The Conservative Strategist

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A pandemic ravages lungs and portfolios

"A big one-two punch."

This is how Warren Buffett recently described the double hit of the coronavirus and the OPEC "price war" between Russia and Saudi Arabia, which has sent oil prices more than 60% lower in weeks, and devastated the US energy sector. It looks like the two are trying to sink US shale producers. The problem for them is that they too will be devastated by $20 per barrel oil, so we don't think the price of oil will be down here for long. More on the opportunities in the energy sector next quarter.

No one was prepared for this one. On February 19, the economy was humming along, the stock market was at an all-time high, the restaurants and cafes were filled. Life as usual. A virus in a Chinese province was just another news item, albeit a concerning one.

Five weeks later, Covid-19 has spread to 177 countries, millions are sick, tens of thousands are dead, whole countries are under lockdown, millions are unemployed, the global economy is at a standstill, the streets of New York City are empty, trillions of dollars of wealth have vanished, and the US government is spending a record $2 trillion (and counting) to carry American citizens and businesses for the weeks and perhaps months that the Pause button has to be depressed for the economy.

Dash for cash

On Wall Street, panic. Fear of widespread bankruptcies led investors to dash for cash, selling assets of every stripe to buy Treasury Bills and other super-safe investments. Even municipal debt, normally rock-solid, needed stabilization from the US government.

A *Bank of New York Mellon* municipal money market fund nearly 'broke the buck' before emergency funds allowed it to retain a $1.00 net asset value. Many ultrashort exchange-traded funds (ETFs) composed of high-quality bonds, which normally trade within a 1% annual range, traded down 6% to 8% or more in the depths of the crisis.

Some mutual funds suffered runs by redeeming investors, not unlike the runs on banks in the 1930s. To meet the redemptions, the funds had to sell newly illiquid securities into a market that simply did not have any reasonable bids, and suffered very steep losses.

Of course, telling the redeeming investors that they were only hurting themselves and fellow investors would be as fruitless as walking into a grocery store at the height of the pandemic panic and persuading folks not to hoard toilet paper and canned foods as they were clearing the shelves. There was never any problem with the supply chain, as there was not a problem with most of the underlying securities in many funds. But there is no arguing with fear and panic.

Stimulus calms nerves, for now

The government stimulus passed the week of March 23 has a gone a ways to calm nerves. But it's likely not enough to buy us more than eight to twelve weeks. Much depends on the

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The Markets March 31, 2020	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	2584.59	-19.63%	-19.63%
International Stocks (Vanguard Index)	13.48	-24.33%	-24.33%
Emerging Markets Stocks (Vanguard Index)	21.20	-24.59%	-24.59%
Real Estate Stocks (Vanguard REIT Index)	23.24	-24.11%	-24.11%
Bonds (30 year US Treasury/Vanguard Index)	1.35%	20.64%	20.64%
Dollar (US Dollar Index)	99.05	2.76%	2.76%
Gold (London Afternoon Fix)	$1618.30	6.84%	6.84%
Money Market Funds (IBC Index/7-day yield)	1.09%	-0.62%	-0.62%*

*change in yield

Portfolio Planning

Legacy Subprime should survive the crisis, but with at least one casualty

Last quarter, in the "Picks & Pans" column on page 3, I mentioned *legacy subprime residential mortgage-backed securities* as a potential safer play in what I saw as a coming market storm. The thesis was that it was corporate debt, not mortgage debt that was the most exposed to a downturn.

The storm did come, but it has been violent enough to encompass all debt securities. Two of our three favored mortgage-backed funds *(Rational Special Situations Income,* RFXIX, and *Catalyst Enhanced Income Strategy,* EIXIX) have held up reasonably, given they are invested in senior tranches that won't be affected badly until we have a worse housing drop than 2009-2011. I have confidence they will recover and are even poised to exploit mispricings in this chaos.

The third fund, *AlphaCentric Income Opportunities,* IOFIX, was invested largely in junior tranches, and though they are likely to make it through this difficult time, there was a run on the fund by investors that forced the fund to sell securities into an illiquid market where bids were very low. The fund has sold off very steeply. While there is likely to be a recovery, it likely will be only partial.

For all three funds, the argument is:

1. They are "pre-disastered", given that they are composed of mortgages from homeowners who kept current on their payments even through the housing crisis of 2009-2011. The weakest credits were long ago flushed out in the crisis.

2. Most of these homeowners are most of the way through their mortgage term, and now have six figures of equity in their homes.

3. The loan-to-value (LTV) ratios of the underlying mortgages are in the 60% range. Housing prices would have to fall 40% before the collateral disappears.

4. These legacy subprime mortgages are the easiest to modify, so in a crisis like this, there is room for accommodation for those homeowners who need it.

5. Mortgage rates are now at historic lows. This not only supports housing prices, but increases the odds that homeowners will refinance, and that some of these securities, many selling at a discount, will prepay at par.

