The Type 2 Investor

May 12, 2020

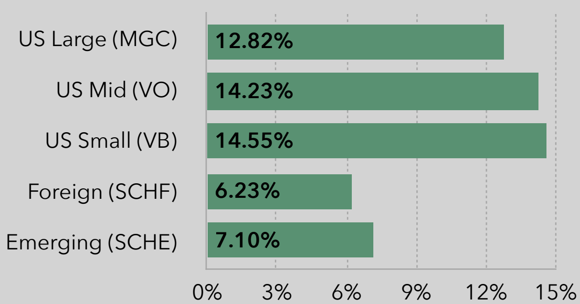
April 2020

Economic Data

- US payrolls fell 20.5 million in April and unemployment rose to a post-WW2 record high of 14.7%
- US GDP decreased at a 4.8% annualized pace in Q1
- Retail sales fell a record 8.7% in March; auto sales down 27.1% and clothing down 50.5%, while hoarding pushed grocery sales up 26.9%
- Y/y inflation (CPI) fell eight-tenths to 1.5% in March
- Existing home sales fell 8.5% in March
- The Conference Board LEI crashed 6.7% in March

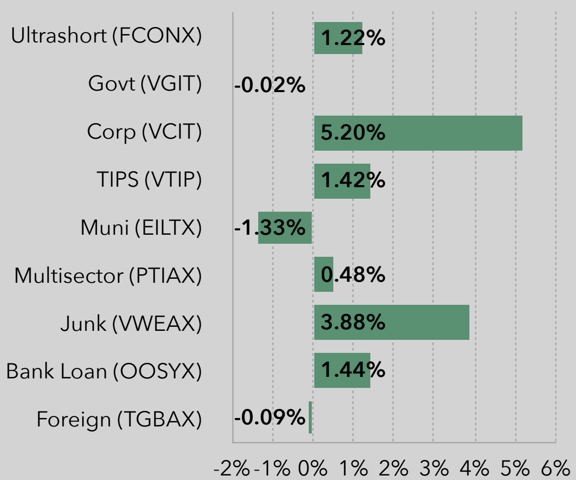
Stocks

April Returns



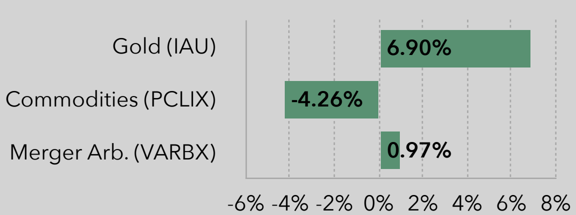
Bonds

April Returns



Alternatives

April Returns



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system — type 2 — that we want in control of our investment portfolios.

The Year 1 AV (Anno Virum)

It's December 31, but the New Year's Eve celebrations are notably subdued as the world readies itself to enter the year 1 AV. It's been exactly 365 days since China first reported a troubling outbreak of what we now call the C-19 virus to the World Health Organization, which made it convenient and easy for people to accept the new calendar and forget about the beforefore times. I am still on Utila because I can't get a Safe Travel Antibody Identification (STAID, ironically) to move freely in the US. The stores on the island ran out beer months ago, but I was able to get a growler from my buddy at the local brewery to drink during the countdown to midnight.

I just received another $2,000 check emphatically signed by newly re-elected President Trump. Just kidding…it was a direct deposit. It was quite startling how quickly Modern Monetary Theory (MMT)—the idea that governments with fiat currency can just create and spend money with little consequence—moved from theory to practice with virtually no resistance. But in the face of declining production in the economy, it hasn't turned out exactly as theorized.

When the economy did start to open up again this past summer, many found the enhanced unemployment benefits—as much as $74k per year in Massachusetts—exceeded what they would earn going back to their menial jobs. So they decided not to return until the benefits ran out, which is today since the original July date was extended six months. Now, as the benefits are finally running out, many are finding the businesses they worked for no longer exist. Half of the restaurants and bars never reopened. Shopping malls, which were already on life support in the beforefore times, are empty inside while the parking lots outside are full of the mothballed remnants of the car rental industry. Many salons closed, but you can still get a barber to come to your house for about $200 under the table. Sales for the Flowbee now far exceed those seen even in their late-night infomercial heyday in the 90's.

It's funny now to think people were actually worried about deflation. To be fair, demand destruction was keeping most commodity prices under pressure at the time, masking the early effects of monetary inflation. Shifting supply chains away from China, and regressing from efficient just-in-time global inventory systems eventually put upward pressure on prices. Food inflation was particularly acute due to severe breakdowns in our supply chain. Food that was meant for restaurant distribution went to waste because it couldn't be efficiently repackaged with government-approved labels for consumer distribution. It's tragic to think that something seemingly so trivial couldn't be quickly fixed. Some of those who lived near enough to local farmers began buying hogs direct, and a cottage butcher industry sprung up to supply those who didn't have the stomach to do it themselves. Even prices for things that quickly became cheap in the beginning, such as gasoline (haha, remember -$37.63 oil?) and the automobiles to put it in, or anything related to travel or tourism, are starting to get expensive, as well. Wages and economic growth haven't kept up, though, so we now find ourselves in a period of stagflation.

