Cavelti & Associates Ltd.
188 Eglinton Avenue East, Suite 706
Toronto, Ontario, Canada M4P 2X7
Phone 416 - 486 1900
Website: www.cavelti.com

June 1, 2020

A Second Catalyst

Dear Reader,

I'm deviating from my usual quarterly format, primarily because events warrant an update. Since I last wrote just eight weeks ago, we've gone through a number of Covid-19 induced changes. The most visible fallout is on the economic front, where GDP contraction and employment loss remind of the Great Depression. The social upheaval is equally alarming: throughout the developed world, governments have experimented with measures thought to contain the pandemic, many of which disastrously contributed to economic suffering. Tragically, existential hardship results in even more social frustration, making for an exceptionally powerful feedback loop.

In my last commentary I reiterated that Covid-19 was not the cause of any of this, but rather the catalyst that brought down a broad policy construct that had, over a period of many years, become utterly unsustainable. The pre-conditions to a crash were solidly in place:

- Economic growth was only possible with ever larger liquidity creation by the world's central banks.
- Debt levels in most developed nations were at astronomical levels—at the government, corporate and individual level.
- Few large corporations spent money on productive capacity; the vast majority used capital to buy back shares and reward their top executives.
- Wealth disparity went from an unjustifiable level to an extreme one.
- Policy platforms across the board were utterly mismanaged. Whether we looked at health, education, agricultural, industrial or environmental policy, the direction we were going in was utterly unsustainable.

I also predicted that other catalysts would come into play and complicate things further. I mentioned a serious wobble of the technology platforms, on which virtually everything is based, as a prime candidate. As it happened, another problem popped up: the brutal murder of an innocent man by a Minneapolis police officer provided the catalyst to throw two dozen major U.S. cities into chaos and destruction.

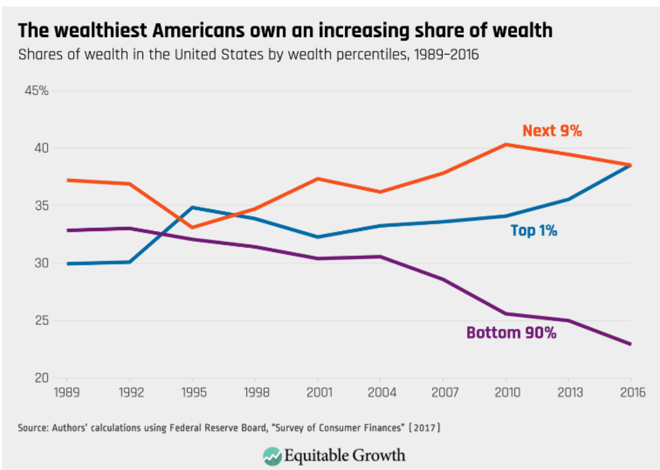
That America's social fabric is among the first to come undone is no surprise. While governments in Europe, Japan, Canada and down under have erred on numerous fronts, they've at least paid attention to social basics, something the United States has blissfully ignored for decades. Spending more than $800 billion on "defense", while mismanaging areas like health and education and allowing wealth disparity to soar, is now having grave consequences. As the philosopher Plutarch noted nearly two thousand years ago, "An imbalance between rich and poor is the oldest and most fatal ailment of republics."

Two Choices

Going forward, there are two choices: to ignore social inequities and, by doing so, perpetuate the current protests or endure even broader uprisings, as the anguish of a broken economy deepens. Or, acknowledge and address the plight of the disenfranchised masses, incurring unimaginable costs and, by doing so, further delay a return to eventual prosperity (the feedback loop, again). How all this will play out is unknowable, but the dynamics already in place are likely become further entrenched. Key among them are these:

-Social tensions will further escalate as the reality of mass unemployment takes hold.

-The notion of a U-shaped recession, as advertised by numerous economists, is illusory. The correction phase will take years, not months. (As an aside, economists, their eyes forever trained on the rearview mirror, have become irrelevant—we are dealing with the comprehensive collapse of almost every part of economic input equations. Anyone making specific forecasts should be ignored).



-Government's role and powers have been immeasurably boosted, both by Coviod-19 and social upheaval. In centralistic structures, like America's or the European Union's, the pandemic is also creating enormous tension between different layers of government.

-Geopolitical strains will escalate as trade disputes deepen, isolationism rises and unpopular governments seek to focus their citizens on an external enemy that can conveniently be blamed. The United States, with its targeted campaign to discredit China, is a prime example.

Is there any way out of this mess? Historically, comparable incidents of collapsing economies and broad social discontent leads to massive industrialization initiatives, usually with a heavy militaristic overlay. War often follows.

Implications for Financial Markets

Interestingly, financial markets are shrugging off any of the possibilities discussed in this commentary. After posting the most terrifying decline in postwar history, stocks bounced back in similarly sensational fashion. To be sure, equities are still 10% or so below their February peak, but few financial professionals would have dared predict this kind of a comeback.

On the other hand, no one could have imagined the vigor with which central banks intervened in markets or the enthusiasm with which politicians showered the economy with newly created debt. Some, especially the economists, believe that such interventions will guarantee a swift return to economic stability. Others, like myself, are sceptical. What I see is that every slightest risk of economic contraction during the past 20 years was been met with ever greater, and largely ineffective, infusions of monetary and fiscal stimulus. The result is stock, bond and real estate valuations became stretched beyond belief, while governments, corporations and individuals ended up hopelessly indebted. And the fix to all that: push everyone even deeper into debt.

Interestingly, as government and private sector economists debate the exact shape of the recession (V-shaped, U-shaped, W-shaped)—an exercise reminiscent of the proverbial rearranging of deck chairs on the Titanic—a large number of strategists and hedge fund managers foresee a different future. Some, like me, feel the recession will be L-shaped, with the horizontal part of the letter far more drawn out than it appears in print. The bottom line: current valuations of heavily propped-up stocks and bonds bear no relation to the grim economic realities in which we find ourselves.

Last time I wrote, our portfolios looked distinctly different from typical mutual fund holdings. Thanks to a huge cash reserve and a 15% gold exposure, our first quarter drawdown was small. Now, two months later, we're back to where we were at year-end 2019. Our equity position, still only around 45%, has recovered, while our gold allocation has helped as well. In other words, we've gone through one of the most tumultuous episodes in financial history without experiencing much turbulence.

No one can know what comes next, but if I had to take a guess, I'd say the odds for another major market decline are strong.

Thank you for your continued trust.

Peter Cavelti