CONTROL-ALT-DELETE

Four months or so into the global pandemic, governments, businesses, and individuals alike are desperate for a “reboot” of economic and social life. Despite continuing uncertainties on how to best control the COVID-19 virus’s spread and the destruction it has wrought, the Great Lockdown is (perhaps only temporarily) easing in the US and elsewhere as we approach mid-2020. And notwithstanding a parade of economic statistics which mostly continue to paint a grim economic picture (e.g., more than 20 million US workers are jobless; an unemployment rate of roughly 20%), global capital markets continued to reflect nascent optimism during the month of May.

The Road Just Behind

The unique nature of the COVID-19 crisis has complicated analyses of the economy’s downturn – what has transpired and what may occur – in comparison to previous modern recessions. Knowing that the Global Financial Crisis resulted in peak job losses of 6.6 million and an unemployment rate of 10%, for example, provides little relevant guidance for the current environment. And data on aggregate economic activity (GDP) is far too stale in a fast-evolving global crisis. Two months into the year’s Second Quarter, a more comprehensive read on First Quarter GDP (pegged at a -5.0% annualized decline) is only now available. Initial measures of GDP for the current quarter (recent consensus: -37% annualized) are not due until late July. Likewise, reported first quarter corporate earnings (-23% for the S&P 500 Index) were not wholly instructive for what is likely to come. Lacking any clarity on economic trends, analysts can at best only estimate that overall earnings will worsen further this quarter.

In the face of such widespread and intractable uncertainties, it has been surprising that asset classes and sub-sectors of financial markets which stand to lose the most from a deep global recession continued to produce strong returns in May.

Two examples:

- Corporate Bonds: Despite the prospect of rising corporate bankruptcies (following on the heels of filings by notable brand icons including Hertz, J. Crew, and Neiman-Marcus), credit spreads improved in May. The result: strong QTD returns on investment-grade (+6.9%) and below-investment grade (+8.9%) corporate bonds.

- Small Cap Stocks: After logging the worst (-31%) performance of any major global equity market segment during the year’s first quarter, these stocks have recently produced stand-out returns (+21% QTD) as investors wager that an easing of the Great Lockdown will produce strong economic growth across the second half of 2020.

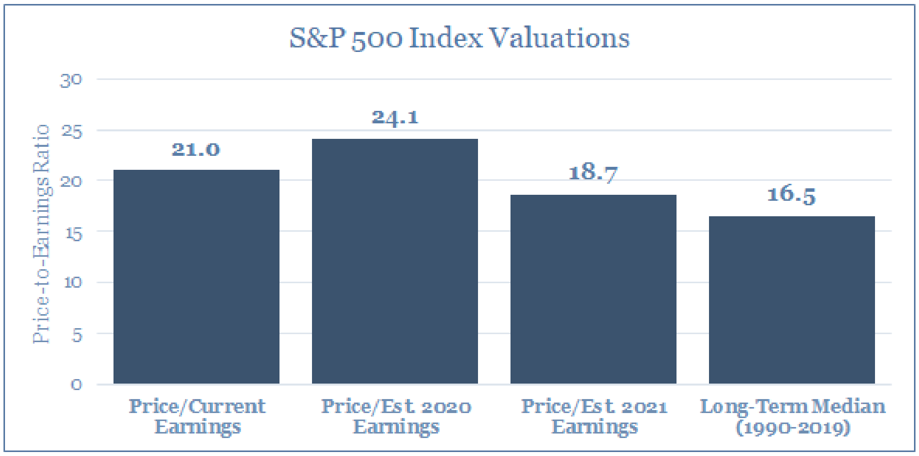
More broadly, the rally in stocks since late March has trimmed overall declines (total returns on global equities were -9.2% through May 31). Substantially improved market liquidity has boosted returns in the municipal bond market (+1.7% YTD) and improved corporate bond prices, atop already strong Treasury bond performance, has produced high (+5.5% YTD) returns on taxable bonds.

The Road Just Ahead

The case for optimism largely derives from the premise that the Great Lockdown may more closely match a debilitating natural disaster – for example, a hurricane or earthquake producing massive but short-lived economic dislocations – than a multi-year Great Depression. Economic activity often accelerates in the aftermath of a natural disaster, and there is a less sustained loss of jobs and of confidence (reflected in spending restraint) on the part of consumers than is characteristic of a typical economic recession.

Just as capital markets looked for “green shoots” suggesting that the worst of the Global Financial Crisis was easing in mid-2009, they are now evaluating various more readily available data sets to gauge global economic activity trends in real time. This information includes using cellphone based “mobility” data to assess whether people traveling more frequently and more widely, statistics on public transportation ridership and energy usage, and new job listings. Though not infallible, or time-tested, much of this data is suggesting that economic activity in the US and in most other major developed markets may have bottomed in late-March, early-April.

It is certainly a possibility that across some dimensions (the pace of new COVID-19 cases and deaths; business shutdowns and new claims for unemployment; falling revenues and earnings) the worst of the crisis is behind us. But a case can easily be made for being only cautiously optimistic. Certain sectors of the economy (travel-related, meals away from home, energy) will still be under duress as lockdowns ease globally. And continued high unemployment and soon-to-expire (July) enhanced unemployment benefits could curtail consumer confidence and spending. It remains possible, too, that less collectively lessened diligence to curtail the virus’ spread and a lack of substantive progress on the medical front could result in an economically – and psychologically – debilitating sequel: Great Lockdown II.



Down the Road Apiece

Capital market prices react to unexpected events in the short-run, but trend higher (or lower) in anticipation of longer-term eventualities. Prices of individual stocks, for example, may vary in reaction to current company and industry news. But they trend in anticipation of changes in future fundamentals (e.g., earnings). In the context of current market prices, US equities are ignoring consensus projections of much lower (-15% to -25%) earnings in 2020. Instead, they appear to be pricing in a robust recovery that would take earnings to new (and all-time) highs by December 2021 and thereby justify current above-average valuations. Record low bond market yields, conversely, portend a period of continued low inflation and paltry economic growth. Low rates (e.g., 10-year Treasury yields of 0.65%) are a relative boon for government and corporate borrowers but are a long-run drag on savers' incomes and investors' returns.

Rebooting an economy after an unprecedented pandemic and global shutdown is far more complicated than the three keystroke (Control-Alt-Delete) combination by which the earliest PCs could be coaxed into restarting. Caution and patience will, we think, remain watchwords for real life, for the real economy, and for investing across the balance of 2020 and perhaps beyond.

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Mill Creek Capital Advisors
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