Outlook Memorandum

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ACCELERATION & CONVERGENCE

To say the current environment is unprecedented is an understatement. After delivering the quickest bear market in U.S. history, stocks posted their best 50-day return ever. The S&P 500 finished the second quarter up 20.5% (39.3% off its March low), bringing its first-half performance to a loss of just 3.1%. The recovery is welcome, but the v-shaped turnaround contrasts with rising new infections, record unemployment, the rollback of re-openings, and the dimming outlook for a quick recovery among hard-hit industries (restaurants, entertainment, airlines, and so on).

At the heart of the widening divergence between stocks and the economy is the Fed's unprecedented, rapid expansion of its balance sheet – a necessary push to shore up solvency across businesses, municipal borrowers, and households as the shutdown rippled across the economy. While the Fed has substantially stabilized credit, its efforts are far slower to restore employment and incomes – a dynamic that is even more pronounced due to the depth of the recession and exacerbated by the ongoing virus spread. Notwithstanding the initial reopening surge in jobs and spending activity, the recovery has a long road ahead (and will take years) – which assures that monetary and fiscal policy will continue to be a dominant theme in markets and the economy.

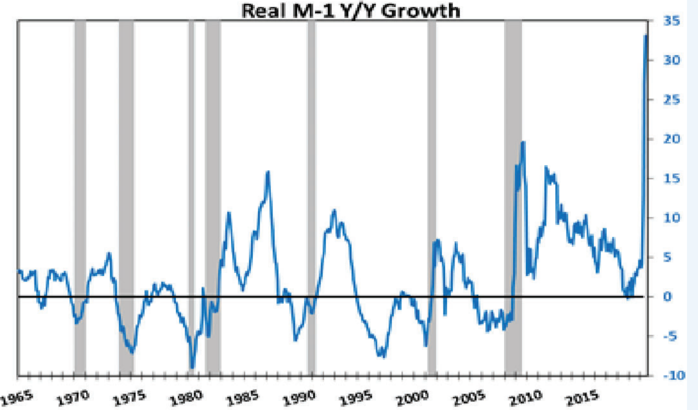
Beneath the surface, the more limited economic impact of expansive monetary policy is revealed as the prices of assets viewed as more stable surge relative to their more cyclical peers. The Russell 1000 Growth Index is up 10% on the year but its Value sibling is down 16%. The tech-heavy NASDAQ Index is up 13%, while the financials, industrials, and energy components of the S&P 500 are down 24%, 14%, and 35% respectively. For the "winners", the prospect for falling rates rule the day; for the "losers" the concern over the earnings outlook is a heavy burden. The result is a wide divergence in valuations based on a "normal" earnings profile, and a positioning that is sensitive to the pace of virus spread, treatment progress, profit updates, the pace of reopening, and the lasting effects on some businesses versus others (airlines, office buildings). Simply put, markets are settling in for a prolonged period of very generous monetary policy under the presumption that the real economy will remain too weak for policy makers to reverse course.

There is a strong argument that economic activity must move comfortably above prior levels to restore lost jobs and service the accumulated debts caused by the pandemic. In addition, accelerated timelines of long simmering issues (unfunded pensions, high debt levels, and income-wealth inequality) stand as a strong headwind to recovery policies. Bottom line: Markets may not fully appreciate the degree to which the economy will depend on easy monetary/fiscal policies and how difficult the disinflationary trends will be to overcome. We are incrementally bearish on cash and long-term bonds as the most prosperous path forward for the U.S. and global economy is to push hard on monetary/fiscal levers to ultimately lift employment, wages, and inflation while maintaining rates near zero. We see opportunities within equity markets, as reopening puts a floor under earnings expectations for many companies that still trade with low valuations; but limited gains for the overall market through year end as policy slowly shifts toward income restoration.

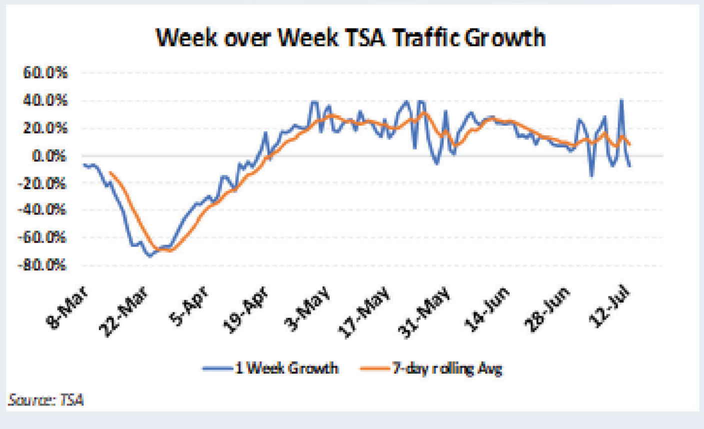
Liquidity is still the driving force for the economy… Amidst the shutdown and convulsions that ripped across markets and the economy, the essential role of credit has not abated – in fact, channeling money to businesses that are solvent and have a productive use for it is even more important given the indiscriminate nature in which loan losses across commercial mortgages, residential/business loans, municipalities, and credit cards can cause lenders to retrench.

