Sitka Pacific
Capital Management, LLC

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Dear Investor,

Before we begin our discussion of the markets, let us first say that we hope you are managing through this unprecedented time as well as possible. Here in the Puget Sound region, at the earliest edge of the communal response to Covid-19, life today is quite different than it was a month ago: many storefronts are closed, schools are closed, and most people spend their days at home (except for taking long walks). If your daily life hasn't changed much yet where you are, it probably will soon. Fortunately, investment management naturally tends to thrive in relatively isolated conditions, so rest assured, these changes have not impacted our oversight of your account with us. Yet, as you probably know, the impact of these changes on the financial markets is another story altogether.

When, in our annual letter, we compared the market at the beginning of this year to the market in 1929 and 1999, it was not done lightly. When valuations are in bubble territory, it is a fragility that comes with a long list of risks hidden below the surface. One of the most difficult things to do in the asset management business is to prioritize anti-fragility in the face of such a fragile, but exuberant, market environment. Anti-fragility comes in many forms, but to some extent it usually involves walking away from additional market gains as long as those risks remain beneath the surface. Although being increasingly cautious as valuations rise and risks increase may be the prudent thing to do, managers are most often rewarded for doing so by seeing their business shrink dramatically — which is not exactly a great incentive. However, it is the right thing to do in the long run, and it is the reason why we ended the first quarter relatively unscathed despite the market's plunge.

The Covid-19 pandemic is an unexpected event, though it merits mentioning that it is hardly a Black Swan; many people have warned about the potential for a pandemic like this for years. In any case, the effort to mitigate its effects represents a huge external shock to the economy and the financial markets, and the effects of this shock will likely reverberate for years to come — and we are only a little more than one month into that process. The ability of financial markets to weather shocks depends on how fragile they are, and it's clear the markets were pulled into this new environment in a very fragile state indeed. This is why years of market gains could be taken back in a matter of weeks, and also why the Federal Reserve swooped in with monetary stimulus in amounts that took years to roll out following the financial crisis in 2008. In this month's letter we'll begin our look at what has happened so far, and what these changes likely mean for asset prices going forward.

In this month's letter:

- An Avalanche into a Whole New Monetary Paradigm
- After Laying Low for Two Years, a Long-Term Devaluation Is Exposed by a Virus

An Avalanche into a Whole New Monetary Paradigm

> *Economic sudden stops start small, they cascade, then they reach critical mass. Over the weekend we reached critical mass globally, and now we have reached critical mass nationally. And that brings the economy to a virtual stop. It is something that is necessary because social distancing is the only way to stop this virus from what it needs to spread. So, people will rightly put health in front of the economy, but there will be significant economic and financial damage.*
>
> *Very, very few people understand the economics of sudden stops. Even fewer understand the economics of fear. And we're just starting to understand the economics of circuit breakers. So the analytical underpinning is all massively catching up. All this is a long way of saying that I fear that people are still over optimistic. They're applying old mindsets, old models. They're looking for precision that doesn't exist. There's so much we don't know.*
>
> *And the big question mark out there is how far will the financial deleveraging go. Because when you get simultaneous economic and financial deleveraging, you need a whole host of circuit breakers. And these are not easy to design on the run.*
>
> \- Mohamed El-Erian, Chief Economic Adviser at Allianz, March 20, 2020

