# Long Lake Capital Management, LLC

401 S. Old Woodward Ave. Suite 333
Birmingham, MI 48009
248-712-6160
www.longlakecapital.com

July 24th, 2020

Friends of Long Lake,

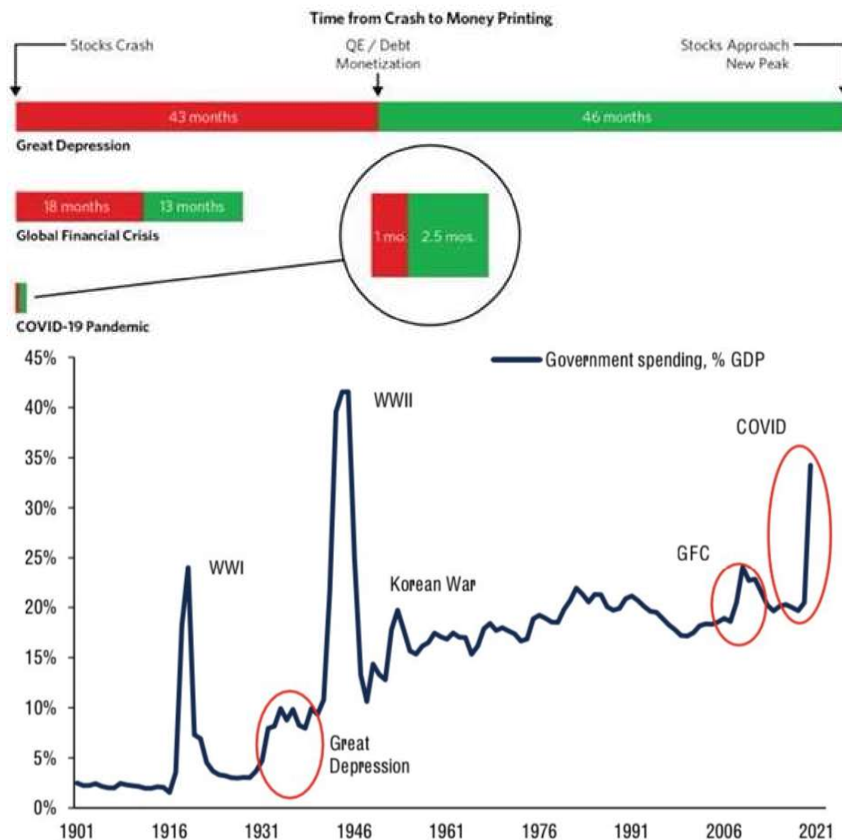
Unlike most quarters, where we hear from very few of you, this quarter we heard from many clients regarding our view of the market. The questions were generally similar, so we would like to take this opportunity to summarize our thoughts.

**Q – Why has the market been so strong? Aren't the economic and employment data terrible?**

**A –** This question really speaks to the rapidness of the recovery seen in US equity markets following a historic collapse in March. As the adjacent chart shows, so far, this was the fastest decline in history followed by the sharpest recovery. A recovery that caught many investors off guard, as [81% of investors] believed in April that the market would retest its March lows.

So why has the market been so strong? That's a fairly complicated question, but if there's one big actor in the game who has tipped the scales in favor of markets it's the Federal Reserve, which has pumped trillions of dollars of liquidity into the markets. This has done two things.

1) It has likely taken many of the worst outcomes off the table. Full blown banking or liquidity crises that threaten the entire financial system do not seem very likely when the Fed, and other central banks, are willing to 'print' money and inject enormous amounts of liquidity into the system.
2) The actions of central banks have contributed to lowering the yield or return on other assets. For example, at current rates if an investor bought a US 10-year treasury bond (essentially lending the US government cash for 10 years) you'd get a paltry return of about 0.58% a year, albeit risk free.

