Capital
INVESTMENT SERVICES
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Investment Stewards since 1981

Perspective

A Quarterly Publication | *March 31, 2020*

In This Issue . . .

- ✓ As investors begin to look past the near-term deep valley in economic activity, they are debating the shape of the recovery.
- ✓ Similar debates about recovery have occurred every recession in the past 40 years.
- ✓ The adaptability of the U.S. economy is likely again being underestimated.
- ✓ The U.S. economy is uniquely able to adapt to challenges.
- ✓ The early months of World War II provide some historical perspective on adaptability.
- ✓ Is there a turning in the tide of COVID-19 at hand?
- ✓ The unique dynamism of the U.S. economy comes via creative-disruption, our collective "divinely discontent" nature and our "voracious appetite for a better way".
- ✓ Innovation hasn't been shut down.
- ✓ Digital trends have been amplified by response to virus.
- ✓ Appendix: Kinsa and new, smart digitally-connected devices.

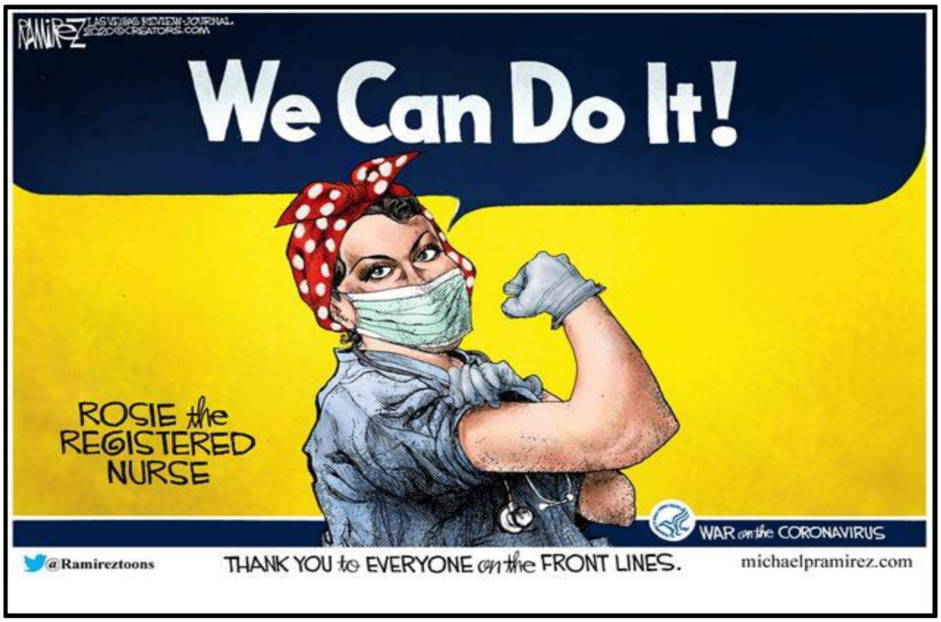
The Alphabet Debate…and Midway

It's a 'V'. No, a 'U', or a 'W'. No, it'll be an 'L'.

The alphabet debates have begun. No, we're not talking about a new format for debates among presidential candidates.

It's the debate among pundits, economists and investment strategists over what path U.S. economic activity will be tracing out in the future.

As we wrote a few weeks back in "*A Big Valley…But Also Considering What Lies Just Beyond*", governments here and abroad have literally switched "off" significant portions of the commerce round the globe via mandated business closures and social distancing measures to stem the spread of Covid-19.



The alphabet debates are about "what lies beyond" the emerging valley.

The bookends of this debate are the "V" (sharp rebound) and the "L" (no rebound, prolonged stagnation). The other debate letters are scenarios between these bookends.

Alphabet debates are nothing new, by the way. They've occurred in the wake of every contraction in economic activity we here at *Capital* have experienced as investors.

For example:

The debates occurred in the late 1970s and early 1980s when the government essentially, also, shut down economic activity. The impetus then was to stem the seemingly intractable problem of inflation.

Credit controls and 20%+ interest rates from Paul Volcker's Federal Reserve ("Fed") strangled economic activity into back-to-back recessions.

Unemployment rose to levels not seen since the Great Depression. Volcker received multiple death threats. Lots of alphabet debates were offered about what would come next.

The recession of 1990, driven by large accumulated excesses in debt (Savings and Loan crisis, junk bonds, commercial real estate, loans to South America, extended consumer finances), launched its own set of alphabet debates.

