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Economic Perspective

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REOPENING THE US ECONOMY: WHAT SHOULD INVESTORS EXPECT?

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The S&P 500 appears to be reasonably valued from a short-term perspective. However, it is instructive for investors to view the equity as a tale of two segments. The approximately fair value of the S&P 500 is a result of the dominant influence of three mega-cap sectors: Technology, healthcare, and consumer staples. Meanwhile, several sectors are extremely undervalued and offer compelling long-term opportunities: Financials, industrials, machinery, transportation, and aerospace. The risk-reward ratio for equity investing is more attractive when evaluated over a two-year time horizon.

Summary and Major Conclusions:

Although the global pandemic is far from over — and could persist indefinitely at an undefined level of infections — financial markets are beginning to turn their attention to reopening the US economy and the implications for future business conditions and company earnings. This Special Report provides an update of current public health developments and economic trends in conjunction with world financial markets.

- Recent news on the coronavirus pandemic has been mixed, with a slightly favorable bias toward good news versus bad. In the positive column, the number of new cases appears to have peaked in most countries in early April; the number of fatalities will soon peak, with a lag to confirmed cases; and progress in developing both an antiviral therapeutic medicine and a vaccine appears to be on track.

- On the stimulus front, Congress passed a $484 billion relief package last week, designed to provide additional funding (more than $300 billion) to supplement the original Paycheck Protection Program (PPP). The phase one $350 billion in PPP funds was exhausted in only two weeks.

- Cases in New York appear to have peaked. The total number of new cases in New York — which rose to nearly 10,000 in early April — has declined to a daily average of roughly 6,000. Daily fatalities have declined from an average of 900 to 600.

- The four major negative trends are the continued increase in confirmed cases worldwide; a continued rising trend in the number of fatalities; the resurgence in new infections in Singapore, Indonesia, and Japan; and the failure of the number of cases in the US to trend lower following the peak in early April.

- Unlike most major countries — which have witnessed steep declines in new cases in the wake of their peaking processes — the US is experiencing more of a ***plateau***. The number of new daily COVID-19 cases in the US peaked at 35,000 around April 10, but has declined only modestly from that level.

- One explanation for this plateauing phenomenon are crosscurrents in infections on a regional basis. The number of new cases is still in a rising trend in nearly 50% of states, while 35% of states are exhibiting a flattening trend. Only 15% of states are in a decisive downturn.

- Both early-responding countries (China, South Korea) and intermediate responding countries (Germany, Austria, Italy, and Spain) are experiencing steep declines in confirmed cases, and as a result are at varying stages in reopening their economies.

- China is leading the post-pandemic recovery, but has shown disappointing economic results. Following an all-time record 10% slump in Q1 GDP, *the Chinese economy has stabilized, but its recovery has been lackluster*, partially because of a timid response by policymakers in delivering stimulus to the economy.

- There are three major lessons from China for investors to contemplate:

  1. Rigorous and consistently applied lockdown programs are essential in containing the pandemic and in reducing the number of infections.

  2. A less than full throttle and open-ended fiscal and monetary response to the crisis — which has been the case with China — is likely to result in a weak recovery in economic growth.

  3. *Rigorous containment is a necessary but insufficient requirement to spark a strong recovery*. Although the Chinese economy is in recovery mode, the recovery is far from V-shaped, reflecting the *unprecedented challenges in reopening an economy following a sudden shutdown*.

- Investors can look to China as somewhat of a prelude to a reopening of the US economy. *While the majority of Chinese factories have reopened, the service sector has been a notable laggard*. Even in manufacturing, supply chain disruptions are constraining output. As a preliminary forecast, China's GDP for all of this year is expected to decline by 1%, its weakest year in more than 40 years. This compares with my forecast for a US GDP decline of 5%.

To conclude, because of the enormous complexities involved in re-starting the economy, investors should be prepared for a more modest U-shaped, rather than V-shaped, recoveries in the US and Europe.