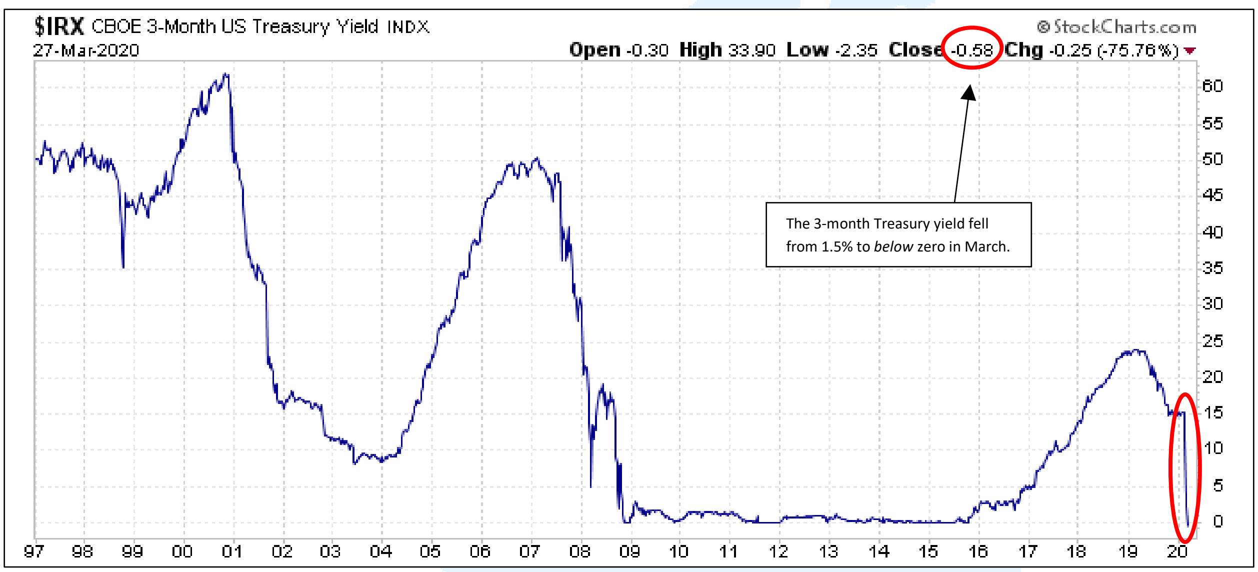
Since our last letter a month ago, it is difficult to convey just how much has changed in the financial market landscape, and the speed at which those changes unfolded. As was mentioned at the outset, part of the reason for the eye-popping speed of price changes and policy responses over the past month is due to the inherent fragility of the financial markets today to *any* external shock. When the stock market's valuation is in bubble territory, the underlying expectation is there will be a high and durable increase in profits directly ahead, and the total return from stocks will be much higher than other asset classes; otherwise, valuations would be lower. And when the yields of the riskiest corporate bonds are at very low levels relative to risk-free Treasuries of similar duration, the underlying assumption is there is a very low probability of significant defaults in the years ahead. Such conditions are fragile because only a slight shift in those optimistic expectations and assumptions could trigger a large shift in how the market values those assets.

At the same time, debt serves to *amplify* any of those shifts. When assets are revalued in response to a slight shift in expectations, let alone a large shift in expectations due to an external shock, high debt levels will greatly amplify the resulting price changes. Discussing record high debt levels in the global economy, or the climb up to a record high level of corporate debt that has defined this most recent cycle in the U.S., as we have done in recent years, can sound esoteric and theoretical . . . until something comes along to trigger a sentiment shift. Then, in part due to the dynamics created by high debt levels, the speed and extent of the market repricing can be an utter shock to those who weren't thinking about the markets in terms of fragility and risk.

During the last few trading days of February, it was clear market sentiment had suddenly, and significantly, shifted, but there were few overt signs of what this shift would lead to in terms of the actual policy responses seen during March — which were truly extraordinary. At the end of February, the market had priced in a 50-basis-point rate cut by the Fed's next meeting in mid-March. As we commented in last month's letter, this degree of shift in the market's expectation hadn't happened since the financial crisis in 2008, and it implied the Fed may actually be prompted to cut rates before its next meeting. As it happened, that market's expectation for an inter-meeting 50-basis point rate cut was only the beginning of what was seen in the weeks that followed.

In fact, the Fed did not wait until its scheduled meeting to act. In its first emergency rate cut since the financial crisis, it cut short-term interest rates by 0.5% on Tuesday, March 3rd, from a range of 1.5%–1.75% to a range of 1%–1.25%. In a quickly arranged news conference following the action, Chairman Powell said: *My colleagues and I took this action to help the U.S. economy keep strong in the face of new risks to the economic outlook. The spread of the coronavirus has brought new challenges and risks.*

Cutting interest rates by 0.5% so quickly after the market priced it in was a seemingly bold move, but in the four days that followed the Fed's emergency rate cut on March 3rd, the market did something absolutely astounding — it priced in *another* emergency rate cut of 100 basis points (!), implying the Fed would very soon lower the Fed Funds rate from the new 1%–1.25% range all the way down to zero. This dramatic market shift, from *the Fed is on hold* to *monetary policy is about to cross the threshold into a whole new paradigm* happened in less than two weeks, between the end of February and early March. This epic shift in the market's expectations can also be seen by the sheer vertical drop in the 3-Month Treasury yield on the far right of the chart below:



Despite the market's expectation for the Fed Funds rate to drop to zero, the Fed did not immediately act again to lower interest rates, and in the intervening days risk assets endured the most severe sell-off in more than thirty years. On Thursday, March 12th, the Dow Jones Industrial Average fell 10%, and the S&P 500 fell 9.5%, in the largest single-day loss since the infamous Black Monday crash in October of 1987. By that point the market had fallen nearly 27% in just sixteen trading days, and it was not only stocks that were falling. On March 9th, corporate bonds of all grades had begun declining as well, and by the end of the second week of March, this had sparked a dynamic of portfolio deleveraging that appeared to be spiraling out of control. On March 12th, the day of the 10% stock market crash, a standard 60/40 diversified portfolio of stocks and corporate bonds fell 8%.

