Independent Investment Advisory

GKV Capital Management

Quarterly Update

First Quarter 2020

GKV CAPITAL

March 2020 Quarter Review

Coronavirus
A Physical and Fiscal Pandemic

Opening Thoughts

While it is an impossibility to fully prepare for every event, we do try to plan for the unexpected. Ours is a humbling business. Spend enough time watching over investments and invariably some unanticipated event will come along and knock you flat. The way you survive is to manage assets intelligently. Always assume there is something you don't know that can hurt your performance. The best tool is to diversify. Own multiple companies with varying business models across multiple industries. Have a strategic plan for identifying opportunities. Own some growth for appreciation and own some value for cash flow and dividends. Own equities and bonds and have exposure to real estate. And even then, an unforeseen event can come along that lowers asset values across the board. Stick with the plan unless the foundations are no longer sound and then change the plan. Hardest of all, don't react emotionally.

The markets do not function well with the unknown. Given a choice between a poorly known outcome and a completely unknown outcome, Wall Street will generally choose the negative but knowable scenario. This year we are clearly sailing in uncharted waters. We were not in business during the 1918 Spanish Flu pandemic. Today, through science and technology, we are far better equipped to find a solution to this crisis and we believe we will, but it will take time and the economic cost is painful.

While an unprecedented medical research effort to find both a treatment and a vaccine is underway, we are trying to buy time. Reduce the spread, flatten the curve. We are concerned as to how long business will be partially shuttered. Certain industries will take considerable time to recover. Some industries may never recover. We are already changing our lifestyles and habits. Movies at home, garage gyms, drinks with friends over Zoom. We are hopeful that the first wave of the spread of the virus will crest as we pass into mid-May. It will take time for jobs lost to return. It's easy to panic and prudent to be cautious, this too shall pass.

Please feel free to reach out to either one of us with any questions, concerns or comments.

1Q20 Data Points

DJIA	**-23.2%**
S&P 500	**-20.0%**
NASDAQ	**-14.2%**
US Bond	**-0.6%**
10-Year Treasury Yield	**0.70%**
S&P 500 LTM Dividend Yield	**5.97%**
S&P 500 EPS Next 12-MTH	**$163.10**
S&P 500 P/E	**16.7x**

GKV Capital Management is an independent registered investment advisor.
For more information about us please call (805) 497-2616 or visit **gkvcapital.com**

First Quarter Review

We started the year with a positive economic outlook and rising corporate earnings. It appeared that the U.S. and China may be able to finally move past the trade war that had been continuously escalating for more than a year. With a backdrop of positive economic growth, low unemployment, low inflation and strong household income, the market moved higher with the technology heavy NASDAQ gaining 9.4% by February 19th. While the novel coronavirus was already in the headlines, the infection seemed limited to China. Armed only with the recent historical knowledge of the short-lived SARS and MERS scares, investors chose to shrug off initial concerns until it became apparent that the virus would become a global and U.S. problem as COVID-19 spread through Europe.

Within a week all the gains of 2020 were wiped out and within a month all the gains of 2019 were wiped out as well. The S&P 500 ended the first quarter down 20.0%. The Dow Jones Industrial Average fared slightly worse declining 23.2%. The technology sector, with less exposure to hospitality, leisure and entertainment industries, did less poorly taking the NASDAQ Composite down 14.2%.

