April 23, 2020

The first quarter of 2020 was challenging. The S&P 500's total return was -19.6% while Banyan's equity composite returned -23.0%. In a single quarter, we gave back most, but not all, of our 2019 gains. Although disappointing, it is not unjustified. The world changed drastically, and markets swiftly discounted the change.

To recap, the U.S. entered 2020 on sound economic footing with low unemployment, respectable GDP growth, and benign inflation. Unbeknownst to the world, meanwhile, a novel coronavirus, or "COVID-19," is believed to have leapt from one mammalian species, bats, to another, humans, near Wuhan, China. As viruses do, COVID-19 then began to spread throughout the population.

To slow the spread, Chinese authorities quarantined 60 million people, but it was not contained. The virus infected societies across the globe. Quarantines and shutdowns followed as nations mimicked China's response. The virus's spread slowed, but the global economy's fate was sealed.

Now, the world is in the midst of a sharp recession. Cash flow is the lifeblood of economic animals. Starve them of their lifeblood, as shutdowns do, and they grow more malnourished by the day. To conserve resources, they slash costs, including labor. This buys time, but financial leverage adds an important wrinkle. A hungry balance sheet *must* be fed on a fixed schedule. Otherwise, creditors feast on the financial remains in a restructuring or liquidation. Owners get the leftovers, if any.

This is problematic in a leveraged world. Hence the unprecedented intervention by monetary and fiscal authorities. In record time, the Federal Reserve is primed to create and pump over $4 trillion into the financial system, and the Federal Government passed over $2 trillion of spending bills. While extraordinary, more intervention is sure to come.

The fairness of these measures will be debated in the years ahead, but they bought the economy invaluable time. Widespread defaults would have otherwise crippled large swaths of society. A full recovery ultimately hinges on a full normalization of behavior, which requires a lifting of restrictions *and* an abatement of fear. That will take time, which our economy now has.

Business conditions will be poor in the interim, but Americans are a resilient bunch. Our free enterprise system energized by an unbreakable can-do spirit birthed the greatest wealth creator in history – American industry. COVID-19 won't change that. Some firms will fail in the months ahead, but most won't. The survivors will adapt to a less hospitable environment and thrive when conditions improve. Stock prices may wilt, but America's future remains bright.

With that in mind, we selectively bought stock, but, in times of stress, what you *don't* buy matters most. With some exceptions (e.g., banks), we were fortunate our holdings did not occupy the economy's hardest hit niches. This remains true. Some niches are virtually inhospitable at present. Firms occupying those niches rely on reserves, but, once depleted, their survival depends on the helping hand of others, including a fickle Uncle Sam. That's a precarious position we aim to avoid.

Our buying was reserved to areas where survival is all but assured. American Express, for example, will be thrown off course by the gales of weak consumer spending and higher defaults, but a strong balance sheet and variable cost structure will keep the ship afloat until the storm passes. We felt the price was more than fair for those willing to stomach choppy seas.

We recognize a firm's health depends on the health of its environment. As noted above, the current environment is not welcoming, but Americans are resilient. We'll beat this virus, life will resume, and conditions will improve. Until then, the firms you own will not achieve their potential, but they will survive to capitalize on the rebound ahead. Our portfolio is built to weather storms such as this, and that is key to ***building permanent wealth***.

Sincerely,

Drew Estes
Partner & Portfolio Manager

Alek Nabulsi
Partner