ALEXANDRIACAPITAL

Outlook Memorandum

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PANDEMIC EXPOSED IMBALANCES

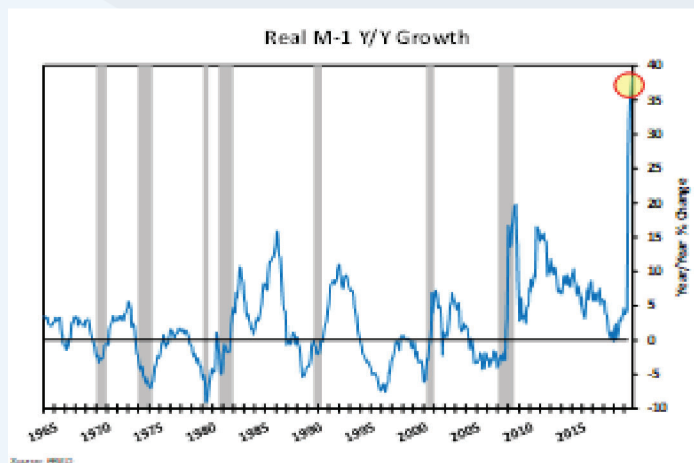
There is nothing comfortable, nor settled, about the extreme divergences characterizing the current environment. Daily new Covid-19 cases remain elevated as colder weather arrives in the northern hemisphere. Public trust in the development and approval of treatments/vaccines is slipping, even as recent clinical trials show that new, effective therapeutics will soon be available. High new unemployment claims are a weekly reminder of the many people and businesses that are struggling deeply. Meanwhile, the budget deficit is severe ($5+ trillion); interest rates on government bonds are negative after subtracting inflation; federal/state debt levels are rising rapidly; and the political climate remains extremely divisive. Nevertheless, stock markets continue to move higher, with the S&P 500 gaining 8.9% in the third quarter. Bonds rose about 0.4%, while international stocks gained 5.9%. Commodity markets were mixed with copper and gold continuing their rallies up 11.8% and 5.9% respectively, while oil remained flattish.

Stocks reaching new highs seem counterintuitive but reflects exceptionally low interest rates that investors accept as a pre-requisite for restoring jobs and lost incomes. Low interest rates result in smaller discounts on the value of future expected earnings and, thus, higher asset prices today. This is especially true for companies growing consistently through this environment, such as the high-flying cloud/subscription-based technology companies. Magnifying this dynamic is the expectation that the depth of economic disruption will take longer to heal, thus adding to the secular headwinds that have been gradually developing and weighing on interest rates/growth over the past decade.

Looking ahead, the cyclical impulse for the economy is set to improve. The lift from the unprecedented fiscal and monetary actions has been muzzled by restrictions on business and the general reluctance of people to resume normal life until the virus is under control. In economic terms, this shows up as a lower stimulus multiplier and an unprecedented spike in the private sector savings rate. The multiplier is likely to rise materially in the quarters ahead, particularly with the introduction of new therapeutics and vaccines that enable a gradual easing of restrictions and allow individuals to feel safe resuming “normal” activities. Until the virus is defeated, additional fiscal measures are needed to support the large constituents still struggling – enhanced support now should accelerate the healing later. While markets are beholden to the debate over additional fiscal stimulus, prospects for a Democrat sweep in November may pave the way for more consistent support for the pandemic-induced unemployed and ease investor jitters. Against a backdrop of unattractive low interest rates along the entire yield curve, stocks continue to look comparatively attractive. We are mindful, however, that the next stage of the reopening/recovery may entail a rebalancing within markets and the economy and thus overall market progress may be more muted.

Policy actions have been, and should continue to be, forceful. The government pandemic response is not one of benevolence, but rather existential survival. Private sector and state/local debt at the end of 2019 stood at $52 trillion, equivalent to 2.5x GDP. At the height of the shutdown the economy was more than 30% smaller, transiently pushing the overall non-federal debt ratio ~40% higher (to ~4x GDP). That deterioration was poised to continue spiraling downward as the shutdown instantly undermined the ability of businesses to pay rent and their suppliers, which then rippled across other businesses, employees, and landlords as job cuts mounted. The Fed's initial scramble along with fiscal stimulus propped up solvency across the economy.

In pumping massive amounts of liquidity into financial markets, the implicit compact the Fed made with lenders, investors, banks, households, and businesses was that it would enable stakeholders to look beyond the sudden credit abyss and focus on the recovery. Real M-1 money supply (see chart below) surged at a 35% annual rate early in the pandemic and has continued to grow at an exceptional pace with the Fed's objectives shifting toward energizing the recovery. To date, the Fed's balance sheet has surged over $3.3 trillion this year.



