MID-QUARTER ECONOMIC REVIEW AND OUTLOOK

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Incoming monthly government data will likely show that the US economy hit rock bottom in April, followed by some modest improvement in May and June. An estimated 25% of the nation's GDP is currently off-line, down from close to 30% in April. This metric could decline to 10% to 15% in June and to 5% to 10% in July. My forecast assumes that a moderate and choppy but sustained economic recovery will begin in the second half of this year, but that the economy will not fully reopen until a vaccine is available in large quantities, expected during 2021.

Summary and Major Conclusions:

- Self-imposed containment measures across the US have resulted in the most severe recession since the 1930s. Depending upon the future path of the pandemic and the timing of medical discoveries to treat and prevent COVID-19, the recession could also be the shortest in American history.

- The US economy has been held hostage by the coronavirus pandemic since the economic lockdown began in February. Developments on the public health front continue to unfold at a rapid pace, with numerous crosscurrents.

- The number of new infections daily reached a peak of 35,000 more than one month ago, and has been on a plateau since that time. The economic significance of this trend is that many states will be reopening their economies at a time when infections are still elevated.

- The obvious risk is that the relaxation of social distancing practices will almost certainly lead to an increasing trend in infections at a time when the number of confirmed cases is still near its peak.

- Progress in medical research has unfolded at a faster than expected pace. Gilead's antiviral drug Remdesivir has received FDA approval for emergency use. This therapeutic has shown success in alleviating symptoms and shortening the duration of the illness.

- The biggest positive surprise is the unprecedented pace in the development of an effective vaccine. Although a vaccine will not be available in mass quantities until 2021, the pharmaceutical industry has dedicated unprecedented resources toward a speedy discovery of a drug.

- The critical economic issue for investors is whether a potential resurgence of the pandemic during the remainder of this year will be met by an increased arsenal of medical tools necessary to minimize the impact of any possible outbreaks.

- Incoming monthly government data will likely show that the US economy hit rock bottom in April, with some modest improvement in May and June. My forecast assumes that a moderate and choppy but sustained economic recovery will begin in the second half of this year.

- An estimated 25% of the nation's GDP is currently off-line, down from close to 30% in April. This metric could decline to between 10% and 15% in June and 5% to 10% in July. The economy will not fully reopen until a vaccine is available in large quantities, expected during 2021.

- Following the worst economic decline in second quarter GDP since the 1930s, economic activity should stage a gradual rebound in the third and fourth quarters of this year. Rather than a V-shaped recovery, my forecast assumes a more moderate U-shaped recovery, although a W-shaped recovery could result from a surge in new infections.

- I continue to believe that the recession will be the deepest but also the briefest since 1945. My forecast assumes that real GDP will not return to its previous 2019 peak of $19.22 trillion until the fourth quarter of next year.
- With some exceptions, history reveals that company earnings return to their previous peaks within roughly three years. It seems plausible to assume that corporate earnings are unlikely to return to their 2019 peak until 2022.
- The divergence in valuation between growth and value stocks continues to widen, with relative valuations for growth stocks approaching their all-time peaks of 1999. A shift in equity market leadership could occur once there are concrete signs of a sustained economic recovery.

Self-imposed containment measures across the US have resulted in the most severe recession since the 1930s. Depending upon the future path of the pandemic and the timing of medical discoveries to treat and prevent COVID-19, the recession could also be the shortest in American history. This week's report is the regular *Mid-Quarter Economic Review*, which discusses critical variables in the economic and financial market outlooks.

CORONAVIRUS PANDEMIC

The US economy has been held hostage to the coronavirus since the economic lockdown began in March. Developments on the public health front continue to unfold at a rapid pace, with numerous crosscurrents. In the negative column, unlike Asia and Europe, the number of new cases nationwide has flattened but not yet declined, while the number of deaths remains elevated. In contrast, developments in the area of medical research and product development are ahead of original expectations.

- The number of daily new infections reached a peak of 35,000 more than one month ago and has been on a plateau since that time, fluctuating within a range of 25,000 to 30,000 in recent weeks.
- These averages are comprised of striking divergences nationwide: New cases are in a steep decline in New York, California, and the Pacific Northwest, while continuing to climb in 20 other states. The declining trends on the East and West coasts are consistent with trends in Germany, France, Italy, Spain, and the UK.
- *The economic significance of these trends is that many states will be reopening their economies at a time when infections are still elevated*. The obvious risk is that the relaxation of social distancing practices will lead to an increasing trend in infections at a time when the number of confirmed cases is near its peak.

