MEDALLION WEALTH MANAGEMENT

Where Trust is Earned

We're All Zombies Now!

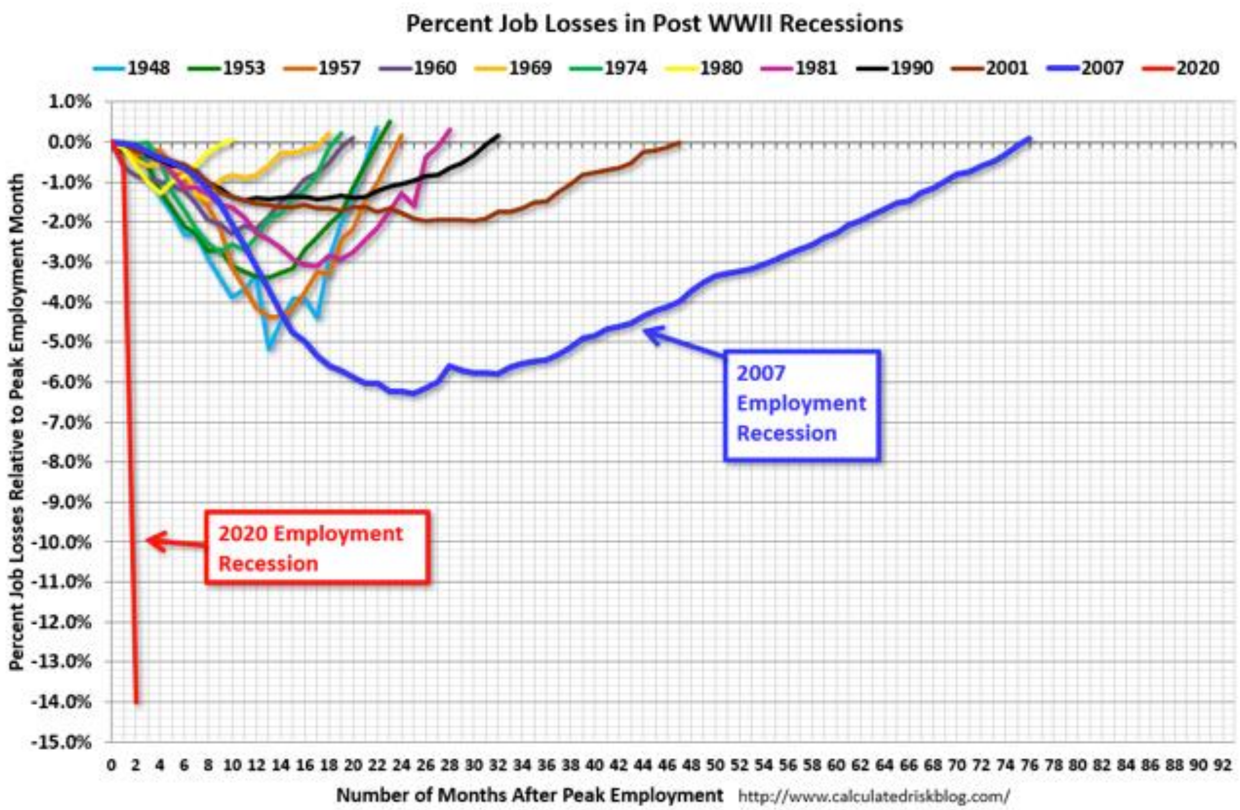
Last summer I wrote a piece titled, "Fear The Walking Dead" in which I talked about the rise of zombie companies and the consequences to our capitalistic society. A zombie company is defined as a company that only generates enough cash to fund operations and interest service, but cannot invest for growth or pay down debt.

Zombies have always been with us, but in the "old days" many died off and were replaced by stronger, more innovative competitors. The problem with letting zombies die off is that there is an initial spike in unemployment until the stronger competitors grow to absorb the unemployed. We used to call this a business cycle, how quaint.

During the 2008-2009 Great Recession our politicians/central bankers decided that they would rather sacrifice future growth and innovation in order to stave off high levels of unemployment and bankruptcies. By cutting interest rates to zero and injecting the capital markets with massive doses of liquidity we pulled out of the recession with one of the longest but also one of the weakest economic recoveries ever. The number of zombie companies in the S&P 500 rose from about 2% in the 1980's to 16% in 2019.

Fast forward eleven years and we now have the Great Cessation, the government mandated shutdown of the economy to fight Covid-19. This is unlike any prior recession in history since it is government mandated and all encompassing. Having learned from the 2008 Great Recession the Fed has wasted little time in flooding the economy with cash. Nearly $3 trillion has been allocated to individuals, and small and large businesses. I'm not arguing about the merits of the Fed's largess, they are doing the best that they can given the unprecedented nature of this collapse, I just want to look at some of the ramifications.

