ECONOMIC OUTLOOK

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unique investment insight

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Coronavirus Pandemic Wreaks Havoc
Awakening From An Economic Coma

Just a little over two months ago, the U.S. economy was sailing along with jobs growing over 200,000 a month, a 3.5% unemployment rate (a 50-year low), rising financial markets, booming travel & leisure, new business creation, and strong American confidence and optimism. What happened was the "Coronavirus Shock," a novel COVID-19 virus that has been an existential threat to health, life and global economies as well as governments, the medical community and policymakers on the responses necessary to counteract the effects of this natural disaster. Outbreaks in recent decades such as SARS, MERS, and Swine Flu were either milder/less contagious than anticipated or controlled more quickly. Beyond the human toll of the pandemic, the economic fallout has been profound, causing a halt in production, hitting supply chains around the world, and reducing consumption and confidence. Stringent measures such as stay at home orders and physical distancing, are essential to slow the spread of the virus, but have put the economy into a self-induced coma and U.S. jobless claims skyrocketed to over 22 million workers filing for benefits in the last month.

In the U.S., the Federal Reserve is playing a key role in trying to stem the crisis. The $2 trillion stimulus package passed by Congress in March, the CARES Act, includes direct cash payments and expanded unemployment benefits. The Fed will be acting on an unprecedented scale with the power to lend up to $5 trillion. Already, the Fed has re-started some of the same initiatives designed for the last financial crisis: injections of liquidity into the Treasury, repo, mortgage and overseas markets along with facilities to support money market funds and commercial paper both of which started to falter in March. In addition, in early April, the Fed announced another $2.3 trillion stimulus/lending plan to support U.S. states, counties and cities ravaged by the pandemic. The Fed, for the first time, is buying municipal bonds and corporate bonds including high-yield or "junk" bonds. Although purchases of corporate bonds were necessary to keep credit markets functioning, the risk is the government is now interfering with and propping up private market debtors some of whom are not credit worthy. Unlimited quantitative easing and emergency liquidity programs will double the Fed's balance sheet during 2020 to over $10 trillion.

States are already discussing plans to ease public health restrictions in order to eventually re-open the economy. While a safe, effective vaccine is still more than a year away, researchers are rushing to repurpose existing drugs and non-drug therapies as well as testing promising experimental drugs that were already in clinical trials. Even moderately effective therapies or combinations could dramatically reduce the crushing demand on hospitals and intensive care units. New drugs, together with testing, new diagnostics, antibody tests, patient- and contact-tracing technologies, disease surveillance and other early-warning tools, mean the anticipated next "wave" of the global pandemic does not have to be nearly as bad the first.

U.S. Economy

As expected by epidemiologists and health care officials, COVID-19 infections have accelerated over much of the globe, now especially in the United States, even with attempts to stem the spread of the pandemic by shutting down the economy and stay at home orders. With the shock, the global economy fell into a recession in Q1. The U.S. recession, really an economic tsunami, will be centered in Q2, extending into Q3, the biggest decline since the Great Depression. The federal response will provide very significant, but temporary help to individuals, companies and state/local governments, but it won't be able to prevent the economy from falling into a sharp recession. However, it should allow both households and companies to avoid the worst effects of recession until a vaccine has been developed and the economy can embark on a robust recovery. However, this stimulus has come at a very high fiscal price with the federal deficit likely to top $3 trillion or 15% of GDP this fiscal year and the Fed doubling the size of the balance sheet.

Consumer and Manufacturing

The virtue of closing so much of the economy to limit the spread of the virus has led to a huge and unfathomable number of layoffs and furloughs, throwing into the ranks of the unemployed, hopefully temporary, but probably not, millions of people. Aggregate consumption is nearly 70% of the U.S. economy. Jobs and income are the key fundamental for short- to intermediate-term consumption. Consumer sentiment also is important as is the ability to borrow and spend, or to finance consumption with savings. Household wealth, financial assets minus financial liabilities, is yet another significant consumption fundamental. Unfortunately, 28% of Americans do not have any savings and an additional 25% only have sufficient savings for three months. March manufacturing data was negative, clearly impacted by the pandemic and energy market volatility. The Purchasing Managers Index was in contraction territory at 49.1 and new orders registered a sharp drop of 7.6% from February's reading.

Business Sector

With expected sales, earnings and cash flow sliding, businesses will have to cut expenses and spending over the next few months. The leading edge starts with first quarter sales and earnings reports that companies are now releasing. The effects of the shutdowns are already evident. Nonfinancial businesses are already laying off and furloughing workers in droves to protect profits and cut expenses. This likely will accelerate in coming months as companies adjust to the new reality and plan for a difficult year. Many job cuts will be in areas that had strong growth in recent years including leisure & hospitality, manufacturing, retail sales, and professional & business administration categories.

Oil and Commodities

Gold prices traded higher during the quarter and hit a seven year high over $1,700 in April. The rally was based on safe-haven demand amid a global economy that has lurched into recession as well a mammoth $2.3 trillion Federal Reserve stimulus package. Oil prices collapsed following Russia's early-March decision not to cooperate with proposed OPEC production cuts and Saudi Arabia's retaliatory move to drive down prices via increased production and discounts to global customers. Recently, there have been reports of cooperation between both countries to cut production by nearly 25% although production cuts have not offset lower global demand due to the pandemic.

World Economy

Europe and U.K.