While the Fed has delivered (asset prices have recovered/ borrowing costs have fallen sharply), the shape and pace of the recovery is still at the mercy of less predictable variables, such as the rate of new infections, availability of new treatments (better health outcomes), fewer restrictions, and willingness of people to get on with their lives. Unwavering fiscal support is also critically important. Thus far Congress has implemented multiple programs exceeding $3 trillion for small businesses, hard-hit industries, and the unemployed over the past eight months – but many have or are about to expire. The extent of unemployment and the unevenness in which some businesses/industries continue to struggle (while other segments thrive), requires more persistent fiscal support until the recovery is self-sustaining and reversing most of the economic displacement. The Fed can provide additional liquidity, but even higher asset prices and even tighter credit spreads will do little to improve the plight of people in the lowest quartile of household earnings, which has disproportionately borne the brunt of job losses.

The savings rate is soaking up policy stimulus. The fiscal/ monetary initiatives that have been rolled out rank highly pro-growth and pro-inflationary by historical standards. Transient constraints on the economy, however, are suppressing the translation of policy stimulus into consumer spending (~70% of GDP). The money still must go somewhere, and while it has shown up in home sales, RVs, and other discretionary spending – a substantial portion was diverted into domestic savings (see chart above). The savings rate is normalizing as enhanced unemployment expires and other stimulus measures fade, but swollen bank accounts should still cushion consumer spending in the months ahead. Eligibility for future fiscal stimulus checks and enhanced unemployment benefits, however, may be more targeted to lower income households and thus less likely to pad the savings or discretionary spending of those that remain employed.

In an underappreciated dynamic, we have noticed a similar phenomenon regarding federal spending. The U.S. Treasury, through its scheduled bond issuance, has raised far more cash than it has been spending – to the tune of $1.2 trillion. This excess cash, which sits on deposit at the Fed, has effectively neutralized roughly 30% of the Fed's policy stimulus since

February. Like excess household savings, the drawdown of this excess cash will be highly stimulative for the economy.

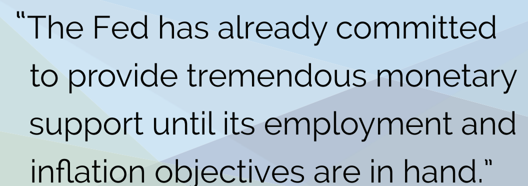
Treatment/vaccine progress should lift the economic multiplier on stimulus. Initial clinical data for antibodies (single doses) from Eli Lilly and Regeneron demonstrate profound impacts on viral loads among infected individuals, particularly those that are sicker. Early signs for these antibodies and Remdesivir suggest they cut the COVID-hospitalization and death rate almost 80%. We should also soon have initial data for Merck's pill, in which it preclinically shows potency against the virus.

There are also over 200 vaccines in various stages of development, and we believe there will be more than one that proves successful. Four vaccines are in final Phase III trials under the auspices of either U.S. or Western European drug regulators and we should have a view into their effectiveness and availability before year-end. That said, we do not underestimate the logistical challenges of mass vaccination, particularly given cold storage requirements and the potential need for booster shots. There are also surveys highlighting that a broad swath of the population is reluctant to be vaccinated.

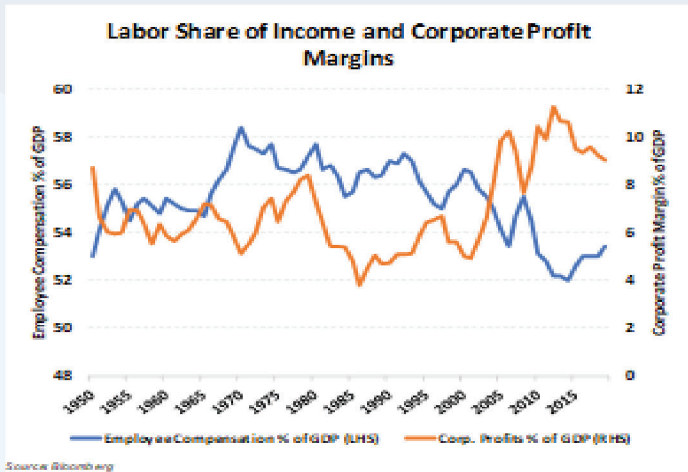
Assuming vaccines start becoming available in early 2021, the implication is that the government imposed / individually embraced restrictions will start fading and begin to release the pent-up stimulative impact of successive rounds of monetary and fiscal stimulus. Importantly, the accumulated loss of jobs and business closures means the road to a sustaining recovery is paved with additional stimulus from the Fed and Congress. The Fed has already committed to provide tremendous monetary support until its employment and inflation objectives are in hand. And while politicians jockey for advantage, the only real question in terms of additional fiscal stimulus is timing. Additional stimulus checks may again raise the savings rate, but such savings will also underwrite future spending as household risk taking normalizes. Given an already improving economic outlook (consumer spending is inching higher, the non-manufacturing ISM index is well into expansionary territory, and consumer confidence recently jumped higher and is far above its pandemic low) treatment progress and mass vaccination sets the stage for a continued cyclical rebound during 2021 (though the inability of Congress to come to an agreement threatens to add new turmoil).