Ditto for the economic downturn that followed the bursting of the dotcom bubble and the 9/11/01 terrorist tragedy.

Finally, the Financial Panic of 2008 and the ensuing recession triggered very intense debate about whether the economy would ever rebound.

We'd also point out that in the heat of the debates during these previous economic contractions, the "L" (prolonged stagnation) proponents were typically the most articulate of the alphabet debaters. They offered compelling, well-reasoned support for their doom and gloom outlooks. Their forecasts were (and are) scary.

However, the "L" forecasters in those past alphabet debates underestimated the resilience and underlying dynamism of the U.S. economy.

The U.S. economy (and stock market) not only recovered from each of these contractions just mentioned but went on to achieve new "higher highs". The economic downturns were indeed painful, but economic expansions did follow.

We believe today's "L" forecasters are again underestimating U.S. economic dynamism, resiliency and adaptability to change.

Adaptability and Midway

*"It is not the strongest of the species that survives, nor the most intelligent, but rather the one most **adaptable** to change."*

This quote is often attributed to Charles Darwin, but apparently there is fair amount of controversy surrounding this.

Whoever deserves credit, we believe the statement offers important insights for investors.

For example:

Have you seen the movie "Midway"? For those who have not, it's based upon U.S. engagement with Japan early in World War II.

There is a scene where Japanese Navy Admiral Yamamoto, even as his colleagues celebrate their successful Pearl Harbor surprise attack, offers the following prophetic statement, "I fear all we have done is to awaken a sleeping giant and filled him with terrible resolve".

A book from several years ago, *Wealth, War and Wisdom*[1], by the late Barton Biggs documents the resolve, adaptability and resilience that was displayed during that period. And most interesting from an investor perspective, he views events through the lens of financial markets.

Biggs was an investment strategist at Morgan Stanley for most of his long career. He remains a well-respected observer of the investment world, especially by those of us that "came of age" in the investment management profession reading his weekly missives.

He recounts how the U.S. military was very poorly prepared for World War II. When Pearl Harbor was bombed, military training was still largely focused on World War I tactics—horse cavalry and all.

Our military planes were significantly inferior to Japanese Zeros or the Stukas of Germany's Luftwaffe. Our soldiers and pilots were poorly trained in those early days compared to the discipline and training of the Japanese and German military juggernauts.

"A little perspective can be the difference between spiraling into dark despair and clawing your way back to the light….."

-Dan Crenshaw, Navy SEAL blinded in Afghanistan[2]

From the Pearl Harbor attack in early December 1941 until the Battles of the Coral Sea in May and Midway in June 1942, military engagement with the Japanese did not go well—despite public pronouncement to the contrary.

As Biggs writes, "By the spring of 1942, the Philippines had fallen, and 65,000 men had been taken prisoner at Corregidor. Crushing naval losses had been suffered by the Allies in the Singapore Straits, in the Indian Ocean, and at the Battle of the Java Sea. Hong Kong had been taken in days, Malaysia was overwhelmed, and the great fortress of Singapore had been outflanked and ignominiously surrendered."

[1] *Wealth, War and Wisdom* by Barton Biggs, Wiley, 2008
[2] *Fortitude* by Dan Crenshaw, Grand Central Publishing, 2020

The U.S. stock market responded to these events by extending its 1941 decline into the first half of 1942. Fear, uncertainty, and doubt ran rampant for U.S. and British investors.

At the time, stock markets continued to rise in Japan and Germany as the Nazis overran Europe and Japan 'had its way' across the Pacific region.

"America's war effort was faltering, and, as the press repeatedly pointed out, its military management was inept," Biggs recounts.

Yet, behind the scenes, the U.S. was adapting, building resilience. The great resolve Yamamoto feared was unfolding as the U.S. was adapting to the new realities of the world.

The U.S. fighting force was in the process of growing to 12 million soldiers (from about a half million in 1940), approaching 10% of the county's entire population.

The U.S. started the war with seven aircraft carries and one escort carrier. By war's end, the naval fleet included 27 carriers and 72 escort carriers.

Woman helped make this possible as they entered the official workforce in unprecedented fashion to fill the void in workers. The iconic "Rosie the Riveter" poster remains symbolic of the great adaption to change that occurred.

The Japanese attempt to capture Midway in June 1942 was thwarted by U.S. forces.