European Union leaders have abandoned budget limits, allowing governments to employ fiscal stimulus to combat the coronavirus fallout. The spending packages include loans and wage support to businesses most impacted by the pandemic. The ECB has launched a series of initiatives including roughly €750 billion to buy corporate and government debt. With many regions implementing various degrees of lockdown to combat the virus, the goal of policy support is to (1) keep companies and workers afloat during this time and (2) promote demand as soon as the disease is contained. Germany announced a massive fiscal package of €550 billion of state-backed loans. Governments across Europe have begun preparations to ease lockdowns when infection curves are under control. Denmark and Germany are in the process of reopening schools. The Czech Republic said shops selling some nonessential goods could reopen and, in Austria, small shops, DIY stores, and garden centers would be able to open.

The U.K. breathed a sigh of relief after Prime Minister Boris Johnson was discharged from the hospital after a severe coronavirus infection. The U.K. announced a large fiscal package with additional guaranteed loans and tax cuts totaling around 350 billion pounds in an effort to buffer the pandemic impacts. The government assured the public that it will do more to protect jobs and income through this unnerving situation.

Japan

Prime Minister Abe announced a massive stimulus effort totaling ¥108.2 trillion ($992 billion), a headline figure that is nearly 20% of the nation's economic output. Economic activity for Japan in the second quarter is set to turn much weaker than previously expected due to falling foreign demand and postponement of the Olympic Games. Alarming deterioration across sectors was revealed in the Tankan Survey, which plunged in Q1 from the previous quarter. The large Manufacturing Enterprises Business Conditions Index plunged to -8 from 0 in Q4 and the large Non-Manufacturing Index fell to 8 from 20. Capital expenditure slowed to a crawl, to 1.8% y/y compared with 6.8% in the fourth quarter. The Business Conditions Index for Accommodations, Goods and Drinking Services plunged to -59 from 11, a record drop.

China

China's economy plummeted -6.8% in the first quarter, the country's first such drop since Beijing started to report GDP in 1992. The sharp contraction in the world's second largest economy foreshadows the pain expected in the U.S. and around the world as the pandemic halts business activity and cripples global supply chains. According to official data, more than 90% of large enterprises and more than 60% of small and mid-sized enterprises returned to business by mid-February. The actual economy is running at about 80%-90% capacity, at best, with most consumers still limiting activities and spending. Of more concern, the kind of surge in consumption like the one after SARS in 2003 may not show up because of weak underlying demand. Although China does appear to be turning around, it will be nearly impossible for China to recover its production and services capacity rapidly after the collapse in business from aggressive containment measures.

As a result of the pandemic, the global economy is projected to contract sharply by -3% in 2020, much worse than during the 2008/09 financial crisis. In a baseline scenario - which assumes that the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound - the global economy is projected to grow by 5.8% according to the IMF in 2021 as economic activity normalizes, helped by policy support.

Investment Perspective

The COVID-19 pandemic has yet to reach its peak in the United States or in the world at large. While we are not over the mountain, scientists are finally indicating that they can see the top, which means there will be a downslope ahead. Asset markets are anticipatory, meaning they price in what is in front rather than what is here. A bull market that lasted a decade became a bear market in less than a month. Investors want to know if it is safe to come back into the market as the progression of the pandemic evolves. The markets do not like uncertainty and the path and severity of coronavirus outbreak is still not contained. Financial markets will act first on any news about the illness and its course, as well as how the U.S. and other countries return to some semblance of normality. This certainly has been the case in China, South Korea, Taiwan, perhaps Thailand and Singapore, all seemingly past the apex of the coronavirus and reopening in one fashion or another.

It appears inevitable that the U.S. economy will enter recession in the second quarter, putting an end to the longest expansion in U.S. history. First quarter numbers will start to reflect the virus outbreak that hit mid-quarter. By mid-March, non-essential businesses were closed in much of the country with travel stopped and events shuttered. Many analysts are waiting for the official numbers before making adjustments, but right now earnings for the first quarter are expected to fall over 10%. Second quarter GDP estimates vary widely from -10% to -30% or greater with earnings likely following the same pattern. The third quarter may still be negative, with hopes for a rebound in the fourth quarter. Given what we know about the virus right now, this could be a relatively short, but deep, recession. Still, that depends heavily on the trajectory of the virus.

As investors, we take a long-term view of investing even in the midst of anxiety and stress. Most types of bonds, besides Treasuries, showed they were vulnerable to the economic freeze as prices sank in March until the Fed stepped in to steady the market. Even money markets are once again suspect without the aid of the government. With rates again at 0%, bonds and cash have negative yields after inflation. However, cash and higher-quality, shorter term bonds offer ballast in times of turbulence. Precious metals continue to provide a measure of safety and real value as governments print more money. In equities, we expect more volatility. We continue to favor certain sectors including healthcare, communications, and technology. We would avoid REITs (particularly commercial real estate), brick and mortar retailers, airlines, and travel related stocks. Sustainable dividends and strong balance sheets remain an important factor. As global growth stalls and volatility continues, look for global central banks to come up with creative ways to keep the economy afloat even though aggregate debt will be extraordinary. In this time of trouble and anxiety, we would like to sound a note of optimism. It is easy to be pessimistic in the midst of the pandemic. However, over the past century, we have seen amazing improvements in poverty, technology, and living standards. As investors, we need to maintain a fair amount of patience and optimism for the future. Eventually we will awake from the pandemic dream/nightmare – there will be summer days and we will talk in person and go to movies, games, and restaurants. We will hopefully celebrate and enjoy life to the fullest. Stay safe and healthy.

March 31, 2020
DJIA: 21,917.16
S&P 500: 2,584.59

About Bounty Management
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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.

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