Memo to: MCJ Capital Partners

From: M. Carter Johnson

Re: Last Call For 2020

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The end of the year always offers a valuable window to reflect. By most measures, 2020 will go down as one of the more challenging years in the history books. And while it is easy to write off the entire year based on those challenges, progress was made. In this month's memo we explore a few bright spots, reasons to be cautiously optimistic, and a few creative areas to look for reasonably valued high quality companies.

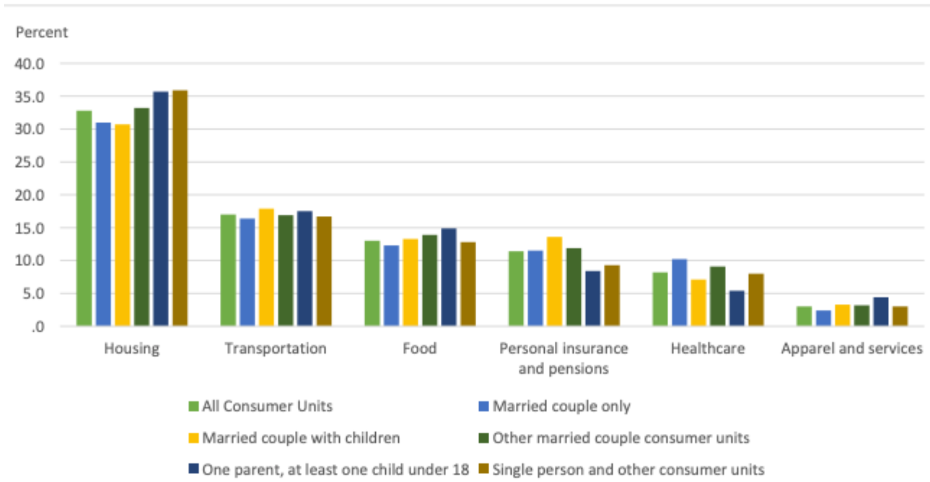
Progress Made

Violent forest fires, social unrest, a contested election and of course the worst global pandemic in over 100 years occupied this year's headlines. Who wouldn't want to welcome in 2021? Yet if we take a moment to reflect, between the seemingly never ending challenges, progress on several fronts was made. Here are five themes to consider:

1) *Vaccine Development and Distribution* – The opinion among experts vary but traditional estimates have vaccine development taking between 10 and 12 years. Typhoid Fever took 13 years, Polio took 18 years, Anthrax took 56 years and yet in 2020, a vaccine for Covid-19 was developed (and began distribution) in a matter of months. Currently it may not feel like a "win" but this is an accomplishment for humanity. In the future (hopefully very far off), when a new pandemic hits, the world will draw from lessons learned in rapid development of vaccines.

2) *Acceleration of Technology Adoption* – The pandemic brought many changes to daily life and routine order. Across the world individuals and businesses were forced to embrace new technology to carry out daily functions. While theses adaptations were originally out of necessity, incorporating them into the fabric of how we operate will yield productivity gains well into the future. How long would it have taken these changes to occur without the pandemic?

3) *Gains from Remote Work* – A subsequent benefit of technology adoption was the shift to remote work as a norm. This shift in how employees work has the potential to create substantial ripple effects in life for generations to come. Consider in 2018, the average American's commute was 27 minutes one way or 54 minutes roundtrip. In an eight-hour workday that translates to roughly 10% (54 minutes divided by sum of 54 plus 8 hours), of wasted time. Viewed differently, that's a 10% tax for just showing up to work. If remote work remains a staple for employers, time will be reallocated to more productive (and enjoyable) uses. Remote work also has the potential to shift long term trends in housing. The previous economic paradigm has required individuals to reside in high cost living areas in order to commute to the best in person jobs. As jobs transition to become less geographical dependent, individuals and families have the potential to relocate to more affordable living areas. Considering roughly 33% of consumer expenditures go towards housing, a shift to more affordable living has the potential to free up how consumers spend across the economy.



Source: https://www.bls.gov/news.release/pdf/cesan.pdf

4) *Government Stimulus* – Say what you will about the government, but when trouble hit, payments were sent out to 153 million people. In total, this effort pushed forward $269 billion in funds to help mitigate the financial burden during the pandemic. In addition, nearly 700,000 businesses received $660 billion in paycheck protection funds. This effort supported 52 million jobs directly. The process wasn't perfect. Some people never got checks they needed. Some individuals took advantage of the system. However, at the end of the day, the government was able to deploy funds across the country to over 153 million people and 700,000 businesses. The sheer logistics of organizing, approving and deploying this effort should be commended.