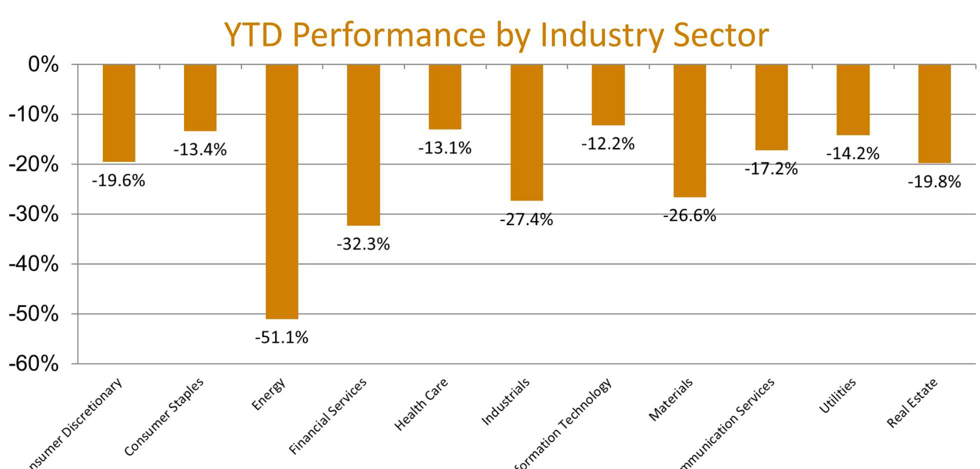
The U.S. Federal Reserve made two emergency rate cuts reducing the target interest rate to zero. The Fed also launched several massive asset purchase programs to stabilize the bond and credit markets which were showing unnerving signs of stress as investors dumped securities to raise cash. The yield on 10-year treasuries ended the quarter at 0.7% after several weeks of wild fluctuations.

At the beginning of the year, the earnings forecast for the combined companies in the S&P 500 in 2020 was for $175.52. Much has changed since that estimate. Travel, leisure and entertainment have been effectively eliminated. Restaurants are shuttered as is much of retail excluding online. We estimate that unemployment in the U.S. closed the quarter at roughly 10%, up from a historic low of 3.5% only a month ago. The cause of the shutdown is the coronavirus of course. To make any kind of estimate of what the economic picture will look like beyond this crisis depends on how much economic damage is incurred. The longer the duration, the more harm to businesses and employees. We can be certain that corporate earnings will be substantively impaired for 2020. What is uncertain is when will we move past this and how long a material recovery will take. With the market down 20% we could assume that 2021 earnings of $140.00 is currently being discounted. This forecast seems optimistic at this early stage of the crisis.

The unemployment numbers are particularly unnerving. The U.S. workforce is approximately 157 million. The unemployment rate was 3.5% going into March resulting in 5.5 million unemployed looking for work. For the last two weeks of the March quarter, new unemployment claims jumped 10 million. There may have been some hiring during the period but one can assume that in just two weeks, unemployment totals nearly 15 million or close to 10%. This is still well below the peak unemployment reached at the end of the 2008 recession, but we expect the number to move higher through the month of April and hopefully peak in May.

Stocks traded lower for the first quarter around the globe and in every sector. The worst performing sector was energy which was hit by a perfect storm of slowing global demand due to the coronavirus pandemic combined with a price war between Saudi Arabia and Russia. The price of oil fell from over $60 a barrel at the start of the year to $20 by March 31st. Energy stocks ended the quarter down 51% followed by financial services down 32%. The best performing sectors were technology, down 12% and health care and consumer staples (toilet paper) each down 13%.

With the uncertainty brought about by the economic implications of the coronavirus we have been reducing equities and raising cash. We ended the quarter with 17% in cash, 48% in equities and 33% in fixed income.



Dow Jones LLC, March 31, 2020

Coronavirus

"The stock market is the only market where people run away when there is a sale. Beforehand, they crowd in when the wares are most expensive."

- Unknown

We have all witnessed in the past 30 days the most severe decline in stock prices in history as measured by the S&P 500 index. The 34% descent was faster than the unraveling of the stock market in the crash of 1929 which marked the beginning of the Great Depression. Along with the unprecedented swift decline in stock prices is the dramatic fall in oil prices. During the past year oil prices have tumbled downward by 65% to their present level of $21.00 per barrel. Much of the United States oil production industry cannot operate profitably at sustained prices below $30 per barrel. The fall in oil prices, as mentioned in our previous market review last week, is primarily attributable to the oil price war between Russia and Saudi Arabia, but the sharp decline in demand worldwide because of the coronavirus pandemic has further exasperated the situation.

At the beginning of this year most economists were projecting U.S. economic growth for 2020 of 1.5% to 2.0%. Because of the huge economic disruptions cause by COVID-19, the economy for the first half of this year will contract by at least a negative 20-30% annualized. Any reasonably accurate forecast of domestic economic growth at this time is impossible, but it is guaranteed that the decline will be very severe. Like the stock market, the swiftness and cataclysmic descent of the economy in such a short time period is unprecedented since 1900. Unemployment is now projected to soar, industries are threatened with collapse and bankruptcy and corporate profits are now an unknown.