- In the positive column, progress in medical research has unfolded at a faster than expected pace. Gilead's antiviral drug Remdesivir has received FDA approval for emergency use. Remdesivir has shown success in alleviating symptoms and shortening the duration of the illness. Availability of diagnostic testing remains less than adequate but should improve significantly in coming weeks and months.

- The biggest positive surprise is unprecedented progress in the development of a safe and effective vaccine. Although a vaccine will not be available in mass quantities until 2021, the pharmaceutical industry has dedicated unprecedented resources toward a speedy discovery of a drug.

The key point is that a potential resurgence of the pandemic during the remainder of this year is likely to be met by an increased arsenal of medical capability and tools necessary to minimize the impact of any outbreaks that might occur. *The ultimate outcome of the battle between these two forces will determine the direction of the economy over the next six to nine months*.

ECONOMIC UPDATE

Global GDP in the first quarter suffered its worst decline since 2009. Compared with a 6.5% seasonally adjusted annual decline in the first quarter of 2009, world GDP declined by an estimated 5% in Q1. All major economies contracted in the quarter, led by China (-10%), the US (-5%), and the eurozone (-4%). The two largest depressants on Q1 US GDP were consumer durables and consumer services, which declined at a 15% and 9% annual rate, respectively. Second quarter US GDP data will be much weaker than those of Q1, with an annualized decline that could exceed 25%, by far the largest contraction since the 1930s.

GOVERNMENT POLICY

A major difference between the current crisis and the 2008 world financial crisis is the unprecedented response of policymakers in both the speed and magnitude of stimulus. Policymakers moved slowly and cautiously in responding to the 2008 financial crisis, but have moved swiftly and boldly in recent weeks in introducing multi-trillions of dollars of fiscal and monetary support.

- The Federal Reserve has provided massive support to the financial system. The increase in quantitative easing (QE) since the onset of the crisis has been staggering. The Fed's holdings of government bonds have surged from less than $4 trillion in January to nearly $7 trillion, and could reach $10 trillion before yearend.

- In a more targeted fashion, the Fed has created numerous lending facilities to support various segments of the credit markets, including the commercial paper, money market, and corporate bond markets.

- Fiscal policy stimulus has also been unprecedented. Congress has already passed $3 trillion in fiscal policy support. Relative to GDP, total federal government outlays thus far are equivalent to 15% of GDP, 50% greater than the 10% of GDP supplied during the 2008 financial crisis.

ECONOMIC OUTLOOK

Incoming monthly government data will likely show that the US economy hit rock bottom in April, with some modest improvement expected in May and June. My forecast assumes that a moderate and choppy but sustained economic recovery will begin in the second half of this year. Of course, all assumptions regarding the economic outlook must consider trends and developments pertaining to the coronavirus pandemic.

- An estimated 25% of the nation's GDP is currently off-line, down from close to 30% in April. This metric could decline to between 10% and 15% in June and 5% to 10% in July. The economy is unlikely to fully reopen until a vaccine is available in large quantities, expected during 2021.

- Following the worst economic decline in second quarter GDP since the 1930s, economic activity should stage a gradual rebound in the third and fourth quarters of this year. Rather than a V-shaped recovery, my forecast assumes a more moderate U-shaped recovery, albeit with setbacks along the way.

- A W-shaped recovery would result from severe outbreaks of infections during the fall and winter. The next several months will be crucial in revealing the sensitivity of infections to a resumption of normal economic and social activities.

- Despite widespread warnings by the media, the odds that the current self-induced economic downturn will morph into another 2008 Great Recession and protracted deleveraging cycle are quite low. *I continue to believe that the recession will be both the deepest and the briefest since 1945*.

Pulling it all together, the US economy should be in a gradual and somewhat uneven recovery during the second half of this year, with output in most sectors remaining well below normal. Manufacturing and construction should be the first industries to return to normal, while consumer services and travel-related industries will lag. *My forecast assumes that real GDP will not return to its previous 2019 peak of $19.22 trillion until the fourth quarter of next year*.

CORPORATE EARNINGS

Company earnings tend to follow the trend in nominal GDP. The biggest year-over-year declines in corporate profits will occur in the second and third quarters of this year. On a sequential quarter-to-quarter basis, earnings should bottom in the second quarter and begin to recover in Q3. On a calendar-year basis, my forecast assumes a decline in operating profits of nearly 30% this year, followed by a 25% increase in 2021.