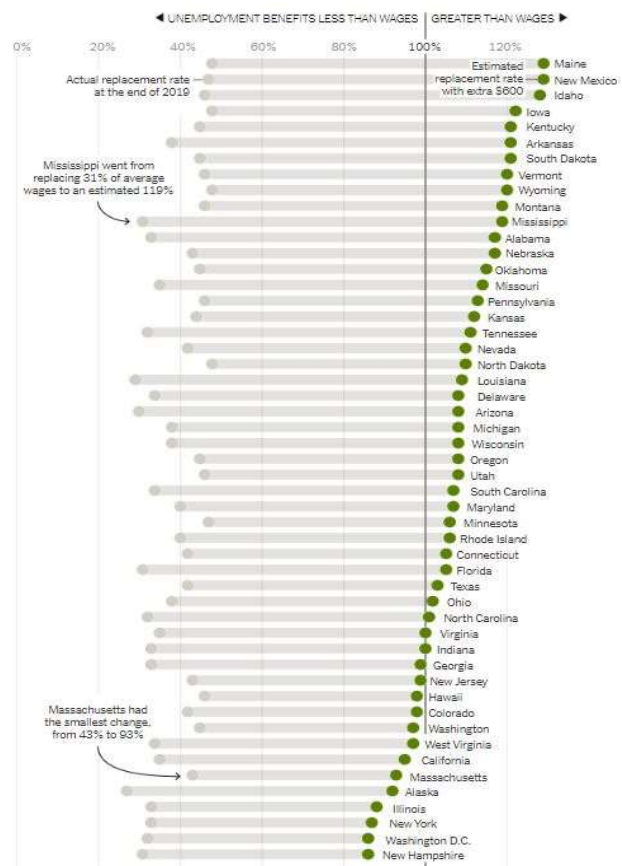



Unlike prior economic collapses, the Fed was very quick to act. As shown in the above chart, it took one month for the Fed to deploy the large-scale type of quantitative easing measures that it did not release for 1.5 years during the Global Financial Crisis, and well over three years in the Great Depression. As of 7/24/20, there are expectations for more government intervention and stimulus, likely in the form of continued Federal unemployment extensions (though dropping from $600 to $400), a payroll tax holiday, and potentially another round of stimulus checks.

Outside of the Fed's involvement, it is also worth considering what companies are driving the market higher. Wall Street loves acronyms, and came up with "FAANG" (Facebook, Apple, Amazon, Netflix and Google) a few years ago. That moniker has evolved into the more jovial "FAAT MAN" (Facebook, Apple, Amazon, Tesla, Microsoft, Alphabet aka Google, and Netflix), which as of 7/8/2020 had added $1.75 **TRILLION** in market cap since the start of 2020. To put that into context, Microsoft, Apple, Amazon, Google, and Facebook are larger than the 350 smallest companies in the S&P 500. When compared to the NASDAQ, and including Tesla, those six companies account for 49% of the index's weighting.

For as much as the media and those in the asset management industry like to point out these statistics, readers may find it interesting to note that the dynamic of concentrated index leadership is not abnormal.

In regards to the unemployment situation, it can be argued that the government has again come to rescue. The adjacent graphic displays an interesting dynamic of the government's Federal unemployment benefits program: it actually pays many workers more money than they had been making while working. Additionally, the savings rate in the US has been between 6.5% and 8.8% since 2015 before [jumping to 32% in April and 23% in May](). So, despite jobless rates approaching Great Depression [levels](), it might be possible that a great many of the 50 million plus that have filed for unemployment actually find themselves in a better financial position – at least for the time being. Oddly, in some sense, Wall Street may have viewed higher unemployment as somewhat bullish given the overall dynamic. Strange times indeed…



Note: Estimates use average weekly unemployment benefit and average weekly wages from the last quarter of 2019 and add $600 to the average weekly benefit. • Sources: Department of Labor; Ernie Tedeschi, Evercore ISI Research

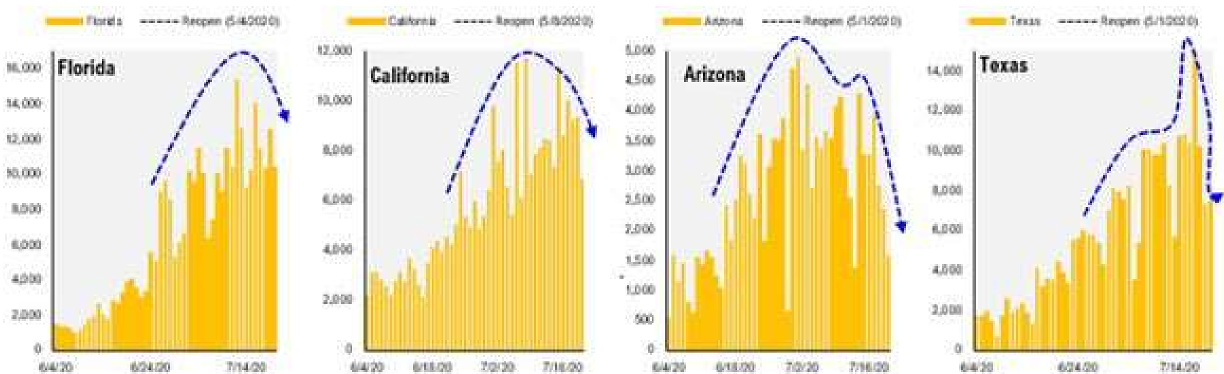
On the economic front, there is much debate over the shape of the recovery. As usual, Wall Street likes to apply labels, and in this case, has settled upon various shapes: V-shaped (rapid decline, sharp bounce back), U-shaped (rapid decline, period of stagnation, sharp bounce back), hockey stick (sharp decline, slow and measured rebound), or the dreaded L-shape (sharp decline, no recovery). If forced to choose, we would fall into the hockey stick camp, albeit with a non-linear recovery.