The graph below shows just how severe this contraction in economic activity and employment has been compared to prior recessions. Unfortunately, these numbers are going to get close to -20% before they start to improve. The trillion dollar question is just how quickly those job losses will be recovered. Most seers expect an initial jump but then a much slower recovery as we figure out what life will be like living with the virus.

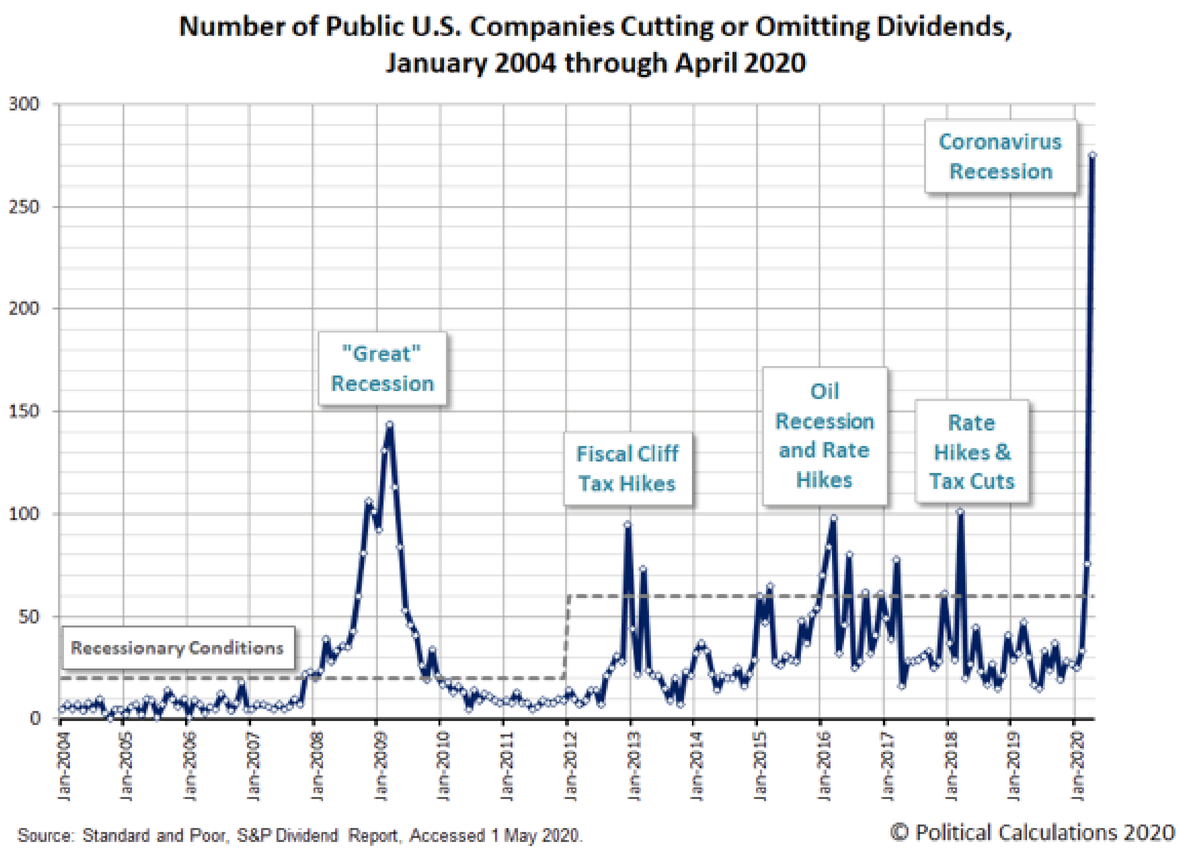


One of the unintended consequences of this massive flow of money and nearly 0% interest rates is a lot of companies and households that shouldn't be kept alive are being kept alive (I mean financially). The number of zombies, those companies and individuals that are living paycheck to paycheck without the ability to save or invest is increasing exponentially. Truly there is a very real humanitarian reason to help those in need, but there are also many corporations that are being kept alive when their business models or management decisions are below par. This has resulted in a massive increase in "moral hazard", where both companies and individuals continue to make poor financial decisions and take on more risk than prudent with the proven belief that the Fed will bail them out.

