Memo to: Ransome Clients

From: Dawson A. Ransome

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Re: Some Things Never Change

"If you can meet with Triumph and Disaster and treat those two impostors just the same"

If - Rudyard Kipling

A pastor once commented; "Do not make the lethal mistake of assuming your current circumstance is a permanent fixture in your life." The context of the comment was, of course, a message intended to encourage the congregation to persevere, and have faith, knowing there were surely better days ahead. I believed then, and still believe, this perspective to be wise and useful in ones daily life. Today, I contend it is equally wise and useful in an investment context.

Within the last 40 days we have witnessed markets move from new high (triumph) to bear market (disaster) the shortest interval in history. Along with the move in markets there has also been a pivot by investment managers, and market pundits, which would make the head of even the most seasoned D.C. insider spin. Phrases like "new normal" "we will never be the same" "new reality" and the like, become buzzwords throughout the media universe. Having lived long enough to experience the Tech Bubble and, more poignantly, 9/11 and the Great Recession/GFC, the aforementioned terminology is not at all foreign, in fact it is virtually identical. This realization causes me to consider the reality of change as it relates to human behavior, and by extension, market behavior. How much does human behavior really change over the long term, and particularly, after these type of wholesale shocks to normalcy bias?

In psychology a Normalcy Bias is a tendency for people to presume that things will function in the future the way they normally have functioned in the past and therefore to underestimate both the likelihood of adverse outcome and possible effects. For the most part normalcy holds and therefore reinforces our natural presumption. When this bias is challenged, it can be difficult to frame an appropriate response, which often results in expectation related questions about what normal may look like in the future.

Many of you know it is my philosophy that, in cases of stress or uncertainty, humans are generally not rational, but rather highly irrational, causing behavioral inefficiencies which, in an investment context, can be exploited. To clarify, it may be better to say I believe humans are long term rational but short-term irrational. From a practical point of view, the importance of this distinction can be explained by the caveat that; one must not incur such significant damage in the short term as to be precluded from benefit, or participation, in the long term. Consequently, it is the ability to maintain long term rationality when faced with short term challenges to our normalcy bias (uncertainty) that matters most.

"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'."

Howard Marks - *On The Couch* (2016)

In a recent LinkedIn post I referenced the Kipling quote from his poem *If* (included at the outset of this note) and correlated it with the above observation from a Howard Marks investor letter. The interesting parallel between the two statements lies in the characterization of the personified Triumph and Disaster as imposters by Kipling, and Marks use of the word perception as it relates to the polar extremes of flawlessness and hopelessness in the investment context. Implicit within both statements is the notion that *our* perception is often *our* reality. However, *our* perception should never be assumed as *the* reality.

So, what are the negative realities we are facing?

- Major word economies are facing dynamics of forced sudden stop as a result of the spread of COVID-19
- Social distancing requirements are needed to impede the spread of infections to such a degree as to potentially overwhelm existing healthcare capacity. These requirements are not supportive of normal economic activity in the near term
- Travel, entertainment, and dining within affected economies are virtually frozen resulting in millions of unemployed workers who are, on balance, more likely than not ill prepared for the loss of income. Small business owners, who are likewise ill equipped to sustain complete loss of revenue, are disproportionately affected
- Unemployment claims last week totaled a record 3 million, which is likely to be eclipsed in coming weeks as continued shutdown is required. (a recent estimate by the St Louis

Fed projected the potential of 47 million unemployed resulting in a 32% unemployment rate)

- Estimates for second quarter GDP by many major firms range between -20% to -30%. (as an aside, I agree with commentary from Mohamed El-Erian wherein he cautions economic forecasters to limit speculation given the unknowable aspects of this shock. His point being the futility of trying to accurately project in the current environment and the credibility risk of doing so)
- Earnings estimates for the S&P 500 are being adjusted but subject to the same "unknowables" encountered by economic forecasters above
- A decline in stock market indices of 34% (closing) between February 19th and March 23rd resulting in/as a result of disruptions to market plumbing and liquidity
- Spike in volatility to record highs
- Extreme widening in credit spreads