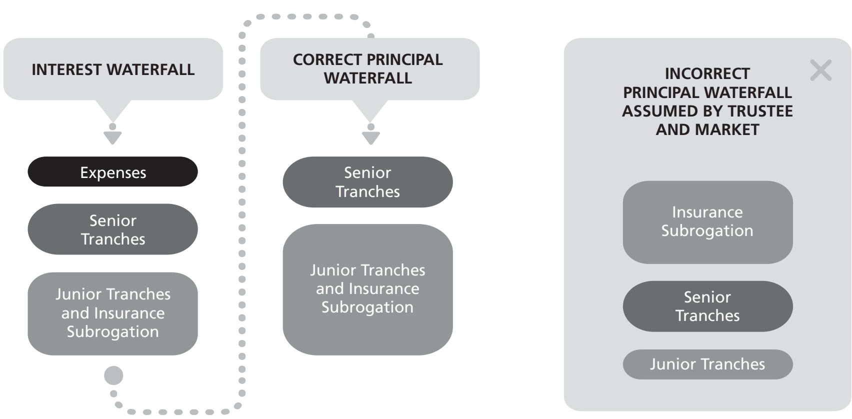
Each fund also has its own strength, based on a legacy market that is shrinking and often mispriced. RFXIX actually digs into the covenants governing these securities, finds errors in the way the mortgage servicer is paying off all the participants, then takes legal action to correct those mistakes, often resulting in a substantial boost to the price of the security in question.

EIXIX is managed by Leland Abrams, a 20-year veteran of the business, who makes incremental returns by being a marketmaker for these often illiquid securities.

And finally, IOFIX often buys packages of mortgage-backeds from banks interested in getting out of a sector that is shrinking rapidly. Often the banks won't do their homework like the specialty funds will, overlooking special features in certain securities that may enhance their value.

Unfortunately, the very characteristic of these securities that allow these funds to add value — their illiquidity and inefficiency — can turn to be a liability in the rare panic-driven market like the one we have just experienced, which contributed to IOFIX's steep decline. But it also opens opportunity for these managers to add value. We're most confident about RFXIX's capacity to bounce back. Its managers note that today's market is a dream scenario for them, with mispricings abounding. The opportunity set, they say, is as rich as it has been since 2010. ■

RFXIX adds value from mortgage servicer errors

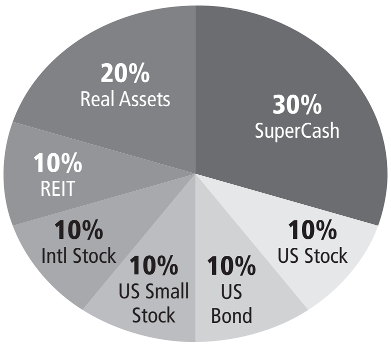


RFXIX managers identify a bond where the servicer is not correctly interpreting the payout sequence, and instead paying to an insurance subrogation before the senior tranches. RFXIX buys the senior bonds and then challenges the service provider to correct the sequence — in court, if necessary. Outcome: bond rises in value. Source: Rational Funds

SuperDiversified Portfolios (SDPs)

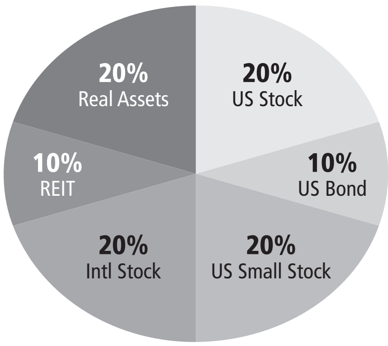
Worst quarter in 12 Years for SDPs

SDP1 *Conservative*



1st Quarter	Last 12 Months
-14.08%	**-8.16%**

SDP2 *Moderate*



1st Quarter	Last 12 Months
-20.83%	**-13.33%**

In this space last quarter, I noted imbalances (growth/value, foreign/domestic), that I thought had reached historical extremes, and that this was a sign that something was afoot with the high level of asset prices in general. But no one could have predicted a global pandemic and market crash.

Further, much like in 2008, the selling was indiscriminate, sweeping up all asset classes and subclasses. Emerging markets (EM) stocks, for instance, were already cheap relative to US stocks, but fell roughly as far. These crises often mark turning points in relative value; EM may outperform on the rebound.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

2019 rally erased. Is that enough?

Asset Class	Mutual Fund	Performance 1st Quarter '20	Performance Last 12 Months	
SuperCash	PIMCO Instl Low Duration	-0.34%	2.60%	Best
	Merger	-2.39%	1.34%	Worst
	Calamos Market Neutral	-3.85%	-0.50%	
US Stock	Vanguard Index Trust 500	-19.63%	-7.11%	
US Bond	Vanguard Long-Treasury	20.64%	31.61%	
US Small Stock	Vanguard Small-Cap Index	-30.10%	-23.44%	
Intl Stock	Vanguard Intl Index	-24.33%	-16.64%	
REIT	Vanguard REIT Index	-24.11%	-16.65%	
Real Assets	PIMCO Commodity Real Return	-28.36%	-26.65%	

In this space last quarter, I noted that 2019's stock rally was built on air — 92% of it was from investors placing higher valuations on stocks, not from earnings growth. Now the coronavirus crash has erased nearly all of 2019's 31% S&P gain, back to S&P 2500.

