Dear Friends,

I want to start this by acknowledging the very difficult environment we are working through. This has proven to be one of the more demanding periods in my 30-year career. I can only imagine how challenging this environment is for each of you. It is in times like these we get to see firsthand the value of our relationships and the importance of gratitude and appreciation. With that in mind, Thank you! Thank you for working with us and helping us build our business. We remind ourselves every day that without you we do not have a business. We appreciate your time, commitment and trust in us.

We are following with another round of reflections from the investment team. I've asked my partners to spend some time reflecting on the markets with a focus on what is grabbing their attention. We hope to return with the 5x5 format as markets calm down. Similar to other reflection pieces, we continue to focus our communication on bringing our investors closer to our process.

A few thoughts from my end –

Our focus earlier in the year was on reducing the volatility in our strategies and positioning ourselves to take advantage of what we thought would be better opportunities in front of us. We expected greater volatility and more extreme outcomes but did not expect a pandemic or a full shut-down of the global economy. While extreme, the current environment has presented some incredible opportunities but has also presented risk factors that I never expected to see in my career. There promises to be great uncertainty, volatility and very challenging times in front of us. But also, some extraordinary opportunities…

We have been discussing the "Great Reset" thesis over the last several weeks. The pandemic, the global economic shut-down and the adjustments to the energy markets are central to the "Reset" thesis. One of the key outcomes will be the swapping of liabilities and debt obligations from Corporate America to the Federal Government, similar to what we experienced in the "Great Financial Crisis" but on a much greater magnitude. The process will be filled with nuance and moral hazard. We will see many undesired/unfair outcomes and second and third derivatives that will have big impacts on society and markets. I have every intention of expanding our thoughts around these issues over time. Please watch for more communication from us in this arena.

With the shutdown of the global economy, issues have been raised around corporate liquidity and solvency. While this is stating the obvious, there will be great winners and horrible losers. Our investing jobs are ever more focused on the intricacies in understanding the differences between the two. Thankfully the Federal Reserve and the Federal Government have been very proactive and aggressive in addressing the current environment. We see the big moves in the CARES program as well the massive liquidity that the Fed has brought to market as absolutely essential and healthy steps down a path toward normalization – albeit it is a very long path. We also applaud the reactions from Central Banks and Governments around the globe. They are following very similar paths in providing massive liquidity and a solid Keynesian backstop to the slower growth environment in front of us. These large and expeditious moves will prove to be a great source of improving liquidity, the risk transfer mechanism and helping to reverse the strong negative feedback loop that was guiding us toward a much more extreme outcome. While I usually favor allowing markets to work, there are times where intervention is essential – this is one of those times. We think these actions will prove smart in the near term, but it will take a lot of time for us to return to a sense of normalcy in both markets and the economy.

We are working on more detailed communication around what we are watching as well as what we see on the horizon. The unprecedented volatility and uncertainty force us into daily reevaluation and reconsideration of the outcomes. We appreciate your engagement with us and promise to do all we can to keep our level of communication as fluid as possible. Please know we are always happy to get on the phone and discuss markets or answer questions you may have. Please take us up on this.

In closing, I hope you find these reflections helpful. I feel incredibly fortunate to be surrounded by a great group of investors who are committed to our core tenants.

Thank you for your support.

Let’s talk.

2Q 2020
Reflections from the First Month of COVID-19

Welcome to the Smith Capital Investors Reflections
(Use the links above to jump to a section)

Reflections from the First Month of COVID-19

Introduction

We are a little over one month into the Great Reset and at this point, policymakers have pulled pages from every playbook possible. We expected volatility this year, we believed that valuations were stretched and there would be a day when spreads widened but no one expected that a virus would bring the globe to its knees. Add to the once in a lifetime global health pandemic, we've layered in an oil crisis. In light of the massive volatility, we are finding opportunities and utilizing the tailwinds the Fed has provided while also prudently managing risk exposure as we believe there is still negative news ahead. We've seen CAPEX cuts, dividend cuts, earnings revisions, furloughs, and layoffs. We must assume that the economic headlines over the next month will be more negative than positive. A reminder that discipline is needed. The changes in sentiment happen on an hour by hour basis. That being said, we are seeing a coordinated global fiscal and monetary response, this is positive and will help the globe to find a point of stabilization.

1. Significant Headwinds

From the Strategy Lens – Steve Zamsky, Investor

On Thursday we discussed details of the Fed's programs (click here), designed to backstop credit markets and the economy during this unprecedented time. Market participants are now scrambling to figure out the next stage - how will it work, what are the specifics, who could get left behind, what are the ramifications for different sectors, companies, and investors. Looking further out, there will be questions of moral hazard, unintended consequences, corporate balance sheet management, and long-run economic growth.