To counteract the effects of these issues the following monetary and fiscal actions have been taken:

- The Fed reduced the funds rate by 150 bps to 0% in two separate actions
- The Fed increased QE including initiation of facilities to allow for purchase of non-government financial instruments through SPE's facilitated and managed by Blackrock
- Estimates of Fed balance sheet expansion in the $4-6 trillion range
- Congress approved a $2.2 trillion stimulus package designed to support incomes, affected small businesses, and specific industries most impacted by the economic sudden stops (i.e. airlines)

As many have rightly pointed out, given that this problem is predominantly medical in nature, it can not be corrected by means of either monetary of fiscal policy action. Monetary and fiscal policy can merely attempt to underpin systems of our economic foundation as we work to slow the spread of the virus sufficiently to allow for increases in testing and treatment which will permit a return to a normalized economic state. Having said this, I do think that those who dismiss the monetary and fiscal measures as ineffective do so under the mistaken assumption that these measures will prove to be perpetually impotent. To the contrary, as we see the oft touted "flattening of the curve", a reduction of the number reported daily infections, and progress in medical testing and treatment, these policy measures should facilitate a more robust recovery as similar measures have in the past.

In order for the market to look through to a normalized future we must have containment, and reasonable understanding, as to how the population will be protected from further infection as economic activity returns. To do this we can look to the following:

- China, the first mover as ground zero for the outbreak, is demonstrating a FIFO map which we can extrapolate to show the potential duration of economic disruption and a path to return of normal economic function
- Infection stats in other countries are showing signs of peak, fattening and/or contraction as a result of distancing actions
- Dr. Anthony Fauci Director of the National Institute of Allergy and Infectious Diseases and Former FDA Commissioner Dr. Scott Gottlieb have spoken to a potential peak in infections within +/- 4 to 6 weeks
- Accelerated development of test technology to allow for virtually immediate results will allow for a more targeted response, consequently, facilitating a return path to normalcy.
- Accelerated efforts and collaboration by pharmaceutical companies worldwide to fast track therapeutic and preventative test and treatments
- Public private partnerships have been undertaken proactively and voluntarily without the necessity of wartime mandate

This brings us back to the original question; how much does human nature and behavior really change in the long term? History and my life experience tell me, not much. Given that assumption, what can we deduce about the outcome of the COVID-19 pandemic? There is no shortage of opinion however I will add mine nonetheless.

The market will start to price in a recovery in advance of perfect clarity regarding the future trajectory of cases. As stated above, FED action can stabilize market function, but it can not cure the virus or stop its spread. However, the liquidity provided for stabilization will provide a meaningful tailwind once the health issues are, or are perceived, to be contained. The American spirit which, for better or worse, may be causing a delay in case count decline as a result of reticence in implementation of lifestyle adjustment recommendations (or their outright dismissal) will likely result in a more pronounced rebound in the economy and markets as the traditional American drive results in a strong snap back in economic activity. For my money, the most important component in the analysis of the future in light of the past is what I refer to as Mean Regression of Human Nature. In every shock, whether caused by financial excesses, terrorism, or force majeure the initial response projects that the future will be significantly different than the past. However, retrospective analysis does not support that projection, why?

The normalcy bias inherent in the human psyche strives to return to the familiar. What this suggests is that the same subconscious drivers of conditioned behavior will be sustained as acute stressors dissipate. To put this in the context of investor behavior; increased liquidity, low borrowing costs, historically low yields on credit instruments, an American public that is conditioned from birth to produce and consume are likely to drive domestic production and corporate earnings resulting in higher stock prices.

No one can tell you with prospective certainty that the recovery will be a V, L or U. Neither can I. What I can say absolutely is that the winners, from an investment perspective, will be those who are able to look past the facade of triumph and disaster, and avoid swings in perception between flawless and hopeless.

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