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The Path to Recovery

MAY 2020 COMMENTARY

> Just as there was a focus on "proxy" countries and U.S. states as the pandemic raged, now analysts and scientists are monitoring the steps taken to open economies in the U.S., Europe and China. The return of cases, without effective and available therapies, is a major threat to plans to move at a faster pace in restoring economic activity.

Highlights

- The path of the market followed massive and unprecedented measures by the Federal Reserve.
- Results from testing and therapeutic treatment and vaccine trials will be essential to investors.
- The market remains headline-driven as to news on the virus.

The before-and-after world we're in offered a semblance of normalcy as the S&P 500 rallied more than 30% since the pandemonium of indiscriminate selling that highlighted most of March. This stands in stark contrast to the general deterioration of the overall economy; the growing number of unemployed; the stalling of the housing market; the collapse of consumer optimism; and, in actions reminiscent of the 2008-2009 financial crisis, the closing of accounts and lowering of credit limits by credit card companies. The first quarter (Q1) earnings season similarly has the tinge of the before and after, as earnings decelerate and guidance is increasingly suspended, and as uncertainty permeates the outlook. Estimates for where the S&P finishes the year span a broad range, as analysts grapple with the duration and depth of the recession, and the type of recovery that follows.

The path of the market followed the massive and unprecedented measures implemented by the Federal Reserve, whose balance sheet has grown from approximately $4.29 trillion at the beginning of March to $6.7 trillion at the end of April. The Fed's actions have stabilized both equity and credit markets. The $2.2 trillion Coronavirus Relief Bill passed by Congress, followed by another $484 billion package, have complemented the Fed's efforts to help cushion the downturn until the economy fully emerges from the restrictions imposed by state and local governments.

At the April 29 meeting of the Federal Open Market Committee (FOMC), the Fed reiterated its commitment to doing what is necessary to "mitigate the damage to the economy." And Chairman of the Federal Reserve Jerome Powell pledged that the FOMC will act "forcefully, proactively and aggressively as needed." However, he warned that a recovery will be limited by a cautious consumer.

As investors concluded that funding would be made available, despite partisan wrangling, attention focused on the number of new COVID-19 cases announced each day, both in the U.S. and globally. Italy, in particular, became an important proxy for market headlines because it had shut down its economy and restricted activity. As a result, markets reacted favorably if the number of cases there declined. Soon, New York State became the world's No. 1 hot spot for new cases, and daily reports were monitored with increasing intensity.

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As cases began to recede in the Northeast and other areas of the country, investors waited for reports on the lifting of restrictions, as well as any headlines regarding potential therapies, testing and vaccines.

In mid-April, President Trump mapped out a phased plan to open the economy that called for "one careful step at a time," while acknowledging that "Some states will be able to open up sooner than others."

THE TUG OF WAR – ECONOMIC RECOVERY VS. A SECOND WAVE

With spring in full bloom, some Americans have flocked to beaches, taken to the roads on their motorbikes, or demonstrated that they want quarantine regulations lifted. The majority of Americans, however, according to numerous polls including a recent one from CBS, want to "try to slow the spread of coronavirus by keeping people home and social distancing, even if the economy is hurt in the short term." A fear of a "second wave" has already had many companies cancel large meetings in the fall, while planning to maintain remote working throughout the summer. Colleges and universities are deciding whether to bring students back for the fall semester. And sports events and concerts continue to be postponed.

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Just as there was a focus on "proxy" countries and U.S. states as the pandemic raged, now analysts and scientists are monitoring the steps taken to open economies in the U.S., Europe and China. The return of cases, without effective and available therapies, is a major threat to plans to move at a faster pace in restoring economic activity. In Germany, small stores began to open at the end of April, and students returned to school, albeit wearing masks and following safe distance rules. Angela Merkel, chancellor of Germany, warned of a virus second wave if restrictions were lifted too quickly. Following a monthlong shutdown, Norway opened its preschools, as did Denmark, after a period of restrictions. Still, many parents have expressed concern, as they remain worried about their children's health. In Norway, a Facebook group entitled "My child should not be a guinea pig for COVID-19" has already attracted more than 30,000 members. France is scheduled to begin opening schools where there haven't been cases of the virus, but plans for large gatherings are still not approved. In Italy, steps have been taken to open small stores and the full lockdown is scheduled to be lifted on May 4. U.K. Prime Minister Boris Johnson, who was hospitalized and spent three days in intensive care after contracting the virus, resumed his duties at the end of April and is under pressure to lift restrictions. He has replied that the public debate could begin "in the next few days," but added that "we are still some way off getting any easing of the lockdown." Regardless, in the U.K. and around the world, people are venturing out and protesting restrictions, without regard for social distancing.