To sum it up, the Fed alleviated the worst case scenario, and now we are likely to experience a prolonged period of job gains and economic growth.

**Q – The market seems to be ignoring new covid-19 cases, isn’t that a risk?**

**A –** The short answer is probably that we have seen the worst of the economic impact from covid-19 and now know the disease is nowhere near as deadly as initially feared. That is not to say covid-19 is harmless, it is certainly a nasty disease, but the early estimates of 5-10% of infected patients dying is clearly no longer considered accurate. Currently, the CDC estimates that the total infected fatality rate is likely somewhere between 0.2% and 0.6% depending on which day one checks their website. For readers that are interested, this is the most comprehensive article we have come across regarding covid-19’s mortality risk by a variety of factors, including age and morbidities, as well as what it takes to get to herd immunity.

Overall, Wall Street seems to care most about the potential for states to enact new lockdown measurers and thus slow the economy. Given the disease’s incubation period and death cycle, we know that reported cases and deaths lag the total infected base’s peak. Put another way, by the time confirmed cases peak, the infected base has already begun to decline. As a result, in terms of actual case data, Wall Street appears to care more about the rate of change (i.e. new cases appearing at a lower rate than the prior day or week). As seen in the chart below, the four major current hot spots have potentially peaked, thus the rate of new cases in actually declining and the total infected base has likely peaked.




In addition to the cases themselves, many investors are focused on hospitalizations and deaths. Both of these trends are less severe than what was seen in the Northeast back in March and April. Improvements in the standard of care (particularly around ventilator usage), earlier treatment, better protection of those most at risk (i.e. not putting covid-19 patients into nursing homes, where >50% of the US’ deaths have occurred), and a younger infected base are likely reasons behind this dynamic. Additionally, there is some evidence covid-19 may be losing its potency.

Given a seemingly more manageable situation than we saw in March-April, it appears most investors are primarily focused on what lies ahead in a post-vaccine world. Speaking of vaccines…

**Q – How quickly does the world normalize after a vaccine arrives?**

**A –** This question is very difficult to answer. It is our belief that multiple vaccines will be approved and will have a high degree of efficacy, though not 100%. There is currently less clarity around how long a vaccine

will provide immunity and how many citizens are willing to take it. Additionally, there are questions about whether the vaccines will just prevent sickness vs. actually eliminating the virus from the body. In the non-human study component of Astra-Zeneca/Oxford's vaccine candidate, the virus did not sicken the host but remained present in the body and therefore was still transmittable to others.

On the plus side, some of the leading vaccine candidates are producing antibody levels that are multiples higher than what the virus itself produces (link, link), which may suggest longer levels of immunity. A number of the vaccines under development are mRNA (messenger RNA) vaccines, which are different than traditional vaccines, and have never been used in society. mRNA vaccines encode for a protein found on the surface of the novel coronavirus, and by doing so, it compels the body to produce an immune response that in turn generates antibodies. A traditional vaccine injects a weakened form of the virus into the body to generate the same immune/antibody response. Given the speed of development and new technology, it is likely that some citizens will be afraid of the vaccine and the perceived risk of side effects. For those interested, we have attached an overview of the vaccine landscape to this letter. Additionally, this is a good resource for anyone who cares to track the various drugs used for covid-19 treatment and vaccines under development.

