

## Quarterly Review and Outlook – 2<sup>nd</sup> Quarter 2020

*We all got holes to fill, and them holes are all that's real.  
Some fall on you like a storm, sometimes you dig your own.*  
- Townes Van Zandt, "To Live is to Fly"

Historical parallels are of questionable use in the face of a global pandemic, subsequent economic shutdown, and unprecedented policy response. Not since World War II have monetary and fiscal policy coordinated to this degree, while at the same time the disjointed nature of the virus-economy interaction stirs anxiety not easily squared with the sharp recovery in asset prices.

The torrent of government programs is hard to keep straight, but plugging the hole created by a sudden economic shock turns out to be straightforward—get cash out, and get it out fast. Long-term effects aside, the U.S. government ran a fiscal deficit of over \$2 trillion (9% of GDP) during the first half of the year while the Federal Reserve bought about the same number of Treasuries. It is hard to overstate the impact of this spending on both the economy and financial markets.

Employment is typically a good barometer for the economy, but not so in recent months. The CARES Act replaced much of the lost income and, along with payment deferrals, buoyed retail spending despite a depression-level unemployment rate. The impact on capital markets has been similarly large. Federal Reserve policy has been so overwhelming that it has forced certain asset prices back to pre-COVID levels, despite highly uncertain post-COVID fundamentals.

As an investment thesis, "Don't fight the Fed" often works well. Yet, *Fed supported* is not the same thing as *risk free*. Despite its quirks, the Fed is still a political institution serving a congressional mandate. The events of March are a sharp reminder that there is something inherently unsettling when a complex and highly leveraged system relies so heavily on one person or governing body to make the right decisions under hugely stressful conditions.





While total consumption has—so far—been supported by government policy, there has been a massive shift in the outlets for this spending. Large swathes of the economy saw revenue collapse overnight, while other businesses strained to handle the surge in demand. The United States is a large, diversified economy constantly reinventing itself through creative destruction, but for many businesses there was nothing creative about this reshuffling, only destruction.

Nowhere are the winners more concentrated than among large U.S. companies synonymous with the online economy. These dominant platforms have low debt levels and visible cash flows and have therefore outpaced the broader market off the March lows. We maintain a core investment in these companies, but the ease with which passive indexing has consistently outperformed almost any other strategy is by itself reason for skepticism.

Markets are reasonably efficient and rarely reward the same companies year after year, for multiple decades. Investors flood in chasing those high returns, prices adjust higher, and performance falls back to the mean, or worse. In the mid-2000s, conventional wisdom was that venture capital was dead and house prices could never fall. We do not see those dynamics currently at play in the technology sector, but at some point—possibly even today—superior returns will be available elsewhere. One thing is for sure, it will seem obvious in hindsight.

Outside of the comfortable confines of the S&P 500, very little is obvious. Companies with earnings that rely on economic growth appear either cheap or bankrupt, depending on the path of reopening and policy response, both of which remain uncertain. Active management has been valuable in identifying companies with strong balance sheets and durable cash flows, but otherwise large chunks of the market look more like lottery tickets than investments.

The attractiveness of fixed income depends on your vantage point. On one hand, yields on many high quality assets are too low to justify a sizable position. The upshot is we see tailwinds for active managers skilled at credit analysis. Companies with debt loads optimized for a pre-COVID world must adapt, and the price of resiliency is a higher coupon and stronger covenants.

We value the optionality of cash and its risk-dampening role opposite riskier asset classes, but the absence of even a modest yield in high quality bonds makes cash difficult to hold over the long term. This is the dark side of “Don’t fight the Fed.” We will continue to deploy capital into attractive, resilient cash flows as we find them, but we also believe chasing headline yields into the dark allies of financial markets is a recipe for regret.

News happens fast, and we acknowledge that all of the above could be rendered obsolete by a headline, a tweet, or even a retweet. Nonetheless, the process itself is valuable and humbling, and we welcome the opportunity to discuss these or any other topics in more detail.

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