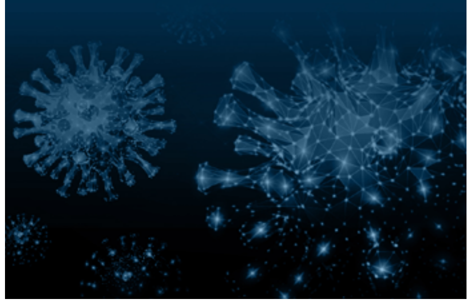
As China tries to revive its economy, following its closure from late January to the end of February, global demand for its manufactured products remains depressed and domestic consumer spending weak, while job losses have led to record unemployment. Although first-quarter growth declined by 6.8% compared to last year's first quarter, the International Monetary Fund (IMF) projects that the Chinese economy will expand 1.2% this year and grow 9.2% in 2021. This is in contrast to the IMF's forecast for global economic growth to contract by 3% this year. A government official from China's Bureau of Statistics said that the coronavirus "has caused China economic losses and activity has been suppressed, but it may be unleashed next year." Stimulus measures continue to be introduced, including lowering interest rates, extending unemployment benefits and creating jobs with infrastructure projects. At the same time, attempts to respond effectively to a second wave have been implemented, such as issuing strict restrictions on international travel, and closing gyms in Beijing and other cities. A COVID-19 task force in Beijing issued a statement that the "risks for sporadic infections and localized outbreaks have not gone away."

In the U.S., the reopening of the economy is beginning, with Georgia allowing small businesses and larger venues, such as movie theaters, to open. Restaurants as well will be allowed to offer dine-in service. Mayors in Georgia's larger cities, however, are calling for restraint, and business owners, while anxious to resume operations, are also expressing concern about virus exposure. Atlanta-based Coca-Cola said most of its office workers would continue working remotely until further notice. President Trump said at a news conference, following the announcement by Georgia Governor Brian Kemp, that he told the governor "that I disagree strongly with his decision to open certain facilities which are in violation of the phase one guidelines for the incredible people of Georgia." There's no doubt that Georgia will serve as a key gauge for how quickly you can open up an economy.

South Carolina, Tennessee and other states are also scheduled to begin opening their economies. Volkswagen's plant in Chattanooga is opening and 3,800 workers have been recalled for early May. In mid-April, Boeing reopened its plant in Washington, with 27,000 employees returning to work. In New York, the governor announced plans to allow "low-risk" businesses in the northern part of the state to open in mid-May, with the focus initially on manufacturing and construction. Before endorsing a return to work, the United Automobile Workers union continues to confer with Ford Motor, General Motors and Fiat Chrysler regarding safety concerns and the introduction of safety measures and procedures. And more states across the country have similarly begun phasing in the easing of restrictions.

Joshua Bolten, chief executive and president of the Business Roundtable (an organization comprised of CEOs of the largest corporations in the U.S.), said, "As keen as companies are to reopen, they are quick to say that if their employees don't feel safe, they are not going to come back in to work. And if customers don't feel safe, they're not going to come back into stores."

Collectively, scientists worry that without proper testing or effective and available therapies, COVID-19 could easily return with a forceful second wave that would require another round of lockdowns.



THE SCIENTISTS SPEAK

Collectively, scientists worry that without proper testing or effective and available therapies, COVID-19 could easily return with a forceful second wave that would require another round of lockdowns. Dr. Anthony Fauci, who has served as director of the National Institute of Allergy and Infectious Diseases for more than 30 years, has expressed his concerns at the president's daily press conferences, in addition to separate interviews with media outlets. He's been adamant that "We will have coronavirus in the fall. I am convinced of that. Whether or not it's going to be big or small is going to depend on our response. It's not going to be what we've gone through, in any way, shape or form."

