A Passel of Known Unknowns

In the face of strong economies and surging equity markets, economists and market analysts often stated that it would be some combination of *unknown unknowns* that would ultimately upend the status quo. Now that the COVID-19 virus (now a known risk about which much is still not known) is spreading quickly across the globe, there is a large and growing set of known unknown economic, business, and capital market risks about which we are collectively concerned. This update summarizes and offers our perspectives on some of the key economic unknowns and discusses some recent trends in capital markets. In doing so, we hope that it addresses many of the common questions and concerns that we are hearing from our clients.

A Macro-Perspective

In brief, there remains considerable fluidity as to how damaging COVID-19 and related (and growing) social distancing practices will be to the global and US economies. Analysts' estimates are changing – and changing dramatically – on a near daily basis.

- **Global GDP**: The consensus is that the rate of overall GDP will decline across the first two quarterly periods of 2020, the first such back-to-back declines since the December 2008 and March 2009 periods. The big unknown: will the crisis abate thereafter and propel a strong economic rebound, or will it persist across 2020 or longer?

- **US GDP**: Likewise, the US economy will be dented by COVID-19 during 2020. With the virus' late arrival here – and efforts to curtail its spread later still – the economic impact will be greater in 2Q 2020 than in the period ending within the next two weeks. The wide range of estimates (e.g., GDP shrinks at a -5% annualized rate; shrinks at a -15% rate) reflect how much is unknown currently.

- **Monetary Policy:** The US Federal Reserve made an extremely unusual move on Sunday, March 15 when it cut its benchmark rate by -100 basis points, to 0.25%. Thereafter, it has used a variety of policy tools to inject liquidity into the financial system to guard against a 2008-type of financial crisis. In the process, the Fed's balance sheet (which it had sought to shrink when the economy was strong) is approaching and most likely will surpass its post-Global Financial Crisis (GFC) all-time high.

- **Fiscal Policy**: This week, the US government adopted some additional measures to inject money into the economy and provide worker protections with the *Families First Coronavirus Response Act.* Legislation was passed earlier this month to provide supplemental funding for the government's Health and Human Services' effort to combat COVID-19. Additional measures – perhaps topping more than $1 trillion – to help individuals, small businesses, and large at-risk industries (e.g., airlines) are being discussed and negotiated currently.

It would be misleading of us to put forth definitive forecasts of when the COVID-19 crisis abates, how much economic damage it inflicts and for how long, how low interest rates will fall, or how much fiscal stimulus and policy change are needed to mitigate the crisis' societal impact. Although strictly speaking there are no comparable modern scenarios upon which to draw for accurate guidance, big downturns are a part of US financial history. The *GFC (Global Financial Crisis)* produced four consecutive quarters (4Q 2008 through 3Q 2009) of contraction; the overall US economy shrank -2.8% in 2009. The US' *Second Oil Crisis* (1979-1980) produced a one-quarter contraction of -8.7%, the worst such outcome of the past 40 years and second worst since 1Q 1958 (-10%). Directionally, a 2Q 2020 that rivals these two recessions now seems a certainty. However, we think there is some cause for tempering current pessimism. The relative recency of the GFC and some policy changes implemented thereafter have prompted both the Fed and the US Government to step in quickly to inject liquidity and cash into capital markets and into the economy, respectively. And they are vowing to continue doing so.

A Capital Markets Perspective

The transition from cautious market optimism (as reflected in all-time high stock markets on February 19th) to fearful market pessimism has been brutally short. The uncertainties that markets abhor have returned to 2008-era levels amid the rising number of known unknowns. Absent guideposts for how poorly the economy may fare, companies and analysts alike are unsure of near-term prospects for revenues and earnings. Likewise, uncertainty about business' prospects amplify concerns about their creditworthiness (i.e., will loans be repaid and bond interest and principal payments occur on time). Record low interest rates and the lowest oil prices ($23/barrel) since 2001 further complicate the environment.

Some current perspectives on core segments of the capital markets:

<u>US and Global Equities</u>

The current crisis has illustrated that in free-falling markets, virtually all markets (US and Non-US) and segments therein (e.g., banks, consumer goods, industrials) move downward in tandem. From the February 19 high to March 19, US and Other Developed Market equities returned a similar -30.1% and -31.9%, respectively. It now ranks as the fastest-ever move into bear market territory, eclipsing the speed of the 1987 crash but not yet matching its -34% decline across 101 days.

The biggest known unknown for equities: earnings. Too little time has elapsed, and too little data is available for making anything approximating rational earnings estimates. Per share earnings (S&P 500) fell nearly -36% in 2008, the first year of the GFC. Across the comparatively less damaging Second Oil Crisis, earnings actually rose +3%. Absent updated and rationally calculated earnings estimates, investors cannot yet assess the "cheapness" of equities relative to past cycles. This makes it difficult to consider whether to maintain current positioning or add excess funds into the market. Furthermore, in conversations with our equity portfolio managers this week, their shared view is that the sharp downturn in prices has created once-in-a-decade types of investment opportunities for investors with a reasonably long time horizon. Hence, it is our strong belief that most investors are probably better off staying the course rather than seeking to time such volatile markets.

Taxable Bonds

Despite differing root causes of the GFC and COVID-19 crises, the US bond market reacted in a similar fashion across both. US Treasury Bonds, long considered a safe-haven for investors worldwide in a time of crisis, have appreciated on balance (+2.9%) since mid-February. Mortgage-backed bonds, too, have been comparatively stable (-0.9%). But bonds subjecting investors to credit risk have been subsumed by worries about potential missed payments and defaults. The result: credit spreads that have risen rapidly and prices on both investment grade and below-investment grade corporate bonds have fallen across this short horizon. We think that at some point in this cycle, the opportunity for investors to earn equity-like returns on bond investments will present itself.

Tax-Exempt Bonds

Likewise, the municipal bond market underperformed expectations as the current crisis gathered speed this week. Unlike their taxable counterparts, credit concerns have not been the root cause of muni bonds' falling prices. Rather, this individual investor-centric market has a long history of temporary price dislocations when too many investors (typically, investors who own such bonds inside mutual funds) try to sell all at once and there are no other "natural" buyers for these securities. Recent muni ETF and mutual fund outflows have been three-time the previous record. Conversations with our muni bond portfolio managers have given us great confidence that the bonds comprising our clients' portfolios are "money good" and that values of their holding will bounce back once this temporary period of trading dislocations abates.

We know that capital markets' reactions to the current crisis will not entirely replicate those of the GFC or the sharp-but-quick Second Oil Crisis. But from our perspective, the over-reaction by financial markets to wholly unexpected known unknowns is not unique. The decline in virtually all asset prices – even gold has uncharacteristically fallen in price – is creating opportunities for future outsized gains across a variety of asset classes. Something will happen – if we had to guess, it will be the release of data showing that the coronavirus spread has peaked – that will spark renewed investor confidence well-before information is available showing that the economy has bottomed, that unemployment is trending down, and that consumers have begun to spend again.

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