Making the Important Decisions

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Mast Investment Letter
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Unlimited Government Capacity for Economic Support Implied
Equity market rebound from March 23 lows demonstrated investor optimism based on apparently unlimited potential monetary and fiscal government support and stimulus. Added to this life-support, economic recovery is considered imminent based on vaccine development and distribution. The unlimited support, promised until the recovery occurs, includes money-printing, fixed-income bond market purchases (including low-grade and ETF funds), and up to five waves of fiscal stimulus directly into lending and labor markets.

Although the existential cause of this crisis, health pandemic, was historically unique, the activity stop was quick overload for an excessive and unsupportable volume of debt and illiquidity. The previous crisis was precipitated by the collapse of residential real estate prices as overload for an excessive and unsupportable volume of debt and illiquidity. **Levels of debt are deemed supportable by many economists as long as economic growth exceeds interest rates.** In both 2009 and 2020 recession declines in economic activity impaired debt support. Ironically, easy-money low interest rate Fed policy for 11 years kept interest rates below secular deceleration of economic growth, until it didn't.

Making a back of the envelope calculation of the value of the USA, we could apply a capitalization rate to the national output, gross domestic product (GDP). At $22 trillion and a generous 5% capitalization rate, **the value of USA is $440 trillion. The annual federal budget is $4.8 trillion. Estimated state and local government spending is $2.4 trillion. All combined, the government take of USA output is 32%**. In 2009 the federal government bailed out GM and handed much equity to unionized labor. Germany recently nationalized Lufthansa while U.S. government considers bailing out Boeing. For the $ trillions being given as direct funding or loan backing, how much of the $440 trillion-valued U.S. economy can the total government sector, currently $7.2 trillion, sustain or rescue?

Fed Lender and Buyer of Last Resort
Economic dislocations and losses caused by the pandemic health crisis are historically large and quick. Preceding this distress was moderate economic growth, public and private debt expansion and prolonged/extensive monetary and fiscal stimulus recovery from the 2009 recession. **Suddenly and greater than many previous economic declines, unemployment spiked while economic activity and consumption plummeted.** Business, labor and financial markets are accustomed to support from both monetary and fiscal policies. The policy responses included continuation of 2009-era economic stimuli with the introduction of sizeable and new policy initiatives.

Government monetary and fiscal policy supports are sizeable. "The Federal Reserve is preparing to **lend directly to middle-market businesses,** filling a hole left by the government's economic crisis relief efforts, and it is shaping up to be one of the trickiest things it has ever done. The risk for the Fed is that it goes where the central bank has rarely ventured and that not many businesses seek help, creating both financial and political headaches. Under the Fed's middle-market program, a company would get a loan from a bank, which would then sell up to 95% of the debt to the Fed. This leaves the bank with less additional debt on its books and free to make more loans to other borrowers.
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After credit markets started seizing up amid the coronavirus pandemic, the Fed responded in March and April with promises to backstop them – including municipal debt markets – reducing borrowing costs and lifting stocks. Now its biggest challenges are making these programs work, former Fed Chairman Ben Bernanke said in an interview. With the midsize business program, a key challenge is **setting the terms so the Fed doesn't become a dumping ground for bad loans** – but not so onerous that companies don't want to participate. For the foreseeable future new credit is pretty much non-existent.

Absent the Fed program there will be very, very little commercial and industrial lending for the 120 days or so." (WSJ 5/19/20)

In addition to "lender of last resort" the Fed now also functions as the bond "buyer of last resort". "There was deep trouble in almost every corner of the bond world by mid-March. Junk bonds, investment-grade bonds, Treasurys – all saw shortages of buyers. **BlackRock and Pimco manage more than $8 trillion across bond and private equity markets**. With the decline of trading and custody services at banks, asset managers are now the custodians, traders and managers of publicly traded financial assets. They oversee money in **exchange-traded funds and traditional mutual funds that are held mainly by individuals.** The firms run all kinds of funds and managed accounts. In these, a client entrusts the money-management firm with cash that the firm invests.

