

April 30, 2020

BLUME CAPITAL MANAGEMENT
Second Quarter Newsletter

It is difficult to know where to begin given all that has transpired over the last several weeks. As COVID-19 has spread around the world it has forced a broad-based economic shutdown, and the damage to health, wealth, and well-being has been enormous. With containment efforts leading to surging unemployment and widespread business closings, the global economy has plunged into recession and faces its largest contraction in modern times.

While policymakers across the world act aggressively to stem the contagion of the virus, they are also moving with unprecedented speed to limit the economic damage. The Federal Reserve quickly brought short-term interest rates down to zero and massively increased its bond buying, in addition to numerous other programs.

We have also seen enormous fiscal support with nearly \$3 trillion of initiatives including the CARES Act, which provides larger payments to millions of newly unemployed and helps small businesses retain employees during mandated shutdowns. Additional aid is likely on the way, and while the stimulus will not prevent a recession, it will mitigate systemic downside risks and hopefully prevent a deeper economic crisis.

Market Overview

The longest bull market in U.S. history evaporated almost overnight in March as pandemic fears triggered the most rapid 30% decline in U.S. stock market history. What started with declines in directly impacted sectors, such as travel and retail, quickly accelerated to include all areas of the equity and credit markets as investors digested the broader implications of a global economic shutdown.

As the sell-off progressed, panic selling and forced liquidations drove even the highest quality securities lower. Measures of market volatility matched all-time highs, and nearly every asset class declined in unison—a hallmark of extreme financial panic. After weeks of massive, sustained selling pressure, unprecedented actions by central banks and governments across the world helped stabilize credit markets. Stocks followed with a recovery of their own in late March, but the S&P 500 ultimately finished down 20%, the worst quarterly performance since 1987.

Foreign stocks held up better in the initial stage of the sell-off, but as a flight to safety drove the U.S. dollar higher, shares of companies priced in foreign currencies ultimately underperformed their U.S. counterparts. Foreign developed stocks, as measured by MSCI EAFE Index, fell 23.5%, while emerging market equities declined 24.4%. Interestingly, the stock market of China, where the virus appears to be further contained, was one of the strongest in the world, declining only 8%.

The U.S. bond market, as measured by the Bloomberg Barclays Intermediate US Aggregate Index, rallied 2.5% during the quarter. Not surprisingly, U.S. Treasury bonds, the ultimate safe haven asset, generated substantial gains as the 10-year yield fell from 1.92% at the beginning of the year to 0.67% (bond prices move inversely to yields). However, sharp declines in other areas of the bond market with greater credit risk (corporate bonds, mortgages, etc.) offset some of the upside from lower rates.

Index	Three Months 12/31/19 – 3/31/20	Twelve Months 3/31/19 – 3/31/20
S&P 500 Total Return ¹	-19.6%	-7.0%
DJIA Total Return ¹	-23.2%	-15.5%
MSCI All-Country World Index Ex-US ¹	-24.1%	-16.3%
Barclays Int Agg. Bond Index	2.5%	6.9%

Outlook

To state the obvious, we are in unprecedented times. We endured the fastest market crash ever, we are in the deepest economic contraction in history, we are witnessing the most rapid and massive government stimulus ever deployed, and, lastly, we just experienced the most rapid 20+% recovery from a bear market in history. In many respects it feels like we have lived through an entire market cycle in the course of several weeks, but, of course, we still have a long and challenging road ahead.

We think it is important to remember that the economy was doing reasonably well heading into this pandemic and we did not have the large economic imbalances (a la 2008) that can lead to a deeper downturn and multi-year adjustment period. Said another way, this started as a health crisis, not a financial one. Faced with necessary measures to lock down the economy, slow the spread and avoid overwhelming the health care system, investors are faced with two primary issues that are not typically a part of their analytical framework.

