MORE AGGRESSIVE POLICY MEASURES AND SOMEWHAT BETTER PUBLIC HEALTH TRENDS

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It cannot be emphasized enough that current monthly data are of little relevance to investors because of their artificial, temporary, unsustainable nature, and because they are simply a byproduct of deliberate public health measures designed to save lives. Instead, investors should be focusing on the reopening of the domestic economy in the summer months, and the potential level of GDP and corporate earnings in 2021. My assumption is that the economy will reopen slowly and in small waves over a period of months and quarters, implying a U-shaped recovery.

Summary and Major Conclusions:

Financial markets staged a massive rally last week as investors responded to improving data pertaining to the coronavirus pandemic. At the same time, the economic news continues to worsen, as expected. Government data on the economy will continue to lag the news regarding COVID-19 infections, hospitalizations, and deaths. Finally, there is further evidence that policymakers are in a "whatever it takes" mode, which should bode well for financial markets.

- Through the end of last week, the US equity market has risen by 25%. In a very preliminary sign of a shift in market leadership, value stocks have rallied by 28%, compared with a cumulative gain of only 22% for the Russell 3000 Growth Stock Index. The MSCI World Index (ex-US) has risen by +20% off its bottom.

- As would be expected, the fixed-income market has lagged the rebound in the equity market by a wide margin. From their recent lows, total returns on US Treasury and mortgage-backed bonds are +4% and +3%, respectively, while corporate bonds have registered superior returns in both investment-grade (+9%) and high-yield (+12%).

- The future direction of both the economy and the equity market remains heavily dependent upon developments on the public health front. There were at least two encouraging news items last week: (1) The pace of new cases globally is showing signs of flattening; and (2) Scientific models now indicate that the severity of the pandemic might be far lower than previously believed.

- New coronavirus infections appear to have peaked in San Francisco and the Pacific Northwest, and have begun a peaking process in New York. New daily cases nationwide have been on a plateau of roughly 30,000 since April 1, and are set to decline in coming weeks.

- The CDC announced that its models had greatly overestimated the cumulative number of fatalities expected in the US. Compared with previous estimates of 240,000, the most recent models are now predicting fatalities of fewer than 60,000.

- Globally, new cases in many Asian countries have plummeted, while the number of new cases in Italy, Spain, and Germany have peaked. Active cases in Switzerland and Austria are in a steep decline. In short, there is growing confirmation that social distancing is beginning to flatten the curve, as expected by leading medical experts.

- *The news in the public health sphere is not all good*. The decline in the number of confirmed cases is likely to be gradual. In fact, scientists believe that COVID-19 will never totally disappear, with ongoing risks of potential outbreaks until a vaccine is developed. Meanwhile, diagnostic tests remain in short supply, as are other vital supplies such as masks, ventilators, and respirators. In short, there is still a long way before something approaching normalcy occurs.

- An effective vaccine might be at least 18 months in the future, including research and clinical trials, followed by a ramp-up of mass production capacity. In the interim, many medical professionals expect the illness to become seasonal: A sharp decline in July and August followed by multiple outbreaks in the fall and winter.

- In the absence of a vaccine, the most important medical development in the short term would be the discovery of a therapeutic (antiviral) drug, which would alleviate symptoms while reducing hospitalizations and fatalities. Gilead's Remdesivir is currently at the most advanced phase of clinical trials. Increased availability of diagnostic testing devices that are timelier and more efficient would also help.

- Another mitigating factor would be breakthroughs in *contact-tracing* — a smartphone technology designed to provide real-time information that has proven to be effective in slowing the spread of the coronavirus. A proposed national surveillance system would help suppress potential future outbreaks, thereby accelerating the process of reopening the economy.

- Investors are likely to be shocked by economic data for the months of April and May, but they should not be. It should already be well understood that regular monthly government reports — including data on retail sales, industrial production, nonfarm payrolls, and housing starts — will show unprecedented weakness.