They will be **central players in what is expected to be a multitrillion-dollar overall program of central-bank support to the economy and markets, a program that will help decide which businesses survive the pandemic**. Stocks fell more than 7% March 18 and trading almost stopped in several bond markets, making it hard for corporations as well as cities to raise needed cash. The Fed had said it would **intervene substantially in money-market funds**, and would shift its purchases of Treasury bills toward a broader range of maturities. Then on March 23 it unveiled sweeping measures. It said it would **purchase all kinds of bonds, pledging to do whatever was needed to shore up the economy**. The Treasury promised to shoulder any initial losses on the Fed's mammoth purchases. The central bank isn't allowed to risk taxpayer money by propping up insolvent companies. During negotiations over the Treasury funds, Senate banking committee members tried to lock in prescriptive terms on how the Fed and Treasury would deploy the money. Fed officials voiced concerns and won flexibility." (WSJ 5/11/20)

"The Fed, meanwhile – after saying in March it would buy an unlimited amount of Treasurys – has slowed the pace of its purchases to $6 billion a day from $75 billion a day. Still, yields have barely budged, indicating there is tremendous demand for that high-quality debt. Treasury yields that are reliably this slow have wide-ranging implications for markets and the economy. **For investors, paltry yields might signal a gloomy future. But they can also propel them into riskier assets in search of returns, a likely factor in the surprisingly strong rebound in stocks since their sharp decline** earlier in the year. Low yields have also encouraged borrowing. Last month Costco sold 10-year notes with a 1.619% yield, the lowest on record for that maturity according to S&P Global Market Intelligence. Other companies that have recently issued 10-year bonds with sub-2% yields include Apple, Clorox and IBM. Overall, through Tuesday, nonfinancial companies had issued $150 billion of investment-grade bonds this month after selling a record $231 billion in April.

Treasury yields could turn even **less volatile if the Fed adopts a policy known as yield-curve control**, several analysts said. A cousin of quantitative easing, yield-curve control entails **purchasing an unlimited amount of bonds** at a particular maturity to peg rates at a target. In the U.S., Fed Chairman Jerome Powell said last fall that 'short-term yield-curve control is something that is worth looking at' as a tool to fight the next recession. Minutes of the Fed's April 28-29 meeting released Wednesday also revealed that a few participants at the meeting discussed the possibility of capping short-to-medium term Treasury yields for a period, while several said bond purchases could generally be used to keep longer-term yields low.

It is far from certain that the Fed will embrace yield-curve control. Still, the mere discussion has likely contributed to the **bond market's calm**. Something similar happened to corporate bonds after the Fed said in March it would start buying the securities. Though it was nearly two months before the Fed started implementing the program, the announcement alone sparked a rush into the asset class as investors anticipated the Fed's backing. Not all investors are unconcerned about a pickup in inflation that could push longer-term yields higher. A welcome surprise – such as an early vaccine available for emergency use this fall – could provide a major boost to the economy. Some also see risk in the tremendous amounts of money that the federal government is spending to help the economy, coupled with the promise of unlimited bond-buying from the Fed, which essentially helps finance that spending." (WSJ 5/21/20)

Plateau the Curve: People and Financial Assets

Epidemiologists inform us of the benefits of spreading out over time the peak curve of population receipt of the pandemic virus. This allows limited healthcare capacity to absorb, to **process and to digest the volume of sick people** from beginning to conclusion of heavy first-wave contagion. Sudden and damaging economic events receive similar attention from financial system managers. Keep economic participants and assets alive long enough to survive until recovery.

Policy for workers supports them for survival until re-employment. "Factory furloughs are becoming permanent closings, a sign of the heavy damage the coronavirus pandemic and shutdowns are exerting on the industrial economy. Factory shutdowns in the U.S. will **further erode an industrial workforce that has been shrinking** as a share of the nation's overall economy for decades. While **manufacturing output last year surpassed a previous peak from 2007**, factory employment never re turned to levels reached before the financial crisis. The burst of job-cut announcements indicates **many companies are bearing down for a sustained slowdown**. Some are also using the moment to accelerate strategic shifts. In April, payrolls fell by a record 20.5 million, erasing a decade of job gains. The factory closures suggest a growing share of the record job losses in recent weeks won't be temporary. The more that job losses turn from temporary to permanent the harder the hit to consumer spending an every company that relies on it – including manufacturing. **Layoffs have wiped away nearly a decade of employment gains at U.S. manufacturers.** Factories added 1.4 million workers from 2010 through the end of last year, employing a total of 12.9 million people in December. The manufacturing workforce has since dropped to 11.5 million." (WSJ 5/11/20)