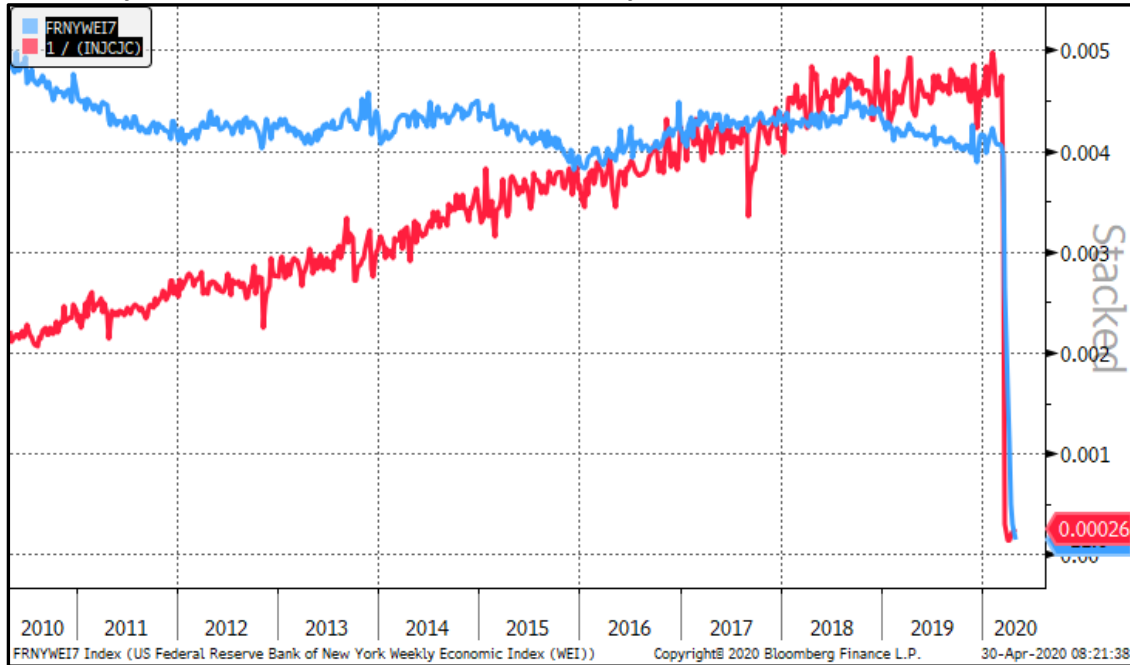
The first question is when the economy can safely and sustainably reopen, which is a matter of science. We know that life will likely not fully return to normal until we get a medical solution, but, given the massive economic and other costs associated with a shutdown, we also know we cannot stay closed until that time. Government and public health officials have the extraordinarily difficult task of balancing the priorities of protecting lives while forging a path to restart the economy.

We cannot predict when this chapter of the crisis will end but based on the opinions of health experts we follow, it could be anywhere from several months to several quarters. The world's massive technology and medical resources across the private and public sectors are exerting a moonshot-like effort to deliver a solution. We are certainly hoping for a positive surprise and a quicker return to normalcy, but, from an investment perspective, we are also preparing for a longer, drawn-out struggle that persists for some time.

¹Includes dividends in addition to index price appreciation.

The second critical question is how much lasting damage the economy has suffered during the shutdown. The immediate harm is obvious. Large portions of the global economy are closed. The sudden stoppage in U.S. economic activity has led to an unprecedented surge in jobless claims with 30 million workers filing for unemployment in just six weeks, and the New York Fed Weekly economic index has already fallen well below the 2008 lows.

NY Fed Weekly Economic Index (blue) and Initial Weekly Jobless Claims (red, Inverted): 2010 - Present



Source: Bloomberg

Indeed, it is not hard to envision how the shockwaves emanating from the shutdown could trigger widespread economic damage and ultimately a depression IF governments do not provide support to bridge the chasm.

Fortunately, governments across the world are rapidly responding. To give a sense for the massive size of support in the U.S., the growing stimulus spending is already much larger than the total amount expended in the 2008-09 downturn. Central bank initiatives have been even more extraordinary. In March, the central banks of the G7 most developed economies were creating money to buy bonds and other assets at nearly five times the peak rate seen in April of 2009.

Clearly, governments are employing a “whatever it takes” approach to get us through the shutdown, but as we look forward to the next phase of the pandemic there is significant work left to do. With provocative headlines already emerging regarding relative winners and losers, we find ourselves with more questions than answers.

As the unemployment rate approaches 20%, how will the country help more vulnerable segments of the population who lost service sector jobs that may not come back for a long time? Will political differences interfere with addressing the second wave of impacts such as state and local muni deficits, so that we do not face a deterioration in basic services like education?

When we look abroad, we have similar concerns. Will the northern countries of Europe support the more challenged nations in the south and keep the Eurozone intact? How will the richest nations of the world help emerging economies that do not have a reserve currency and monetary printing press to mitigate the effects of the virus? Finally, can we address these challenges without creating moral hazards that impair the future health of the economy?

The widely respected economist, Ed Hyman, recently summed it up by saying, “the economy is in freefall, but stimulus appears to be winning for now.” We tend to agree that barring the need for a prolonged shutdown, the scale of stimulus enacted and to come, for now, appears to be sufficient to stabilize markets, avert a downward spiral, and head off a depression. However, we are under no illusions about the challenges that lie ahead.

Portfolio Update

We thought it would be helpful to share additional detail on measures we are taking in response to the rapidly changing environment. Even more than usual, we focused our efforts on two primary issues as the crisis unfolded: 1) identifying areas within the portfolio that were at elevated risk; and 2) uncovering mispriced opportunities created by forced selling.

