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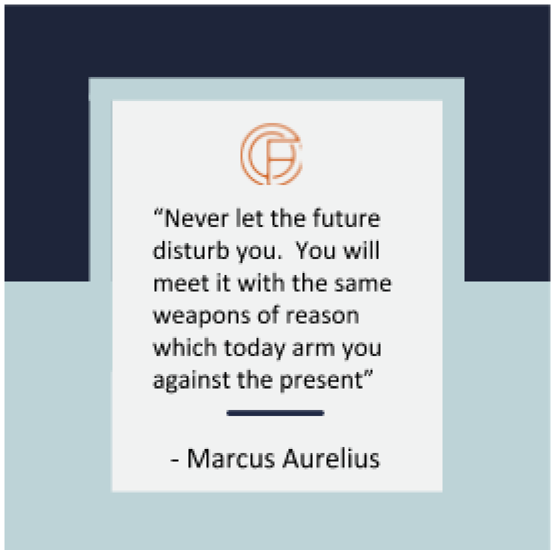


Part One: Prediction

March 2020

Like you, I have been reading a wider range of opinions lately to understand our world. The sudden onset of coronavirus has confined nearly four billion people to their homes. Undoubtedly, this includes you. After making sure that family and friends are safe, many people just want to know what's next.

The future has never felt more uncertain. In the world of investments, predictions are far more common than they are useful. In fact, I recommend that you turn your attention away from prophecies. The noise will distract you from your priorities. This is the best time to review what is important and unique about your situation and to retain your focus on opportunities that are actionable today.

Tomorrow has not yet come

There's a contradiction at the heart of investing. Asset prices are supposed to be predictive, or forward-looking. The market's job is to provide a price today by tallying the forecasts of millions of different investors. The problem arises when people (or computer algorithms) make faulty predictions, which happens all the time. The size of the market adjustment that results is proportional to the surprise, plus the amount of faulty confidence that was priced into the original forecast.

Since 1996, the founders of O.F.O. have guided clients through many such events. The investment industry likes to call these episodes "exogenous shocks", which sounds scientific. Instead, most panics are the byproduct of long-simmering imbalances. (We wrote about this in a client note, Sailing Along). Instead of joining the panic, look at ways in which predictive powers in the market can go awry -- and what you can do to protect yourself from the effects.

Consulting the Oracle. John W. Waterhouse (1884)

Yesterday's gone

People tend to use their recollections of past crises to make predictions about the future. Instead, observe what has changed, and accept incoming information with as little bias as possible. When the coronavirus appeared, bond investor Dan Fuss noted that lessons from the past can be misleading.

> "I've been doing this since 1958. I've seen some tough markets. The worst of all was from February through the first week of October in 1974. That was a killer. But it was confined to the U.S. and Canada. This one is very different.
>
> It has a few similarities to 2008, but not as many as is often times referred to. You have the market volatility with a lag effect on the economy. But this one is global, and it's very important from a geopolitical standpoint. The interaction between the markets around the world is notable."
>
> - *Dan Fuss, Vice Chairman of Loomis Sayles*

You cannot see in a storm

When the economy began to shut down in March, new market forces arose. Forecasting became fiendishly difficult. For one thing, policy response from central banks, regulators, and Congress have reshaped events in unpredictable ways. Technical flows also appeared and magnified feedback loops. At the start of the new quarter, technical trading in commodities drove the price of oil to *negative* $37 per barrel. Investor sentiment, or the market's mood, became unpredictable and one-sided. These factors together made the direction, timing, and magnitude of market behavior even less predictable than usual.

Visibility is further dampened because many companies and Wall Street analysts have dropped their forecasts altogether. By discarding this common practice, companies and analysts are signaling dense fog ahead. As shown to the left, remaining estimates have widened to near record levels of dispersion.

The noise is really loud

Investors encounter more predictions just as the probability of their accuracy falls. Beware of the incentives built into predictions. People look for stories during times of uncertainty, and lucky forecasters can become famous. Likewise, watch out for doomsayers. They are trendy right now because their sensationalism matches our fears.

In reality, market forecasters perform very badly. The CXO Advisory Group researched the accuracy of 6,500 market predictions. They found a 47 percent success rate, which is slightly worse than calling a coin toss. (At right, we have revived some non-investment forecasts in which experts drew the incorrect inferences – in spite of, or perhaps *because of* their experience.)

"There's no chance that the iPhone is going to get any significant market share"

- Steve Ballmer, Microsoft CEO April 2007

"I think there is a world market for maybe five computers"

- Thomas Watson, IBM Chairman 1943

"The Beatles have no future in show business"

- Dick Rowe, Decca studios 1962

"It will be years – not in my time – before a woman becomes Prime Minister"

- Margaret Thatcher, Prime Minister 1969

"We can close the books on infectious disease"

- William Stewart, U.S. Surgeon General 1969

Insiders can make lousy predictions, too

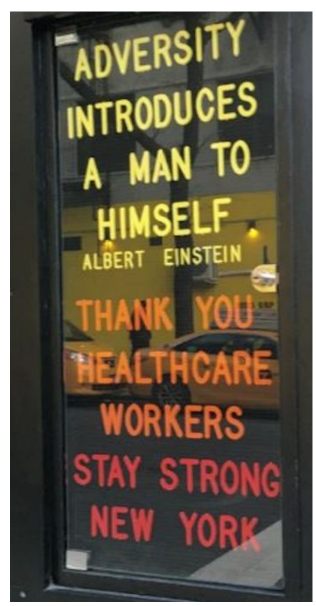
Nowcasting is better

To overcome the speed of coronavirus spread, some CDC researchers have shifted their efforts from medium-range predictions to a practice they call “nowcasting”:

