

Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: Certain About Uncertainty

Date: 3/15/2020

It's Sunday afternoon and this will be my fourth re-write of this month's memo. I've come to accept the speed at which events are unfolding and changing makes it all but impossible to update and encompass everything that is happening. Just this past week we saw a number of historical market drops, only to watch a Friday afternoon rally at a breathtaking rate of 7% over the final 22 minutes of trading. What happens this upcoming week in markets is anyone's guess because no one really knows.

During periods of uncertainty, I find it of particular importance to zoom out from the current time period. Temporarily removing yourself from all the headlines and hysteria gives you an opportunity to breath and assess situations from a 30,000 foot view. Flipping through my planner, this time a month ago news headlines were still consumed with the death of NBA legend Kobe Bryant, oil was priced at \$63.96 per barrel, and COVID-19 had spiked in China but seemed to be largely considered as an isolated regional event with only short-term, second order consequence to the American economy. Zoom back to today, and we can see just how much has changed. Right now the only thing that seems to be certain is that our overall narrative is that of uncertainty. In this memo I hope to share with you how I am assessing the recent events...

Economic Impact

While COVID-19 was isolated in China, the two dominant economic concerns were impact to the world's second largest economy and severe short disruptions to supply chains. Supply chain disruption was of particular importance because of the ongoing ripple effect it could create across the global economy. A large portion of end products in today's marketplace are assembled with an assortment of small components. Interruptions to one single small component could take entire production offline in more complex supply chains. While small, these tiny interruptions could cripple sectors of economic production or perhaps create chaos in a single industry. At the time, these impacts were mostly considered to be second order consequences that would send tremors to the U.S. economy but not necessarily deliver severe blows.

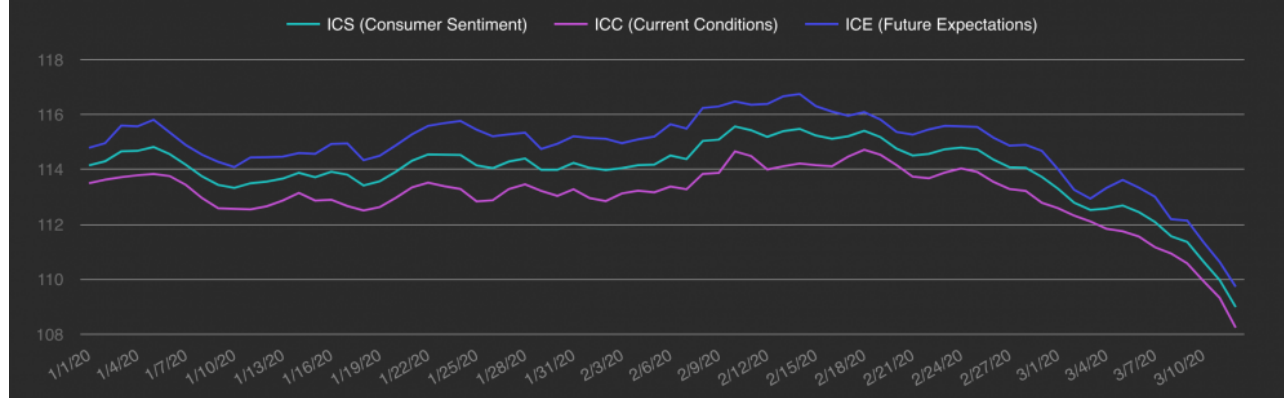
As it became apparent that COVID-19 was no longer just a "China Problem," necessary counteractions began to unfold here in the United States. Major sporting events were canceled, schools and community centers indefinitely delayed, businesses began issuing work from home orders, retailers curbed operating hours and other measures were put in place to slow the spread of COVID-19. As of this writing, all indications point to somewhat of a two week (perhaps longer) hiatus of business as usual. What a short term hibernation will do to the economy, no one really knows.

While it will be weeks, even months before actual economic data trickles in and sheds light on the true economic impact, it does appear consumer sentiment is changing. On Friday, Consumer Sentiment showed its single steepest day drop in over two years. My suspicion is Consumer Sentiment and Consumer Future Expectations will see steeper declines over the next few weeks as COVID-19 case count accelerates in the United States.

UPDATED: MARCH 13, 2020; 5:00 AM ET

HOW U.S. CONSUMER CONFIDENCE SHIFTED TODAY

Today: ICS shows steepest single day drop in over two years



Source: <https://morningconsult.com/form/consumer-confidence-tracking-us/>

The trouble with Consumer Sentiment and Consumer Future Expectations, is that sharp slides often turn into self-fulfilling prophecies. Like wildebeest at a watering hole in the Serengeti, one spook can send the entire herd into chaos whether the threat was real or not.

Overall, it appears the conditions for economic impact are very real and understandable. However, the overall impact still very much can't be quantified. Too much is changing too fast. We still do not know enough about COVID-19 to stabilize the variables used to model level one impacts on society, let alone model how those impacts on society will carry over in economics.