The corporate debt market had begun to fall apart when news of a feud between the Saudis and the Russians spilled out of OPEC's meeting room and into the open market. After an OPEC meeting contentiously broke up without an agreement, Saudi Arabia effectively vowed to pump as much oil as needed in order to bring Russia and other higher-cost producers back into coordination with the other members of the oil cartel, and this resulted in an immediate 25% decline in the price of oil on Monday, March 9th.

This had relevance for the U.S. debt market because energy producers, many of whom were already operating with severely strained finances with oil in the $40–$50 range, were all of a sudden at risk of default if the price of oil remained at $30 or below for any extended period of time — which is just what Saudi Arabia's new policy appeared intent on doing. With a large share of the junk bond market suddenly at risk of default, and the risk of investment grade energy debt being downgraded into junk ratings, yield spreads throughout the corporate bond market suddenly jumped. By March 16th, yield spreads of investment grade corporate bonds had climbed to 240 basis points over Treasuries from 136 basis points on March 6th, and junk bond yields had rocketed up to 827 basis points over Treasuries, from 464 basis points on March 4th. In just under two weeks, the amount of distressed debt trading in the market, which is debt yielding 10% or more over similar-duration Treasury securities, increased by a staggering $500 billion.

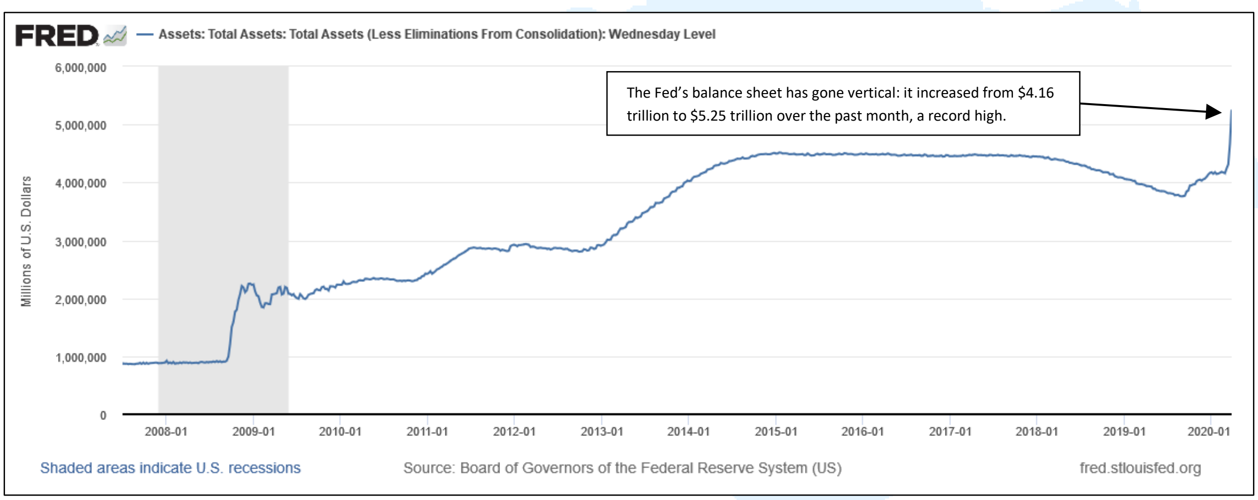
During any other month, the events in the energy sector alone would have carried the possibility of sparking a larger conflagration in the corporate bond market. However, during this particularly chaotic month, it merely added fuel to the deleveraging which was already beginning to consume risk assets. Then, while risk assets continued to fall after the energy shock and stocks suffered the worst decline since 1987, far more serious cracks began to appear — this time, in the Treasury market. In response to *highly unusual disruptions in Treasury financing markets*, the Fed quickly announced a massive $1.5 trillion repurchase program effective on March 12th, and then, when that failed to calm the Treasury market or stem the sell-off in risk assets, it announced a one-day $37 billion quantitative easing program for the following day, Friday the 13th.

Despite all of these monetary measures — the 50-basis-point rate cut on March 3rd, the new program to repurchase up to $1.5 trillion of bonds from the banking system, and the last-minute $37 billion purchase of Treasuries on March 13th — the stock market ended that second week of March having suffered the largest weekly decline since the bankruptcy of Lehman Brothers in 2008. It was clear the markets were in the middle of a serious deleveraging, and so, although the Fed's Open Market Committee was scheduled to meet just five days later on the 18th, Chairman Powell decided instead to convene the second emergency meeting of the month over the weekend. And on Sunday, March 15th, before the financial markets began to open in Asia, the Fed announced the first steps in what would become a new era of U.S. monetary policy.

The Fed announced it was lowering short-term interest rates to zero, and would restart quantitative easing by buying $700 billion of Treasury and mortgage-backed securities "in the coming weeks and months." In the phone-in press conference following the announcement, which carried with it a hint of the Sunday televised address in which the dollar was officially severed from gold in 1971, Powell made it clear that the Fed was no longer thinking in terms of fixed amounts of bond purchases, or a fixed timetable. He simply said: *There's no monthly cap, no weekly cap … that language is open ended and it's meant to send a signal to the market that we're not going to be bound by, for example, $60 billion a month or anything like that. We're going to go in strong starting tomorrow*.