- *I cannot emphasize enough that these monthly data are of little relevance to investors* because of their artificial, temporary, and unsustainable nature, and because they are simply a ***byproduct*** of deliberate public health measures designed to save lives. Instead, investors should be focusing on the re-opening of the domestic economy in the summer months and the potential levels of GDP and corporate earnings in the fourth quarter of this year and in 2021.

- My assumption is that the economy will re-open slowly and in small waves, based upon the inherent population-intensity of each sector. Industries deemed "essential" will also begin to reopen first. The epidemic could linger for months, implying a bumpy re-starting of the economy. As such, a more *gradual U-shaped economic recovery* appears more likely than a steep V-shaped recovery.

- *Manufacturing and construction will likely be among the first sectors to open*, while travel-related industries such as airlines will lag. Entertainment and recreation will also be in the lagging category, as will consumer services. Retail sales will continue to be dominated by e-commerce. Mass gatherings — including sporting events, movie theaters, conventions, and amusement parks — will continue to be discouraged.

- The response of the Federal Reserve has been magnificent in terms of speed, scope, creativity, and size. *The Fed has made it clear that it will provide whatever liquidity is deemed necessary* to prevent a severe cash flow and liquidity crisis from becoming a solvency crisis.

- Monetary data reveal that the Fed's aggressive actions are having an immediate effect. The massive injection of reserves into the banking system has triggered a surge in the *monetary base*, also called "high-powered money." The M2 money supply is currently increasing at a 15% annual rate, the fastest growth rate since 1983.

- Fiscal policy is also set to receive another boost, initially in the form of additional federal funds to support lending to small and medium-sized businesses. Policymakers understand the urgency of minimizing the spread of *permanent* unemployment, bankruptcies, and corporate bond defaults.

- The underlying economic and financial foundation of the US economy was healthy just prior to the pandemic. *The economy's human, physical, and intellectual capital remain intact, and the financial system is at decreased risk of implosion*, given the firm commitment of the Federal Reserve to backstop key credit markets.

- The spike in unemployment has been disheartening but not unexpected. The good news is that a record 85% of the 1.2 million job losses in March were *temporary (furloughs)*, rather than *permanent*. *The primary mission of policymakers is to prevent these layoffs from becoming permanent*.

- Companies do not want to permanently sever links with their employees; *permanent layoffs would require a painful multi-year period of rehiring, retraining, and lost productivity*. Continuation of this favorable trend of *worker attachment* is dependent upon the effectiveness of various government transfer payments to companies.

- *There is currently no definitive answer regarding the ultimate bottom in the equity market*. While it is not unreasonable to assume that the primary market low of Monday, March 23, will hold, there are no guarantees. The history of bear markets reveals a strong tendency of stock prices to *retest their primary low* reached early in a market downturn.

- The most relevant conclusion is that the equity market is in a *bottoming process*, which can persist for weeks. The direction of the stock market is totally dependent upon the future path of new infections, hospitalizations, and fatalities. Assuming a continued flattening of the curve in new cases, it is likely that the most volatile and disorderly phase of the bear market has passed.

- *Corporate insider trading* has historically been a highly consistent signal of the future direction of stock prices. Executive purchases of their own company stocks have surged to record levels in recent weeks, a confirmation of the attractive valuations of stocks within selected sectors of the domestic equity market.

- It is vital for value-based investors to exercise selectivity and to differentiate among sectors in the S&P 500. *Cyclical stocks currently offer the most attractive valuations, while traditional defensive stocks appear fully valued*. Industrials, financials, and transportation stocks should easily outperform consumer staples, utilities, and real estate.

- It is also imperative for bond investors to be selective. Corporate bonds offer attractive valuations and should easily outperform the government, asset-backed, and mortgage-backed bond sectors.

- The most important risk to financial markets is a resurgence in newly confirmed cases of COVID-19 and a second wave of infections following a possible summer lull. The other major risk involves a logistical and execution failure of emergency government lending programs designed to enable companies to retain workers on their payrolls. It is imperative for government agencies to move swiftly to distribute funds to individuals and small businesses.

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