Capital
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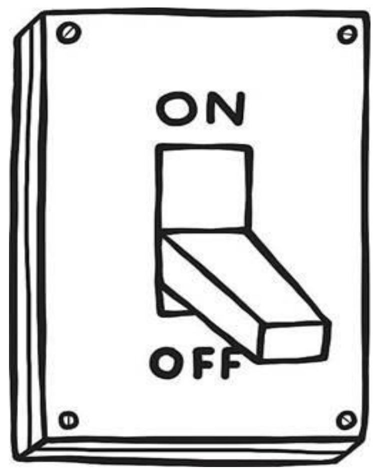
A Big Valley…*But Also Considering What Lies Just Beyond*

Like a light switch flipped from the "on" position, a significant amount of economic activity in the U.S. has been switched off by mandated business closures and social distancing measures adopted to stem the spread of the COVID-19 virus.

The economic implications of the "lights out" actions are not lost on the financial markets or business forecasters.



For example, upcoming U.S. weekly jobless claim reports are anticipated to reflect off-the-chart increases.

Second quarter Gross Domestic Product (GDP) is widely expected to contract at an (annualized) rate that may well exceed levels registered at the depths of the 2008-09 financial panic or during the "Asian Flu" induced contraction of early 1958. (These latter two contractions had been the worst since the Great Depression).

We believe, however, it's important for investors to keep the following in mind. *Stock price movements from this point are less a referendum about whether things are "good" or "bad", and more about whether things are getting better or worse relative to expectations*.

The expectations bar against which economic and business results will now be judged is incredibly low. With fear, uncertainty, and doubt so thick, it's easy to succumb to worst case thinking.

We strongly advise against doing so.

We expect that as the country moves beyond the valley in economic activity immediately ahead—things will prove not only better than the worst-case scenarios, but also better than the widely-held gloomy expectations.

Here's why…

The experience from earlier afflicted nations

China, South Korea and Singapore are beginning to turn the lights back on in their respective economies after virus lock downs.

We'll get there too. No one knows when, but it's likely to be relatively soon.

The race for efficacious drugs, vaccines and tests to combat the virus is "on" in a big way

The power plug has not been pulled on human ingenuity.

COVID-19 tests are rapidly becoming available. (The Cepheid division of our portfolio company *Danaher* received approval for its rapid testing in just the past few days, by the way.) Yes, more testing will likely lead to the discovery of more cases. But it will also yield more—and better—data including *recoveries* from COVID-19.

Technology, like artificial intelligence applied to big data sets via cloud computing, is helping to rapidly winnow the universe of existing drugs down to those most likely to work against Covid-19. Genome sequencing (enabled by our portfolio company *Illumina*) and novel biotech approaches are also in on the hunt.

We believe it remains a mistake to bet against human ingenuity.

Policymakers have a big role to play and are not out of ammo

With interest rates administered by the Federal Reserve (Fed) now at or near zero, some fear our central bank is out of ammo to support for the economy. We absolutely disagree. The Fed can do, and is doing, more.

The Fed was created in 1913 in large part as a response to the financial panic of 1908. Its role was to behave as the lender of last resort for the economy. As part of this role, it needs to ensure the financial plumbing underlying commerce continues to operate.

Its first big test was the 1930s, and it failed miserably allowing the financial system to collapse. 20%+ employment and economic hardship was the rule throughout that decade.

The Fed did not make this mistake in the 2008-09 panic. While many of Fed's actions from this period were loudly criticized, it did prevent a Great Depression rerun.

Last week, panicky behavior was starting to cause "frost" in the financial plumbing. The Fed has stepped in and provided liquidity to melt the frost.

The credit markets are showing promising signs of operational order as Fed liquidity actions take hold. More is likely to come from the Fed in the days ahead…by itself, and in conjunction with fiscal plans being designed by the Treasury, the Administration and Congress.

Measures being discussed will also help alleviate business credit and employment stresses triggered by the government-mandated economic shutdown. Such actions will likely be the "bridge" across the government-induced valley in economic activity.

Yes, the package that appeared to be working its way through Congress is proving to be a messy process. But just as "TARP" failed to get Congressional approval in its initial forms back in the 2008 panic, it's likely a sizable fiscal program will be enacted soon. The negative political consequences of failure to pass such a program are also likely too great for both major political parties.

Beyond the near-term valley, economic recovery will arrive

While January and February economic activity seems irrelevant now, evidence suggests the economy had been in pretty good shape until the switch was turned off on the economy this month. We believe there remains an underlying resiliency to growth in the form of significant innovation that's underway.

One of the key growth trends we've discussed at length over the past few years is the continued emergence of the digital economy and the many innovative productivity tools being provided by many of our portfolio companies. The social distancing mandates may well be accelerating the adoption of these tools.

In trying times new mindsets evolve as new business practices are considered and adopted out of necessity. Whether it's *Microsoft's* productivity tools, like its Team collaboration feature that enables work groups to consult from nearly any location, to *Adobe's* Creative Cloud or *PTC's* Vuforia augmented- reality software, physical proximity is often no longer necessary in growing segments of the economy.

With many of these critical tech infrastructure tools being offered via subscription arrangements run on the cloud, the financial outlay for adopting firms is relatively modest and "asset light". These are not trivial features in normal times, let alone during times when firms are understandably anxious about their balance sheets.

We've selected the stock investments we own in large part because of the durability of the underlying businesses. Many of our companies are net debt free when the cash balances they own are factored into the equation. Those with debt have high recurring revenues and abundant cash flow providing comfortable debt servicing coverage. Bonds we own were selected as a portfolio diversifier to complement our stock selections.

In our opinion, whatever fluctuations are happening in the market these days—especially this week— both up and down, are *not* a reflection of fundamentals. These market swings reflect of day-to-day sentiment, back-and-forth trading between those speculating on a bottoming in value, and those who are just trying to make it to the other side of this economic shutdown. We invest for the long term, based on our best thinking of what fundamentals might look like in the future, regardless of the type of economy we experience.

We really liked what we owned two months ago (we hold the same stocks and bonds in our company retirement plan), and for the most part, we like them even more now that they're cheaper. On the other side of this crisis, the themes that dominate the stock side of our portfolio—asset light (lower property, plant, equipment and labor to run the business), high levels of recurring revenue resulting in high levels of free cash flow, and low levels of debt—in areas we alluded to earlier like cloud computing, 5G, IoT, AI, and electronic payments should continue to grow faster than the overall economy. Others, like *Stryker* and *T.J. Maxx*, should continue to take market share and grow profitably. We are trying to use the volatility to upgrade the portfolio where we can.

Human history has been a constant process of overcoming obstacles, setbacks and adversity. We will get through the current challenge. ***Recovery lies just beyond the valley***…we fully expect investor patience will be rewarded.

Established in 1981, *Capital Investment Services of America, Inc.* is a Milwaukee, WI-based independent investment counsel providing custom-tailored portfolio management to individuals, businesses, and charitable institutions.

If you would like to be added to our mailing list, email us at: info@capinv.com or call us at (800) 345-6462.

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