5) *One More Experiment* – Perhaps the most important piece of progress made in 2020 will be the painful gains that come from going through "one more" economic downturn. Consider for a moment the differences in the Great Depression, the Great Recession and this year's recession:

> Great Depression – At the start of the Great Depression, the Federal Reserve was a relatively new organization with little real-world feedback around monetary policy. John Keynes hadn't yet written, "The General Theory of Employment, Interest and Money" leaving fiscal policy mostly nonexistent. The United States had few tools to work with when the recession hit. As a result, unemployment swelled to 25%. GDP collapsed 26.7%. People didn't just lose their homes, they literally starved. It was devastating and permanently scarring for generations of people. Yet out of the Great Depression rose new tools and innovations. Agricultural price support programs were enacted to stabilize future supply and demand shocks. Unemployment insurance was created to provide temporary assistance for individuals without a paycheck. The standardization of economic indicators such as GDP and unemployment awarded a methodology to steer the economic ship in the future.
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> Great Recession – Fast forward to the Great Recession. The global economy was staring down the unimaginable. Things were bad with unemployment swelling to double digits (10%) and GDP contracting 5.1%. The entire financial system was on the verge of complete collapse. Yet this recession we had new tools. We understood more about monetary policy, and had a Federal Chairman who had devoted his life's work to understanding Keynesian economics. We applied what we learned from studying the Great Depression (and smaller recessions since), while introducing new "experiments" around fiscal policy.
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> 2020 Recession – Fast forward to 2020. In three weeks, 24 million people lost their jobs. GDP dropped 32.9% in the worst three months for the U.S. economy ever. Yet again, we applied what we learned from previous recessions and tried some new things too. This

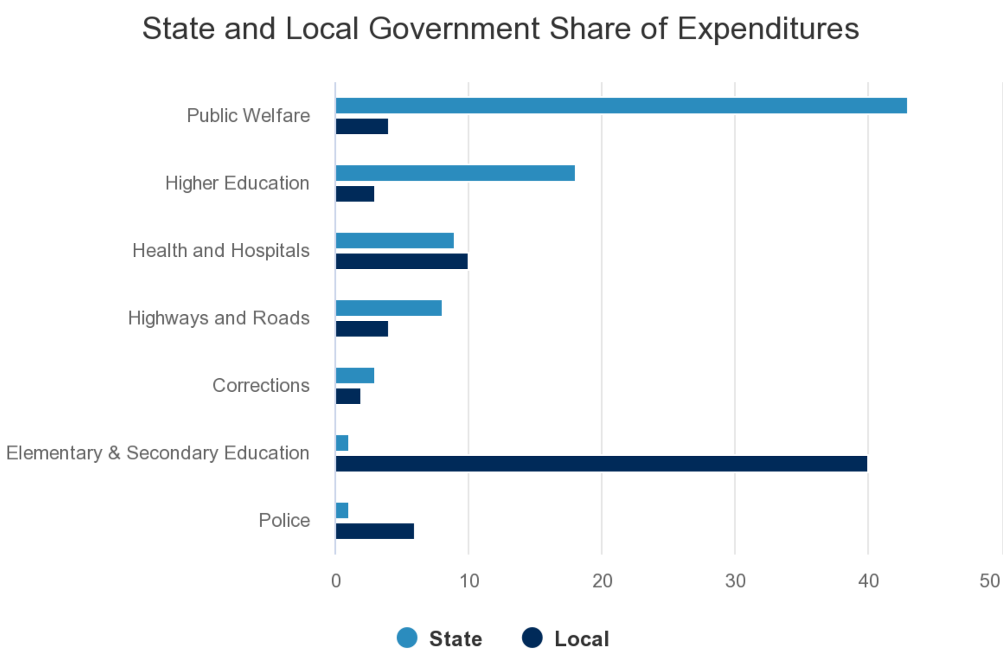
time around, unlike the Great Recession, fiscal stimulus was immediately deployed. In addition, the Fed rushed to provide liquidity as markets threatened to dry up.

Economics may be a science, but it doesn't offer controlled environments where we can test assumptions and run experiments. The experiments of economics are carried out in real time. In a few years, we will use the data currently being compiled to add to the overall rulebook for navigating recessions. Are we to assume one day we will be able to manage out the down cycle altogether? Not likely. However, we can optimistically move forward with the hope that each cycle brings an opportunity for improvement. That's progress.

Far from Perfect

To be clear, things are far from perfect. Roughly, 10.1 million people in the U.S. remain unemployed and the expiration of deferment and forbearance clauses will leave many in dire situations. Economic gains by minorities and women have severely regressed. While the start of the pandemic brought equal economic hardship, white Americans have now recovered half of their lost jobs, while black Americans have recovered a third and Hispanics have only recovered a quarter of lost employment. In addition, as the pandemic forced schools to go remote, women largely answered the call of sacrificing their careers for family. Employment for women with school aged children fell a third more than it did for men of the family.

Perhaps the most frightening uncertainty resides in the fate of state and local municipalities. These entities employ over 20 million workers or approximately 13% of total U.S. employment. Income for state and local government is driven by local tax revenue. Revenue collected is used to fund education, health, infrastructure, emergency services, and many necessities we rely on without much consideration. In total, local government expenditures tally approximately 15% of U.S. GDP, providing stability in the overall economic machine.