Not only has the stock market suffered extreme pain this past month, but the bond market has also experienced sharp losses. There has been nowhere to hide. Corporate bonds, commercial paper, mortgage backed securities and treasuries have all been under growing stress this past month. In response to the deterioration of liquidity in all areas of the credit markets the Federal Reserve has lowered short-term rates to almost zero. Even more important the Federal Reserve has taken the unprecedented step to assure investors that it would do on a daily basis whatever it takes to maintain the orderly functioning of the debt markets. Within the past week the Federal Reserve has injected trillions of dollars to provide sufficient liquidity for all credit markets.

For its part, Congress has passed a $2.0 trillion aid package to assist workers and businesses, large and small, to survive the shutdown of communities, entire states and their businesses. The emergency rescue efforts by the Federal Reserve will assist the capital markets and financial institutions, and the fiscal stimulus provided by Congress will more directly help workers recover lost wages and provide businesses with access to funds to allow for their return to more normal operations. Financial aid will enable financially weakened industries, such as airlines, travel, entertainment and restaurants, to avoid a rash of bankruptcies and will buy time for businesses to restore their vital operating cash flow. These emergency financing measures by Congress and the Federal Reserve were meant to put a floor under the country's precipitous economic decline and to restore confidence among investors in the viability and stability of the capital markets. The financial markets serve as a transmission mechanism. In other words, stress caused in the stock and bond markets due to the spreading severity of the COVID-19 pandemic increases stress to the nation's companies and banks. Also, the stock market has come to have a huge effect on the real economy. Severely falling stock prices beyond a momentary decline almost always leads to a reduction or deferral of consumption by the moneyed class. Consumer spending is the key parameter in the stability and growth of the U.S. economy.

Globalization was the driving economic force of the past 40 years until 2016. The administration's program of tariffs and xenophobia started to reverse this phenomenon and the appearance of the coronavirus pandemic may have permanently altered it for at least a generation. Factories and production may refocus on being domiciled domestically. Supply chains which enveloped the globe are being disrupted, perhaps permanently, and reoriented within the confines of domestic borders. The theory of comparative cost advantage may be discarded in the future because of the disastrous effect of COVID-19. Globalization was one of the key variables causing a slowdown in domestic wage growth and conjunctively surprisingly persistent low levels of inflation. A reorienting of the global supply pipeline may mean in the future higher wage costs for business, lower profit margins, higher material costs and rising inflation.

There are other likely changes in personal behavior patterns caused by the coronavirus pandemic. The ascension of online shopping will only accelerate. The decline of the shopping mall will continue along with increasing vacancies in the retail outlet sector. The movement towards working at home has been given a dramatic and permanent push. Video conferencing is in ascent, business travel may be permanently reprioritized as less than necessary. Pleasure travel will resume but some sectors of the travel/vacation industry, such as cruise lines, may never fully recover. Hotel occupancy will likely be less for a considerable period of time. The same may also be true for restaurants. The entire commercial real estate market will be adversely affected for an indefinite time period. The trauma of the coronavirus pandemic may change people psychologically toward better financial and personal preparedness for future disasters. Humans are social animals so we anticipate social gatherings to resume in public venues such as concerts and sports events, but pre COVID-19 attendance levels at movie theatres may not be realized. On balance the possible changes in lifestyle for this generation because of the pandemic will alter the pattern of economic growth and corporate profitability for the country. The American consumer may not return quickly, if ever, to his old patterns and may not be the foundation pillar to the economy as in the past.

In the summer of 2019 there was a debate in economic and political circles about which economic theory should guide U.S. economic policy in the future: capitalism, socialism or modern monetary theory. The country is well imbedded with capitalism on an individual and private business platform, but the levers in government are increasingly moving toward greater control of our economic lives through expansive deficit spending and expansionary monetary policy, and these forces are removing us further from traditional capitalism to government sponsored capitalism. Socialism has been spurned as a working doctrine for the United States, but government largess for the populace continues to expand and social programs are deeply imbedded into our society. Government has correctly assumed the financial responsibility of the welfare of the people. The proper extent remains debatable. Government intervention has resulted in growing deficit spending in an effort to provide for the universal welfare of the American people.