Unemployment income loss impacts loan support. "**Millions of people are behind on their credit-card and auto-loan** payments. Lenders in April had nearly 15 million credit cards in financial hardship programs. That accounts for about **3% of the credit card accounts**. Nearly three million **auto loans** were in these hardship programs, accounting for about **3.5%** of those tracked. About 840,000 personal loans were in deferment, accounting for 3.6% of those tracked. Lenders hope that being flexible with borrowers will buy time for the economy to recover and for consumers to get back on track with payments. But lenders can shoulder the unpaid loans for only so long, and many are bracing for a **mountain of defaults** that they'll eventually write off as a loss." (WSJ 5/21/10)

Decreased/Halted Economic Activity and Unemployment Impacts Housing and Commercial Real Estate

Most mortgages are now non-bank originated and serviced. Who holds the risk of default? It is the servicers and the **investors (wealth management financial products) holding packaged mortgage loans**. "Many mortgage companies aren't positioned to help their customers through the economic collapse. Many of them are **nonbanks that don't have deposits or other business** lines to cushion the blow, and they have raised concerns that fronting payments for struggling borrowers will quickly drain them of capital. Over the past decade, the business of originating and servicing mortgages has **shifted toward nonbanks**. They made **59%** of U.S. mortgages last year, the highest level on record. Regulators didn't focus on the strength of the mortgage companies themselves. The loans are sturdier, the infrastructure did not change." (WSJ 5/11/20)

Nonbank mortgage financing increased risks for originators, servicers, investors and borrowers. "As the big banks refocused their mortgage operations on wealthier borrowers, nonbanks stepped into the void, often representing the only path to a mortgage for buyers of lesser means. Nonbanks expanded in the crucial business of servicing mortgages. They now service more than half of them, five times their share from a decade ago. In bad times, servicers are supposed to create new payment plans for struggling borrowers, which takes much more work and expense. When all else fails, servicers initiate foreclosures. **Pools of mortgages are packaged and sold to investors around the world**. When a borrower stops paying servicers are caught in the middle, forced to front payments to the investor even though they are not receiving money from the borrower. They may eventually get reimbursed by the two-third of mortgages guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae, but that is a slow process. Forbearance thrusts both banks and nonbanks into the position of cushioning the blow for their customers. Nonbanks, which depend on short-term bank loans to fund daily operations, are struggling to do so. **About 7.5% of borrowers obtained forbearances as of April 26. That means about 3.8 million homeowners are skipping their monthly payments with permission.**" (WSJ 5/11/20)

Commercial borrowers, like Pyramid Management's 14 retail centers, are packaged into commercial mortgage-backed securities and **sold into investor accounts**. "The company has $1.6 billion of debt in commercial mortgage-backed securities involving 11 malls. Pyramid was late on mortgage payments for six of these properties in April. Pyramid has begun the process of debt restructuring. Pyramid's debt problems are worse than many peers because it has a **large exposure to loans that are packaged into commercial mortgage-backed securities**. Borrowers say it has been easier to get relief from direct lenders such as banks or insurers during this crisis. But holding restructuring talks with servicers of commercial mortgage-backed securities loans has been difficult. **Servicers are flooded with relief requests and some aren't obliged to respond until a default occurs."** (WSJ 5/6/20)

Retailer **J. Crew seeks bankruptcy protection**. "The apparel brand had struggled for years with slumping sales and a hefty **debt load from a leveraged buyout by private-equity firms**. Private equity firms typically buy companies using a small amount of their own funds and lots of borrowed money. If sales and profits don't meet targets, the debt can become too burdensome. **Nine of the ten retailers the defaulted on their debt last year were owned by private-equity firms**.