- **Protracted Recovery**: With some exceptions, history reveals that company earnings return to their previous peaks within roughly three years. In the current cycle, earnings projections beyond this year are predicated upon the effectiveness and sustainability of the current reopening of the economy. Investors should assume that earnings for companies in the S&P 500 will not return to their 2019 peak until 2022.

EQUITY MARKET OUTLOOK

The recovery in the equity market since its March 23 low has been nearly unprecedented. A portion of the 32% advance in less than eight weeks can be attributed to panic and indiscriminate selling during late February and March, resulting in an overshoot to the downside and an exaggerated bottom in stock prices.

Short-Term Volatility: It seems reasonable to expect a pause in this first leg of the rebound in stock prices in coming weeks and months as a normal consolidation phase sets in. Investors should expect a sideways market in the short term, with stock prices fluctuating within a volatile trading range.

Equity Market Ceiling: There are several compelling factors that could act as a ceiling for stock prices in the short term:

- **Reopening Risks**: There will be profound uncertainty revolving around the reopening of the economy in the weeks and months ahead. The probability of a spike in infections is nontrivial, and would imply a setback in restoring the economy to normal operation.

- **Evidence From Asia**: Despite a decisive reduction in confirmed cases, many Asian countries are enjoying only modest success in restarting their economies. The evidence from China, Korea, and Taiwan is that these economies are on a sluggish recovery path despite considerable success on the public health front. The experiences of these countries should raise doubts about the outlook for the US and Europe.

- **Company Earnings**: Wall Street analyst estimates for both 2020 and 2021 earnings appear overly optimistic, and are therefore vulnerable to downside adjustments. The absence of earnings visibility is a major headwind for the equity market.

- **Speed of Economic Recovery**: There remains widespread disagreement among economists as to the speed of the economic recovery, with advocates of V-shaped, U-shaped, W-shaped, and L-shaped recoveries. The shape of the recovery could remain unclear for many months.

- **Valuation Constraints**: Traditional valuation metrics suggest that the S&P 500 has returned to fair value, limiting price gains in the short term. That said, it is imperative for investors to understand the degree of polarization within the overall market — numerous deeply undervalued sectors offset by several notable overvalued sectors.

- **The New Normal**: Market concerns over long-term fundamental changes to the economy — the unknown structure of the new normal — could also act as a ceiling on future equity market gains. The most important of these include protectionism, consumer decisions regarding spending and saving, and decisions by employers with respect to managing their workforces.

Equity Market Floor: At the same time, there are also several compelling factors that should provide continued support for equity prices in the short term, even as equity investors are disappointed by setbacks on both the public health and economic fronts:

- **Recession Bottom**: Although certainly subject to change, *the economic bottom appears to have been reached in April*, which should be followed by a gradual improvement in May and June followed by more rapid growth in the second half of this year. *The equity market has a long and consistent history of bottoming **before** the end of recessions*.

- **Policymaker Support**: Unprecedented monetary and fiscal stimulus has provided enormous support for the economy and equity market. Policymakers have adopted an open-ended mindset in doing whatever is necessary to avoid a depression and another meltdown in stock prices.

- **Credit Market Support**: In particular, continued recovery of credit markets is a prerequisite for a healthy economy and equity market. Massive liquidity injections by the Federal Reserve have ensured a continued flow of credit within the financial system.

- **Medical Innovation**: In the end, the direction of the economy and equity markets will be decided by breakthroughs in research on antiviral medications and vaccines. In this regard, the pace of innovation has been unprecedented, and further positive surprises should support stock prices.

- **Public Health Toolbox**: The economic outlook during the second half of this year is dependent not only upon the pace of new infections but also the availability of public health tools to address any new outbreaks. *The message from healthcare officials is that a robust arsenal of tools will be available by the fall, including adequate supplies of diagnostic tests, masks, and ventilators; sufficient hospital capacity; and the availability of new medicines*.

- **Equity Risk Premium**: Although the S&P 500 appears fully valued on an absolute basis, common stocks are significantly undervalued versus the bond market. *The equity risk premium (ERP) is at its highest level in several years, strongly suggesting that stocks will outperform bonds over all time horizons*.

Equity Market Sectors: The divergence in valuation between growth and value stocks continues to widen, with the valuation premium for growth stocks approaching its all-time peak in 1999. Relative valuations for growth stocks are currently more than three standard deviations above those for value stocks. Although a decisive shift in equity market leadership awaits concrete signs of a sustained economic recovery, value stocks could massively outperform growth stocks over one- and three-year time horizons.

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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.

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