When markets opened the following day, at first it appeared the Fed's Sunday announcement had had the desired effect: long-term Treasury yields fell and corporate bond prices stabilized. However, the stock market, reacting to stay-at-home orders in an increasing number of major cities, did not share the same relief, and the next day the financial deleveraging continued. And so, the Fed began to delve into its credit-crisis-era toolbox. Beginning on Tuesday the 17th, and continuing on each subsequent day of the week, the Fed announced an alphabet-soup of new lending programs to support the commercial paper market, new special purpose vehicles to buy assets, and new dollar-swap lines with foreign central banks. It was clear by this point that monetary policy had crossed a threshold into a new paradigm, but as risk assets ended the third week of March at the lowest prices of the downturn, despite all these programs, the Fed then really decided to pull out all the stops.

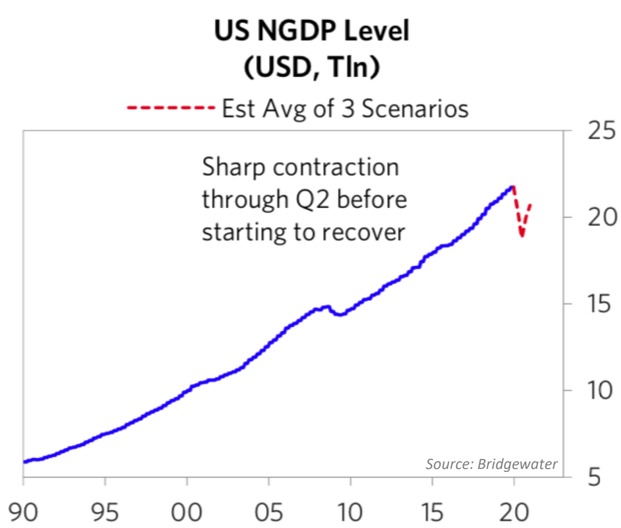
On Monday, March 23rd, the Fed made an announcement that will surely mark the beginning of a new monetary era. The Fed said it would begin buying Treasury, mortgage-backed and corporate bonds *in the amounts needed to support smooth market functioning and effective transmission of monetary policy to broader financial conditions and the economy*. In other words, there would no longer be any fixed dollar limits on the amount of quantitative easing purchases, nor would those purchases be restricted to government-backed securities. Through the establishment of special purpose vehicles, which would be partially backstopped by the U.S. Treasury, the Fed would begin buying investment grade corporate bonds for the first time in its history — including the riskiest investment grades. It would also provide corporations and businesses with 4-year bridge loans, along with open programs in the weeks ahead to lend to small businesses. All in all, some estimate that the Fed could lend over $4 trillion through all of these programs, which would be more than the Fed's entire balance sheet as of last year — though there really is no effective upper bound on these new policies.

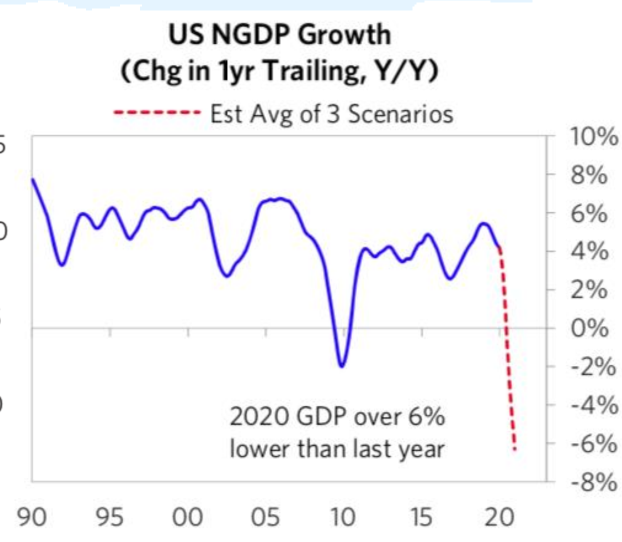


As all of these new monetary policies have only been in place for a couple of weeks, and some only a matter of days, there is hardly any data at this time showing the scale at which the Fed has been operating in all of these new programs. There were some indications after the Fed's return to quantitative easing, when it announced it would buy $700 billion of Treasury and mortgage-backed bonds "in the coming weeks and months," that it may have purchased half of that amount in just one week. And we also know that it took only one week following the first of these announcements for the Fed's balance sheet, shown above, to swell beyond the high-water mark set in 2015. A week after that, which is the latest data available at this time, the Fed's balance sheet had ballooned to $5.25 trillion — indicating it had already taken in $1 trillion in assets between March 11th and March 25th. In other words, in the space of just two weeks, the Fed expanded its balance sheet by more than the entire monetary base in existence in early 2008.