- *Investors can also look to New York as a forerunner of possible nationwide trends*. The number of new COVID-19 cases has declined by nearly 45% from its peak of April 9, while fatalities have declined by 55% from their peak. Governor Cuomo told reporters that "there is no doubt that we've gone through the worst," indicating that a phased reopening could begin as early as May 15.

- Another significant negative is the continued inadequacy of diagnostic testing nationwide and the shortfall in available personal protective (PPE) and hospital equipment. The shortfall in testing is especially worrisome. *Compared with a desired pace of three million tests per week, current testing is barely above one million*. An even greater number of tests will need to be conducted in the fall and winter.

- *Expected sharp swings in headlines regarding a restarting of the US economy will be the dominant influence on world financial markets in coming weeks*. The reopening process is extremely complex and needs to unfold in a gradual and methodical manner on a state-by-state and industry-by-industry basis, so as to avert a sharp rebound in new COVID-19 cases. Investors should expect setbacks along the way.

- The *best-case scenario* would be a relatively smooth reopening in May, accompanied by only a mild increase in confirmed coronavirus cases thereafter. Under this scenario, mitigation efforts are successful and deaths are limited. Stock prices and government bond yields will likely trend higher under this scenario.

- The *worst-case scenario* would be an escalation in new cases as the economy reopens, resulting in another wave of shutdowns and a possible double-dip recession later in the year. Stock prices would test their March 23 lows, exerting additional downward pressure on government bond yields.

- *The most likely outcome could fall somewhere between these two extremes*. My base-case forecast assumes scattered outbreaks of the virus regionally as the economy reopens. Certain states could experience a more rapid acceleration in cases, forcing local officials to temporarily resume containment measures. *In short, it seems reasonable to assume that a second wave — and maybe a third wave — is likely until an effective vaccine becomes available in mass quantities*.

- Investors will be closely evaluating reopenings in several states this week — most notably that of Georgia — where new cases are still on the rise. There is a high risk that the growth rate in infections could escalate as commercial activity resumes.

- A resurgence of new infections will prompt the governor to backtrack on restarting the economy, accompanied by a renewal of lockdown mandates. South Carolina, Oklahoma, Tennessee, Texas, and Alaska will also begin the process of relaxing stringent stay-at-home rules this week.

- US equity prices have risen by 25% off their March 23 low, a reflection of four principal factors:

  1. The *overshoot* in equities during the initial reaction to the pandemic
  2. A generally improving trend in *public health data*
  3. *Unprecedented policy stimulus* from the federal government
  4. Success of Federal Reserve intervention in maintaining a steady *flow of credit*

- *The critical variable with respect to the domestic equity market is the impact on the trend in confirmed COVID-19 cases as social distancing measures are relaxed*. Further sustained stock price appreciation in the short term could be more challenging until there is evidence of a relatively smooth and successful reopening of the US and European economies.

- The risk-reward ratio for equity investing was extremely favorable in March, when investor hysteria triggered a collapse in stock prices in waves of indiscriminate selling. The S&P 500 has since retraced roughly 50% of its cumulative decline through Friday of last week, and thus appears less undervalued.

- At current valuations, the risk for stock investors is roughly equal to the reward in the ***short term***, implying a sideways trading range as markets closely observe weekly data on the coronavirus pandemic. Stock prices are likely to follow an *alternating weekly pattern* of gains and losses in response to media headlines pertaining to the pandemic.

- *The risk-reward ratio for equity investing is positive when evaluated over a two-year time impact on the number of new cases horizon*, assuming substantive medical breakthroughs. Widespread availability of a vaccine for COVID-19 will spark a solid rebound in economic growth necessary for a recovery in company earnings.

- The US equity market remains a tale of two segments. The approximately fair value of the S&P 500 is a result of the dominant influence of three mega-cap sectors: Technology, healthcare, and consumer staples. Meanwhile, several sectors are extremely undervalued and offer compelling long-term opportunities: Financials, industrials, machinery, transportation, and aerospace.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.