS and Swine Flu playbook. However, I cannot be sure of that.

We had said in the last newsletter and on several segments of “Coffee with Dr. Steve” that the market was also experiencing some heartburn with the possibility of Bernie Sanders clinching the democratic nomination. Interesting enough, Sanders is running on the Democratic ticket, but he is really an Independent. That aside, I said that if Sanders won the majority of the delegates from the Super Tuesday elections, we would look to trim the portfolios by 5% to 10%. On Tuesday March 3rd, Joe Biden roared ahead of Sanders to be in the lead and the market applauded with a 1100-point rise in the Dow Jones Industrial Averages. Health stocks were the best performers. Sanders poses a more systematic risk to corporate profits as he tries to completely radicalize the American economy. Joe Biden is more of a moderate. However, to be fair, Sanders policies would not destroy the American economy, but his policies would likely affect corporate profit margins. Lower margins mean lower profits, which translates into lower stock prices. That being said, it is looking like that Joe Biden will win the democratic nomination.

In one of the segments of “Coffee with Dr. Steve” I talked about a “Black Swan.” A black swan is an event that has a low probability and comes out of nowhere. It isn’t an Iranian military strike, a missile from North Korea, or a Chinese warship chasing down an American destroyer. Those are known facts and the markets have priced any one of those occurrences. The coronavirus, on the other hand, was an unknown and came out of left field. This is a black swan event because it is a low probability event with a large impact. In itself, a black swan may not be dangerous to the stock market, but when the toxic brew of an overvalued, overextended and overbought stock market combines with a black swan, the effects on the stock market are exactly what we have seen.

For a month or so, I have been saying that the U.S. stock market is overvalued and that we would be cautious. We have been cautious, and we continue to be so. All I can say - without getting into trouble with my compliance officer - is that that actions that I have taken have been gratifying.

Some investors don't think about the downside and at times push me into doing something I am not willing to do. In rare circumstances do we have an all stock portfolio. My reasoning for having a mixture of bonds and stocks is that bonds, in the majority of cases, cushion any downside in the stock market. In the market declines of the past 12 days, the bonds have increased in value while stock have gone down. The bonds and our portfolio protector of gold and Treasuries have done their job to limit any damage. We have not sold many stocks in any panic, but instead we trimmed a few. We sold our Luckin Coffee, Yum China and a global exchange traded fund. I thought that these China specific stocks would get hammered in any market decline because they were located in the epicenter of the coronavirus outbreak. I was wrong and I am mad at myself for selling them. Like I said tonight, Chinese stocks have held up remarkably well. We recently bought a China centered exchange-traded fund and we may buy Yum and Luckin back when the time is right. We also added a few positions in the past few days to buy up some incredible bargains that some idiots were basically giving away.

The market is still not cheap enough to bottom fish, so I am still being cautious and keeping the stock-to-bond ratio at a reasonable level. In many cases, the stock allocation is less than 55% and our new target is between 50% to 55% down from 65% stocks. There is still a lot of uncertainty in the air. Every day is fluid and we are prepared to reduce the stock allocation further, if we have to, but at this time, I am comfortable at the current levels and we are not planning to drastically reduce the stock allocation unless circumstances warrant. The COVID-19 epidemic should pass when the weather gets warmer, but the damage to the supply chain is an unknown at this time. However, I suspect that pent up demand would make any recession short and a recovery very sharp. This time around is different from the financial recession of 2008 when the banking system was on the verge of collapse. Most of my clients will remember that we did pretty good in that scenario, all things considered.

One thing to remember is that cheap money goes a long way in propping up the stock market. This week the Federal Reserve did a ½ percent cut in interest rates calling it an emergency. Not sure if these Fed Governors who are running the show were asleep in all of their economic classes, but that was a stupid move in my opinion. For one, it wasn't needed. Why? Because we don't know the extent of the damage to the economy that this virus will cause. Second, at some point in time, interest rates will have to go back up and the stock market surely won't like that. Third, the Fed will have no room to cut rates if a recession actually happens. Honestly, like a heroin addict, who relies on an ever- expanding supply of the drug, the stock market relies on an ever- expanding expansion of money. One day the music will stop, but we are not there yet. In the meantime, interest rates won't rise by much and this shift towards ultra-easy money means that stocks most likely will move higher once this COVID-19 passes. The stock market could even get frothy due to pent up demand, similar to the time in 1998 when the Federal Reserve cut interest rates to save the financial system from the collapse of the hedge fund, Long Term Capital Management.

I would like to invite you to join me every Friday when we talk about stocks and the markets on our video, Coffee with Dr. Steve. Katie sends out an email with a link every Friday so you can conveniently click on the link and watch the video. If you have not received Katie's email, then please email Katie@bfsg.com and she will check to see if your name is on our list. Also check your spam folder. I will now talk about some individual stocks and take your questions.