Modern Monetary Theory carries the argument in favor of deficit spending to the next level. It says a country can print all the money it wants to help its citizens regardless of its impact on the national budget or deficit as long as this money is spent on domestic matters, such as wages, welfare and public support programs. The size of the deficit is considered irrelevant in MMT. For those educated in traditional economic theory, the Modern Monetary Theory appears to contain serious pitfalls. However, during the current administration the risks of deficit spending on our future have been pushed aside by both political parties in favor of safeguarding and stimulating the economy. The COVID-19 crisis has removed all shackles of financial restraint in this period of national and worldwide emergency. Deficit spending has exploded along with monetary stimulus to rescue the economy, so while preserving the mantel of capitalism in our system the government has quietly embraced the concept espoused by Modern Monetary Theory of massive federal deficits to prevent a second Great Depression. The debate would be esoteric except that it has a profound impact on our future as a nation and the accumulation of wealth in general. With the creation of so much money to save our economy, our future becomes harder to ascertain. Looking to the future, beyond this crisis, we will be faced with the negative impact on financial markets and behavioral patterns as we remove the monetary excesses initiated by the coronavirus pandemic. Maybe an unwinding will be impossible as the public has come to expect and depend on greater support of the government in increasing sectors of our life. We went into a brave new world to rescue the economy in 2008. The present government support measures are several times greater in the present crisis than the recession twelve years ago. Regulation of our economy has increased with each crisis along with a dependence on government policy. We expect this blending of economic doctrines will continue, further eroding traditional capitalism with each new crisis.

The American economy will recover from the collapse caused by the coronavirus pandemic. The question for investors is to determine the pattern of the recovery. To use Wall Street parlance, will the economic recovery from our present recession/depression be sudden and swift, or slow and drawn out or perhaps experience a brief quick recovery to only collapse again before resurging once more in an erratic pattern of gains and deterioration. Whichever pattern evolves, the stock market will proceed almost in tandem.

Wall Street has always loved its charts. Like the Inuit Eskimos with their 50 different words for different types of snow, technicians have a whole vocabulary to describe the patterns of charts. Analysts are already trying to look beyond the near-term economic impact of the virus to determine likely scenarios for an economic recovery. The two common outcomes out of a recession are either a rapid recovery – resulting in a chart that looks like a “V”, steep on the way down followed by a rapid recovery. Or, less positive, an “L” shaped recovery- a sharply falling economy followed by economic growth which is only slowly improving or stagnant for some period of time as the damage done in the swift descent takes longer than expected to correct before allowing the economy to gain traction. Of course, there are other possibilities including a "W" scenario where the economy falls precipitously, recovers strongly but then has a relapse again before finally ascending into a more permanent recovery.

Based on the experience of China and South Korea, it appears most probable to us that the U.S. recovery from the coronavirus pandemic is less likely to be a "V" shaped recovery and more likely to be an "L". Some serious damage is being done to the economy right now. The huge fiscal and monetary stimulus will prevent the continuation of a freefall, but the recovery will be slow. The COVID-19 has been a major disrupter. Based on the imperfect models of the virologists, we expect this wave of the contagion to taper by early May. A recovery could begin but will not be able to recover to 2019 levels for some time. Additionally, most experts anticipate another wave of spread in the fall, although less lethal with better preparation and hopefully more effective treatment. Congress has already indicated the possibility of a second major stimulus package of a magnitude similar to the first. President Trump announced his intention to request from Congress approval for another two trillion dollars for the purpose of rebuilding the country's infrastructure. We think more government stimulus will be forthcoming since both political parties wish to see an improved economic scene before the major elections in November. Regardless of a pending major election, the present decline is so deep that more stimulus will be needed to accelerate our economic recovery into something approaching normalcy by the beginning of next year. Without more government aid than presently approved, the "L" shape recovery we expect will take unacceptably too long politically. Again, Washington is becoming an advocate of deficit spending and concomitantly MMT. No one is even suggesting these deficits will ever be or should be repaid.