Since corporate earnings in 2020 will reset much lower than 2019 levels, is that selloff enough to account for the new reality? It seems like the markets are lurching lower in an effort to find a new fair value for stocks. For a while, the 2500-2700 range for the S&P may function more as a ceiling than a floor.

Merger arbitrage bends, not breaks

You would think that lots of merger deals would be broken during this crisis, and that merger arbitrage would suffer accordingly. But mergers can only be broken if there is a *material adverse change* (MAC) during the term of the merger deal. And in 99% of merger agreements, a global pandemic is actually excluded as a material adverse change. So as serious as are the business consequences of the spread of COVID-19, companies cannot call of mergers for that reason.

So nearly all existing merger deals continue. And there even have been new ones announced during the crisis.

Our three main merger arbitrage funds have dipped in March. At the March 18 market bottom, they were down as much as 12% from their February 19 highs. But since that time, they have recouped between 50% and 75% of their losses, compared to only a 35% retrace for the S&P 500.

At press time (3/27/20), the three funds were down for the year:

Merger..-2.33%

Arbitrage..-2.16%

Blackrock Event-Driven........................-4.95%

This compares to a 20% decline for the S&P 500.

In past market routs, these funds suffered similar peak-to-trough drawdowns, but were back to new highs within 2 to 17 months. We expect a similar recovery.

SEASONAL STRATEGY

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Robert J. Gavrich
CA-Licensed Investment Adviser
President, Seasonal Strategy
1517 Fountain Street • Alameda, CA 94501

Phone 415.956.1721
Fax 415.956.1722
Email bob@seasonalstrategy.com

seasonalstrategy.com

Rays of sunshine

Are investors over-reacting? Perhaps, especially in the credit markets. Panic seldom serves the panickers well, but may reward those with patience to hold through this period, and especially those intrepid enough to wade in and accumulate select securities.

First, pandemics have a limited life span, measured in months, not years. Since the way to value companies is based on discounted cash flows over long periods of time (10 to 20 years or more), it is not sensible to sell them down by 32% (the recent stock decline) or 50% or more (the decline in some high-yield corporate securities) because of a one, two, or three quarter hit to earnings (especially when there may be pent-up demand on the other side of the crisis).

Second, the history of widespread epidemics has been such that markets take a short-term hit, but are generally higher as soon as 12 months later (see chart).

Third, on March 18, Wuhan, China, the epicenter of the pandemic, reported no new cases. Throughout the country of nearly 1.4 billion, only 34 new cases were reported — and every one came from travelers to China. Apparently, China's suppression measures have managed to contain the virus in about three months.

Fourth, as poorly as the Trump administration has responded, we have seen state and local governments step in with vigor and take proactive leadership measures to protect the public health. Here in California, Governor Newsom has asked all citizens to limit movements outside the home to essential trips. And at least from our perch here in Alameda, we see widespread citizen compliance. This should go a long way toward "flattening the curve" — lowering the number of cases at any given time so as not to overwhelm the health care system.

Fifth, there are some silver linings. Interest rates are lower, and gas prices are a lot lower. Both should help the consumer with cash flow when the turnaround comes. The governmental missteps in this crisis are likely to pave the way toward much better pandemic preparedness going forward. It should improve the chances of Joe Biden vs. Donald Trump in November. Unlike 2008, there seems to be an awareness that aid should not go to big corporations, but directly to small businesses, the out-of-work, the sick, and those on the frontlines of the battle against the virus. Finally, as commerce grinds to a halt, the environment is healing. "It buys us a year of grace in terms of the long struggle to reduce CO2 emissions," says GMO's Jeremy Grantham.

There is much pain and suffering. There may be long-lasting scars. But we will get through this, and public health and wealth likely will rebound. ■

The market has rebounded from past epidemics

Total return of S&P 500 after prior health events

Epidemic	Month Ended	6-Months Later	12-Months Later
HIV/AIDS	June 1981	-0.30%	-16.50%
Pneumonic Plague	September 1994	8.20%	26.30%
SARS	April 2003	14.59%	20.76%
Avian Flu	June 2006	11.66%	18.36%
Dengue Fever	September 2006	6.36%	14.29%
Swine Flu	April 2009	18.72%	35.96%
Cholera	November 2010	13.95%	5.63%
MERS	May 2013	10.74%	17.96%
Ebola	March 2014	5.34%	10.44%
Measles/Rubeola	December 2014	0.20%	-0.73%
Zika	January 2016	12.03%	17.45%
Measles/Rubeola	June 2019	9.82%	N/A

Source: Dow Jones Market Data

Pandemic

(Continued from page 1)

path of the virus and whether we can *flatten the curve* so as not to overwhelm the health care system. South Korea, Singapore, even Hong Kong have managed it, Italy has not. Even here, some states have been much more successful than others thus far.

If the curve can be flattened, we may be over the worst well before summer. Workers may return to their jobs, businesses may recover, and portfolios will heal. If containment fails, it will be a long year and a steep recession. "You don't make the timeline, the virus makes the timeline", says infectious disease expert Dr. Anthony Fauci. Stay safe, and protect yourself, your loved ones, and your fellow citizens. ■