Unfortunately, we do not believe vaccines will be a panacea. While it is possible one of the vaccines will prove 100% effective, it is unlikely. Additionally, we suspect a significant portion of the population will not take the vaccine. The culmination of these two factors likely results in covid-19 becoming endemic to the population and being something we simply learn to live with until it hopefully fizzles out.

**Q – How big a risk is the November election?**

**A –** At this point, Wall Street and Las Vegas both seem to expect a Biden victory. The following table from Oddsshark has Biden with a commanding lead (note: the more negative the number, the more likely Las Vegas believes the outcome to be) and national polling data reflect a similar dynamic.

**2020 Presidential Election Odds Chart**

| Candidate | Current | July 3 | June 27 | June 22 | June 17 | June 4 |
|---|---|---|---|---|---|---|
| Joe Biden | -150 | -160 | -140 | -130 | -120 | -110 |
| Donald Trump | +135 | +140 | +120 | +115 | EVEN | EVEN |

The following is from AGF, a politically-oriented investment firm based in Washington DC, which sums up the situation:

> *Markets haven't paid too much attention to the race up until now because the pandemic and economic crisis that resulted from it have been all-consuming for the good part of the past five months. Recently, President Trump's handling of the crisis and his recent refusal to acknowledge the latest surge in the virus have landed poorly with most voters. The election will now bear more scrutiny from investors as we move through the summer. In fact, we're already starting to see that happen. For instance, headlines that Elizabeth Warren might be the top choice to become Treasury Secretary if Joe Biden wins the presidency caused a stir recently because markets generally believe such an appointment would lead to more stringent banking regulations. Likewise, Biden's running*

*mate choice may also generate a reaction from markets when it's announced in the next few weeks—especially if his vice-presidential nominee ends up being someone to the far left of the political spectrum. Then, there's Trump's electioneering to consider. He's bound to ratchet up the rhetoric given that he currently trails in the polls. And what if speculation about him wanting to throw in the towel proves persistent? Markets would surely begin to react if forced to seriously contemplate Mike Pence or some other Republican as the party's official nominee for President. So, there's no shortage of election-related storylines to watch for in the coming weeks and that may even extend beyond November given the very real possibility that election results end up being disputed [due to the potential for fraud as a result of mail in ballots] by the losing party.*

*The market may be less concerned about which party wins the election and more worried about how resounding the victory ends up being. A sweep of the White House and both chambers of Congress would be the worst-case scenario because it would negate an important check and balance and open the door to some of the more clear-cut partisan ideas that each party espouses being passed into law. To that end, a Democratic sweep raises the specter of higher taxes, which many investors would not view kindly. After all, by some estimates, the corporate tax cuts introduced by the current administration added somewhere between 16 and 20 dollars of earnings to the S&P 500 and rolling back even half of that would automatically push the market multiple higher. There's also the impact that Democratic initiatives like Medicare For All and the Green New Deal might have on certain sectors of the markets*

Poling data are somewhat challenging to rely on, but for what it is worth, Trump trails nationally by as much now as he did against Hillary in 2016. Obviously a lot can happen before November 3rd, but it does appear there are significant potential risks on the horizon from the upcoming election cycle.

**Q – Where do we go from here?**

**A –** The argument can be made that the largest threats to the stock market are fairly well known at this point. If the market truly is a discounting mechanism, those variables should be included in today's market prices. The Bull case seems to be that the global central banks and governments have pumped trillions of dollars in stimulus and support into the economy, consumer balance sheets are stronger now than pre-covid-19, the world normalizes post-vaccine, 2020 does not really matter because the market is already looking ahead to 2021, and the economy could be super charged at that point regardless of who is in the White House. All of that is certainly possible, if not likely.

On the flip side, we could see a longer period of weak economic growth as consumers and businesses continue to work their way through the virus' impact. Schools not re-opening in the fall could be a substantial headwind, though it does seem as if most families have found ways to cope with the home-schooling situation. The election cycle will likely cause some turbulence, though the market has generally found a way to navigate through whomever is in office. Additionally, the threat of escalating tensions and trade with China continues to loom in the background.

While there is much that can and will occur in the near term, it does seem likely to us that we are headed into what should be a fairly substantial period of economic expansion. There is clearly pent-up demand, we will begin to add back the millions of lost jobs, interest rates are very low, and most corporate and

consumer balance sheets are strong. Taken as a whole, that should ultimately produce a positive environment for equity markets, but given some of the outstanding potential risks, it would surprise us if the ride was completely devoid of volatility.