Dr. Deborah Birx, the White House coronavirus task force coordinator, has said that the "U.S. needs a breakthrough" on coronavirus testing to screen Americans, and needs to develop a more accurate map of the spread of the virus. As states began lifting restrictions, Birx reiterated on *Meet the Press* her concern that although coronavirus trends offer her "great hope," social distancing needs to be maintained throughout the summer "to really ensure that we protect one another" as we move through the phases of opening the economy. As to whether governors are moving too quickly, Dr. Birx said, "I've had really very good conversations with a series of governors. And they've really been very insightful of how they're looking at this. They understand the risk. And they talk about this not as turning on a light switch, but slowly turning up the dimmer. Very slowly."

The former Commissioner of the Food and Drug Administration (FDA) Dr. Scott Gottlieb has been another noticeable presence in the media as COVID-19 events have unfolded. Asked on *Face the Nation* what he thought about the swift opening of Georgia, he said, "It does up the risk of infection. They're only testing about 1% of the population. They have 23,000 cases. They may have plateaued in their epidemic, maybe, but they're still accruing a lot of new cases and they certainly aren't coming down in terms of the number of cases each day." Echoing the president's comments, Gottlieb said, "Georgia's certainly jumping the gun."

In an interview with *The Washington Post*, Robert Redfield, director of the Centers for Disease Control and Prevention (CDC), said, "There's a possibility that the assault of the virus on our nation next winter will actually be even more difficult than the one we just went through. We're going to have the flu epidemic and the coronavirus epidemic at the same time."

Dr. Ravina Kullar, an infectious disease expert with the Infectious Disease Society of America, said, "We really need to have wide-scale testing available, and contact tracing to find everyone who has been exposed. We don't have a system like that in the U.S. at present." She is concerned that "COVID-19's sweet spot could be October to May."

The Bill and Melinda Gates Foundation has donated approximately $250 million to support work toward development of a vaccine. During an interview with CNN, Bill Gates noted that there are more than 100 efforts underway to develop a vaccine. According to Gates, when a vaccine that has been tested and found to be effective is available, "that is when we go back to true normal."

THE MARKET'S RESPONSE

During May and June, there will be a series of announcements on progress in the development of therapeutic treatments and vaccines based on COVID-19 trials. The results from testing and these trials will be as essential for investors as is continued Federal Reserve and congressional support. The promise of effective and available therapeutic treatments will help underpin the market's ability to broaden and enjoy "risk on" performance, serving as confirmation that Americans—as both consumers and employees—feel comfortable about the country's attempt to open the economy. The market remains headline-driven as to news on the virus: its direction, new cases, therapies, vaccines and the push to get the economy back on board.

We need to keep in mind, however, that a market that has climbed so forcefully will need to consolidate, as overbought conditions demand new catalysts. Similarly, any event that causes tremors in the credit markets or damage in the ETF markets could jeopardize April's "risk on" dramatic performance.

The proverbial "sell in May and go away" approach may not work this year. Scientists from around the world are working assiduously to keep the virus at bay, and their results will certainly move markets in one direction or another. The continued move to bring America back to work is also a key market catalyst and that won't stop in May or June. And markets will be ever vigilant to events here and abroad to capture every move of economies recovering. The path to recovery has begun. Regardless of how bumpy, difficult and slow it may be, it has definitely begun.

References include the following: *Barron's*, BBC, Bloomberg, CBS, CNBC, CNN, Cornerstone Macro, Evercore ISI, *The Financial Times*, *The Guardian*, MarketWatch, NBC, *The New York Times*, Oxford Economics, Renaissance Macro, *The Wall Street Journal*, *The Washington Post*.

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Whatever It Takes

APRIL 2020 COMMENTARY

There is a long-held belief that markets can deal with bad news but not with uncertainty. As we begin to get a clearer picture of just how much the economy and ultimately corporate earnings will suffer, we'll see how much has already been discounted by the market.