We will know much more about the unfolding monetary response in the weeks and months ahead, and our discussion of the investment implications of this will be an ongoing one. At this point, the Fed has gone through and announced the equivalent of its entire policy response to the credit crisis in just a few weeks, and it's quite likely there will be more to come. Yet this radical monetary shift is really only part of the story of the past month. The other parts of the story include the recently enacted fiscal stimulus packages, which total more than $2.2 trillion, and the uncertainty over just what will happen to the economy in the coming months.

As the quote at the beginning of this section alludes to, there is very little that can be known about how deep the economic impact will be from the pandemic. There has never been such a dramatic "sudden stop" in the economy as we are currently witnessing, and that includes the Great Depression and both world wars. There have been extreme numbers for GDP and unemployment tossed around for this year, but in truth, as Mohamed El-Erian said in an interview on March 20th, nobody really knows what will happen — which is a big part of the problem for financial markets at the moment. However, in even the optimistic scenarios, like the one shown below, which include a sharp GDP decline in the second quarter followed by a rebound in the second half of the year, 2020 will likely see a much steeper economic contraction than during the financial crisis.





After Laying Low for Two Years, a Long-Term Devaluation Is Exposed by a Virus

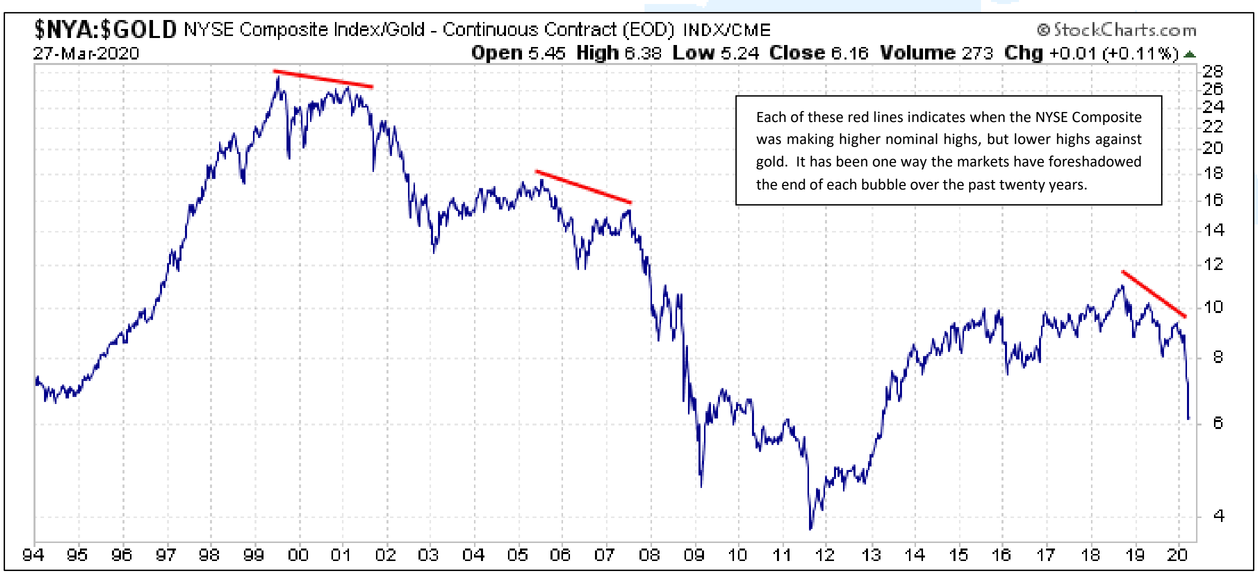
> *Well, this is something extraordinary we're facing. It is really hard to think of a historical parallel. I have talked about this with my co-author, Carmen Reinhart, and we have to go back to 1918-1919, the Spanish influenza epidemic, which killed millions and millions of people, to think of something like this worldwide. And it's not exactly the same. It was after World War I, when things were pretty bad already.*
>
> *We're in a war. You have to win the war. I would have no problem with the government debt magically going up $5 trillion in the blink of an eye, if we could get out of this in two or three months healthily. This is an emergency. You're not worrying about your credit standing right away. I don't think that's going to be a problem. And you know what? If we have inflation at the end of this, so what, if that is what we needed to do to win this war. We're trying to protect the American people, protect our interests, protect the future.*
>
> \- Kenneth Rogoff, Co-Author of *This Time Is Different*, March 19, 2020

One of the most remarkable aspects of the quantum shift over the past month is just how quickly, and how thoroughly, sentiment has changed regarding the rising national debt — even among those, like Kenneth Rogoff, who have spent a good portion of their careers warning about over-indebtedness. True existential threats can do that. If the sighting of a $9 trillion Fed balance sheet on the horizon isn't stunning enough, the prospect of the first $3 to $4 trillion *annual* federal government deficit is surely a sight to behold. And that is only what we know at this early point, as there will almost certainly be more fiscal stimulus measures in the coming months, including more direct payments to citizens, beyond what has been done in the last few weeks. It's as if this pandemic has suddenly drafted Modern Monetary Theory into service, if not specifically by name.

