ECONOMIC OUTLOOK

bounty management

unique investment insight

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After the Global Lockdown
"A Deep Hole To Fill"

During the first half of 2020, the spread of the coronavirus upended lives around the world by threatening health, disrupting daily activity, shutting down economies, and causing massive unemployment. Since our last economic update in April, multiple outbreaks evolved into a global pandemic that moved too fast for most healthcare systems and governments to contain. To reduce the spread, global public health organizations and governments around the world shut down business and advised communities to quarantine. In some countries, the pandemic has started to recede and activity is beginning to pick up. That included the U.S., until there was a recent spike in many states that previously recorded few cases. China, Germany, and other economies that shut down earlier and more completely than the U.S. are recovering first. As the U.S. and global economies started to reopen in the second quarter, economic activity in consumer spending and production recovered faster than initially expected. Unfortunately, COVID-19 is very much alive and spreading in the U.S. as we hit new milestones with over 75,000 daily cases, 150,000 total deaths in the U.S., and over 600,000 world-wide.

A failure to suppress the resurgence threatens the chance for recovery. As a by-product of shutdowns, we are left with recessions in many global economies. During the Federal Reserve meeting in June, Chairman Powell painted a grim picture of the current situation and the longer-term prospects for the global economy. Stating that a full U.S. recovery will not occur until the American people are certain the coronavirus has been brought under control, Powell emphasized that the shutdowns related to the virus had left a "very deep hole" to fill, particularly on the employment front. Bureau of Labor Statistics estimates showed the economy lost more than 20 million jobs in March and April (about one-seventh of the total number employed in February). With so many displaced workers, the Fed is forecasting an uncertain, uneven, and prolonged recovery for the U.S.

The equity markets have reacted positively to both global central bank support and hope for one of the over 150 vaccines in development as well as various treatments. Since March, there has been $6 trillion in world-wide central bank balance sheet expansion. In the U.S., the Fed pledged to use its full range of tools to do whatever it takes to help the economy recover. The Fed's aggressive response to the near meltdown of the markets in March included lowering rates to 0% and buying trillions in Treasuries, mortgage securities, and other fixed income to keep the economy afloat. In addition to the Fed support, the government allocated trillions in financial relief including direct payments to households, enhanced unemployment benefits, and forgivable loans to businesses. As credit markets started to freeze in the early days of the pandemic, the Fed took the unprecedented step of backstopping the credit markets. The Fed even bought individual corporate bonds including the debt of Apple, Disney, and Ford. All this spending has led to huge federal deficits with June's deficit of -$863 billion nearly matching the entire deficit for 2019. A very big hole to fill indeed!

U.S. Economy

COVID-19 infections have recently accelerated in the United States leading to a fear of another economic dip. GDP predictions by economists for the second quarter are in the negative 40-50% range with the Atlanta Fed forecasting a 51% decline. Most economists and government agencies call for a recovery in 2021 with growth of +4 to 6%. Full year 2020 GDP is forecast by the Federal Reserve at -6.5% with unemployment of 9.3% by year-end. The extensive federal stimulus and support from the Federal Reserve will provide temporary help to individuals, companies, and state/local governments, but it won't be able to prevent the economy from falling into a recession. However, the stimulus should allow both households and businesses to avoid the worst effects of recession until a vaccine or treatment has been developed. The stimulus comes at a very high price with the federal deficit likely to top $3 trillion in 2020 or 15% of GDP.

Consumer and Manufacturing

Taking a cue from the stock market, the economic data is beginning to stabilize and possibly point toward recovery. In February, consumer confidence rose to 130.7 -- among the highest readings in the past 15 years. By April, it had slumped almost 50 basis points to 85.7. In May, even as unemployment claims continued to rise, confidence ticked slightly higher. It is worth looking back at the financial crisis of 2007-2009. Back in 2007, confidence peaked at 112 in November, before falling sharply and consistently over the next year to a low of 25 in February 2009 as the markets bottomed. The trajectory of the recovery this time will depend on several factors: success in slowing the spread of the virus, the effectiveness of the government's rescue plan, and changes in consumer behavior after the crisis. Manufacturing appears to be improving from the depths of April, when global trade shut down to slow the spread of the coronavirus. But most regions are far from returning to expansion.

Housing

The housing market was weak through the first half of the year. June housing starts were up 17%, but still down 24% from February. Building permits, which are a leading indicator, peaked in January at 1.55 million units and are now down about 30%. Existing home sales were down 18% month-to-month in April, after falling 8% in March. The S&P/Case-Shiller National Home Price Index for March showed that prices gained 4.4% year-over-year, up from 3.9% growth in January. Meanwhile, inventories of homes have ticked higher. On the other side of the pandemic, we expect demand for homes, with space and yards, to once again be strong. The influx of moves to cities over the past decade has reversed this year with home sales doubling in Connecticut in the past few months, primarily from residents of hard-hit New York City.

Oil and Commodities

Gold spot prices broke above $1,900 per ounce in July for the first time since 2011, driven by continued debasement concerns and lower real interest rates. Safe havens are enjoying increased attention as the stock market's run-up slows. Federal Reserve officials warn the virus' resurgence could freeze an economic recovery, and the Organization for Economic Co-operation and Development (OECD) recently referred to the pandemic's labor market damage as "far worse" than during the financial crisis. The International Energy Agency (IEA) recently predicted slightly improved global oil demand for 2020, but the progress depends on the pandemic and new cases in the U.S. Demand this year will average 92.1 million barrels per day, down by 7.9 million barrels per day versus 2019. Oil prices remained under pressure, with Brent crude, the international benchmark, off 1.3% to $42 a barrel.

World Economy

Europe and U.K.