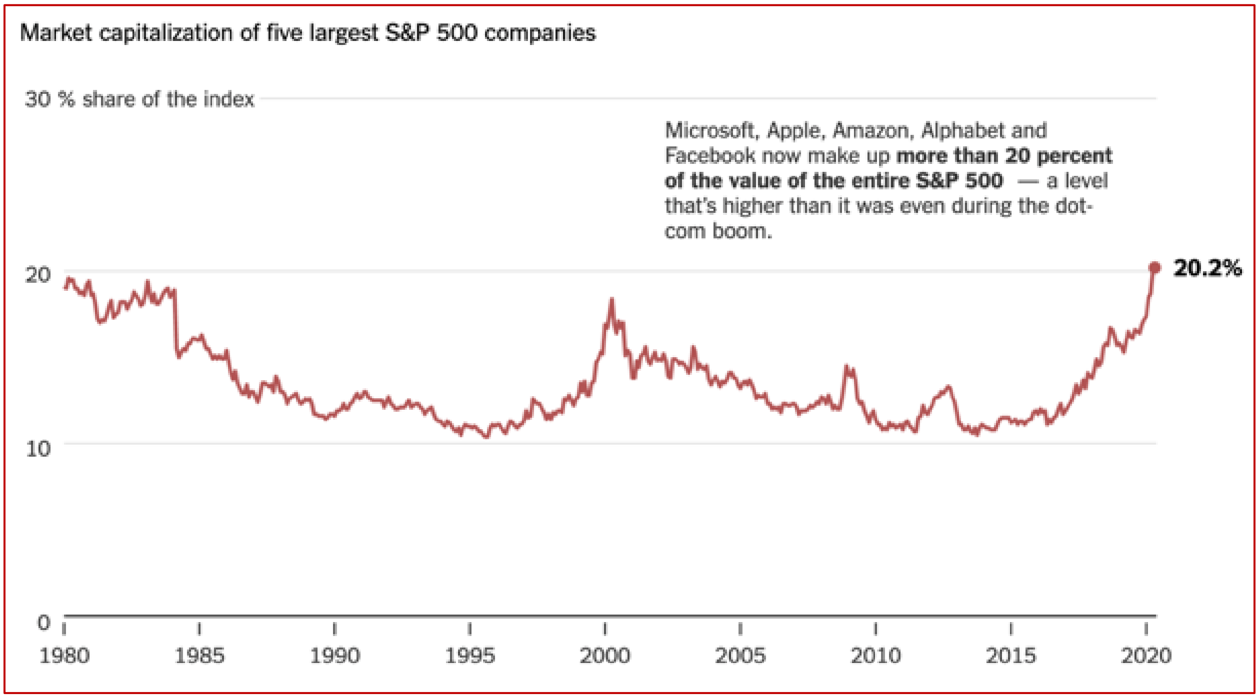
A great example of the massive amounts of liquidity keeping the markets flowing is Norwegian Cruise Lines. Norwegian got a "Going Concern" letter from their accountants on Tuesday, but was still able to raise over $2 billion in debt and convertible financing. The four year bonds were issued at a 12.575% yield. Meanwhile Boeing was able to raise a whopping $25 billion in debt rated BBB-, with the 10 year bonds yielding 5.15%. The yield on a two year Treasury note is now at a record low 0.10%.

And it's not just the bond markets that are benefiting from the Feds flows of cash, equities have also come roaring back. The S&P 500 is up 32% from its March low, and is now only down 8.58% year-to-date. The tech heavy NASDAQ 100 is actually up 6% year-to-date. These gains are being made despite the fact that corporate earnings are falling rapidly. The S&P 500 had earnings of about $163 per share in 2019, and that is expected to drop about 26% to $120 in 2020, and still be 14% lower in 2021 at $140. These numbers are probably generous too.