Biggs continues, "Despite the fact that the official communiques initially did not portray Midway as a victory because the war Department had been severely criticized for proclaiming defeats as victories in the first months of the war…the U.S. stock market perceived almost immediately the significance of the battles of the Coral Sea and Midway…Stock markets understood what nobody else did."

Investors collectively sensed a major tide was turning and began to "look" beyond the valley of despair that remained ahead. ***Even as this valley would be marked by three more years of bloody fighting on multiple fronts***. U.S. stocks ended their slide and rose by nearly 200% from mid-1942 to the war's end in 1945.

What Japanese Admiral Yamamoto understood, as expressed in his fear of U.S. resolve, was the potential the U.S. had if it marshalled it resources. Unless Japan could deliver a knockout blow before the U.S. got its act together, Yamamoto reasoned, Japan was destined to lose the war.

Japan was not able to deliver that knockout punch.

Japan's stock market peaked at the same time the U.S. reversed higher after the Battle of Midway.

To quote Biggs one last time, "Many of the naval officers and aviators involved in the battles of Midway and the Coral Sea had geishas, and when they failed to return, rumors began to circulate." Biggs suggests influential Japanese investors used these unconventional data-points to sell their stocks.

Incidentally, Germany's stock market also peaked around this same time. Like Japan, Hitler suffered his first defeat of the war as his "Operation Barbarossa" invasion of Russian failed. Markets began to "see" the tide also turning against the Nazis.

Though starting from way-behind militarily, and bumbling about, the U.S. adapted mightily to the demands of World War II.

Are investors now signaling a Midway-type turn in the tide of COVID-19?

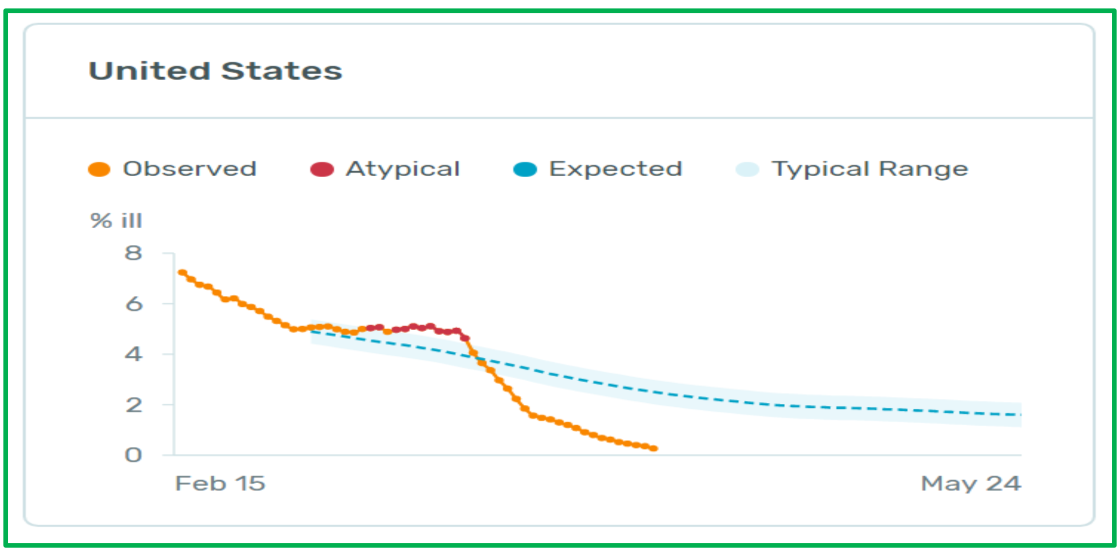
The stock market has bounced significantly since its March lows. This is occurring in the face of truly dismal unemployment readings and widespread forecasts of more economic pain ahead. Significant uncertainty remains about the virus, and how, when, and if shuttered parts of economy will reopen.

Is the market performing what Wall Street calls a 'dead cat bounce', or is it sensing a tide is being turned in the COVID-19 economy?

Social distancing appears to be having the intended impact as the curve of virus contagion appears to be "flattening" in Italy and early hotspots in the U.S. (Seattle and San Francisco).

While it may not be on par with the lonely geishas of Japan indicator cited by Barton Biggs after Midway in 1942, an unconventional source of data-points is being provided in the form of 'real time' fever readings from the Kinsa *smart thermometer grid.* Kinsa readings suggests significantly more flattening is ahead. More information of Kinsa is in the Appendix for those interested. The chart below reflects *lower than normal* fever reading across the country.

