April 2020
Market Commentary

"Only when the tide goes out do you discover who's been swimming naked" – Warren Buffett

The Oracle of Omaha, one of my favorite "Wordsmiths"! In times of financial stress, we do find out who's swimming naked… whether it be corporations who loaded their balance sheets with debt to purchase back stock at all-time high prices so CEOs could hit earnings targets and receive their bonuses… or individuals who decided that having 3-6 months of living expenses in cash at their local bank was not nearly as much fun as taking that European vacation… or the investor who thought their financial advisor had a "Real Investment Plan" for them, only to find out that their portfolios were being ravaged in ways they had not expected. When "The tide goes out"… I.E. the times of plenty end, those that were unprepared for more difficult times are the ones who suffer most.

As we sit here at the end of April, we have seen quite a lot of volatility over the last 2 months. The S&P 500 touched a high to low trough of roughly 35% down in March with comparisons being made to the 1987 and 1929 crashes to the tremendous bounce we have seen off those lows at the end of March into the end of April, again being compared to Bear Market Rallies that occurred in the 1930s! My oldest son Lincoln loves him some roller coasters – the bigger and scarier the better – his father… not so much. Whenever we have such a rapid rise in volatility in markets are main goal is not to "Do Something!" but rather to invest our intellectual capital into understanding what is going on … and then determine if we need to "Do Something!" What we have compiled is the following 1) This is an unprecedented situation (Lock down of the economy) so throw out your models based upon past recessions and timing or shape of recovery 2) We have seen unprecedented action by the Federal Reserve who is now vowing to play in every part of the Credit Markets making it only more difficult for investment managers to determine the "Proper Price" for assets they own or wish to own 3) It's impossible to ascertain the psychological damage this health pandemic is having on the habits/mindset of consumer – just because we "Re-open the Economy" does not guarantee a resumption of consumption.

Let's look at each of the three factors above one by one. The lockdown of the US and other economies around the world has effectively caused a "Demand Shock". If you're Amazon, it's business as usual but for the majority of businesses their revenues are being slashed in some cases to zero (Hence 30 million Americans filing for unemployment claims in 5 weeks) . There's simply no precedence for this not even in times of war. In addition to the acute shock of shuttering businesses or having them run at minimal capacity at current what we still don't know is will these current Social Distancing rules being put in place by govts.

Content

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persist after the health crisis? If so, it completely changes the economics of so many businesses that the list is too long to highlight here. When speaking to one of the Top Commercial Real Estate Brokers here in San Diego recently, she said, "I'm not worried about the retail businesses that don't reopen in a couple of months, I'm worried about the businesses that reopen and then 12 months from now realize the economics don't work anymore". I for one am not going to be dining out anytime soon if I need to wear a mask and surgical gloves… I'd rather stay home. Investors need to think very keenly about the businesses they are invested in moving forward as we believe society is going to experience a "New Normal" where certain business models simply will no longer work in that new environment while others will thrive.

When the Federal Reserve a few weeks ago announced that in addition to purchasing Treasury Bonds and Agency Backed Mortgage Bonds (Something they have been doing since the last financial crisis via their Quantitative Easing or "QE" Program) they were now going to be buying Corporate Bonds (Of all Credit Worthiness), CMBS, CLOs, etc. – I about fell out of my chair. Instead of letting capitalism work, the "Fed" has decided that the answer is to prop up the debt markets for responsible and irresponsible borrowers/investors alike. Their claim of wanting to add liquidity to markets so that they function properly is a nice thought, however the reality is what they are doing distorts markets and pricing. Bad actors need to fail, investors who made bad decisions need to lose money… it takes money away from the irresponsible or foolish and clears a path for new capital to come in from stronger/more astute hands. It's this process of "Creative Destruction" that is at the very core of how and why capitalism has worked to drive the US Economy into the greatest economic engine that the world has ever seen. In an effort to "Help" – we believe the Fed is propping up companies that should go away and is delaying the process of getting those assets into stronger hands. Effectively we have the Govt. – Similar to 2008 – Privatizing the gains and Socializing the losses. The Federal Bankruptcy System was put into place by our founders for the express purpose of handling companies and their management teams that got it wrong. At Koa, we believe there shouldn't be any participation trophies when investing – there are winners and losers… we just work to make sure our clients are winning!

Just because the Governors tell people the economy has reopened doesn't mean people will get back to their old habits and modes of living. Not only are people still concerned about their health (Until we have a proven vaccine and therapeutics) but layer on the economic uncertainty that has hit the economy like a bolt of lightning. I mentioned earlier that there have been 30 million new claims for unemployment benefits in the last 5 weeks… what you're not hearing about are the number of people that are still employed but have had to swallow 20-30% pay cuts by their employers. Even for those that have their jobs – the excess income they may have once enjoyed is no longer part of the equation. When people are worried about their economic reality, they don't tend to spend – they tend to retrench. It's for this reason that we are still waiting to see what the new baseline for consumption will be when the economy is allowed to re-open in the coming weeks/months.

Markets usually go through three stages when the economic cycle turns downward – Panic, Acceptance and Despair before they finally bottom out. We believe that the sell-off we experienced in equity and credit markets In March was your panic moment. There was uncertainty about what the Central Banks and Govts. would do from a monetary and fiscal standpoint – now we know… they are "All In". However, both have limitations – the Fed can provide liquidity, but it can't stop insolvency. The Govt. can put money into your hands, but it can't make you spend it. The markets are still hopeful that we'll have a V-Shaped recovery evidenced by this steep bounce we've had in our markets over the last 5 weeks. If any of you have been listening to quarterly earnings from the various companies, the majority of them are pulling their guidance for the rest of the year because they have no idea where demand for their services or products will bottom out yet. We believe that once that new lower baseline is set in the coming months, the market will need to accept that our very levered economy is going to suffer a number of bankruptcies on the business and personal level … something that always happens at the end of every business cycle but one that will be exacerbated by abnormally low interest rates and an expansion that ran the longest in our

history (Since the previous recession). The Fed and the Govt. can try and play Atlas, but in the end, we think Economic Gravity will win out. Expect more pain on the economic front for the economy in the quarters ahead and understand that we won't experience a bottoming out in the Equity and Credit Markets until we've run the course on acceptance and eventually despair.

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