With even strong businesses vulnerable when customers can no longer spend or pay bills, the reality is that the pandemic/shutdown set in motion a domino-like wave of bankruptcies and defaults that, if left unchecked, threaten to swell to some multiple of historical experience. Some estimates imply lost business revenue, already, in the range of $4 trillion (and a swing of $1 trillion in profitability) against total pre-pandemic private sector debts of more than $30 trillion. The magnitude of policy response should be appreciated from the perspective that economy-wide solvency does not exist at 90% of pre-pandemic GDP levels, let alone the approximately 40% nadir during the shutdown.

The initial policy actions were very much intended, and succeeded, in flooding all sectors of the economy with as much cash as possible. Since mid-March, the Fed has added $3 trillion to its balance sheet, representing ~15% of pre-pandemic GDP. At the same time, Congress is injecting almost $3 trillion into the economy, while allowing tax filers to delay payments on their 2019 taxes and encouraging a very liberal approach to rent/mortgage forbearances. Not surprisingly, real M-1 money supply has surged 33% recently – four times higher than what we historically would have considered stimulative to the economy and markets. To put this into perspective, following the financial crisis the Fed expanded its balance sheet by $1 trillion (representing 7% of annual GDP) by the end of 2008, and then added an additional $2+ trillion in assets over the ensuing five years (the total added reached a cumulative 20% of GDP).

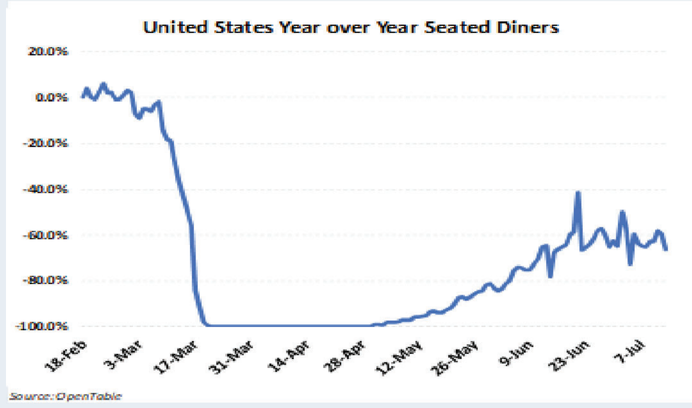


...but the economy has a long road to recovery. Jobs started coming back in May and June, but the ranks of unemployed is still close to 20 million. Job losses classified as temporary have declined 7.5 million from its April peak of over 18 million as the economy reopened, but an additional 1.6 million permanent job losses have been registered since the pandemic began. As the economy opens, reclaiming 75% or 85% of prior activity is the easy part. Recovering from 90% to 95% is poised to be a lot harder as some elements of the pandemic/shutdown will linger (such as remote work arrangements, which will weigh on office buildings and businesses reliant on commuters). Air travel, hotel bookings, theme park attendance, and live events cannot fully recover without putting the virus substantially behind us.



Source: TSA

TSA throughput data, for example, has leveled off after initially recovering at a rate of 20% week over week, and airlines are now signaling significant job cuts/furloughs this fall (and these are high paying jobs). Delta recently reduced planned flight resumptions for August from 1000 to 500 primarily because demand growth is stalling. Restaurants are also facing a long road back and profits were thin before the pandemic. OpenTable's national reservation data shows total restaurant traffic is stubbornly stuck at 40% of year ago levels, though an increase in takeout makes up for some of the lost business, it requires fewer staff returning to work. Commuters' reluctance to return to the office setting is also rippling across the many businesses that cater to workers, including restaurants, salons, and public transit (taxis).



This recovery will present unique challenges. The past forty years have provided investors a consistent tailwind of lower interest rates as the Fed pursued full employment against the disinflationary backdrop of globalization and increasing technology adoption (which boosted productivity and lowered costs). The result has been a steady rise in asset valuations and earnings, while the impact of offshoring "old economy" jobs was largely mitigated by new opportunities in the service and knowledge sectors and the government's willingness to run fiscal deficits to reduce the drag from trade imbalances. Though unemployment reached a record low just prior to the pandemic, the limits of this economic algorithm are exemplified by the long trend of rising debt levels, large trade deficits, record budget gaps, unfunded pensions and entitlements, and growing income/wealth inequalities. This leaves policy makers with less flexibility with which to promote the recovery (and a return to full employment) without exacerbating cumulative imbalances, and this means the Fed may eventually face a more substantial tradeoff between supporting employment as opposed to containing inflation.

