ALTMAN INVESTMENT MANAGEMENT

BRIEF REFLECTIONS

MARCH 30TH, 2020

Market Update:

Last Monday, we provided our best assessment of how we thought markets would respond to the latest announcements made by the Federal Reserve and what that might mean to the U.S. economy and corporate earnings in 2020-21. We concluded that markets should respond favorably by anticipating that the Federal Reserve would continue to backstop markets that started their precipitous decline following the calamity in the credit markets on March 9th. This was triggered by an unanticipated price war between Saudi Arabia and Russia, plunging a barrel of Brent crude 24% from $45.35 the previous Friday to $34.50 the following Monday. The spill over from high yield credit spreads into investment grade corporates and AAA municipals bonds flowing into the 10-year U.S. Treasury created a mad dash for bond fund outflows and caused the credit markets to freeze up. Since our last Market Update on March 16th, we were encouraged by the Federal Open Market Committee (FOMC) emergency session on March 15th when they cut Fed funds by 100 basis points and launched another "quantitative easing" (QE) program to purchase $500 billion in Treasuries and $200 billion in mortgage-back securities (MBS). We concluded that these actions should buoy markets. In addition to QE4 purchases, the Fed also lowered the reserve requirements to encourage banks to use their lowered capital and liquidity buffers to lend households and businesses who were affected by the coronavirus.

On March 23rd, as news of the pandemic virus was spreading, the Fed announced that they would open up the floodgates and pour as much liquidity into the economy as necessary without any limits. In other words, one week after QE4 was introduced, it morphed into 'QE4-ever'. The Fed will buy securities with no set purchasing schedule, no upper limit, and no end date. The program includes purchases of agency commercial MBS in addition to Treasuries and MBS. In effect, Powell put the Fed on a course of open-ended ultra-easy monetary policy given the anticipated strains of halting global economic activity for weeks maybe months ahead.

The Fed implemented similar liquidity facilities to deal with a cascading credit crunch as they did during the 2008 Great Financial Crisis. In an effort to sidestep the need to get congressional authorization to purchase corporate bonds, the Fed also established two facilities to support credit to large employers: the Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance and the Secondary Market Corporate Credit Facility (SMCCF) to provide liquidity for outstanding corporate bonds.

These measures had a positive response by immediately flooding the credit markets with liquidity. The Fed has become the buyer of last resort in the credit markets. This caused the equity markets to soar 17.6% through Thursday of last week, after dropping 33.9% from February 19th. The S&P 500 rose 10.3% last week, but still remains down 24.9% since its record high as we end the quarter.

What does this do to the Fed's balance sheet? The Fed's balance sheet has increased $1.2 trillion through March 27th to a record $5.2 trillion. The message was loud and clear to Congress last week. As long as the economy is shut down, Congress needs to stimulate the economy like crazy, no matter the cost, and the Fed will monetize the resulting debt. On Friday, President Donald Trump signed a huge $2 trillion stimulus package. We estimate it will triple the 12-month forward deficit from $1 trillion to $3 trillion. The deficit could be even larger as a result of plunging revenues in the next two quarters.

In summary: This recent decline is by far the biggest drop we have seen in decades and has turned out to be one of the fastest bear markets of all times. Is this the bottom? The Fed's willingness to backstop almost all the credit markets certainly helped to turn sentiment around dramatically. Of course, while we believe that the Fed might have marked the bear market bottom at the beginning of last week, we are cognizant that the stock market will have to hold its own against expected terrible news on the ongoing health and economic crisis. In other words, the beginning of a full-fledged new bull market may be somewhat premature, especially since industry analysts will be chopping their earnings estimates dramatically in coming weeks.

With respect to our client portfolios, we are proceeding thoughtfully, and at a measured pace, to evaluate and take advantage of what we consider to be the best of an increasing number of potential pricing opportunities coming our way. We are also carefully reviewing all of our individual investments with an eye towards free cashflow and emphasizing conservative balance sheets that can weather the current economic shock and come out the other side as stronger companies. In other words, although disconcerting, we do not believe that the coronavirus will permanently impair the intrinsic value of the majority of our holdings.

While it is too early to know when or how this crisis will be resolved, we remain confident that we are prepared for whatever may come our way. Looking back over the last several decades, the stock market has endured some pretty grim news, and persevered and prospered. At times of crisis like the present, challenging markets will always offer up opportunities, and taking advantage of them when they appear, is, in our view, the essence of successful long-term investing.

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