The 1918 flu pandemic was not restricted to 1918 in the U.S. — it passed in three waves in 1918 and 1919, and the deadliest was the second wave, not the first one. This pandemic a century ago is the only close example we have to compare today's circumstances to, and the trouble is that it is not a very clean example. World War I ended with the armistice in November 1918, and it was followed by a mild economic downturn in 1919, but the economic fallout from the end of the war is nearly impossible to tease out from the economic fallout due to the flu. This picture is further muddied by the Federal Reserve's attempt after the war to shrink its balance sheet back down to its pre-war size, which triggered a steep recession (it was called a depression at the time) beginning in January 1920 and lasting into 1921. With all those simultaneous changes — the end of the war, the monetary deflation and the flu pandemic — there really isn't a way to know the extent of the economic impact from the 1918 flu by itself. As a result, the markets have no historic comparisons from which to draw guidelines for the present day, and we will just have to wait and see how the economic fallout unfolds in real time.

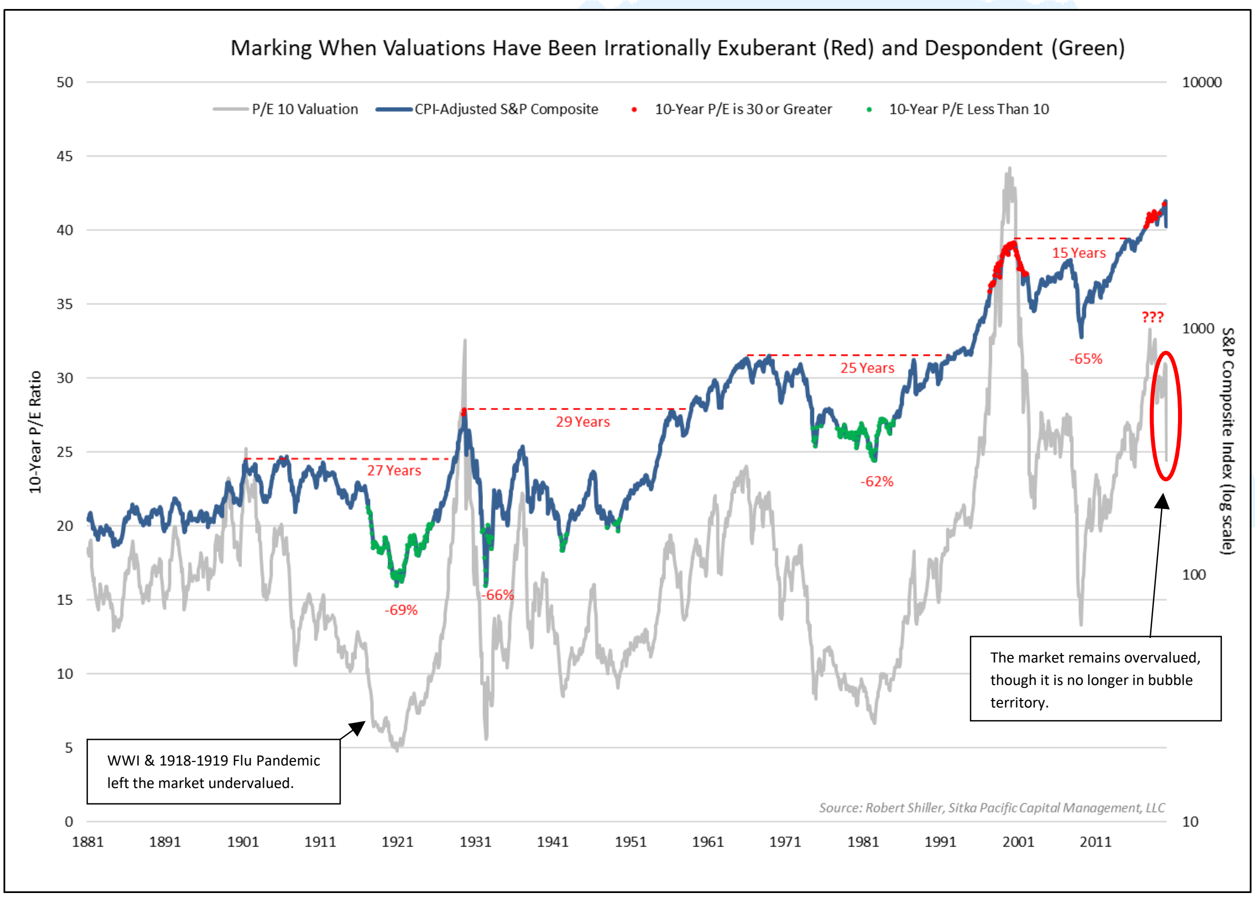
Having said that, there is one point we'd like to make which deserves to be emphasized beyond all others at this time, and it is this: although asset prices have moved dramatically in recent weeks, the markets are only *one month* into what will likely be long process of revaluation. The economic repercussions of the pandemic will continue to dominate the headlines in the months ahead, but from our standpoint, what Covid-19 has really done is to "pull forward" into the present many of the inevitable consequences of the bursting of the market bubble. Focusing on the effects of the virus in this context amounts to focusing on the spark (albeit a very big spark) instead of the underlying reasons why such a spark ended up igniting a larger market conflagration.

