Stark Financial Advisers, Inc.

A Registered Investment Adviser

3rd Quarter 2020 Commentary

July 1, 2020 **Volume 1 Issue 3**

Special points of interest:

- Global Recovery Remains Weak
- What Seems Illogical Really is Not
- Crude Recovers from Negative Prices
- Interest Rate Risk Remains Low
- No Such Thing as Both High Return and Safety
- "Heads I Win, Tails I Tie"

Inside this issue:

The Nearly Nihilistic Market Rally

The world is in unparalleled turmoil—except for financial markets, which seem blithely unaware. The S&P 500 from its March 23 low has risen approximately 40%. **What seems illogical really is not**. Markets care most about the fact that government rescue measures seem to be working. The U.S. is being rocked by protests of a scale not seen for half a century and Washington and Beijing are facing off over Hong Kong, all amid a raging pandemic. But even the riskiest corners of markets are ticking away from distressed levels. Analysts note that a year's earnings doesn't matter much to a company's valuation under a discounted cash flow model, as long as earnings bounce back next year—or even the year after—a likely lower-for-longer interest rate is enough to justify gravity-defying stock markets. So it matters a great deal, to the exclusion of almost everything else, that the rebound is, indeed relatively quick. If the first stage of the rebound was about the realization that central banks would take extraordinary measures to prevent market distress and widespread defaults, the second hinges on the ability of policy makers to engineer a rapid rebound within a year or so, largely with fiscal policy. Data released late May offered ballast for optimists: Despite a wholesale collapse in production, personal incomes rose by 10.5% between March and April, as stimulus checks hit mailboxes. The fiscal backdrop has been generally encouraging elsewhere too: the European Union's pooling of financial resources for a €750 billion ($840 billion) recovery plan outstripped expectations. Japan also announced a 117 trillion yen ($1.077 trillion) recovery plan, of which more than a quarter will be direct spending. But, developments bear watching. How much the next round of spending will pare back generous jobless benefits, which end this month, and how spending will be used to encourage a return to something more closely resembling normalcy, has yet to be seen. What happens with stimulus policies and incomes is not the only thing that matters, of course. But, if the spread of the coronavirus is seen as under control in advanced economies, and a vaccine is expected to arrive eventually, it will be quite close to the only thing that matters for markets.

Should You Join FOMO?

Fear of missing out on the rally has been driving emerging market stocks higher along with domestic securities. The question is whether to join the "FOMO" crowd? We think not. A weaker than expected global recovery, and rising tensions between the U.S. and China, pose big risks to the emerging markets after the current melt up passes. Even as forward earnings per share expectations deteriorate, emerging market securities have rallied to decade high valuations measured against their forward price/earnings ratio. Rallies without supporting fundamentals can last for a while but, typically, end with a crash. Global trade and industrial sectors need to recover for a sustainable rally in emerging markets. That is not yet happening. We remain under weight in the sector and prefer not to join in the FOMO mania.

Black Gold or Coal?

Oil has made a huge comeback in the wake of the historic dip for U.S. benchmark prices into negative price territory in March. OPEC production cuts and production cuts in the U.S. have been the primary drivers. OPEC's agreement to curb production expires at the end of July, unless extended. For prices to continue to rise global demand needs to improve. Despite recent price increases to $39 $/bbl (West Texas Intermediate), prices are still significantly lower than the $46 bbl. level in early March, before Saudi Arabia and Russia called off their deal to cut output. Even now, with the rise in prices, the majority of companies in the industry aren't making money. Even Russia and Saudi Arabia need oil to be higher than $55 a barrel to balance their budgets. Recent low prices aren't sustainable for long and, in our opinion, posed a very attractive buying opportunity in late March. Despite the rise in prices, the risk remains that a second wave of COVID-19 could cause a second dip in oil demand, just as demand is returning. In absence of a second round of the virus, the OPEC+ decision to extend production cuts may cause supplies to tighten too much before year end, and for the global oil market to fall into a severe deficit by the fourth quarter, driving prices to yearly highs. Eventually, U.S. shale production, much of which has been shut-in, will recover and relative balance to the market will return. Crude prices should ultimately trade in a range of between $50 to $60 $/bbl. We have exposure to the energy sector through individual stocks, mutual funds and exchange traded funds. One of the largest holdings is the Energy Select Sector Spider ETF (XLE). The fund has approximately 26 holdings, 91% of which produce consumable fuels with the balance of the companies engaging in the manufacture of equipment and providing energy related services. The fund pays a generous current dividend and offers potential capital appreciation. For now, the oil sector has been Black Gold.

Will Interest Rates Go Negative?

Federal Reserve Bank Chairman, Jerome Powell recently said he does not see below-zero policy rates as "an appropriate tool." St. Louis Fed economist, Yi Wen disagrees. In his view, getting the U.S. economy back to strong growth could require negative interest rates. In fact, he sees it necessary and possible if we are to achieve a "V" shaped economic recovery. Wen compared the response to two major U.S. economic downturns: The Great Depression and the financial crisis. He found that the use of aggressive fiscal response, through President Franklin Delano Roosevelt's New Deal, helped generate a V-shaped recovery after the Depression, while primarily monetary responses, like low interest rates and Fed asset purchases during the financial crisis, produced an L-shaped recovery (in which GDP failed to reach potential). Wen argues that to achieve a quick recovery, that the U.S. will need to consider negative interest rates and aggressive government spending, such as spending on infrastructure. Without aggressive policies, he expects the economic consequences of the coronavirus pandemic to be permanent. Fed Chairman Jerome Powell has been emphasizing the possibility that more fiscal measures will be needed. Congress has passed the $2.2 trillion CARES Act, but Fed officials said higher public spending could be needed as the economic crisis lingers. But, Powell also had expressed strong doubts about whether negative interest rates would ever be used in the U.S., as they have in Europe and Japan. Indeed, Wen's paper is merely one observation on the issue and is in no way binding on the Fed as a whole. Short-term Treasury yields occasionally have dipped into negative territory, and traders in the fed funds futures market are indicating that the Fed's benchmark could dip slightly below zero starting in May, 2021. The takeaway from both points of view is that interest rates are going to remain at a bargain-basement level for the foreseeable future. **Despite the historically cheap interest rates, interest rate risk remains below average.** Also, we can look for aggressive monetary and fiscal policies to continue beyond the current crisis for a robust recovery to continue.