Although losses in the stock and bond markets have been steep this year, we believe we will see improved price levels as we approach year end. We have been able to sidestep some of the losses this year by aggressively raising cash levels in client portfolios in late February. Increased cash positions and significant holdings in corporate and municipal bonds significantly reduced the volatility of accounts under management. Since we are strong believers in the merits of diversity and the importance of diverse asset allocation, our client portfolio structure is primarily a combination of fixed income and equities. The mix between stocks and bonds in an account varies according to client objectives and risk tolerance, but most portfolios contain a representation of both asset classes. This type of diversification creates a more conservative portfolio which usually underperforms the stock market indexes in strong bull markets but also significantly protects the investor in flat to declining markets. So, we expect to underperform a raging bull market in common stocks in accounts diversified between bonds and stocks, but we have almost always outperformed the major common stock indexes in moderately fluctuating markets or declining stock markets. The lesson learned is that diversity counts. It is important for the conservation of principal. Upside potential is slightly sacrificed in protracted strong markets but the rewards of asset diversification for clients have almost always equaled or outperformed the major stock market indexes over an extended period. Asset diversification does not insure against losses. It simply minimizes the losses when compared to 100% common stock indexes in a sharply declining stock market. Diversification is not a magic bullet, but it allows for less emotional and irrational thinking versus the emotional cauldron of no diversification in a swiftly collapsing market.

We have heard from some government officials in briefings that a vaccine or effective treatment for COVID-19 is imminent. This is not accurate and should be disregarded as political fantasy. Even with the massive effort by the drug and biotech industries worldwide, a vaccine, when found, will require three to six months of testing even under expedited conditions. Once the efficacy of a cure is confirmed, it will take another six months to develop manufacturing capability to produce huge volumes of vaccine to inoculate the populace. A vaccine would be a 2021 event in the best-case scenario. We think a treatment to at least ameliorate the mortality rate of the illness is likely, but it will not come in time to prevent serious deterioration in both our economy and worldwide commerce before this summer. We emphasize that no cure will be available quickly to prevent a "lost" first three quarters of 2020, if not an entire "lost 2020." As mentioned earlier, the "lost 2020" will change business practices forever and it will also result in a reappraisal of our daily lifestyle. In 2020 it is the huge financial stimulus by the federal government and Federal Reserve which will prevent a complete collapse of our daily lives, not a fast cure for coronavirus. The government stimulus along with testing and social distancing is buying time for a cure to be found. Business is in a survival mode.

We believe the magnitude of government assistance to business and the people represents a workable bottom to the unprecedented sharp decline of the stock market. Trying to time market tops and bottoms is like trying to catch a falling knife. Hazardous and almost always unsuccessful. An investor does not need perfect market timing to be a successful investor. An investor also does not need to subscribe to the passive blind, deaf and dumb long-term investor mantra of Wall Street to succeed in enhancing net worth via the stock market. The theoretical long-term investor is purely theoretical. It serves little purpose in reality. It ignores human psychology and personal financial constraints which include age, income and lifestyle. The theory ignores the ravages of “black swan” events, even though the long-term trajectory of the stock market has been up. We know from history over time our country perseveres, and its markets rebound, but we also know life is finite – not infinite. Professional proactive management of assets adjusted to personal individual goals is a superior methodology to passive, one style fits all management. Modestly correct, not necessarily perfect, investment timing in 2008 and 2009 and now in 2020 (both black swan events) through active investment management decision making has and will yield superior wealth accumulation. The modern history of financial markets is a tableau of attempts to control risk. They have all failed to protect against the unexpected as witnessed in 2001, 2008, and today’s market. Financial panic in the U.S. has occurred on average every 13 years. Every generation has experienced the madness of crowds which has ended in financial panics. John Hume wrote in The Art of Investing, “Wall Street is as much the natural field for panics as the prairie is for tornadoes.” When you look into a financial bubble, what you should see in that mirrored surface is yourself. Investments do not make or lose money; it is investors with their own excesses of greed and fear. A rational course between financial greed and fear through active, not passive, management produces close to the optimum investment regimen in our opinion since we recognize investing always has risk and a person’s personal investment parameters are always fluid.

