ALEXANDRIACAPITAL

Outlook Memorandum

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IN PURSUIT OF INFORMATION, KNOWLEDGE & VISIBILITY

The pandemic, the resulting economic fallout, and the intense media coverage have no parallels – it is safe to assume we are all inundated by the avalanche of data, opinions, and the impact it is having on families and daily life. The fact that the economy is stretched at the seams is painfully evident. Markets declined 35% from their mid-February high in record time, while daily volatility of +/- 5% has become common. Weekly unemployment claims have shattered prior highs ten-fold. Equally revealing is the support for markets and the economy delivered quickly by the Federal Reserve and Congress. While the broader pandemic response feels disjointed – with an uncertain path for easing mitigation measures – we are reminded of the idiom "it's darkest before dawn". This is not a case of reckless hope, but rather rational optimism. To be clear, very substantial challenges lie ahead in terms of healthcare, business viability, and lost incomes. But looking past the headlines, our entrepreneurial society is doing what it does best: allocating resources to meet a challenge. The tempo at which the private sector is innovating is encouraging; this is not really a matter of what has been accomplished to date, but the pace of progress that is accelerating into the weeks and months ahead. Our baseline expectation is that the immediacy of the pandemic crisis will gradually transition to a sense of control, certainty, and security over the coming months enabled by containment and visible progress along multiple fronts (treatments, contact tracing, and business adaptation) that will support the sustained reopening of the economy. For investments, the impacts to corporate revenue and earnings prospects will not be evenly distributed and the government cannot socialize operating losses universally nor indefinitely. But the gusher of cash flowing into the economy is a blunt force for reflation across jobs, spending, bonds, and stocks.

The turmoil caused by the pandemic and shutdown highlights that liquidity and credit are essential to the economy. The U.S. economy is a "just-in-time" machine, not merely in terms of inventory management, but also in terms of financial payments. Government mandates (with compliance stoked by mortal concern and persistent policy pronouncements) shut down a wide swath of the economy. Most businesses (including restaurants, bars, and retail stores) do not operate with sufficient cash to pay rent and employees during a pause in revenue; nor do their suppliers and landlords who have mortgages, wages, real estate taxes, and their own suppliers to pay. Simply put, the profitability of businesses and the credit worthiness of borrowers is intricately entangled with the financial well-being of workers across the economy. The shut-down lays bare that the fortunes of each American have never been more closely tied together.

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Some pundits are quick to draw parallels between the unemployment and payment strains (loans, rents, mortgages) we are seeing currently with the Great Depression. But there is a critical difference: back then, ill-fated policy decisions by the Fed precipitated the 35% collapse in M-2 money supply that undermined the economy, decimated employment, triggered bankruptcies, and caused the deep and prolonged pain that became known as the Great Depression. No such mistake is likely in present times. Indeed, during the 2008/09 recession the Fed acted to expand the money supply as broad measures of liquidity and credit collapsed when banks and investors realized that many mortgages were junk masquerading as triple-A quality. In a span of just months, the Fed served as the lender of last resort and bought large quantities of low risk assets – and in the process doubled the base money in the financial system. This resulted in a stabilization of M-2 money supply, and the economy/markets found a new equilibrium off which a recovery began.

The Fed is swinging into action again. The economy is in recession now. No need to debate the definition when unemployment has already surged by more than 16 million people. But rather than exacerbate the downturn the Fed is once again counteracting the instinct of businesses, investors, banks, and other financial intermediaries to hoard cash, liquidate assets, and avoid any new risk that an economic or financial arrangement goes sour (businesses needing to order products or materials, for example, suddenly faced onerous payment requirements). Over 25 programs have already been introduced, and with the printing presses working overtime its balance sheet has been expanding at a ~$12 trillion annual rate (representing more than 50% of GDP). The Fed's quick actions are restoring liquidity, reducing borrowing costs, and creating "normal" pricing dynamics across markets for commercial paper, loans, municipal debt, treasuries, mortgages, and corporate bonds. The Fed is also venturing further into capital markets by extending riskier loans with prospective losses to be absorbed by the Treasury (taxpayers).