Neiman Marcus Group Inc. is also completing talks with multiple groups of lenders ahead of a planned bankruptcy filing, and J.C. Penney Co. has been in talks with lenders that could total $1 billion. S&P Global Ratings analyst estimates a 20% default rate for retailers whose debt is rated speculative-grade." (WSJ 5/5/20)

"**Private-equity firms bet that their expertise** and capital would help these companies grow and navigate the rise of online competition from Amazon.com Inc. and others. **Now these businesses, from pet shops to luxury brands that collectively employ more than 1 million people, are fighting to stay afloat** that were often failing even before the pandemic and high debt levels. Twenty-seven out of the 38 retailers with the weakest credit profiles – **more than 70% - were owned by private-equity firms on April 20."** (WSJ 5/11/20)

Public Sector Labor Financial Mismanagement Impairs Public Services

"The condition of state and local government finances affects the health of the broader economy because their spending amounts to almost 11% of gross domestic product, and they **employ about every 1 of 8 American workers, including teachers, police officers and firefighters.** In April alone, **those governments cut nearly one million positions**, two-thirds of which were in public schools and colleges. Governors and mayors have warned of more cuts to come. Across the country, states and cities are being squeezed by a **combination of lost revenue and rising spending on services like unemployment insurance and health care.** Moody's Analytics estimates they will need to make $500 billion in cuts over the next two years. Estimates are that every dollar in cuts costs the overall economy $1.50 to $2. Following the 2007-09 recession, states and localities continued to cut jobs and spending long after the recovery began. They didn't start sustained hiring until August 2013." (WSJ 5/27/20)

The Fed-inspired debt binge becalmed the once-vibrant private sector. **The politically-engineered public labor cartel of confiscatory wage, benefit and retirement compensation euthanized state and local governments.** "Public pension plans lost a median 13.2% in the three months ended March 31, slightly more than in the fourth quarter of 2008. March's stock market plummet led to the biggest one-quarter drop in 40 years of tracking. State and local governments are trying to **figure out how to not cut school aid too deeply, not cut Medicaid too deeply, not raise taxes**.

Pension contributions are pretty far down the list of things they want to pay for. As bad as the first quarter returns were, they do not show the **full extent of the pension losses because reports on the value of private equity real estate, infrastructure and other private assets often arrive one quarter late**. Pension checks come from a combination of money set aside by government employers, money from employee paychecks and investment returns earned on that money. When investment returns fall short, it typically falls to governments to allocate more of their revenues to make up the balance. Even before the record first-quarter losses, **public pension plans were $4.1 trillion short of the $8.9 trillion they will need to cover promised future benefits, according to the Federal Reserve.**

Decades of overly optimistic return assumptions, insufficient pension-fund contributions and lengthening life-spans created **massive shortfalls in public pension funds that the 11-year bull market didn't cure**. Over the past decade, public pensions had **ramped up stock-holdings and other risky investments** in an effort to meet aggressive return targets that average around 7%. For the 20 years ended March 31, public pension plan **returns have fallen short of that target, however**, returning a median 5.2%. Since the last recession, governments around the country have jacked up their yearly pension contributions and slashed benefits for new hires, sometimes shifting the employees to 401(k) type plans that don't promise more than investments can earn. Municipal governments could have difficulty making their annual pension contributions if they face significant drop-offs in revenue collections. States get much of their revenue from **taxes** on sales and income, and **both are falling sharply** amid a deteriorating economy and record unemployment." (WSJ 5/13/20) In the **government-first states, public labor cartel constrictions are causing more than service cuts**. Their **populations, and revenues, are migrating out of the financial decline**, dragging down economic activity, real estate prices (commercial and residential), healthcare, safety and all public infrastructure. The strange group identity emotional victory results in unlivable conditions for everyone, even the most righteous group identity winners.

Debt Losses Surge in Financial Products and Investor Accounts

"**Downgrades of loans owed by heavily indebted corporations have spiked** sharply since February, eclipsing levels seen during the financial crisis, according to S&P. More than 1600 bonds tied to loans owed by risky borrowers have been put on watch for downgrades. Regulators have been sounding the alarms about the market for risky corporate debt, known as leveraged loans. S&P relaxed the ratings criteria it uses to evaluate collateralized loan obligations, or CLOs – a type of bond whose payments are tied to pools of leveraged loans. **CLO issuers are the biggest buyers of leverage loans, making them an important intermediary between private-equity firms looking to finance takeovers and investors** willing to bankroll them. Under the asset-based securitization structure, the lease payments are earmarked for investors such as

pension funds and mutual funds that own bonds backed by the vehicles. Ratings enable bankers to slice the pools of loans, which are typically rated junk, into bonds with various levels of risk. **Investors rarely get a complete picture** of the risks because issuers selectively disclose the best ratings on each bond." (WSJ 5/22/20)