An Investment to Avoid

This year's volatility gave rise to headlines such as this: 'Bankrupt in Just Two Weeks'—Individual Investors Get Burned by Collapse of Complex Securities. Too many individuals managing their own accounts without professional assistance, who were seeking high returns, poured their savings into leveraged, exchange-traded notes; the coronavirus downturn made some of them nearly worthless. The pandemic-fueled economic downturn has sparked turmoil in nearly every financial market. It has taken a particularly brutal toll on investors who bet on risky structured products: complex instruments that include ETNs, options-based strategies and certificates of deposits whose returns are tied to stocks or currencies. Most professional money managers avoided them. For many less sophisticated retail buyers, the market blowup taught the kind of painful lesson that comes with just about every economic crisis: **There is no such thing as an investment that is both safe and highly profitable.** Leveraged exchange-traded notes are complex financial instruments that use debt to amplify returns, which also increases risk. With a leveraged ETN, the issuer purchases derivatives, often options, with borrowed money to increase the ETN's returns. An ETN with three-times leverage would triple any gains, but also triple losses. If an ETN falls below a certain price, the issuer has the option to redeem the note, often paying investors just a fraction of what they originally paid. This year, at least 15 ETNs managed by UBS alone have been taken off the market after tumbling in value. ETNs run by Citigroup and other firms have suffered significant losses. When troubled funds are taken off the market, investors typically are paid just a fraction of what they initially put in. On the surface, ETNs do not look much different than ordinary mutual or exchange-traded funds that track a group of companies. Both products allow investors to bet on the performance of anything from the U.S. stock market to the Swiss franc to wheat. But, unlike ETFs which own the assets they track, ETNs do not. They are debt instruments. For most investors, leveraged ETNs are not a good investment; it is like shooting craps.

An Investment to Consider

The convertible securities market has become an important source of capital in the past two months for companies seeking to get through the current economic crisis. Convertibles are hybrid securities, with the most common type being bonds with equity kickers. Investors get a fixed interest rate, which usually mature, in five to seven years. The bonds can be exchanged for shares if the issuer's stock rallies by a certain amount—usually about 30%. Historically, converts have generated equity-like returns with lower risk. They offer less appreciation potential than stocks, but gains, nonetheless can be significant. In addition, at a time when corporate dividends are being cut or suspended across the board, convertibles offer a relatively safe yield. Issuers face default if they do not pay the interest their bonds. You can invest in convertibles through a range of open- and closed-end mutual funds, exchange-traded funds and individual securities. The largest ETF is the $4.5 billion SPDR Bloomberg Barclays Convertible Securities (CWB) which yields about 3% and sports a 3-year return of 8.9% through May. Franklin Convertible Securities/FISCX is one of several mutual funds offering exposure to the sector. The fund has a current yield of about 1.9% and a 3-year return of 13.7%. If you prefer individual securities, here are some of the companies that have recently issued convertible securities: Southwest Airlines, Carnival, Pioneer Natural Resources, Lyft, and Zillow. Interest rates vary from issuer to issuer and are generally, a reflection of the credit risk and volatility of the underlying stock. In total, over $50 billion in new convertibles are expected to be issued this year. Of course, there are risks, including interest rate risk, credit risk, market risk, and liquidity. In the end, one of the nice things about convertibles is that, if companies do not default, at least investors get their money back. **"It's heads I win, tails I tie."**

Stark Financial Advisers, Inc.

730 S Federal Highway
Lake Worth Beach, FL
33460

16950 U.S. Highway 441 N
Okeechobee, FL 34972

561-243-3815
863-697-8024

gstark@starkadvisers.com

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WE ARE ON THE WEB

STARKADVISERS.COM

Gary L. Stark

President

Ellen R. P. Adler

Vice President

Stacey Stark

Account Manager

Bryan R. Stark

Account Manager

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We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information and a complete performance history, please visit www.starkadvisers.com.

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Facts of the Dow Jones Industrial Average

The Dow Jones Industrial Average was created by Dow Jones & Company (Charles Dow) in 1896 and is the second oldest market index. The companies within the Average are selected to represent each sector of the market, thus, the overall performance of the market in the United States. There are thirty companies within the DJIA. Originally, there were twelve, American Cotton Oil, American Sugar, American Tobacco, Chicago Gas, Distilling & Cattle Feeding, General Electric, Laclede Gas, National Lead, North American, Tennessee Coal and Iron, U.S. Leather, and U.S. Rubber. The list is constantly being revised. The newest addition to the DJIA is Walgreens Boots Alliance. The oldest component, added in 1939, is United Technologies. The Average broke 1,000 for the first time in 1971, 5,000 on November 21, 1995, 10,000 on March 19th, 1999 and 20,000 on January 24, 2017. It is currently trading around 28,000. In point terms, March 24, 2020 produced the largest one-day gain of 2,112.98 points for the Average. The largest loss, 1997.1, occurred on March 16, 2016. In percentage terms, the largest gain of 15.34% (62.10 points) was recorded on 3-15-1933. The largest loss, -22.61% (-508 points), on October 19, 1987.

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As always, the professional staff at Stark Financial Advisers thanks you for your confidence and business