ECONOMIC COMMENTARY: CONTAINMENT, POLICYMAKERS, AND WORLD FINANCIAL MARKETS

Q&A with Robert DeLucia

Can you first provide an overview of the current US economy?

The US economy entered a recession in March that could persist throughout the second quarter. The duration of the recession is impossible to predict, but will depend upon the success of containment measures to flatten the curve of new infections in Europe and North America. The more aggressive the containment measures, the more severe the decline in GDP — but also the sooner the inevitable rebound in growth.

Circumstances are changing on a daily basis. In the **negative** column, the number of new cases in Europe and North America are increasing at an accelerating pace; economic trends continue to worsen; unemployment is rising; and company earnings are on a path toward very large declines in the first half. In the **plus** column, policymakers have responded aggressively with commitments of trillions of dollars to support the economy and credit markets. Public health officials have also begun to exhibit a greater sense of urgency in dealing with the pandemic.

Can you please address your GDP and corporate earnings forecasts?

My forecast assumes a brief but steep recession, with US GDP declines in the next two quarters among the worst in modern history. In particular, the contraction in second quarter GDP could surpass the record quarterly decline of 10% that occurred in the first quarter of 1958. Real GDP should stabilize in the third quarter but experience a very large rebound in the fourth quarter and in the first half of next year.

Corporate earnings in both the first and second quarters will also suffer severe declines. Assuming the number of cases peak within several months, third quarter earnings could increase on a sequential quarter-to-quarter basis. Companies should register very large gains in the fourth quarter and during 2021.

Many people have compared this recession with 2008. What do you think?

Many analysts have made comparisons between the current economic crisis and the financial crisis in 2008. I disagree with this analysis and believe that these two episodes are fundamentally very different, in three important respects.

- **Solvency Issues:** Whereas 2008 was mainly a widespread **solvency crisis**, the current episode is primarily a **liquidity crisis**. Households and businesses are fundamentally sound, but are simply at risk of a shortfall in cash flow to make payments. The banking system is extremely well capitalized today, but was highly leveraged in 2008.

- **Economic Imbalances:** Another major difference were the enormous imbalances in 2008, requiring a lengthy rehabilitation period for the domestic economy. The most glaring of these imbalances was a massive credit bubble and an immense overhang of unsold homes. The result was a **multi-year deleveraging cycle** to restore balance sheets to normal, along with a depression in housing.

» **Pent-Up Demand:** Another deleveraging cycle following the current recession is not warranted, with the possible exception of select industries within the nonfinancial business sector. Importantly, instead of excesses in investment and consumption, the US economy is characterized by a significant pent-up demand for goods and services.

Will policymakers' response help solve this financial crisis?

Policymakers have responded aggressively to the economic and financial crisis, although somewhat belatedly.

» **Monetary Policy:** The response of the Federal Reserve has been impressive. After slashing its policy rate to zero, the Fed announced that it would inject trillions of dollars into the financial system, using various lending facilities that were initially employed during the 2008 financial crisis. The Fed also announced a resumption of quantitative easing (QE4), pledging $700 billion in asset purchases.

» **Fiscal Policy:** The Trump administration finally worked in concert with Congress to enact legislation to provide direct assistance to businesses and workers during the current shutdown of the economy. An initial fiscal stimulus package of $2.2 trillion was signed into law on March 27.

» **Targeting Households and Businesses:** The program provides a $1,200 check to each individual making $75,000 or less (married couples get an additional $500 per child), and $400 billion in zero-percent interest loans is directed toward the small business sector. "Severely distressed" large companies receive large grants or loans. For example, the airline industry gets $25 billion in grants and another $25 billion in loans.

» **The Eurozone:** It is encouraging that other countries are following the lead of America. The European Central Bank (ECB) has announced a very large increase in its asset purchase program. At the same time, Germany has announced that it will use its untapped financial prowess to provide fiscal stimulus.

What are some critical independent variables that investors should closely monitor?

Although there remains enormous uncertainty regarding the immediate future, it is important to remember that financial markets are **forward looking** and will anticipate an improvement in trends well in advance.

Here are 8 independent variables that investors should closely monitor.

1. The timing of a peak in new COVID-19 cases in the US, Canada, and Europe, especially Italy. Trends in China, South Korea, and Singapore should also be monitored to ensure that a second wave of infections does not occur

2. Announcements of public health countermeasures, including availability of test kits and respirators and the ability of hospitals to manage the surge in new cases expected over the next several weeks

3. Medical innovation in terms of new therapeutic treatments to mitigate the illness, along with state-of-the-art medical testing equipment. Regrettably, approval of an effective vaccine is at least one year away.

4. The policy response from the Federal Reserve and the Treasury in providing open-ended relief for businesses, workers, and ailing credit markets

5. The effective functioning of money and credit markets and continued availability of credit for businesses and consumers

6. When new cases reach a peak, the focus should return to commercial activity in order to gauge the speed at which businesses are able to restart the economy

7. The focus should be on timely data regarding initial jobless claims, hiring intentions, airline bookings, retail store openings, and the pace of office openings — all leading indicators of a rebounding economy

8. Economic trends in the early-infection countries — especially China and South Korea — as a possible guide as to how quickly and effectively the US economy might restart once the coronavirus is contained

What investment conclusions can you share?

Both stocks and bonds are in a bear market, which could persist for a while longer. The peak-to-trough decline in the S&P 500 through March 20 was 31.5%. Fixed-income markets have also suffered steep declines, including both investment-grade corporate bonds (-15%) and long-term speculative-grade corporate bonds (-23%).

There are clear signs of a market panic. Correlations on all asset classes — stocks, bonds, commodities, crude oil, gold — have converged on 1.0. This is unprecedented and means that all asset prices are moving in lockstep, an obvious sign of forced liquidation in highly leveraged financial firms — hedge funds, mutual funds, and traders — faced with severe liquidity pressures, which are compelled to sell all assets simultaneously. The obsession over cash is so great that firms are selling Treasury bonds to buy Treasury bills. **The three-month US Treasury bill fell briefly to a negative 0.15% on March 20.**

Evidence of forced liquidation and a mad scramble for cash is ubiquitous. Outflows from bond funds exceeded $100 billion in late March, while stock funds continue to experience the largest redemptions on record. US Treasury bills have been in such high demand that the yield fell briefly into **negative territory** on March 20. The closely watched Volatility Index (VIX) also rose to an all-time high.

How should long-term investors react to the hysteria in the market?

The first thing to recognize is that irrational behavior and forced selling of troubled investment firms are driving the pricing of financial assets. It is also true that algorithmic computer trading and the proliferation of exchange-traded funds (ETFs) have accentuated the indiscriminate selling of all assets.

It is useful to examine market history to understand the pattern of similar market panics in the past. Once economic stability is restored, the normal negative correlation between common stocks and government bonds will be reestablished, which should mean rising stock prices and bond yields and falling bond prices. In an improving economy, corporate bonds should also significantly outperform government bonds.

The performance of the equity market in the aftermath of all post-World War II recessions is uniform: Stocks rebound strongly and are **always** higher in three, six, and 12 months. The subsequent three-year returns have always exceeded the long-term average of 10%, while returns in 12 months have always exceeded 50%. **Value managers** have almost always outperformed growth/momentum managers.

Investors in balanced portfolios should ensure that allocations among asset classes are at desired levels. Based upon relative valuations, this would typically involve a shift from fixed-income assets to common stocks. My proprietary valuation model indicates that annualized total returns for the S&P 500 could easily exceed 12% over a three-year time horizon, whereas expected annualized total returns for a diversified bond portfolio are unlikely to exceed 2.5%.

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