> “I am convinced that there are two things we can do well. One is to make very short-term forecasts — one to two weeks ahead. The second thing, which I think is even more important, is forecasting not the future but the present —estimating in real time the current prevalence of the disease. That’s called “nowcasting.” Without knowing the current prevalence, you can’t even begin to figure out where it’s going next.”
>
> - *Roni Rosenfeld, Carnegie Mellon professor of machine learning, currently forecasting the Covid-19 spread on behalf of the CDC.*

At O.F.O. Partners, nowcasting incorporates the shortcomings of traditional forecasts during stress. We act in a fiduciary capacity with a standard of accountability that investors can trust more than a prediction. We also demonstrate that active rebalancing, tax harvesting, estate optimization, and charitable gifting strategies far outweigh the benefits of forecasting at a time like this.

Change and uncertainty about the future is all around us. The best questions you can ask all begin with your own situation and intentions. The answers you gather this way will align with your priorities and bypass the guessing. Better still, they will prove themselves productive right away. No predictions required.



We look forward to seeing you soon,
Christian Connolly, Ezra Levine, Doug Moon & Karen Sugar

Part Two: Market Commentary

When China sneezes, the world catches a cold

The old saying "when the U.S. sneezes, the world catches a cold" seems to be relevant today, but in reverse. Fear of the unknown has triggered a spike in risk premia, a collapse in markets, and a steep decline in treasury yields. As the quarter ended, the U.S. had entered a bear market, dropping more than 20 percent since February 19. Most of the world's economies are likely heading toward recession.

While the impact of the virus was still accelerating, the first cracks in the market emerged when Saudi Arabia and Russia launched an oil skirmish. At a time when demand is weak, the price war saw oil drop 30 percent overnight. U.S. shale companies, loaded with debt, deserve close watch to observe the level of bankruptcies that emerge. High indebtedness and the disappearance of consumer demand is a theme to monitor in other industries as well.

Bond exchange traded funds (ETFs) in March had a tough time. Briefly, the bell weather investment grade bond ETF (LQD) fell by 20 percent and the municipal bond ETF (MUB) was down by 13 percent. In a sign of unbalanced markets, they traded at discounts to their net asset values by five to six percent. The Federal Reserve has pledged to buy corporate bond ETF's, a response that provides helpful liquidity, but underscores the need to reinspect these funds which were so widely embraced prior to the crisis.

This quarter also saw an increased volume of Fed Repurchase Agreements (Repos), proving wider liquidity concerns existed beyond traditional bond markets. The demand for U.S. dollars everywhere was meaningful, so the Federal Reserve extended dollar swap lines to central banks around the world. The first quarter witnessed the largest U.S. dollar rally since October of 2008, repeating for now the primacy of the U.S. dollar in times of panic.

Central banks around the world have cut rates to ease financial conditions in the wake of the virus. The U.S. made an emergency cut in rates by 1.5 percent this quarter and announced essentially unlimited purchasing of treasuries and mortgage bonds. Despite the Fed's actions, volatility has skyrocketed. The stock market's fall into bear market territory was the fastest in history, occurring over a mere 22-day period. This quarter also witnessed the first week since 1929 that markets closed up or down by more than 4 percent every day.

Historically, it has taken between one and eighteen months for the stock market to trough after initial declines of 20 percent. Recovery times to regain previous highs have ranged from five months to three years. In previous instances, an allocation to fixed income in a portfolio has significantly shortened this recovery time. As we noted above in describing the value of predictions, this crisis will wind its own path to recovery.

Regardless of the uncertainty, our history as a nation proves that the U.S. economy and markets are well structured for a dynamic return. Despite the bickering, we do rely on each other and will work together for common purpose in the end. Our systems and culture support ingenuity, flexibility, and rejuvenation. The Federal Reserve and Congress have taken extraordinary measures to ease financial conditions. Although these first measures will not combat the spread of the virus, they will limit the financial impact on people's lives. Far greater is the sacrifice that we make collectively to ensure the health of neighbors, friends and - cementing our humanity - strangers.

Part Three: Now Hear This

Here are a few articles and ideas tied to the questions we've pondered this spring.

You – yes, you – can help AI predict the spread of coronavirus

Even if you nothing about artificial intelligence, you can volunteer to forecast the future of Covid-19. This article introduces the virus prediction work of Roni Rosenfeld and how to become involved.

What coronavirus means for the global economy

Ray Dalio, the head of Bridgewater Associates, talks in this TED video about how the global economy might recover from the coronavirus fallout. His views are based on his study of long-term cycles of growth, leverage, and policy.

Farsighted: How We Make the Decisions That Matter the Most

Steven Johnson acclaimed 2018 book about decision-making in circumstances that involve serious deliberations.

The Infinite Game

Simon Sinek's treatise on leadership and decision-making using an infinite mindset.