Meanwhile, in recent days, **monetary and fiscal policy have adapted in big ways**.



The Fed has unleashed powerful measures to prevent a repeat of a debt-deflation downward spiral like that which engulfed the economy during the Great Depression.

Sinister stresses that had developed in the bond market a few weeks ago have been alleviated by the Fed's actions. This remains a very encouraging development.

Meanwhile, the formerly grid-locked Congress has also responded quickly in a significant way to help build a bridge across the economic valley. Importantly, many (but not likely all) of the initiatives look to be temporary in design and yet still should cushion the blow of the shutdown until portions of the economy can be reopened.

It needs to be emphasized that current monetary and fiscal actions are in direct contrast to policy stance the 1930's Great Depression. Back then the Fed misread evolving conditions, raised interest rates and allowed the financial system to collapse. Fiscal policy included tax hikes and the Smoot Hawley Tariffs that strangled world trade. These and other policy missteps added to the depth and duration of the 1930's economic tragedy.

We believe the odds do, indeed, favor a turn in the tide of current troubles, if not now, then soon.

We're not saying the stock market is about to go on a 200% run as it did in following its turning of the tide in 1942.

Nor are we saying bad news is behind us. Remember, there were three more years of terrible fighting to come when the stock market bottomed in 1942.

But we are saying that 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.

Yes, the U.S. could, and should, have been much better prepared for the current pandemic. But as the Midway history we reviewed noted, the U.S. was not well prepared for World War II either. The country adapted then; it appears to be doing so now.

Dynamism through Adaptability

We are particularly confident in the U.S. economy's ability to adapt from within. After all, adapting to change is nothing new for the consumers and businesses that represent the heartbeat of the economy.

We have often talked in the past about the *creative-disruption* dynamic that underlies economic advancement.

To briefly review; the forces powering a rise in the standard of living over time are innovative new products, services or someone just figuring out a better way of doing things.

"I miss the status quo."

If a new product or service does a superior job pleasing consumers it will garner market share and displace existing or "status quo" products and services.

Businesses that find themselves with a disrupted product or service will have to adapt to the new reality of the marketplace or go out of business.

Some examples may help illustrate the *creative-disruption* dynamic.

Blockbuster Video was disrupted by Netflix. Motorola was disrupted by Nokia in cell phones. Nokia was disrupted by Blackberry smart phones, which were then disrupted by Apple's iPhones.

Former retail titans Sears and JCPenney are circling the drain after being disrupted by Walmart, Target (and others). The current retail titan Walmart is, in turn, being challenged by Amazon. The beat goes on…and on…and on.

Speaking of Amazon, CEO Jeff Bezos offered these insightful comments related to the need to adapt at the company level in a recent Amazon's annual report:

> *"One thing I love about consumers is that they are divinely discontent. Their expectations are never static—they go up. It's human nature. We didn't ascend from our hunter-gatherer days by being satisfied. People have a voracious appetite for a better way, and yesterday's 'wow' quickly becomes today's 'ordinary'. I see that cycle of improvement happening at a faster rate than ever before….you cannot rest on your laurels in this world. Customers won't have it."*

The U.S. economy uniquely has all the ingredients for growth

Here's what is **unique** about the U.S. economy. We believe it's the secret ingredient that provides the resilience to U.S. economic growth:

1. Our *divinely discontent* nature and our *voracious appetite for a better way* that Bezos identifies makes most Americans very supportive of the *creative* part of the creative-disruption dynamic. Most of us like the "new" for it makes our lives better.

2. As a country we generally tolerate the *disruption* part of the creative-disruption equation even though it may cause considerable economic pain for the disrupted.

3. The basis for most U.S. commerce is *mutually beneficial exchange* of goods and services. We readily exchange hard earned pay for goods and services that we perceive will make us better off. And, during our lifetimes, we nearly all *operate on both sides* of the exchange equation. We also are providers of goods and services that others seek and are willing to purchase.

4. As a country we are also generally supportive of human ingenuity and support it via property rights and the rule of law.

5. Our country is also generally supportive of the chief instigators of innovation. Innovators tend to be out-of-the-box thinkers that aren't afraid of "rocking the boat" and often view themselves as "rebels with a cause to change the world". (See nearby Apple ad).