The European Central Bank (ECB) indicated that the eurozone is rebounding, but faces a highly uncertain outlook. The ECB has provided extensive monetary support with negative interest rates and over $1.5 trillion in purchases of government and corporate bonds. GDP in the eurozone tumbled 3.8% in the first three months of 2020, the sharpest drop since 2009 as coronavirus lockdowns brought Europe's economies to a standstill. A further decline in GDP of 13% is expected for the second quarter even though most countries have started to loosen their strict lockdowns. According to the ECB, GDP is projected to fall 8.7% in 2020 and rebound by 5.2% in 2021 and by 3.3% in 2022. Elevated uncertainty and worsened labor market conditions may induce households and firms to cut back their spending further. Substantial support from monetary, fiscal and labor market policies should help maintain incomes and limit the economic scars the health crisis may leave behind.

The U.K. economy contracted by 20.4% in April, the largest monthly decline on record with the vast majority of the U.K. economy shut down through April. The economy is expected to start to return to growth in the third quarter. Pent-up consumer demand following the lockdown should help, while global economic activity should also be stronger from the latter months of 2020 onwards. There will be challenges, with unemployment still rising and an unfinished final split with the EU. Business groups have warned over the dangers of a no-deal Brexit scenario as the coronavirus pandemic risks delaying talks.

Japan

Japan fell into a recession for the first time since 2015, as the already weakened economy was dragged down by the coronavirus's impact on businesses at home and abroad. Some economists forecast a severe double-digit shrinkage for Japan's 2Q GDP. The world's third-biggest economy officially plunged into a recession in the first quarter, when GDP shrank 3.4% y/y, following on from a 7.3% decline in the preceding quarter. Economists are predicting that the worst is yet to come for Japan following a declaration of a state of emergency in April to contain the spread of Covid-19.

China

China, the world's second largest economy, picked up steam in the second quarter with GDP growth of 3.2% y/y and +11.5% from the 1st quarter. China's economy is far from fully recovered, but there are positive signs as exports and services benefited from government policies. Auto sales increased 10.4% in the second quarter, but are still down 16.9% for the first 6 months of the year. China's manufacturing index rose to a three-month high of 50.9 in June and non-manufacturing PMI jumped to a seven-month high 54.4 (readings above 50 indicate expansion). June's readings came in better than forecast and suggest a broad-based recovery. Even so, a recovery in demand still lags behind production leaving many to question the sustainability of the rebound.

As a result of the pandemic, the global economy in 2020 is projected by the International Monetary Fund (IMF) to fall -4.9% vs. April's -3% projection and much worse than during the 2008/09 financial crisis. The OECD forecast a more severe decline of -6.0% to -7.9% in world GDP. In a baseline scenario, which assumes that the pandemic fades in the second half of 2020, the global economy is projected to grow by 5.4% according to the IMF in 2021 as economic activity normalizes, helped by policy support.

Investment Perspective

Faced with extraordinary uncertainty, the economic outlook boils down to two distinct possibilities: 1) the virus continues to recede and is under control using mitigation techniques such as physical distancing, masks, tracking, tracing, and isolating and 2) there is a second wave or multiple waves that erupt before a vaccine is developed and with each wave consumer confidence/spending falls as the economy slows. These are not the only scenarios – there are many variations, but this helps simplify the outcomes. Under either of these scenarios, economic activity does not return to normal. By the end of 2021, according to the OECD, the loss of income due to the virus will exceed any previous recession over the past 100 years outside of wartime, with dire and long-lasting consequences. Chairman Powell at the last Federal Reserve meeting admitted as much saying the economy will end up "well short" of the pre-pandemic level of early February.

With all this grim news, why is the market rising? The primary reasons are historic stimulus by the world's governments/central banks and the hope that one of the 150+ vaccines is effective and available in the near future. The Federal Reserve has pumped about $3 trillion into the economy and has said they will do whatever it takes for as long as it takes. Economic data has also been better than expected with June payrolls +4.8 million although there are still over 20 million unemployed. Researchers around the world are developing more than 155 vaccines for the coronavirus. Vaccines typically require years of research and testing before reaching the public, but scientists are racing to produce a safe and effective vaccine by next year. Scientists are also scrambling to find treatments and drugs that can save lives and perhaps prevent infection.

There are plenty of reasons to remain cautious including projections for a bumpy economic recovery, setbacks to developing a vaccine, and uncertainty surrounding November's presidential and congressional elections. The aggregate estimate for second quarter earnings per share is negative 44.7%. That would be the biggest decline in earnings since the fourth quarter of 2008, when earnings fell 69% in the midst of the financial crisis. Cash and bonds still have little or no yield, no purchasing power protection, and lots of risk. Long-term bonds are a certain bet to lose ground to inflation as inflation forecasts are higher than the yield on most developed countries' long-term bonds. With the Fed and global central banks still supporting the markets with zero/negative interest rates and quantitative easing, we continue to favor equities over bonds. Gold will continue to be a store of value during a time of instability in the economy and, given the continued world-wide flood of paper money, precious metals are still undervalued. We would avoid sectors that require more personal contact such as tourism, travel, entertainment, restaurants, and accommodation. Working from home and on-line commerce are likely negative for commercial real estate. Studies show that during times of pandemics, people tend to save more so consumer discretionary stocks are at risk. For equity sectors, we favor healthcare, technology, communication services, and some industrials. We are faced with extraordinary uncertainty with two scenarios: one where the virus continues to recede and remains under control and one where rapid contagion continues in multiple waves until a vaccine or treatment is discovered. In the meantime, we are fortunate that the Fed is suppling equally extraordinary support by pumping seemingly unlimited funds into the economy. We remain, as always, vigilant.

June 30, 2020
DJIA: 25,812.88
S&P 500: 3,100.29

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.