Already we've seen the arbitrary nature play out with different companies bonds eligible for Fed purchase based on the date they were downgraded, and more definitions are still open that will likely yield to more random outcomes. That's just the way it goes during a crisis (ask circa 2008 bank bondholders for a dozen examples) and trying to create a planned economy in a matter of weeks is no easy task. Moral hazard may be the more meaningful issue further down the road. The government has again cut off extreme left tail outcomes, and it will have impacts on the investor, banker, and corporate behavior.

We will soon be entering into the most interesting earnings season in a decade, if not more. Of course, first-quarter earnings are irrelevant at this point and it will be impossible and/or dangerous for management teams to try to predict the balance of the year, but the extent of cash burned in the last six weeks will be very telling. While the government stands ready and able to back-stop much of corporate America (at least measured by market cap), companies will be reluctant to step forward and those who do will be subject to great scrutiny of their capital allocation going forward. Those who take aid and many who don't may well find themselves under a much deeper debt burden. In the long run, we will likely be left with a market that is more deeply indebted (and that is saying something given the starting point) and managed by teams who have stared into the abyss. It would be logical to assume a drag on spending while balance sheets are repaired, and confidence rebuilt. It could take years and years, or it may even lead to a permanent risk aversion much like that of our depression-era grandparents (which would be bad for earnings and economic growth but good for bondholders).

At the highest level, looking at the combination of personal savings that will need to be rebuilt, corporate indebtedness which will grow, and government debt which looks to explode**, <u>the economy is going to face significant headwinds</u>.** As we saw coming out of the Great Financial Crisis (GFC), an over-indebted economy is not one that bounces back from a crisis quickly. When it is all said and done, we may well have markets that look more like our foreign rivals than what we grew up with. Enormous levels of debt-to-GDP, massive central bank intervention directly into private markets, and government-chosen winners and losers. It sounds more like Japan or China than the United States!

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2. Bifurcating into the Unknown

From the Portfolio Lens – Eric Bernum, Investor

As we turn the page on Q1 the biggest issue facing the market is the impact of the Feds litany of new programs to support the economy and Fixed Income markets – both for what it means to asset classes that will be impacted directly and indirectly from the Fed's action and then the impact on those outside of the first and second derivative impacts of the Fed's actions.

Over the course of the last two and a half weeks, the Fed's impact on Fixed Income markets has become very apparent, especially within the securitized markets – from U.S. Treasury's at sub 1% yields out to the 10-yr maturity bucket to Agency guaranteed MBS option adjusted spreads (OAS) having tightened by 100 bps despite negative convexity and uncertainty about outcomes relating to defaults, refinancing, credit availability, and home price appreciation (HPA) at all-time highs. Other Agency guaranteed products including CMOs and Agency CMBS have recovered as well given either first derivative impacts from Fed programs (Agency CMBS direct purchases) or second derivative impacts (Fed purchases of the underlying passthrough collateral that makes up CMOs). Even more recently we have witnessed substantial recoveries in spreads in AAA ABS, CLOs, and CMBS that are now eligible for the TALF program.

However, on the other side of the coin, there are the have nots – the asset classes not being directly or indirectly supported by the Fed have seen much more pronounced negative outcomes with non-AAA CLOs, CMBS, esoteric ABS, and Non-Agency RMBS. These specific asset classes lack all but the most limited of indirect Fed support and have seen substantial spread underperformance with limited recent performance recovery compared to the rest of the Fixed Income market. The factors driving this weakness are plentiful ranging from fundamental concerns around lower-end U.S consumer health, corporate credit quality, forbearance, asset recovery values, etc. as well as a structurally more limited trading liquidity nature.

We expect the securitized Fixed Income market to continue its bifurcated trend. Admittedly, investors will slowly be pushed out into riskier asset classes over time as is the hallmark intention of global QE programs, but we fear the timing of this and the scope will be very slow and specific in non-Fed sponsored segments of the securitized world.

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3. Leadership, Earnings, and Uncertainty

From the Credit Lens – Jonathan Aal, Investor

The reporting of 1Q20 earnings is upon us.

This has the potential to be one of the most important earnings seasons we have experienced in a very long time. In times of adversity, there is a necessity and backdrop for good leaders to differentiate themselves. While 1Q20 results will only encapsulate a limited amount of the COVID-19 related ramifications, management teams have a crucial opportunity to provide the marketplace and their company's constituents with incremental certainty and confidence. At times, particularly in times like these, incremental certainty is the silver lining of bad news.

While the marketplace wrangles with numerous ebbing and flowing currents, when distilled down the predominate two are:

1) The expectation for materially weaker earnings and
2) Uncertainty

On the uncertainty front, as it relates to risk assets, the Federal Reserve's announcement to step into the credit markets has chipped away, in a rather meaningful fashion, the level of uncertainty that existed prior to its statement.