A wave of xenophobia and protectionism has marked the end of the globalism trend. Denmark just became the second European nation to invoke Article 50 after voting to leave the EU. Here in the US, many states have been forcefully exerting their rights against the federal government, while local militias are exerting their rights against the states. Most of us still just stay at home and post memes, though.

Nah, it won't be that bad…will it?

Adventures in Amateur Epidemiology

The spread of C-19 was exponential in March. In April it was linear. That seems odd to me.

A Quick Round-Trip

On March 24, we moved our target allocations for US stocks up one notch, bringing small and large caps to an underweight and mid caps up to neutral, and rebalanced portfolios accordingly. As quickly as the market fell into a bear market at the onset of this crisis—16 days—it's return to bull market status was an even quicker 12 days. And just as we believed we couldn't ignore the opportunity a 34% drop in the S&P 500 gave us to rebalance and buy stocks, we likewise felt a 25% increase—a 50% retracement—was a prudent trigger point to rebalance and sell. We moved our domestic equity targets back down to their pre-March 24th levels: underweight for mid caps and heavy underweight for both large and small caps.

We believe this volatile environment warrants more frequent rebalancing. We are currently going beyond a simple constant mix strategy, however, and instead we have increased our target weight to stocks when buying, and decreased our target weight when selling. This is a strategy that should perform well in an oscillating market.

A position in the Fidelity Conservative Income Bond Fund (FCONX) was initiated for most accounts that met the minimum purchase requirements. This ultrashort bond fund will act as a placeholder for our stock sale proceeds until we are ready to redeploy them elsewhere. The fund's focus on super-short-term high-quality bonds, vigilant risk management, and deep resources have earned it a Morningstar Analyst Rating of Silver. Although not as stable as money market funds, FCONX was designed as a slightly more flexible substitute for them. Proceeds from the March 10 sale of the Oppenheimer Senior Floating Rate Note Fund (OOSYX) have also been allocated to this fund until a suitable replacement is found.

Our expectations are for an epic drop in earnings this year, and we do not believe consumer behavior will return to a pre-COVID-19 normal once the economy starts to open up. Equity valuations are actually more rich now than they were at the market peak. The rally, coupled with collapsing earnings expectations, has pushed the forward price-to-earnings ratio for the S&P 500 above 21 to its highest level in over 18 years.

I believe this is just a bear market rally. Stocks will have to go significantly lower and give us a much more compelling entry point to go "all-in". You could argue that the fiscal stimulus will cause monetary inflation—and I agree with this—and so owning stocks would be a hedge against that…eventually. But in the short-term, earnings, catastrophic unemployment, economic recession, and permanent changes in consumer behavior leads me to believe stocks will re-test March lows.

For bonds, the bull case is the Fed is supporting almost everything and you should buy whatever they are buying. The bear case is even though the Fed is propping up bond prices, that doesn't actually stop a company from going bankrupt. Nieman Marcus, J. Crew, and True Religion were just the beginning; there are plenty more bankruptcies coming. So I think risky credits are going to crash again. Treasurys, and to a lesser degree munis, should be safe for a bit longer, but I think that monetary inflation will eventually start to force yields higher, and muni safety is contingent on support from the federal government.

Speaking of monetary inflation, we've had a good run in gold, but I don't think it's over. We are currently evaluating whether we should add silver to portfolios, as well. Silver is a great conductor and also has anti-

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS			●		
Multisector			●		
Bank Loans	●				
Foreign Bonds				●	
Equities		●			
Large Cap	●				
Mid Cap		●			
Small Cap	●				
Developed Intl.			●		
Emerging			●		
Alternatives					
Commodities				●	
Hedging					●

Binge Box

Bojack Horseman

I didn't really get into this show at first. I would watch an episode before bed every once-in-a-while, but never fell into binge mode in the first season. I didn't understand why half the characters were animal people, but after a while you start to see the satire in it, and the metaphors, and how it's somehow easier to not hate someone if they are a horse, and so by the second season I started binging. The show is cynical and dark at times, but also deadpan funny along the way. The voice actors, including Will Arnett, Aaron Paul, and Alison Brie, are excellent, and the dialog is so good you soon forget it's coming out of a cartoon horse's mouth.

bacterial, anti-viral, anti-fungal, and anti-werewolf properties. A little over half of its production goes to industrial and photographic applications, however, which is probably why it has lagged its yellow fellow precious metal. I think that will change and it will actually start outpacing gold as it historically has during gold rallies. The ratio of gold prices to silver prices recently hit an all-time high and is currently at 110, which is roughly double the average over the past century.

Actions You Can Take Now

- Review your emergency savings
- Increase regular investment contributions to take advantage of the market volatility
- Consider refinancing your home as mortgage rates are at an all-time low
- If you are a small business owner or independent contractor, review the Pandemic Unemployment Assistance (PUA) and Payroll Protection Programs (PPP) to see if either is appropriate for you

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About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select clients. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.