North American Management

MARKET PERSPECTIVES
MARCH 26, 2020

LOOKING FOR WHALES AND HELICOPTERS

Since March 13, market prices for stocks, bonds, and commodities have fallen further (moderated by an epic rebound this week), along with various measures of consumer confidence in the economy and the government response to COVID-19. Some of the selling has been extreme, amid volatility not seen since 2008. Shares of companies closest to the epicenter of the crisis — cruise lines, hotels, casinos, airlines, mall operators, autos and car rentals, and nursing homes — have all dropped 50% to 80% peak-to-trough since mid-February, along with the entire energy sector and many banks. While companies involved in healthcare, consumer staples, online retailing and technology have also sold off, they have generally outperformed the first group by a wide margin. Much of this relative price action in the equity markets is to be expected as investors try to handicap which entities will survive, and which ones might fail or fall into stronger hands at punishing discounts. Since equity-holders are last in line to be paid in bankruptcy, the stakes are enormous.

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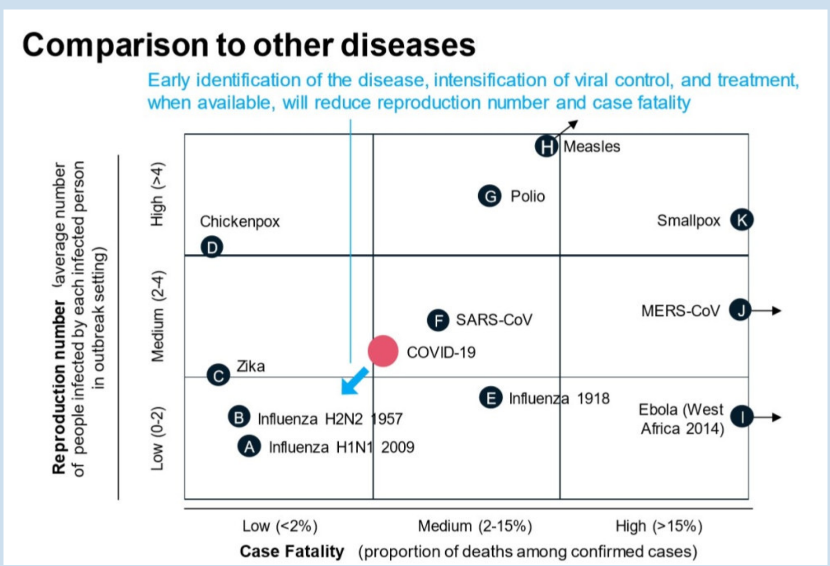
MALFUNCTION AND PRESCRIPTION IN FIXED INCOME

What has not been expected by most market participants, including seasoned professionals, is the level of malfunctioning and consequent volatility at the top of the food chain, in the bond markets. The distance between what buyers will pay and what sellers are asking is a measure of market liquidity, and large gaps between the two have opened up in recent weeks implying serious plumbing problems. Market-makers (mostly large commercial and investment banks) have stepped away since 2009 while high frequency, leveraged trading and shadow-banking (private lending) have greatly increased. In some parts of the high yield bond and leveraged loan markets, for example, there were no buyers at times last week and early this week, and in other cases those willing to buy offered to purchase at prices 10% to 15% lower than the last recorded transaction — despite no material changes in an issuer's ability to service debt. In addition, there have been valuation gaps between bond ETFs and the underlying securities they track — even in the U.S. Treasury market, arguably the most liquid market in the world. These issues have diminished fixed income's intended role as a portfolio stabilizer, blurred the lines between asset classes and caused uneasiness.



Source: McKinsey & Co

Why are parts of the bond market almost as volatile as equities, and why isn't there sufficient liquidity to sell at a reasonable price? We will explore this topic, and others, in our upcoming Q1 Investment Letter, but we believe this day has been a long time coming. Years of regulatory overhang, one-way flows into fixed income mutual funds and ETFs amid falling interest rates (bond prices rise when rates fall), have engendered high levels of complacency and in some cases reckless, yield-seeking behavior. For now, the Fed has injected trillions of fresh liquidity into the bond markets, from treasuries to commercial paper to mortgages to munis and corporate bonds. Importantly, they have relaxed rules on bank capital buffers which will allow more capital to flow where it is needed most. The good news is that it's working. The Fed's efforts, in combination with a bi-partisan deal on extraordinary fiscal stimulus just approved by the Senate, have stemmed the tide and we can see the positive effect in stock and bond markets.

