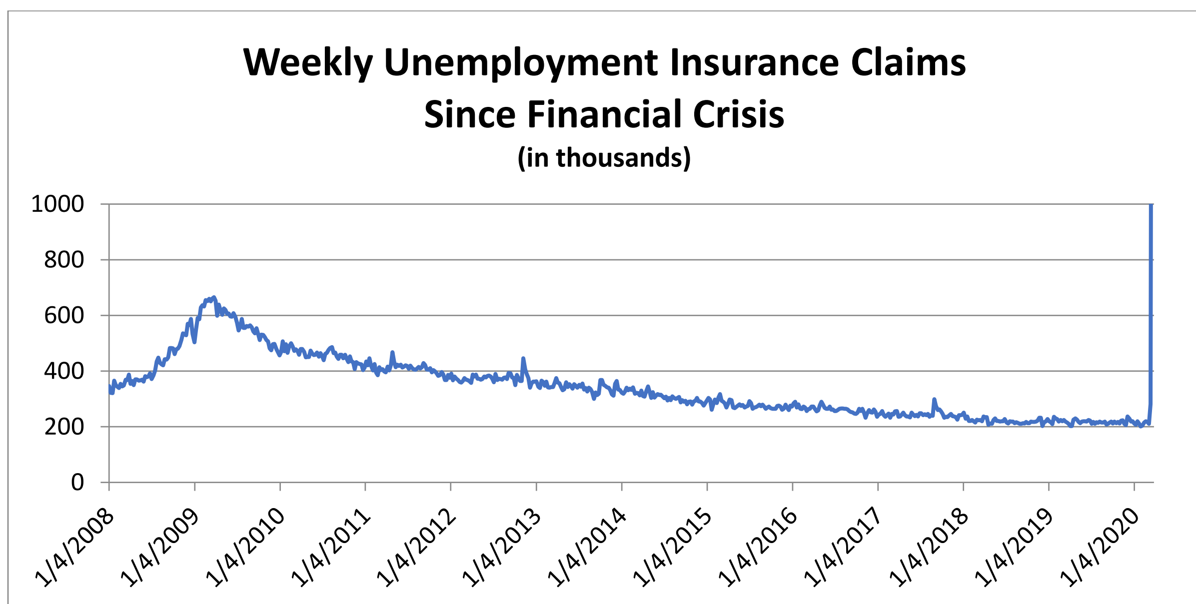
KLCM Advisors, Inc.

April 2020

The Bear Returns

On the heels of stellar returns across asset classes in 2019 that largely continued during the first six weeks of 2020, it was startling to witness the carnage in the markets by the close of a historic first quarter. The world changed a great deal in a matter of weeks. Assumptions made about financial markets at the beginning of the year are no longer relevant given the shock inflicted by the coronavirus.

While clarity remains in short supply, it is almost certain that we have entered a sharp and deep recession as much of the economy has been shuttered. Trying to measure the carnage in real-time may capture news headlines, but forecasting precision is limited. The only real-time data points we have so far are weekly unemployment claims, which have soared to **nearly 10 million** in the last two weeks (**3.3 million and 6.6 million** for weeks ending March 21 and March 28, respectively). These latest two data points are so high they fail to land on this chart below as they are five and ten times higher than peak claims during the financial crisis. This data clearly reinforces what we already know – our economy is facing a very tough second quarter. As a result, volatility will likely continue as markets do not accurately price uncertainty, which will remain heightened until infection rates and fatalities peak and improve.



Source: Bloomberg

We think it is more relevant to discuss the actions that have been implemented to address the economic problems caused by this health crisis, along with our investment approach. First, the Federal Reserve pulled out all stops to provide capital markets with liquidity. Liquidity is essentially the “lubricant” that help financial markets function properly by enabling securities to transact in the marketplace with ease and limited pricing disruptions. The details of these programs are less important – the critical point is the Fed acted very quickly to backstop credit markets by directly buying securities and providing ample funding where needed. Functioning markets are a prerequisite for a stable and growing economy, and, encouragingly, these moves appear to be working. The last couple of weeks, while still volatile, have

shown significant signs of improvement as panic selling has abated, and the pricing and trading of securities have begun to normalize.

Also, at the end of March, Congress approved a $2.2 trillion coronavirus aid bill. This relief package, totaling nearly 10% of annual GDP, is a massive injection of loans, tax breaks, and direct payments to major corporations, small businesses, and individuals to help the US economy bridge the gap created by this forced shutdown. Businesses can hopefully stay connected to their employees and emerge without a considerable amount of additional debt, and workers can find themselves roughly where they were before the onset of the coronavirus. More stimulus may be needed after the virus has passed, but this is a necessary first step to save many facets of the economy from collapsing.

As we move through the next few months awaiting the economic restart, our primary goal is to keep capital intact and find incremental opportunities to add value during this current economic downdraft. We entered this pandemic with a portfolio of companies with strong operating models, and we expect they can emerge as winners. We anticipate using the price dislocation to adjust the constituents of the portfolio as we look over the chasm and project how securities might recover over a one to two-year timeframe.

We remain optimistic about the longer-term outlook as we believe our economy and financial markets will recover from this self-induced coma, starting sometime during the summer. The table below highlights prior bear markets and subsequent recoveries looking out 12 and 24-months from the bottom.

Equity Bear Market Statistics Through History (S&P 500)

Bear Market Start	Bear Market End	Time (Months)	Max Loss	Recovery 12-Months After	Recovery 24-Months After
February 2020	?	?	-34%*	?	?
October 2007	March 2009	17	-57%	69%	95%
March 2000	October 2002	30	-49%	34%	44%
August 1987	December 1987	3	-33%	21%	57%
November 1980	August 1982	20	-27%	58%	61%
January 1973	October 1974	20	-48%	38%	67%
November 1968	May 1970	17	-36%	44%	60%
February 1966	October 1966	7	-22%	33%	42%
December 1961	June 1962	6	-28%	33%	56%
August 1956	October 1957	14	-22%	31%	44%
AVERAGE		**15**	**-36%**	**40%**	**58%**

**Max Loss to-date through March 23rd*

Source: Bloomberg

This data provides hope following the sharp contraction that saw equity markets fall by roughly 35% to 40% from February 19th to March 23rd. Remaining invested during big drawdowns is difficult, but it also allows investors to participate when the markets rebound quickly in the early phases of recovery. While we do not know if the March 23rd nadir will ultimately be the final lows for this cycle, significant incremental damage would appear unlikely if health experts' forecast for peaking of the virus in the next several weeks is reasonable. Therefore, we think it is time to begin repositioning portfolios and improving the cards in our hand for the recovery that we expect later this year.

This is a tall order because the current environment offers as little near-term certainty as we have faced in our firm's 27-year history. That said, our longer-term conviction that our country will weather this storm and continue to march forward is unshaken. The ingenuity of our people, the adaptability of our society, and the core strength of our economic system and our government's response should not be underestimated. For nearly 250 years, being long our economy has been a wise decision. We expect that a year from now, that record will be intact.

Be safe and know we are here to help during this difficult time. Please call if we can help in any way.