We anticipate that the stock market will move higher from recent lows as we are able to see some resolution to the pandemic and because of government and Federal Reserve financial stimulus. We are also convinced that the huge financial aid already prescribed by our government will not be the last aid program. The stock market will also recover some of its recent losses before year end not because there will be a coronavirus vaccine in place for immediate access, but because a promising potential treatment will be found this year even though distribution would be unlikely to occur until 2021. There is a historically unprecedented worldwide medical research effort underway to find a cure for COVID-19. Almost all medical research in every other area has stopped as all resources are focused on finding a cure for the coronavirus. More than 60 major drug and biotechnology companies worldwide are devoting all their resources to solving the mysteries of the virus. This is an unprecedented never before seen cooperative effort worldwide. In our judgment a vaccine will be found for administering to the public by 2021. This vaccination therapy will be analogous to our present flu shots as opposed to a permanent immunity like polio or smallpox.

An investor today should be optimistic that a meaningful cure to the virus will be found before year-end and implemented next year. To wait until this announcement before reinvesting into the stock market will be poor investment timing. Most of the rally will have passed. To place too much emphases on the present economic collapse and not see a more positive way to the future belies a misunderstanding of the operating mechanism of the stock market. It is a future divining marketplace. It never discounts past or present events. Thus, with the government’s financial support in all areas and some form of therapy to effectively treat the coronavirus, we think 2021 will be a rewarding year of recovery for investors. Many wild gyrations may be in store between now and greater normalcy, but the trend will be increasingly positive.

We do not believe the stock market this year will return to its old highs achieved in February 2020. But by the fourth quarter the mending of the economy will be clearly apparent and stock prices should be higher by 10-20% from present levels. Also, the extreme volatility will lessen, an atmosphere of normalcy will return, expected corporate earnings will once again be the driving force for the stock market. We have a high confidence in an improving environment by year-end. Many factors in life and in the economy will have been altered by the virus and economic shutdown, but the worst of the economic decline, panic and disruption of life will stabilize as we approach the summer. The worst of the COVID-19 cataclysm has not been realized yet, the tragic death toll is far too high and will continue to grow, but we are confident of continuing massive government support of our economy and the discovery of a workable treatment and vaccine for the virus. The coronavirus will not disappear. It will be with us like the flu indefinitely, but in a manageable form.

Based on the narrative presented here, we are again starting to commit funds to the stock market. Although the exact timing of catching the bottom will be imperfect, we believe we are closer to a market bottom than a market top. In the near-term there will be considerable negative economic news. As we noted earlier in this paper, we recognize that the pandemic and the necessary measures to prevent its spread and lessen its contagion and government financial intervention will institute major changes on our future way of life and business practices. As we reinvest assets, we will be focusing on those areas which we believe will benefit the most from a recovery into an altered world. Diversification will still be a primary tenet of our investment philosophy as will preservation of principal and a deep respect for risk. We are confident that we can still achieve acceptable investment results in 2020, certainly in comparison to the market indexes and other alternatives. We dismiss irrational fear as a predictor of the country’s future. The pendulum will swing again to normalcy.

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Independent Investment Advisory

GKV Capital Management is an independent investment advisory firm registered with the Securities and Exchange Commission since 1975. We provide portfolio management services for our clients which include individuals, families, charitable trusts, corporations and retirement plans. We are in independent, fee-only advisor. We don not receive commissions and we do not sell any financial products. We have a fiduciary responsibility to put our clients' interest first.

Client accounts are separately managed and tailored to meet the specific needs, including risk tolerance, investment objectives, and tax consequences, of each client. Client assets are held at an unaffiliated brokerage firm.

With extensive expertise in security analysis, we make direct investments on behalf of our clients buying individual securities. This eliminates costly mutual fund fees and increases the flexibility to manage volatility. We actively allocate capital to take advantage of investment opportunities altering exposure to individual companies, industry sectors, and asset classes in anticipation of the changing investment and economic environment.

We are transparent in all facets of our asset management practice and believe it is important for our clients know what they own, why, what their performance is, and what they are paying in fees.

We build comprehensive portfolios for our clients with a goal of reducing volatility and producing prudent growth. We protect and build wealth at GKV Capital.

GKV Capital Management

Build Your Wealth to Fund Your Passions