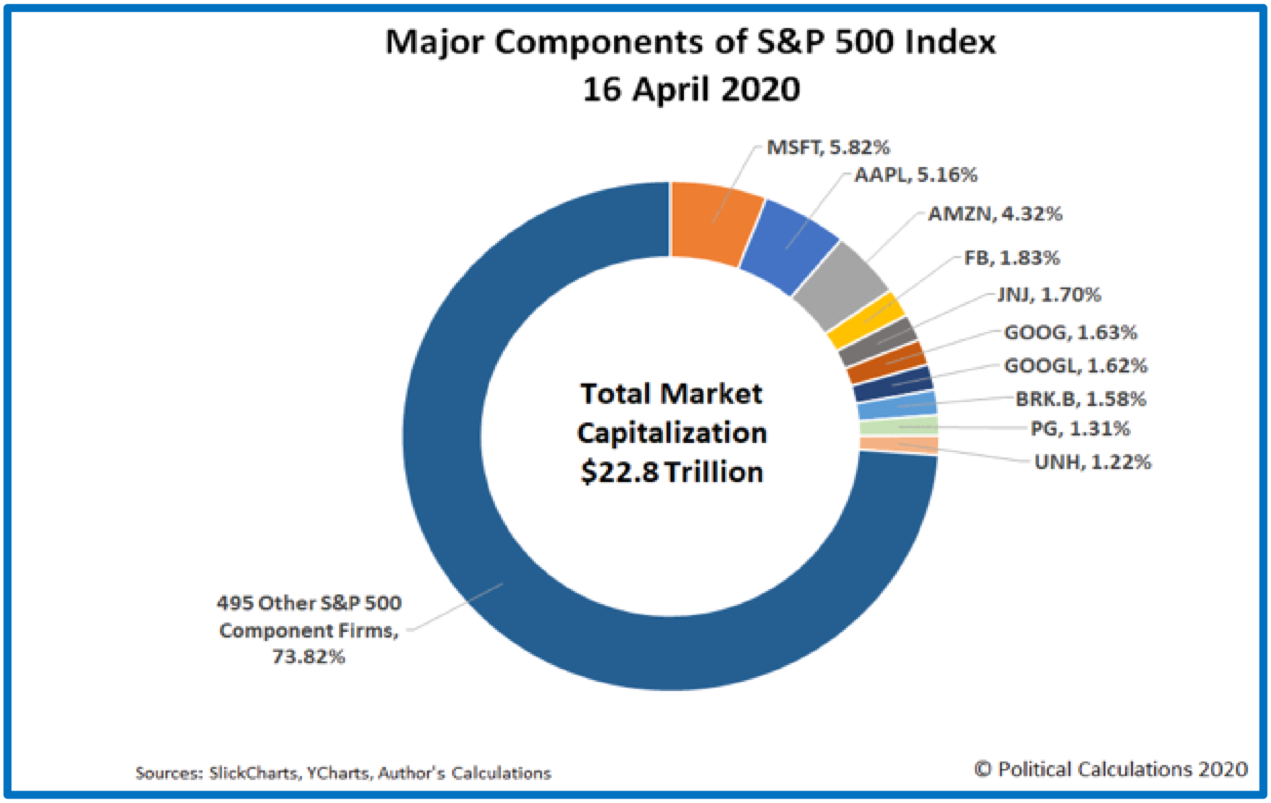
Dividends are also being cut or eliminated at record rates. The S&P 500 paid dividends of $58.63 in 2019, and is expected to pay dividends of $48.50 and $43.00 in 2020 and 2021. Here is a small sample of some of the better known cutters so far: Disney, Schlumberger, Western Digital, General Motors, Ford, Boeing, Estee Lauder, Goodyear, Las Vegas Sands, Invesco, CONSOL Energy, Apache, Harley-Davidson.



So earnings and dividends are declining rapidly and subsequently valuations are rising rapidly, but the fear of missing out is causing investors to continually buy stocks. Of course not all stocks are being bought with equal voraciousness. The clear winners have been the behemoth tech and communication service stocks, MSFT, AAPL, AMZN, GOOG, and FB. These 5 stocks now account for more than 20% of the S&P 500, and a whopping 45% of the NASDAQ.



This seemingly illogical chasm between the very real carnage in the economy and the levitating stock and bond markets has many scratching their heads. Part of the markets enthusiasm can be attributed to "don't fight the Fed." The Fed's ongoing liquidity injections are clearly putting a floor under stocks and bonds, and a 2-year Treasury note yield of 0.10% certainly makes the S&P 500's yield of 2% and Boeings bond yield of 5.15% look attractive. While it's important not to swim against the tide, it certainly feels like this tide is taking us further and further away from shore.



Warren Buffett often talks about waiting for the tide to go out in order to see whose swimming naked, unfortunately in this market the naked swimmers are being kept afloat by the Fed's largesse, at least for now. Speaking of Warren, last week we learned that Warren has sold all of his airline stocks and is now sitting on $137 billion in cash. What was more interesting was that Warren hasn't found any companies worth buying. How big is that $137 billion in relation to Berkshires portfolio? Big. Berkshire has about $250 billion invested in stocks and $137 billion in cash, cash is about 35% of their tradable portfolio.

I continue to be pleasantly surprised by the markets resiliency, and I think it's crazy that it is doing so well in the face of such dire economic numbers. I'm continuing to float along with the naked swimmers and zombies as the tide takes us further from shore, but I'm keeping a close eye on my cash life preserver.

On a personal note I have recently joined the fine folks at Medallion Wealth Management here in Pittsburgh as a Portfolio Manager. I look forward to helping them and their clients navigate these troubled waters.

Be careful out there.

Chris Wiles

Where Trust is Earned