6. We basically still believe in the old adage, "if at first you don't succeed, try, try again." And we're pretty tolerant of failure. This in turn, supports the risk taking that is a key factor within the innovation process. (Sam Walton and Walt Disney are two individuals that come to mind that stumbled early in their careers, but recovered very well we'd say).

"Here's to the crazy ones. The misfits. The rebels. The troublemakers. The round pegs in the square holes. The ones who see things differently. They're not fond of rules. And they have no respect for the status quo. You can quote them, disagree with them, glorify or vilify them. About the only thing you can't do is ignore them. Because they change things. They push the human race forward. And while some may see them as the crazy ones, we see genius. Because the people who are crazy enough to think they can change the world, are the ones who do."

-*Apple Advertisement (1997)*[3]

Because creative-disruption and its requirement that we all must constantly adapt is a regular feature of our economy, it is easy to take it for granted, assume it's no big deal, and underestimate its importance.

That's a major mistake.

We contend that in many other countries, the government and/or citizenry are not tolerant of some, or all, of the six items just outlined. Without any one of these necessary ingredients, economic dynamism is sacrificed.

For example:

Threatened by change, in many countries, the beneficiaries of the status quo often seek protection that can be provided by 'friends in high places'. The 'friends from on-high' can (and do) strangle incipient competitors in red tape and special taxes levied by 'competition committees' to protect the status quo.

[3] *Troublemakers: Silicon Valley's Coming of Age,* Leslie Berlin, Simon & Schuster

Of course, the U.S. is not immune to this either.

But considering how relatively young many of our major corporations are—especially compared to major companies across much of the rest of the world—'the friends in high places' situation is much less prevalent here than in other countries…at least for now.

Some countries want stability and predictability above all else. Creative-disruption and the changes it fosters are almost the antithesis of stability and predictability.

Some governments, fearing potential threats to their power, won't tolerate 'rebels with a cause out to change the world'. They'd prefer to send the rebels to 're-education camps'. (For this reason, it's hard to foresee communist China as a sustained powerhouse of innovation).

And, as we've discussed on previous occasions, many of the countries lacking in economic dynamism are also challenged by unfavorable demographics. It is not easy to grow an economy when its population is declining. Without the dynamism of creative-disruption, growth will prove illusive in these countries.

U.S. demographics, by the way, are much more favorable for growth. But even more importantly, it's the creative-disruption dynamic coupled with our "divinely discontent" nature and "voracious appetite for a better way" that provides the underappreciated resilience to the U.S. economy.

COVID-19 hasn't shut down innovation, it has accelerated its adoption

One of the key trends shaping the economy we've discussed at length over the past few years is investing in the continued emergence of the digital economy and the many innovative productivity tools that are becoming available.

The current trying times appear to be accelerating the speed at which the digital trend is re-shaping the economy. Out of necessity, mindsets are being altered and new digital tools are being embraced.

Consider:

In recent years there have been major progress in genomic research, life sciences and biotech approaches to medical issues.

Much of this is now being aimed at the search for COVID-19 vaccines, tests and drugs.   While it seems like progress is moving agonizingly slow in the current heat of the virus battle, we suspect the speed of therapy discovery will prove amazing in retrospect.

Meanwhile, workers are adapting in significant numbers to work from home (refer to Chart on the following page).

People are connecting to the digital world through new collaboration tools that may well be re-defining the way many people work from here on out.

This is increasing demand for companies providing these tools and the associated tech infrastructure (See the Wall Street Journal headline):

Winner Amid Coronavirus Lockdowns: The Cloud **Cloud-computing emerges as a vital link for companies and governments trying to function amid coronavirus pandemic. Wall Street Journal, March 30, 2020**

Increasingly, businesses are realizing the digital tools are "mission critical". On a recent conference call to update investors in light of the COVID-19 valley in economic activity, portfolio company (cleaning product and services firm) Ecolab announced a reduction in its overall capital spending plans. Yet, it is not cutting its spending on digital initiatives as Ecolab's CEO explains:

“In addition, we are accelerating digital transformation efforts where we know they're going to translate into value-add for customers and reduce long-term cost for us, and this is smart money to spend. It is incorporated in our reduction of capital, but not all capital is created equal, not all spending's created equal, and we want to continue to invest in this area, because we know how important it is to us, one, to position our self even stronger as we come out and to enable us to become even more efficient long term as we progress.” -Doug Baker, Ecolab CEO

Today most *every* company that adapts will likely operate on an infrastructure of innovation-loaded technology. Cloud computing, edge computing, big data analysis, artificial intelligence, augmented reality, 5G, internet of things, digital twins, 3D printing, direct digital manufacturing and software simulation are just a few top-of-mind examples of evolving innovative technologies.