The prospect of a recovery outweighs the policy differences among politicians. The reality is as many as 20 million people are out of work or unable to find full time enployment. The benefit to corporate revenue and profits stemming from a recovery and an economy no longer on life support are more significant than incremental shifts in tax policy or regulations on trade, climate, etc. Moreover, markets recognize that policy ambitions that raise the cost of business and/or reduce the incentive to hire is highly constrained by realities of the current economic environment. While markets historically prefer a federal government where control is split among the parties (thus tamping down the potential for unpredictable and costly changes in regulations), this time may be different as a November sweep by the Democrats is seen as removing contentious obstacles holding up additional stimulus – which remains important for stabilizing credit and preventing defaults from spiraling higher (setting the stage for recovery), especially as forbearance programs end.

The focus on reversing imbalances may be the start of a new investment paradigm. A hallmark of the past forty years has been progressively lower interest rates as inflation pressures failed to materialize. An important corollary has also been sluggish growth over the past ten years. There are a lot of contributors to these dynamics. China's entry into the World Trade Organization added hundreds of millions of workers into the global supply of labor, putting a lid on wages as production was outsourced to China and other low wage countries. The impact on domestic inflation was also enabled by economic policies (domestic and overseas) that championed the benefit of low cost imports and high U.S. trade deficits – even though the adjustment of a rapidly increasing global labor pool was shouldered by a subset of U.S. workers. While declining inflation pushed interest rates progressively lower (with the benefit of higher asset prices), Americans increasingly accessed debt to make ends meet. Such debt largely pulled forward consumption, rather than increasing the basis for future incomes (and thus needs to be repaid out of reduced future spending). Other



factors simultaneously magnified the imbalances, including technological advances and globalized supply chains which enabled companies to continuously optimize their cost structures even as they were able to raise prices. In fact, the divergences are visible broadly, such as the share of the economy represented by labor versus corporate profits (see chart below), and comes at a time when aging demographics are leading to a lower potential growth rate for the economy as a whole.



The resolve to address unsustainable economic imbalances is reinforced by the heightened awareness of wealth inequalities – which suggests the drivers of disinflation over the past forty years are weakening and, in some instances, reversing. Globalization is slowing with trade conflicts and the pool of cheap labor is shrinking. The pandemic exacerbated income and wealth inequality, and exposed rapidly increasing debt levels, deep trade deficits, and unsustainable fiscal deficits – all of which are increasingly being embraced by politicians. This means that reversing imbalances is becoming a popular, recurring theme. The Fed, for example, has been queried on whether reversing socio-economic income inequality should be a third mandate - and while on the surface this may seem outside of the Fed's domain, the Fed may be less apt to tighten policy if inflation pressure is being driven by households at the lowest income quartile. Other policies may also reduce imbalances, such as bipartisan repudiation of large trade deficits (of which China is the focus for now), tax changes for retirement savings plans, minimum wage hikes, guaranteed income policies, and expanded Medicare benefits or a leveling of other entitlement benefits. Policies supporting renewable energy adoption are no longer necessarily high cost – and can lead to greater cost certainty (lessens energy's contribution to inflation), while supporting employment for hourly workers.

The pandemic has accelerated innovation and economic transformation. Many investors focus on return to the office versus remote work, or ecommerce versus in-person retail – the reality will be less absolute, but nonetheless disruptive as businesses adapt to new consumption patterns. At the same time, technology and innovation continue to alter the economic landscape. A typical electric car, for example, has about 95% fewer moving parts than its gas-powered equivalent (lowering manufacturing and maintenance costs). Other advances, such as new healthcare treatments or additive manufacturing may be, on the surface, disinflationary even as they improve living standards and reshape the forces behind historical trade/ budget deficits and wealth inequalities.

For investors, asset prices are clearly responding forcefully to the prospect of continued stimulus – pricing in an exceptionally long period of accommodative monetary and fiscal policy. Predicting market returns from here thus becomes an exercise in how low long-term interest rates (and perceptions of risk among high flying stocks) can go. In time, however, the virus impact will recede; economies will "normalize" beckoned on by more stimulus – and the result may be a move higher in interest rates that caps the market's overall progress even as recently lagging sectors show some life.

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