On the equity side, as the crisis intensified, first and foremost, we stress tested every company to ensure they had the balance sheet strength, liquidity (i.e., cash), and business staying power to endure a temporary (but possibly extended) economic shutdown and deep recession. While every business we owned coming into the downturn was investment grade rated (higher quality credit), we sold a few stocks and reinvested the proceeds in companies better positioned to weather the downturn. The panic and forced selling pressure drove everything down in unison without regard to relative fundamentals. We took advantage of this window of opportunity to upgrade portfolios and reduce downside risk, without compromising long-term upside.

In evaluating opportunities to add to current positions or invest in new equities, we are thinking about companies in three distinct groups:

1. Defensive – Mostly large secular growth and low volatility stocks, plus companies that benefit from the changing stay-at-home environment;
2. Durable Cyclical – Companies exposed to economic downturns but with resilient long-term prospects, strong balance sheets and ample liquidity;
3. Existential Risk - Companies whose business models are fundamentally at risk (retail, restaurants, travel, etc.) or who may not have the financial strength to make it to the recovery side of the pandemic.

Although we already own some Defensive stocks, we are not expending our incremental efforts in that area. Many Defensive equities were already expensive coming into the crisis, and we generally avoid paying a premium valuation for a stock simply because it may hold up better in the short term. Similarly, we are not looking at companies with Existential Risk where the investment thesis starts with “if they make it through the recession....”

Our focus has been on the Durable Cyclical, which would describe the majority of our portfolios today and where we are spending our time looking for mispriced values. One example in this category that we purchased at the depths of the sell-off is Hasbro, the world's premier toymaker. The company has a strong balance sheet, ample cash and liquidity to weather a sustained downturn, and attractive long-term growth prospects.

We selectively purchased a number of new and existing stocks at attractive prices in late March, and we continue to look for opportunities to cautiously add to stocks or shift out of positions that have held up relatively well into names that will provide greater upside into the recovery.

Our fixed income portfolios were very safely invested with minimal credit risk entering the March sell-off. Our view is that the primary purpose of fixed income is to provide ballast for equity exposure, not necessarily to maximize yield. Hence, bond portfolios held up very well through the market correction. This, in turn, allowed us to opportunistically purchase lower-rated credit at much higher yields than were available earlier in the year and add an allocation to high-yield bonds across fixed income portfolios.

Final Thoughts

At some point, hopefully not in the too distant future, we will emerge from our homes to a changed world. Governments around the world have been forced to marshal resources on a scale not seen since the second world war, and society and investors will have to consider the longer-term trade-offs of the policies enacted to fight the COVID-19 battle.

Over the past few years, we have written that our primary long-term concern was the unsustainable level of government debt and deficits, and we have judged there was a high probability that the Federal Reserve would be forced to support deficit spending in non-traditional ways in the next downturn.

Prior to the pandemic the U.S. government budget deficit was expected to be just over \$1 trillion, or ~5% of GDP. Now the CBO (Congressional Budget Office) projects that figure will be close to \$4 trillion and remain above \$2 trillion even in 2021. The U.S. Treasury will issue bonds to borrow that money and fund the deficits.

Who buys these bonds when the 10-year Treasury Note only yields 0.6%? The answer is the Federal Reserve (albeit indirectly), which must absorb the increased supply to keep interest rates from rising, all else equal. Looking forward, we believe the Federal Reserve will have no choice but to keep interest rates at 0% and continue to buy bonds until the economy fully recovers and inflation returns to their targeted level of 2%. In other words, for many years.

What does this all mean for clients and investors more broadly? First, there will likely be no opportunity to earn any "real" return (after inflation) in safer bond investments for a long time. This dynamic will prove even more challenging than the last decade of minimal yields, and investors will be forced to weather higher levels of volatility to generate yield in portfolios.


Second, there is a higher risk of inflation down the road. Looking to a possible historical roadmap that we have mentioned previously, we see parallels to the late 1960s and early 1970s when easy monetary policy facilitated continued deficit spending on Vietnam and the Great Society and ultimately created the conditions for the inflationary environment of that era. History would suggest that higher inflation is the ultimate path of resolution for countries with unsustainable debt/deficits denominated in their own fiat currency.

We have constructed client portfolios with these scenarios in mind and are positioned to weather a variety of potential post-pandemic challenges. Please reach out anytime if you have any questions or would like to discuss these topics further.

Finally, we would be remiss if we didn't close by expressing our collective gratitude to all of those on the front lines of the pandemic – health care workers, first responders, food banks, charitable organizations, etc. – that have done so much to save lives and ameliorate the suffering that has been so widespread.

We send best wishes from our home offices around the Bay Area and hope that everyone is staying healthy.

Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire



James B. Blume

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