Market Reactions

The volatility of the markets over the past two weeks has made 2007 - 2008 look like a kiddie carnival ride. The velocity of the plunge and the surge of the VIX was the fastest on record. Going into this, valuations across public and private markets were viewed as historically high leaving many value investors to deem levels somewhat "frothy." As to the magnitude of how this contributed to the accelerated selloff is anyone's guess.

From my perspective we have clearly left the traditional worlds of Modern Portfolio Theory and Efficient Market Hypotheses. What we are seeing is pure Behavioral Finance. I was even more convinced we had tilted into a world driven by behavioral finance after observing three particular events over the last week that made me scratch my head...

1) *Arbitrage Spreads Widening* - Traditionally there is a small spread between the value of financial products like ETFs and the value of the securities they hold. Certain funds specialize in arbitraging this separation when it gets out of line, thus closing the spread. Over the past week, there were multiple days where this spread widened to a historical significance. To me this indicates that the funds traditionally able to arbitrage the opportunity no longer had access to liquidity or they were so uncertain to the priced risk that they were unwilling to take action on the spread.

2) *Yields & Liquidity in High Grade* - Over the week, yields on high grade investments continued to get pushed down. At the same time there were reports that liquidity was drying up for high grade Munis in the form of less available buyers. Banks hold high grade Munis. To me this indicates banks were facing slight liquidity issues as they were having to sell aggressively to meet draw downs on credit lines extended to their corporate clients or perhaps even redemptions by customers.

3) *7% in 22 minutes* - Lastly, the 7% jump in markets going into Friday's close was absolutely breathtaking. It happened during President Trump's speech addressing health and fiscal plans to combat COVID-19. 7% is an astronomical move for a single security much less an entire market. It's important to digest when the move happened and the circumstances surrounding it. The move happened with 22 minutes left in a trading day, on a Friday, while a president was talking. To me the speed of acceleration was more indicative of a short squeeze than a vote of confidence in the plans unfolding. A short squeeze of that magnitude across an entire market indicates to me that speculators and market participants are still largely unsure as to if they are bullish or bearish at these levels.

All to say, there's a lot going on that's sending mixed feedback and well out of the ordinary of efficient working markets.

The truth is no one knows how to price in what is unfolding because the level of uncertainty is so high. Events are changing at breakneck speed. Howard Marks sums it up perfectly in a memo he wrote January 2016 that said;

"In the real world, things generally fluctuate between pretty good and not so hot. But in the world of investing, perception often swings from flawless to 'hopeless.'"

Compared to where we were a month ago, perception certainly seems to be swinging.

Where To Focus

With all that's going on it's easy to get a little dizzy. What we wouldn't give to wake up and realize this was just a weird dream. It is all too easy to get lost in the fog of uncertainty, which is why it's so important to find a NorthStar that you can keep coming back to. For me, I've found focusing on three things in particular help return my center of gravity...

1. **Remember Your Goal** - My focus is to invest in good businesses at fair prices. That's it, that is my goal. I'm not speculating on interest rates, economic stimulus plans, or what changes may or may not unfold with fiscal policy because of current events. Watching a whipsawing market can become almost hypnotic as you take in the emotions of extremes. Trying to predict what will happen next is near impossible and will only result in mental agony. But when we remember our goals, we can begin to ignore a lot of the outside distracting noise.
2. **Prioritize Rational Thinking** - Charlie Munger has said the goal of any purposeful life should be to master rational thinking. How important it is in times like these. While markets turnover and headlines roar with apocalyptic narratives, it is imperative that we think and try our best to stay rational. COVID-19 is scary and very well could have severe consequences. However, will it decimate all of humanity and forever alter how we carry out life as we know it? Not likely. So, let's be a little more like Munger and try our best to stay rational.
3. **Remember The Long Term** - Finally, it's important to focus and remember the long term. We are in the heat of the storm making it easy to project feelings of our future based on current circumstances. Returning to my exercise in the second paragraph of this memo, I like to remind myself to zoom out on the timeline to prove to myself this is just the current day's event on a very long timeline. In time, this too shall pass. If you don't believe me, dig out an old planner or journal and flip to a few months after September 11th. I'm willing to bet life a few months after 9/11 had returned to some level of normalcy. What humanity accomplishes with its back against the ropes is remarkable. We've survived worse, and we will make it through whatever unfolds with COVID-19.

Between finishing this memo Sunday evening and sending it out Monday, the Fed took rates to zero, bank reserve requirements were removed, and the markets fell 12%. Again, with everything happening as fast as it is, markets and circumstances very well could be different by the time you read this. What my memo will say next month, I have no clue. Perhaps the social distancing and ongoing measures unfolding in the United States will slow down COVID-19 to a point where all the hysteria is deemed an entire overreaction. No one knows and no one can say for sure one way or the other. Until then, stay healthy, find a few positives in your life to appreciate and focus on, and we'll see what happens.

Until next time,

A handwritten signature in black ink, appearing to read "M. Carter Johnson". The signature is fluid and cursive, with the first name "M." and last name "Johnson" clearly distinguishable.

M. Carter Johnson

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