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POSITIVE MARKET RESPONSE TO STIMULUS

The helicopters have arrived. Are there any whales floating to the surface? The question refers to any large institution that might be permanently impaired by this crisis: banks, investment funds, corporations, municipal governments, etc. In other words, is there reason to believe the swift and severe financial liquidity crisis of March 2020 will morph into a solvency crisis with long-term repercussions on credit markets and employment? Obviously, the trajectory and impact of the coronavirus (see chart above) has a great deal to do with this, but for now it looks as if the U.S. Government has papered over about two months of down time while the economy runs at approximately half speed. A sharp drop in GDP and a spike in unemployment have likely been factored into the stimulus calculations — we note the positive market tone today despite news of 3.3 million new jobless claims.

Have investors over-reacted and priced in scenarios that are too draconian? We offer one example close to the Coronavirus epicenter: Avis Budget Group, Inc. (CAR). Naturally, rental-car companies have been left for dead in recent weeks — CAR dropped 88% from its peak on February 20 through March 18. On the afternoon of March 23, CAR reiterated in a press release the company has enough liquidity and rental-fleet collateral on hand to survive "all of 2020 and beyond." The company is also in line for federal assistance as needed. Since then, the stock has almost tripled, from a low of $6.35 to close at $17.91 on March 24, when the Dow Jones Industrial Average enjoyed its biggest daily rise since 1933, and the S&P 500 its biggest day since 2009. We are reminded that market prices often move much faster than underlying business fundamentals can change, for better or worse.

NORTH AMERICAN MANAGEMENT TRADING UPDATE

Many clients will notice we have harvested some losses for tax purposes and rebalanced portfolios back to their strategy target allocations this month. In most cases we trimmed overweight fixed income positions and re-allocated the proceeds to equities. Our rebalancing policy is range-based, triggered when assets go through certain thresholds. Rebalancing helps keep assets in line with strategy targets, avoids over-exposure to outperforming assets (in this case, fixed income), avoids under-exposure to underperforming assets (equities), and helps reduce portfolio drag from volatility. While investors often have the urge to reduce risk in these kinds of environments, we are hesitant to recommend reducing risk in client portfolios as 1) the market has already done it to a certain extent, and 2) going further compounds the market effect and moves clients even further away from their desired targets.

NAM WAS WELL-PREPARED

for Business Interruptions and is Functioning Well

Our journey towards a fully digitized, cloud-based business started nine years ago when we first established a Client Portal for secure transmission of reporting and other documents. In 2013 and 2014 we adopted cloud-based platforms for portfolio accounting, Client Relationship Management (CRM), and computer workstations. For the past six years, NAM employees have been able to log in securely to their remote, cloud-based desktops from anywhere in the world offering reliable internet access. Towards the end of 2015 we adopted a digital document management system that moved us further away from hard-copy storage requiring on-site processing and filing. In 2017 we upgraded our Client Portal and introduced DocuSign for e-signatures on key client documents. At the end of 2018 we began transitioning clients to electronic statements, which also saves paper. Today, approximately 82% of our clients are receiving electronic statements.

Throughout the adoption of these, and other, critical technology solutions, our team has undergone regular cyber-security training and testing in order to guard against phishing and other forms of cyber theft. As a result, recent work-from-home social distancing imperatives have not affected our normal business operations. Since we have been using all these technologies successfully for many years, we were able to initiate more client communications and handle significantly elevated trading and rebalancing needs as required without disruption. Unlike many companies operating in this environment, we are not on furlough — we have to the tools and the commitment to be fully working every day on your behalf.

We look forward to reporting to you again in the near future, and we thank you for the trust you place in North American Management. In the meantime, please call your NAM wealth advisor should you have any questions or need additional information.

Robert G. Scott
Chairman & Chief Executive Officer

Fraser J. McLean, CFA, CFP®
Chief Investment Officer

SPECIAL NOTE TO CLIENTS REGARDING YOUR 2019 TAX FILINGS

The IRS has moved the deadline for filing and paying 2019 personal income taxes of up to $1,000,000 to July 15. Most states will follow this temporary rule change, including Massachusetts. This extension also applies to 2020 first quarter estimated tax payments, which are also due on July 15, 2020 with no penalties or interest applied. Tax preparers and software companies are making adjustments, but this may take some time.

In terms of estimated tax, 2020 is likely not a good year to “Safe Harbor” your tax payments based on what your tax was for 2019. Capital gains, at least, are liable to be less than they were last year. By July, and again in September, it will be worth a look at how your year is going and what payments are necessary. North American Management will be providing assistance to you and your tax preparer, including interim and projected income figures, estimation of their tax effects, and other advice as the year progresses.