Namely, this action helps "answer" the question: Who is going to buy?

For more specifics on this topic see our previously published piece here.

Furthermore, with the reporting of earnings, the marketplace could get important additional information on both the expectation for weaker earnings and uncertainty fronts.

Estimating next quarter's earnings is not central to our investment process, which prioritizes management's adaptability, the margin for error, and investment thesis resiliency among other things. Therefore, homing in on uncertainty or rather the ability to decrease it, we believe leaders, or in this instance management teams, are able to provide incremental certainty in the form of:

- The laying out plans of action
- Identifying levers that can be pulled
- Identifying levers that won't be pulled
- Other similar things that are important within a management team's control

We think good leaders will take the opportunity to do such—some have already done so.

Once this has taken place, it is then the marketplace's job and function to vet those plans and levers.

In closing we are reminded of something we published last year, which is ringing truer now:

> "In our decades of observing businesses, we have concluded that management teams who optimize for the current environment are often guilty of making overly narrow predictions. Namely, they predict that the future will play out much like the present. Conversely, we've observed management teams that place a premium on the ability to adapt, tend to preserve optionality. This gives them the ability to adapt to a wide range of future outcomes, many of which are likely materially different than the current environment. This behavior often looks sub-optimal in the near term but prescient over the long term."

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4. Building the Mosaic from the Bottom Up

From the Macro Lens – Lindsay Bernum, Investor

Macro "data" will lag in this environment so we will look to other information, including company comments/earnings, virus impact, antibodies/vaccine development, re-opening of the economy, monetary and fiscal policy action to determine the virus-related fallout. This is bottom-up building - as opposed to top-down – and as we've watched in the first month of the shelter-in-place orders, there is a heavy sentiment overlay.

We must assess the real-time information to build our mosaic. That being said, the response was the main driver of markets in both directions in March given that we did not have access to real-time economic data. Now that outlook - reflected in the market volatility - has started to calm, we will make a handoff this month to the macro data. The macro data will, unfortunately, remind us what we already "felt" in March…...this is a dire situation.

Guiding our mosaic:

- Virus impact/recovery and plateau – we will look to China and others that are earlier in the cycle for guidance on our domestic timeframe. At this moment there are early signs of plateauing.
- Reopening Strategy – 10 Governors are working together on a re-opening strategy including California, Oregon, and Washington on the West Coast and New York, New Jersey, Connecticut, Delaware, Pennsylvania, Rhode Island and Massachusetts on the East coast while Washington is putting together a national plan with the CDC and FEMA.
- Research development – antibody testing (this will help with re-opening) and vaccine development (this will help long-term).
- Outlook – will be conflicting because daily sentiment can be impacted by real-time headlines (right now positive market feelings) while the economic data will be lagging but will remind us how bad the situation was (this will be negative but backward-looking).
- Monetary/Fiscal Policy – Policymakers will continue to support the economy in every way possible, the Fed has made weekly program announcements and Washington is looking at a 4th stimulus.

At the moment we are marking stabilization based on the combination of Fed support and the stimulus measures as well as early indications of daily stabilization domestically from the virus. Much of stabilization from the virus is due to shelter-in-place orders at the expense of economic activity. Policymakers are balancing health and safety, which is of the highest importance, with safely and slowly bringing back economic activity.

Countries that are ahead of the U.S. suggest a virus model that plateau's 1-month after reaching 1k cases. China is starting to reopen approximately two months following quarantine orders. The U.S. is in early discussions around slowly reopening specific pockets of the country in an attempt to control another spike while also getting America open again.

The U.S. is in a precarious place, we have major contributors to GDP locked down (California, NY, Texas) while others are still open which means we "may" continue to see rolling flare-ups as people move between borders in the future. It is unlikely we will contain the virus in this round, which means that the loss of domestic economic activity in only March/April would be the best-case scenario. It is looking more likely that we will ebb and flow as virus hotspots rise and fall. This takes a V-shaped recovery off the table. In the meantime, **we must continue to address emergencies (health and economic related) while looking towards stabilization and then onto resuming economic activity.**

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5. One-Third of an Oil Change

From the Trading Desk – Zach Tucker, Investor

When was the last time someone came away happy after checking the dipstick on their engine, only to find that the grease monkey put in 1/3 of the oil needed? Well, OPEC++ (or is it three plusses now?) did exactly that and expected Mr. Market to be satisfied.

Over the weekend, the cartel plus other growing producers (Canada, Brazil, Norway and the U.S.), agreed to remove supply after a devasting spat between Saudi Arabia and Russia led to a collapse in WTI oil prices from ~$45/barrel to below $20 in two short weeks. The pact – precariously tentative at times – came after OPEC+ virtual meetings, followed by G20 discussions, and ultimately a dollop of presidential diplomacy from an admitted OPEC-hater, Donald Trump.