Source: U.S. Census Bureau Annual Survey of State and Local Government Finances, 1977-2017 (compiled by the Urban Institute)

The trouble these entities are facing is twofold. The first problem is revenue related. During recessions tax revenue declines as a result of less spending. Seeing as tax revenue typically lags the general economy by 12 to 18 months, the severity of this problem will become clearer in 2021. In addition, local and state tax revenue takes longer to recover than it does for private enterprise establishments. It wasn't until 2013 that Local and State tax revenue recovered to pre Great Recession levels. The second problem these entities are facing is demand. During the pandemic the demand of services by local and state governments accelerated. Strains on hospitals, refitting technology needs of schools, paying out unemployment claims, were all reactive needs fulfilled by these local entities. The combination of these two problems (less revenue and more demand) will likely place severe pressure on operating budgets in the near future. And unlike the Federal government, raising funds through bond offerings isn't quite as easy for municipalities.

The Case for Cautious Optimism

All things considered, there are a number of reasons to be optimistic. The distribution of vaccines serve as the strongest reminder of light at the end of the tunnel. As vaccines make their way to market, a normalcy of life prior to Covid-19 will begin to emerge. It will not be completely the same, but slowly it will take shape. What makes this movement so powerful on an economic front is the velocity in which it will likely occur. Each month the number of people vaccinated will grow. As vaccinations grow so too will the reversal of delayed spending. Restaurants will begin to have more diners. People will take those long awaited vacations. Businesses will begin to have the confidence to move forward on delayed investment decisions. This steady progression will create momentum and momentum is powerful.

During this pandemic, U.S. consumers have accumulated an excess of $2.72 trillion in savings. Following most recessions, the savings rate increases and it can be argued those funds stay on the economic sidelines for years. However, this recession is different. People have been locked in their homes, exhausted by the mundane. With better times in sight, it's not hard to imagine that $2.72 trillion (approximately 12% of GDP) being put to use.

The housing market offers another bright spot. Prior to Covid-19 housing was on the rise. Millennials and their long-awaited capital were finally coming off the sidelines to create home purchasing demand. When the pandemic hit, housing took a temporary pause, but it also created a whirlwind of circumstances that could drastically serve as a tailwind. The cut to interest rates set off an obvious demand for refinancing in addition to giving consumers more purchasing power for new home purchases. The behavioral shifts in how American's are spending time at home parlayed with remote work is fueling a migration to suburbs. Just how important is housing for the overall economy? According to the National Association of Home Builders, for every 1,000 single family homes built, 2,900 full time jobs and over $110 million in tax is generated. In November, new building permits hit a 13 year high of a seasonally adjusted annualized rate of 1.639 million.

Getting Creative

After the year the world has experienced, you would think record level equity markets would not be in the headlines, but here we are. The fastest market decline in March was followed by stocks rallying beyond their previous levels on the way to new all-time highs.

If you're looking for no brainer bargains you'll have to turn over a few more rocks than usual. Although macro is not really our game, it does provide some ideas around where to hunt bottom up opportunities in search of good companies that have fallen out of favor.

Here are four creative ideas if you're in the mood for searching among macro narratives:

> *European Industrials* –While the S&P has left many indices in the dust, valuations are a little more reasonable across the pond. In general, the European economy is more industrial. As the world recovers from this recession more cyclical industrial economies should pick up in demand. A strong Euro and Sterling Pound will further benefit industrials who rely on imported material to manufacture end products. Look for companies that provide essentials to customer bases with low bargaining power to see strong demand and expansion of margins.
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> *Multinationals with U.S. Denominated Debt* – The U.S. dollar has softened on foreign exchange markets. As both emerging economies (more dependent on commodities) and countries dominated with industrials pick up steam, added pressure will likely push the dollar down further. This benefits multinationals that hold lots of debt in U.S. dollars but generate sales across multiple nationalities.

Small, Micro and Nano Caps – Until November, smaller companies seemed to be forgotten. Recently the Russell 2000 rallied enough to surpass YTD gains of the S&P. As this is our area of expertise, we spend most of our time turning over rocks in this space. Valuation levels are more reasonable on a relative basis and we continue to find good companies selling well below private market comps.

Out of Favor Service Companies – 2020 absolutely crushed the earnings of many businesses. As a result 2021 will offer a low hurdle for year over year improvements. Many companies in the service industry were left out of equity rallies. Throughout 2021 as earnings return to pre pandemic levels, the mispricing of these companies will generate attention.

In summary, it's been a whirlwind of a year. While times were tough, there were certainly moments that we will look back and say "that was progress." Things aren't perfect (are they ever?), but there are real reasons to be optimistic. Markets are high, valuations aren't cheap. As a result, get creative looking for opportunities. And finally, have a wonderful holiday.

Wishing you the best as you head into the New Year,

M. Carter Johnson

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