Highlights

- The Fed is all in on keeping the economy solvent and markets functioning
- The fiscal relief package will help cushion the economy during the shutdown
- Markets remain vulnerable to headlines

Coming into the second quarter, the economic data releases are beginning to show how quickly and forcefully we have transitioned from "a good place" in terms of the economy and monetary policy, as characterized by Chairman of the Federal Reserve Jerome Powell, into the surreal world of a global economic shutdown. This is a world now characterized by daily counts of novel coronavirus COVID-19 cases and deaths, both here in the United States and around the world. This is a world in which the data are sliding quickly, erasing the remnants of what was a strong housing market, manufacturing that was finally beginning to expand, the lowest levels of unemployment in decades, and consumer optimism that suggested a healthy backdrop for the second quarter.

This is a world with huge daily swings in the stock market, which had—despite debates regarding valuation—recently reflected optimism, reaching new highs even as the virus began its migration out of China.

The closing down of the economy, as governments on the federal and state levels attempt to contain the spread of COVID-19, has led to broad and intense discussion of whether the measures are too draconian, and whether restrictions should be lifted sooner rather than later for the sake of the health of the overall economy. The issue of individual rights has also become an integral part of the national discussion as state after state invokes containment policies. To be sure, as the data unfold, particularly with unemployment rising to levels we haven't seen since the 2008-2009 financial crisis, the debate will intensify.

NAVIGATING THRU UNCERTAINTY

There is a long-held belief that markets can deal with bad news but not with uncertainty. As we begin to get a clearer picture of just how much the economy and ultimately corporate earnings will suffer, we'll see how much has already been discounted by the market. The $2 trillion fiscal package delivered by Congress, complemented by a Federal Reserve that has been hyper-vigilant in alleviating stresses in markets, may not be enough to cushion the immediate needs of the economy, but it seems clear that both fiscal and monetary infusions will continue until we emerge from the uncertainty.

The surge in weekly initial unemployment claims for the week ending March 21, from a consensus estimate of 1.5 million to a record 3.283 million, suggests that there will be a call for an increase in government support if the trend continues at this pace; however, this will

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also see more calls to get "America back to work" quickly. It is not surprising that Powell, in an interview before the claims were made public, said that "The Federal Reserve is working hard to support you now, and our policies will be very important when the recovery does come, to make that recovery as strong as possible." He added that the Fed is involved in helping provide credit to small and large businesses. With regard to the question of when to resume economic activity, Powell said the "sooner we get the spread of the virus under control, people will regain confidence. When … that is the case, then they will very willingly open their businesses up, go back to work, [and] the consumer will be spending. So I think the first order of business will be to get the spread of the virus under control, then resume economic activity." Moreover, he made it clear that the Fed is "not out of ammunition" in terms of credit.

At the top of the pyramid of uncertainty, however, is COVID-19, and until we contain the spread we will be at its mercy, a humbling experience, but one that we will conquer. For analysts, key will be following reports from Italy and watching for the decline of new cases. The spread of the virus throughout Italy was quick, with cases and deaths offering a chilling prelude to what the U.S. would soon experience. The sooner they win the battle and economic life normalizes, the more we can project how long it will take for the "hot spots" here to cool off.

For now, the Fed is all in and will do whatever it takes to keep the economy solvent and markets functioning.

WHATEVER IT TAKES – MONETARY AND FISCAL RELIEF

On July 26, 2012, Mario Draghi, president of the European Central Bank, gave a speech amid a backdrop of concerns that the future of the euro, and the eurozone in general, was being jeopardized by mounting anxiety over Greek, Italian and Spanish debt problems. Germany's rating outlook was lowered as it was feared that the country could not remain immune to the possibility of Greece leaving the eurozone. Global markets were under growing pressure when Draghi said, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." And markets believed him, and the phrase "whatever it takes" has since become an indelible part of the financial lexicon.