Steering the economy back to a sustainable position will require a new approach focusing on jobs and income. Monetary policy is historically slower to lift the economy than financial markets, and this is particularly pronounced today given the demand shock of a sharp drop in employment and a recovery that is being handcuffed by ongoing virus spread. With credit and liquidity already substantially stabilized, as evidenced by the v-shaped recovery for stocks and credit, policy makers are unlikely to blindly preside over a further widening in income/wealth inequality (this issue has already gained new political prominence in D.C. in recent months). That is, additional excess monetary stimulus would probably worsen existing inequalities

Highlighting this dynamic, the median income was equivalent to over 100 shares of the S&P 500 in 1980, versus only about 20 shares today. Fiscal policies, such as enhanced unemployment benefits and back-to-work incentives for lower income households are thus emerging as preferred policies with the Fed likely playing a supporting role (buying Treasuries) given the backdrop of record fiscal deficits/debt levels prior to the pandemic.

The trends of disinflation, slow growth, and low interest rates remain stubbornly entrenched for now. In times of crisis there is a tendency to look for and find inflection points in the economy, social trends, and markets. This is especially true today given the magnitude of the pandemic/shutdown-induced hit to the economy and the elevation of long simmering issues, including inequalities (income, wealth, race), rising debt levels, budget deficits, trade imbalances, and climate change to name a few. As we stated earlier in this Outlook, the world requires higher inflation. We anticipate policies will move in that direction. But the inflection will be far more gradual than v-shaped, and it is important to understand that the dynamics that constrained growth, inflation, and interest rates over the preceding 10 years are more potent today. The implication is

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that we expect policy initiatives, both domestically and globally, to gradually become more aggressive in the months and years ahead in terms of boosting jobs and incomes, but secondary effects on inflation will be more dependent on policymakers' resolve and global developments (are other countries pursuing similar policies; are spending and investment preferences changing; and is global integration retreating). With the linkages between trade deficits and income/wealth inequality becoming more widely appreciated and the lost jobs and income in this recession more heavily concentrated among lower income households –our baseline expectation is that policies must shift toward income replacement as opposed to outright support for markets.

Monetary and fiscal coordination is not without risk. Most prominently, the Fed is poised to transition from providing credit to the economy to replacing lost income – this is dependent on the extent that Congress approves spending targeted for households that continue to struggle, and the degree to which such spending is monetized by the Fed. Importantly, the policy initiative would be less potent if financed via higher taxes on more wealthy households as the net impact on spending would be reduced.

More subtly, the current environment is undermining the benefit of "free-markets." A key principal of capitalist systems is creative destruction – that is, investment is allocated to where it earns the highest return (which does not have to be strictly defined as profit). To the extent businesses, people, and managers allocate money and earn high returns they succeed; to the extent they do not, they fail – and key resources (labor and capital) are released for more productive uses.

The necessary coordination is inviting policymakers to become more involved in investment decisions. Christine Lagarde, Chair of the European Central Bank (ECB), took the unusual step of openly promoting green jobs and investment as part of the bank's objectives in a recent speech. As a reminder, the ECB is a central bank with the power to adjust interest rates and print money, and now its Chairman wants to use this authority to favor specific industries and causes. We are not arguing whether green jobs is a misallocation of resources, only highlighting that once central banks and governments begin coordinating on monetary and fiscal policy, politically driven investment decisions may erode the "free-market" determination of investments that is vital for producing growth and wealth.

What does this mean for investors? Future expected returns are likely to be lower in both real and nominal terms…the 10 year Treasury now yields 0.60%. All risky assets price off the Treasury rate and have risen to reflect this lower discount rate. With interest rates near zero it is likely that broad equity indexes will see more muted returns compared to the last decade as the secular tailwinds of lower interest rates, taxes, and globalization are unlikely to repeat in the decade ahead. Compounding lower returns in risky assets is the prospect that volatility will be higher given the wide range of outcomes that can occur (deflationary to inflationary) based on which monetary and fiscal policies are pursued. Cash can help buffer this volatility as it is stable in nominal terms, but it will almost surely decline in real terms as central banks pin interest rates near zero despite their goal of 2-3% inflation. Moderate inflation is the most attractive path for reducing debts, rebalancing the trade ledger, and reducing the income / wealth gaps. We see limited gains for the overall market from here but expect that persistent volatility and a gradual reopening will present opportunities across individual sectors and mixed credit bonds as short-term swings in market sentiment affect securities indiscriminately, gardless of their prospects and underlying valuations. In a nod to increasing longer-term uncertainties, we are incrementally more positive on gold and real assets given their relative scarcity in an environment where central banks are effectively monetizing government deficits.

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