THIS TIME IT'S DIFFERENT: 2020 VS. 2008

In some respects, yes things are different now than in 2008. And in others, no they are not. The Great Recession of 2008-2009 exposed large flaws in the US and global financial systems. Only in retrospect was there a realization that there was too much leverage (excess borrowing by consumers and businesses alike) in the economy and in capital markets and too much confidence that these risks were adequately understood by market participants and their regulators and were manageable.

The COVID-19 crisis of 2020 is exposing large flaws in the US and global health care systems. Despite other recent (but ultimately less widespread and less disruptive) worldwide contagions, only in retrospect does there seem to be a realization that insufficient planning and resources were deployed to keep a novel virus from turning into an epidemic and, shortly thereafter, into a pandemic. So, perhaps misplaced confidence that these health risks were sufficiently understood and could be adeptly managed makes the current crisis somewhat analogous to the prior crisis.

Even though the root causes and immediate effects of these decade-apart crises are vastly different, many of the resulting macro-economic uncertainties, capital market reactions, and policy interventions are similar.

Our observations at this juncture about how the COVID-19 crisis is most affecting the economy and capital markets:

- **Economic Impact:** It seems likely that the pace of US and global economic growth will not just slow, but that increasing voluntary ("work from home") and mandatory policies (e.g., non-essential retail store closures, limits on crowds) will cause many economies to contract. With as yet no data upon which to make reasonable projections, current forecasts vary widely (e.g., +1.0% to -5.0% annualized growth in the US for the quarter ending June 30, 2020). Whether the balance of 2020 then worsens or improves depends on how quickly the pandemic is controlled.

- **Monetary Policy:** The US Federal Reserve (and other central bankers worldwide) has aggressively cut interest rates and injected liquidity into the financial system in an effort to forestall further dislocations in capital markets. Its policies – reflecting lessons learned during the prior crisis - leave it little "dry powder" to further cut interest rates without adopting the negative interest rate policies that have characterized policies in Japan and Europe since the Great Recession.

- **Fiscal Policy:** Though final policies are not yet in place, the US government is likely to implement a series of programs to provide financial support to individuals and to at-risk businesses. Despite philosophical and past criticisms of such policies' effectiveness and costs, the unprecedented set of risks posed by the COVID-19 crisis (e.g., a near-certainty that the US rate of unemployment will spike from its 50-year low of 3.5%) leaves the government little option but to respond aggressively.

- **Interest Rates and Credit Spreads:** Federal Reserve policies and investors' collective flight to safety have contributed to all-time low interest rates on Treasury Bonds. The 10-year bond yield touched an historic low of 0.54% on March 9; it bottomed at a comparatively elevated 2.42% yield during the Great Recession. But mimicking that crisis (as well as others), concerns about bonds with perceived credit risk (potential that the issuer would miss an interest payment or be able to redeem the bond at maturity) has caused credit spreads to widen sharply. Investment grade corporate bonds, for example, are now offering 160 basis points (1.60%) more spread than they were in mid-February. The interest rate differentials on lower-rated (aka high yield or junk) bonds have widened by an even larger 500 basis points, to 8.42%.

- **Corporate Earnings:** Already optimistic 2020 earnings estimates (something we pointed out several times prior to mid-February) will be cut sharply by companies and analysts alike as time goes by and more information becomes known about the economic impact of the current crisis. It seems a certainty that estimated and actual earnings will not only be below the now-stale consensus of $172/share (S&P 500 Index) but lower than 2018 and 2019 ($151 and $152, respectively). How much lower is impossible to predict; rolling 12-month earnings declined -18% from September 2007-2008; they declined a further -36% through September 2009.

All of these uncertainties – these storm clouds, if you will – have produced historically high day-to-day price volatility and consequently, levels of investor angst that rival those of late-2008, early-2009. These confidence-shattering daily moves and periodic offsetting "head fakes" higher follow the pattern if not the exact pacing of the last crisis. And if an 11-year long equity bull market tends to make most investors less risk averse on balance (after all, who wants to miss out on participating in the gains produced in a year like 2019 when US and global stocks returned +31% and +27%, respectively), a rapid and precipitous bear market often changes investors' near-term perceptions of their risk tolerance..That's not any different "this time" than "last time."

Nor are the forward-looking opportunities for above-average investment gains materially different now than they were in early-2009, when equity valuations touched decade-lows and credit spreads reached record highs. Despite all of today's underlying uncertainties, we are very quickly approaching a level of market prices and spreads at which we think it will soon make sense to implement the following changes within most of our clients' equity portfolios:

- **Adjust US and Non-US Exposures:** increase holdings of US equities, based on an expectation that the US' stronger economy will better position it during the crisis and immediately thereafter

- **Adjust Growth and Value Exposures:** increase holdings of growth-type investments, based on an expectation that these companies' fundamentals give them more inherent staying power during the crisis and an ability to fully participate in an expected economic rebound thereafter

As unsettling at the COVID-19 crisis is for daily lives and routines, and for the "aspirations" and needs-meeting attributes ascribed to investment portfolios, we are confident that this crisis too shall pass. The investment challenge is to not react to what has already occurred but to look forward, taking advantage of opportunities to earn better-than-average returns that were not available as recently as four weeks ago.

We look forward to working with you and on your behalf to implement the portfolio changes that best meet your particular needs and risk tolerance.

Investment Strategy Group
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