The Fed's half a percentage point emergency interest rate cut on March 3, the first such emergency interest rate move since the end of December 2008, was questioned by analysts and market participants as being a move prompted by fear and panic and poorly thought out. President Trump just after midnight on March 3, following a rate cut by the Reserve Bank of Australia, tweeted that Powell "called it wrong from day one." Initially, the market moved higher on the Fed's move, but the market rally faded. Still, the move made the cost of capital more attractive and even at the margin made it clear that the Fed was focused on "evolving risks" posed by the spread of the virus, and that the Fed would "act as appropriate."

In a press release, the Fed pledged to use "its full range of tools to support households, businesses and the U.S. economy overall." Following a series of measures introduced by the Fed designed to pump liquidity into pockets of the market that had frozen up, particularly the Treasury market, a March 23 *New York Times* article, "Whatever It Takes: How the Fed Aims to Rescue the Economy," outlined how the Fed is helping to ensure that financial markets run smoothly.

From making certain that the repo (overnight lending) market is functioning properly to buying Treasuries and mortgage-backed securities (retail and commercial), commercial paper and municipal bonds, Powell's Fed has moved quickly, aggressively and decisively. The Term Asset-Backed Securities Lending Facility (TALF), which was created in 2008, was restarted in order to help consumers and small businesses in particular. The Fed, as well, can give four-year bridge loans to investment-grade companies that need financing, provided that the funds are not used for share buybacks. And moving into uncharted areas, the Fed can now purchase high quality corporate credit, which can include Exchange Traded Funds (ETFs) that track the corporate bond market. The Fed's initial announcement of a $700 billion quantitative easing (QE) package was quickly made open-ended as the $700 billion was deployed within a short time. There is no discussion of where the Fed's balance sheet will be when this is finished. For now, the Fed is all in and will do whatever it takes to keep the economy solvent and markets functioning.

The $2 trillion fiscal relief package passed by the federal government is designed to provide direct funding to businesses, citizens, hospitals and state and local governments. Its purpose is to help cushion the economy as the shutdown continues, and to help ensure that businesses and consumers emerge from the downturn prepared to resume normal business activities. The $377 billion targeted for small business loans is crucial to the success of the program, as small business owners typically do not have large emergency funds for rent and even a skeletal staff. Large businesses will have access to loans backed by $500 billion, and $50 billion is earmarked for loans to U.S. airlines and state and local governments. There is $150 billion for equipment and supplies needed by hospitals and health care providers. Lower- and middle-income Americans will receive direct payments of $1,200 for each adult, and $500 for each child. The checks are scheduled to be ready on April 6. Unemployment insurance will be extended by four months and increased by $600 a week. The legislation extends who can receive unemployment insurance, and now includes those classified as “gig” workers. The rating agency Moody’s said in a recent report that “Most companies can cope with a 15-to-30 day lockdown, but a few additional weeks would likely exhaust available resources for a significant number. This crisis is beyond what they could have reasonably prepared for.”

All of this has a cost, and these actions have already begun to draw criticism about the growing deficit and the Fed’s ballooning balance sheet. The question remains whether this will lead us towards an economic landscape hindered by high inflation. But at this point, all that matters is a concerted effort to envelope the economy and markets with liquidity and funding to survive the shutdown and regain momentum as soon as possible.

This is a world where markets remain vulnerable to headlines, and where the search for the market bottom is an ongoing discussion. The bottom will surely be found and long-term investors and traders alike will monitor the health of the credit markets, particularly high yield, corporate guidance, and the migration of the virus to determine when to begin allocating funds. History suggests that it typically comes before the recession has ended. And this is why the debate will continue on when America goes back to work. Should the lockdown continue into May, the government and the Fed will keep bolstering financial relief to help ensure that the country emerges ready to start its economic engine. Politicians may quibble about another package, but the markets and citizens headed to the polls in November will make certain that relief is delivered swiftly.

References include the following: Associated Press (AP), Axios, *Barron’s*, Bloomberg.com, CNBC.com, Cornerstone Macro Research, *The Economist*, Evercore ISI Research, *The Financial Times*, *The New York Times*, Oxford Economics, Politico, Renaissance Macro Research, TheStreet Real Money, Reuters, *The Wall Street Journal*.