Almost forgotten amid the focus on Covid-19 is the fact that the U.S. economy entered 2020 already heading toward a recession. Last year the Treasury yield curve registered its first inversion since just prior to the last recession, and a yield curve inversion followed by a recession is just what would be expected in the aftermath of the monetary tightening that began in 2016. The Fed increased short-term interest rates from zero up to a range of 2.25%–2.5% in late 2019, and for the first time since the 1930s, it intentionally began shrinking its balance sheet in 2018 in an effort to undo at least some of the expansion from the credit crisis. The combined effect of these actions began to show up in some parts of the economy as early as 2018; growth in manufacturing activity, for instance, peaked in mid-2018 and spent 2019 oscillating between expansion and contraction. At the same time, leading market indicators signaled throughout 2019 that an economic downturn was visible on the horizon.



If there had been no Covid-19 outbreak, and no partial economic shutdown in response, it's quite likely 2020 would have still seen a recession of some duration and depth, but we will never be able to know how it would have unfolded. Of course, such a recession almost certainly would *not* have begun with some of the early readings we have seen recently, such as a weekly unemployment claims number of 3.2 million, which is four times the previous record high set in 1982, or a -70 reading on the most recent Texas Manufacturing Outlook Survey, a record low. These are signs that the sudden stop the economy is currently experiencing is much more dramatic than anything in post-war experience, and it will take time for what is rapidly unfolding in the real economy to be fully reflected in the economic data.

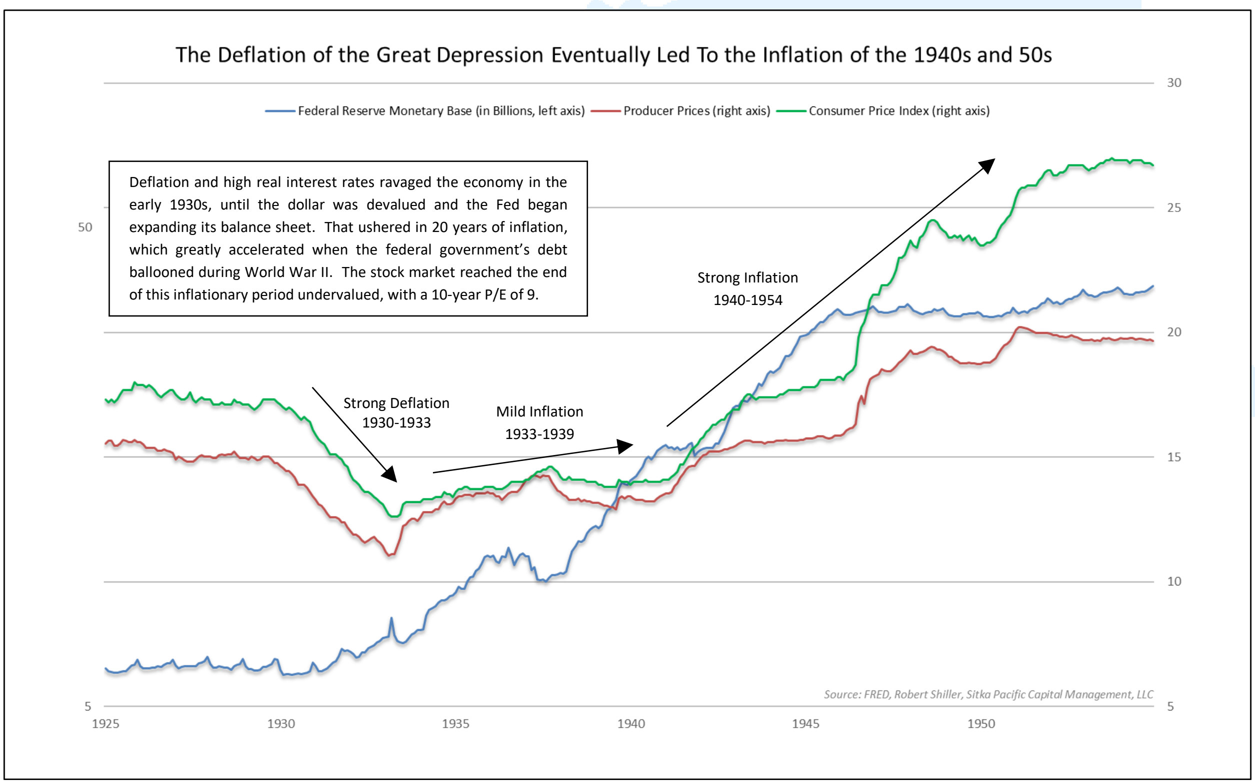
In this context, the equity market's dramatic fall from its February high is not as incredible as it first seemed. The market recorded the fastest 20% decline in history in March, faster than the initial decline from the 1929 high, then it proceeded to record the fastest 30% decline in history a few days later before finding its footing. This brought the market's valuation down out of bubble territory, but on a long-term basis it would still take another decline of 35% to bring the S&P 500 to its median cyclically adjusted P/E. For some perspective, the market ended March near the highest valuation seen in the 1960s, and from that point in 1966 the market would not recover its full real value for twenty-five years. The market can go nowhere, in a volatile way, for a very long period of time as valuations descend from a high level; it has happened several times in the past, and we refer to these devaluations as long-term bear markets.