So, what was the deal? A nameplate cut of 9.7mm barrels per day (bpd) from OPEC+ nations starting on May 1st and stepping down in successive periods to 7.6mm bpd in 2H20 and 5.6mm bpd in 2021 through April 2022. Interestingly, the "cut" is from higher baseline levels – 11mm bpd for both Saudi Arabia and Russia – despite both having increased production to get to those higher watermarks. In reality, a 'balanced' market saw the Saudis producing slightly less than 10mm bpd, so the baseline reads as artificial. Additionally, the "++" producers will "cut" another 3.7mm bpd through low oil price attrition (oil prices being so low that Canada/Brazil/US domestic E&Ps will naturally reduce output, though it likely will go unmonitored).

For context and arriving at the oil change analogy, the world consumes roughly 100mm bpd (for round numbers). OPEC++ has "removed" 13.4mm bpd of supply in theory, though the higher baselines would say this is really an un-manipulated ~10mm bpd cut. What about the demand side? Therein lies the rub. JP Morgan estimates that ~24mm bpd of demand was removed in April due to COVID-19 effectively shutting down economies and global travel. Other estimates run as high as 35mm bpd. Split the difference…you get the point. About 30mm bpd of demand could be gone and only 10mm bpd of supply was cut.

If that math still does not work for some, let us look to the market reaction: WTI -1.54% and Brent +0.83%. A 10% supply cut simply had no effect, even after Thursday's -9.29% drop. **In other words, the market was about as happy as getting a 1/3 oil change.**

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6. Managing Money Through a Crisis

From the Equity Lens – Brinton Johns, Senior Advisor

We've observed that during a crisis the overwhelming human urge is to speculate. Our brains love to trick us into the false sense of security that often accompanies developing and anchoring on speculative conclusions. The new world will be like . . . People will no longer . . . After this is over, we will all . . . Industry X will never . . . We've all done it.

Instead of endless speculation, we believe these two exercises mark a better use of energy.

- **Shift thinking away from rudderless speculation and anchor thinking around process.** Crises tend to accelerate trends that were already happening. That deserves saying again: **Times of crisis tend to act as accelerators for trends that were already happening before the crisis.** Focus on trends that were already happening before the crisis likely to become accelerated. Follow these steps:

    1. Look at dynamics that were strong before the crisis
    2. Look at current events during the crisis
    3. Ask key questions that arise
    4. Look for evidence (this is key, suspend judgment until evidence presents itself)

- **Focus more on developing the right questions instead of trying to jump to conclusions.** For example, "Will the COVID-19 pandemic accelerate the shift to cloud computing?" or "How will already struggling mall operators cope with further profit declines from their customers?" You get the idea.

Managing a portfolio through a crisis means owning shares in companies that maintain as much room to adapt to the changing environment as possible. It means focusing on the safest predictions (extrapolations of trends already happening that are likely to become accelerated) while avoiding narrow predictions of the future. It means suspending judgment while tirelessly searching for evidence. It means even more rigor applied to portfolio decisions. It means focusing more on the questions than half-baked or overconfident conclusions. Finally, often during times of crisis, our best thinking comes from stepping away from our desk. It comes while on a walk or sitting in nature allowing time for reflection.

No one knows how long the current crisis will last. No one knows exactly how our worlds will look when we emerge. Instead of trying to speculate on impossible predictions; focus on trends likely to become accelerated, learn to ask the right questions, search for evidence that begins to answer those questions and give yourself the time and space to reflect.

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Conclusion:

These are unprecedented times in which we are constantly evaluating new information as well as new Monetary and Fiscal Stimulus measures and how they impact not only our portfolio but also the broader market.

There will be some surprising and critical long-term outcomes from this current environment. There will be incredible winners and unbelievable losers, but it is going to continue to be bifurcated for some time. Our job is to always start with our underlining process which centers around both security selection as well as security avoidance.

Our discussions continue to center around the risk of reversal on both interest rates and credit spreads. Small changes in interest rates result in larger changes in prices due to the longer duration of bonds today. We feel the same way around sentiment today - small shifts to a more positive outlook and further validation of accommodative Central Bank policy, Fiscal stimulus or other pro-growth initiatives, could trigger a quick reversal in interest rates, the shape of the curve, and valuations in the credit markets.

While difficult to call the timing on these changes, every data point is a new piece to the puzzle. Every new piece gives us a new perspective. **We will remain pro-active in how we alter the portfolios based on the changing environment.** Times like these remind us of the benefit of bonds in a diversified portfolio, even starting from such low yield levels. What is going on is real, we take it very seriously, and have made prudent adjustments. We have used the same care with the recent reversal, and we will use the same attention again with the next bout of volatility. We believe in active management.

Let's talk – Smith Capital Investors

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