How much liquidity is enough? A few of the macro variables that we track closely and typically discuss in our outlook memorandums include the growth in real M-1 money supply, the level of our ACAP Liquidity Index, and whether short-term interest rates are at a stimulative level relative to GDP growth. Each of these key measures are responding to the substantial actions under way by the Fed. Indeed, since February our ACAP Liquidity Index has moved higher, short-term rates are lower, and M-1 money supply has been expanding at an estimated 20%+ annual rate. Each is at a level that is historically consistent with a robust economic expansion – but in this unprecedented environment liquidity alone is not sufficient to promote growth. With the shutdown in place and people avoiding risk of infection, nominal GDP contracted sharply in March and is poised to decline 25% or more during the second quarter. Thus, the expansion in the money supply is translating into neither economic growth, nor price inflation. As a result, the implication is cash is piling up, and outside of bare necessities must go somewhere – under the mattress, into savings accounts, money markets, or back into asset markets.

At the same time, the CARES Act is cushioning the impact of lost wages and revenue. The Act is implementing 21 programs showering $2.2 trillion on affected constituencies. Individuals are receiving up to $1,200 and an additional $500 for each child. Unemployment claimants, of which we have already seen more than 16 million extra workers file, are receiving an additional $600 per week for up to four months (most workers that had been earning less than $60k may wind up collecting more through unemployment). The CARES Act also includes lending to corporations, support for stricken airlines, and small business loans through which the government effectively pays the cost of eight weeks of payroll, rent, utilities, and healthcare. From an economics perspective, the CARES Act, together with monetary policy, is essential for preventing a long-lasting slump in spending.

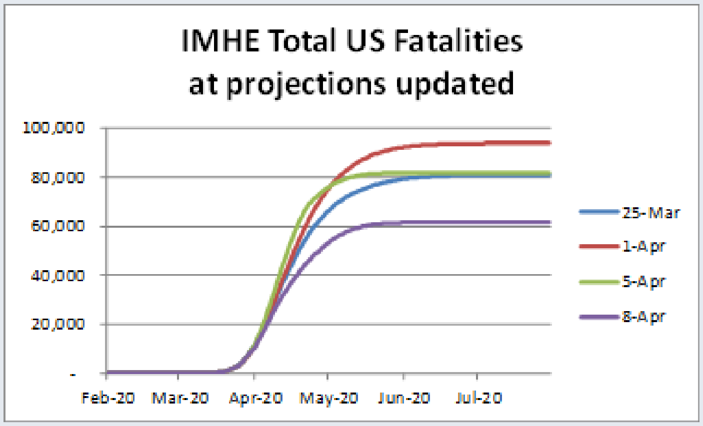
The Anatomy of the $2 Trillion COVID-19 Stimulus Bill

Category	Total Amount	Share of the Package
Indivuduals / Families	$603.7 billion	30%
Big Business	$500.0 billion	25%
Small Business	$377.0 billion	19%
State and Local Government	$340.0 billion	17%
Public Services	$179.5 billion	9%

(source visualcapital)

The Fed and Congress are promising more, and the effects are synergistic. The weakness created by the pandemic shutdown is precisely why the Fed and Congress will continue to pour money into the financial system and economy – to enable most rents, loans and mortgages to continue to be paid, and enable private businesses to resume activities to the fullest extent possible on a reopening of the economy. This is not intended as stimulus but rather a bridge from the economy we had to the one that will emerge – anything short of generous support for the economy would risk a far more substantial and prolonged recession. The money gushing into the economy will not be distributed fairly, but the stakes are high-enough that the best approach is to err on the side of doing too much.

Not surprisingly, stock and bond prices have thus far surged 25% off their lows reflecting such an abundance of liquidity and magnified by improving prospects for reopening business as the outbreak severity is revised more favorably. The timing and degree to which economic activity resumes will influence the degree to which policy efforts wind up being pro-growth versus anti-recessionary. For markets, this dynamic is exemplified by the closely followed IHME model of the pandemic, which has been updated multiple times in April with recent revisions offering a much better outlook in terms of the expectation for fatalities.



Fed easing and CARES money aside, the pace of recovery will be determined by the evolving virus response. Politics and missteps aside, the initial panic is transforming into a more organized, methodical approach to contain the virus impact. This is not to say that things will easily return to the way they were or there is a high degree of certainty, but there is steady progress in areas that will affect how rapidly economic activity can resume. Beyond a stabilization of daily new confirmed cases and hospitalizations (both of which are lagging indicators), multiple areas are worth tracking:

Serological assays: Initial efforts are now underway to identify the degree to which the general population now has some sort of immunity to the coronavirus, which will impact future transmission rates and policies.