"Losses on these investments could hamper the banks at a time when bad loans are rising. They could also sour investors on CLOs, which bought roughly 60% of the debt that private-equity companies used for deals in recent years. The rising risks in **CLOs threaten to limit the biggest source of funding for private-equity buyouts and a source of funds for struggling companies that are owned by PE firms.** If too many loans held by the funds are downgraded to the lowest levels, the funds may not be able to buy new loans, further tightening the lending markets." (WSJ 5/28/20)

Defaulting Hertz bonds imbed financial products. "Restructuring is expected to trigger at least a partial liquidation of the Hertz rental-car fleet. **Hertz doesn't own the cars**. It essentially leases them from banks and bond funds that bought **asset-backed bonds and loans used to purchase the vehicles**. Moody's Investors Service and Fitch Ratings cut their ratings of Hertz's safest ABS bonds to single-A in recent weeks and are reviewing them for potential future downgrades. An index of wholesale use3d-car prices fell 11.4% in April, more than double the previous monthly record decline in November 2008. **Losses on the bonds could have a ripple effect in the market for automotive ABS debt, which amounted to about $250 billion at the end of 2019.**" (WSJ 5/12/20)

Debt, Financial Products, Illiquidity Preceded Pandemic

The health pandemic suddenly halted all economic activity, without warning or precedent. This caused economic change to fall way below already repressed-down low interest rates. **If this had happened slowly, due perhaps to the buildup of too much debt or financial-product overhang, or debt-saturated consumers and investors, then the economic decline may have been more moderate and over a longer period of time, gradual loss plateau**. That is the way Japan engineered its 1989 market collapse and how the Fed engineered our 2009 residential housing collapse. This pandemic required an unprecedented toolbox of financial machinations to **maintain the economic body pulse long enough to breathe on its own** again.

One of the financial machinations was **raising the dead (lower grade debt, defaulting loans) to zombie status** so we could spread the debt default over a longer period of time. Among other monetary and fiscal stimulus, the faint pulse convinced investors that financial assets were through the worse and that any further shocks will be shocked back to faint-pulse by more stimulus. 25% unemployment, what, me worry? Let them eat cake.

Stocks gave us another relative return victory. They look good against fixed income, as depicted in our expected return research. **Optimistically celebrate the stock relative return advantage but the celebration is liquidity, borrowed liquidity**. Now we need two ingredients for a vibrant, heavy-breathing, heart-pulsing economy. First, **we need economic growth which is not borrowed but accrues from real economic activities**, such as consumption and investment. Second, **we need corporate earnings** at levels adequate to achieve expected returns which attract investors to financial assets, notably equity risk assets. Let's **see that before we price stocks on good feelings about vaccines and borrowed liquidity**. Our research criteria and investment by objective will inform Mast investors when the markets make their best return offer.

Respectfully,

Jim Henderson
Mast Investment Advisors LLC

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- Mast Investment Advisors LLC is Registered Investment Advisor (RIA) in the state of Illinois.
- Mast Investment provides active index money management services for its clients.

- To minimize trading expenses and to preclude conflicts of interest, Mast Investment manages its clients' assets on a discretionary basis at independent discount brokerage firms.
- Mast Investment receives fees only from its investment clients for this service, and receives no compensation or consideration from any other provider of financial services or products.

Investment Thesis:

- Active money managers (portfolio and mutual fund managers), generally under perform passive equity and fixed income indexes, and create much higher costs and expenses.
- The overwhelming portion of investment return is determined by strategic allocation to asset classes, and not by picking individual securities or funds.
- Over extended periods of time, different asset classes, and different components of those asset classes, perform better than others.
- Investors will, generally, be better served by utilizing index investments, and specifically, those index investments which may perform better than others. Index exchange traded funds provide broad diversification and direct replication of specific index performance.

Investment Methodology:

- Using models previously used over a ten year period for individual stock selection, Mast Investment created models to identify and to monitor superior index performance.
- Mast Investment changes asset allocations among asset classes, and within asset classes, based upon risk adjusted fundamental and technical analysis.
- Each client has a specific, neutral asset allocation provided, preferably, by an investment policy statement from a plan provided by a Mast Investment approved independent financial planner.

Investment Team:

- James D. Henderson, with 25 years of investment management experience, Kellogg MBA, Duke BA, is manager of Mast Investment in its Northfield, IL office.
- Research and decision criteria are in consultation with John R. Tilton, CFA and his investment research models.

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