In the chart above, the three question marks on the far right sit atop the highest cyclically adjusted valuation seen during the recent stock market bubble, using end-of-month prices, and we mention it because it occurred all the way back in January 2018. This highlights that although the market made marginal new highs in later 2019 and early this year, it appears the last two years were, in fact, the first two years in what will likely be a long descent from the valuation peak in 2018. In other words, the Covid-19 decline over the past month did not trigger a new bear market all by itself — it appears it is just one phase within a fledgling long-term bear market.

As happened in the late 1960s and 1970s, new nominal highs don't necessarily mean the market is in a long-term bull market — it may just mean the market is actively devaluing against other assets, such as gold. Prior to the collapse over the past month, the broader market had already fallen 20% against gold as valuations fell from early 2018, and based on the policy responses we've seen over the past month, it seems most of the devaluation of risk assets against gold remains ahead of us.

The sudden-stop recession which has started is acutely deflationary, and it seems we have only seen the very leading edge of the cascading contraction unfolding in the economy. In time, there will likely be a wave of defaults on commercial and residential mortgages, corporate loans and debt of all grades, as well as all types of consumer debt and small business loans. This default wave is what the Federal Reserve and federal government are now racing to get ahead of, but their efforts will likely fall short . . . at least at first. What we can count on is that the Federal Reserve will eventually expand its balance sheet, and the federal government will eventually take on as much debt as needed in order to counter that deflationary undertow. And in the aftermath of that monetary and debt expansion, there will be inflation — just as happened during the Great Depression.



The extraordinary response by the Federal Reserve to the cracks in the bond market over the past month, including in the Treasury market, is an indication that monetary policy is already playing a subservient role in the events unfolding all around it. We suspected such an era was approaching, which is why our last two annual letters focused on how monetary policy was coerced and subjugated in the late 1960s and early 1970s. It is difficult to understate what this means for the value of the dollar over the coming decade. The period of “strong inflation” during the 1940s and 1950s, highlighted in the chart above, occurred while monetary policy was effectively taken over by the U.S. Treasury during another national emergency, and what we saw over the past month as the Fed put out fires in the bond market and coordinated with the Treasury to create special purpose vehicles and various lending programs was reminiscent of the earliest steps taken in that direction in the 1930s.

There are times when being aware of monetary and market history leaves one conspicuously out of step with the prevailing market environment, and then there are times when such an awareness begins to pay off — and this past month was one of those times. When the broader stock market erases seven years of gains in just four weeks, it is not solely because of a White Swan suddenly appearing. And when the price of gold endures such extreme volatility in risk assets and remains higher for the year, it is a sign that the market is already beginning to anticipate the impact all the events over the past month will ultimately have on the dollar. On this front, it was notable that while inflation expectations in the bond market for the next five years fell dramatically in March, expectations for long-term inflation rose back to near their old levels by the end of the month.

Risk asset valuations have historically ended long-term bear markets at far lower levels than they are at today, and it appears the stock market is already more than two years into such a revaluation. How much this devaluation shows up in nominal prices as opposed to against real assets such as gold will be a function of how successful the Fed is in its efforts to cushion the impact of deleveraging; the more successful it is, the higher gold will trade in the years ahead. As we were at the start of the year, we remain prepared for this devaluation in risk assets to continue, however it unfolds.

We appreciate your taking the time to read this letter. As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us — we would be happy to talk with you.

Sincerely,

Brian McAuley
Chief Investment Officer
Sitka Pacific Capital Management, LLC