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 were not trivial features in pre-COVID-19 times, let alone during times when firms are understandably anxious about their balance sheet strength.

We suspect many supply chains that presently span the globe will be redesigned in light of recent events. Innovations noted above like 3D printing, direct digital manufacturing and quick turn manufacturing will likely enable the ‘shortening supply chains’ to be closer to end market U.S. consumers.

The tide will turn if it hasn’t already

The alphabet debate about recovery will rage on. On some days it may even appear that the permanent stagnation “L” forecasters are going to be right.

We don’t think that will be the case. The unique heartbeat underlying the U.S. economy—creative-disruption, the power of human ingenuity, our *divinely discontent* nature and our *voracious appetite for a better way* strongly favor the emergence of a new economic expansion ahead.

Yes, the shape of the economy will likely be changed by COVID-19. Some industries and companies may never recover. Many other industries will be significantly changed.

But, new industries, new products and new services will be birthed, new processes built, new mindset will develop. It's the way setbacks are overcome.

Investors will be well rewarded for their patience.

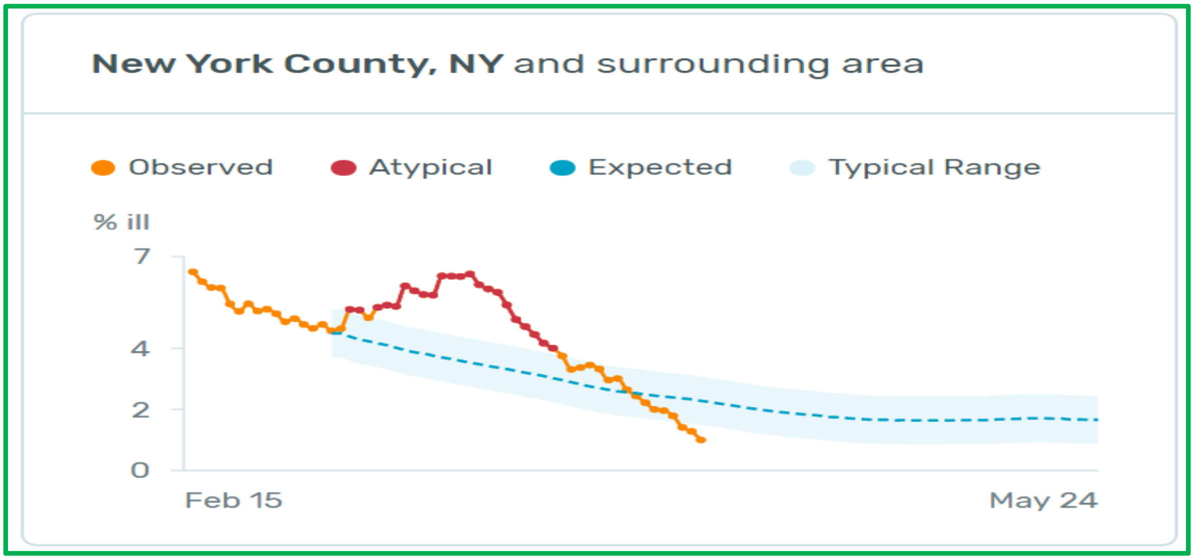
Appendix: Kinsa

Novel, smart, digitally-connected devices like Kinsa's 'smart thermometer grid' are providing real time insight about both potential COVID-19 hotspots and progress towards "flattening" of the contagion curve.

From the recent (March 30, 2020) New York Times article,"Restrictions Are Slowing Coronavirus Infections, New Data Suggest," by Donald G. McNeil Jr.:

Kinsa's thermometers upload the user's temperature readings to a centralized database; the data enable the company to track fevers across the United States.

Kinsa has more than one million thermometers in circulation and has been getting up to 162,000 daily temperature readings since COVID-19 began spreading in the country.



Owners of these thermometers can type other symptoms into a cellphone app after taking their temperature. The app offers basic advice on whether they should seek medical attention.

To identify clusters of coronavirus infections, Kinsa recently adapted its software to detect spikes of "atypical fever" that do not correlate with historical flu patterns and are likely attributable to the coronavirus.

The Kinsa daily chart of fevers has been suggesting that social distancing is yielding progress. (https://healthweather.us/)

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