Rapid testing: Abbott is rolling out tests with results in as little as 15-minutes. Others will follow. Rapid diagnostics can be used to identify infections early and blunt transmission, treat patients more proactively, and potentially diminish the severity of infection.

Anti-virals: The healthcare industry is racing to find drugs and treatment approaches that inhibit. Anti-malaria and anti-ebola drugs are receiving a lot of attention, though a magic bullet seems less likely despite some promising anecdotes. Other approaches include delivering antibodies derived from recovered patients. Therapeutic antibodies produced by biotech companies that specifically neutralize the virus are also underway, with prospectively accelerated timelines for initial availability as soon as this Fall. Directly targeting the virus may not only reduce potential transmission, but also the severity of infection.

Anti-inflammatory: Several approved drugs block signaling components of the immune system (such as Regeneron's Kevzara) and are being tested to treat the hyper-inflammation that is a serious complication associated with coronavirus infection. Bringing the immune system back into homeostatic balance may lessen the acute respiratory distress that is leading to the worst outcomes.

Vaccines: The CDC indicates over 70 candidate vaccines currently in development, including both traditional approaches and newer technologies. While long-lasting immunity has not been demonstrated, even a transient period of protection can be immensely beneficial. Resources are mobilizing to accelerate the timeline for availability, particularly for newer vaccine technologies using messenger RNA to prompt vaccinated individuals to produce key virus fragments.

Mitigation/tracking: Apple and Google are teaming up to develop an app using Bluetooth proximity to track if you have come within range of someone that tests positive. This will

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be very enabling for both a resumption of daily activities as well as promoting containment, social distancing, and self-quarantines. Yet to be determined will be whether voluntary opt-in will be sufficient for widespread adoption, or whether privacy concerns will force a more heavy-handed approach.

China (even hard-hit Wuhan), South Korea, Hong Kong, and Taiwan provide real-time evidence that virus spread can be contained (including in dense urban areas) even as the economy gears back up. We also know what persistent mitigation may look like: sporadic and targeted re-implementation of restrictions to halt transmission rates. The framework that we are modeling progress against does not necessarily require the successful development of a traditional vaccine, or long-term persistence of immunity. We also recognize that concentrated plasma is a costly treatment to deliver.

However, our rational optimism builds on the reopening experience throughout Asia with progress from the healthcare industry (including associated research institutions), manufacturers, and tech companies. Together with widespread adoption of masks, the use of hand-sanitizers, and at least a partial continuation of social distancing, the economy should be able to reopen steadily in the coming months. Bottom-line: the coronavirus is not magically disappearing, but the tools to limit infection, detect early, inhibit replication, limit the severity of COVID-19, and to begin immunizing segments of the population (even if the duration of immunity is relatively short) are coming into focus.

Policymakers need to continue providing a bridge until activity substantially resumes. Progress aside, government support absolutely is essential in the current environment and the only question is whether the actions taken thus far are sufficient to shepherd the economy back to a much-restored level of activity. More support may be required – and the actions are very much about preventing a dominoes-like freeze in rent, mortgage, loan, payroll, and inventory payments. The stakes are high, and policymakers have no illusions to the contrary.

In recent outlooks we postulated that monetary easing may become the new normal due to persistently sluggish growth and disinflation trends, largely reflecting the headwinds of rising global debt to income levels and unfavorable demographic trends. That view is now in sharper focus with the rapid increase in debt and unemployment, the looming weakness in tax receipts, and broad business challenges. Simply put, longer-term expectations for interest rates and growth are moving lower, while the hurdles for anchoring inflation around 2% may be harder to clear.

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Mindful of these dynamics, we continue to trim duration among our bond holdings while focusing where credit quality remains strong and yields continue to be attractive. We are cautiously optimistic for equity markets – on the back of continuing monetary and fiscal stimulus, the broad indices can gain upwards of another 10% and close the year near flat. The path, however, is unlikely to be smooth as recent gains may cool some of the urgency on the part of the Fed and Congress to rollout additional stimulus. Further, an uneven economic recovery may continue the shift within markets toward new economy bellwethers (many of which are flush with cash and profitable) and away from some of the more mature, debt-laden cyclical industries.

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