INTERPRETING THE NEWS FLOW

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Investors should exercise caution over the next several months. Prospects for equity investing should brighten later this year and during the first half of 2021. The combination of a gradually strengthening economy, continued massive monetary and fiscal policy stimulus, increased optimism regarding corporate earnings in 2021 and 2022, and potential medical breakthroughs with respect to one or more vaccines and therapeutics for COVID-19 should act as catalysts for higher stock prices. Only a massive second wave of coronavirus infections can abort the cyclical recovery in spending, output, and employment.

Summary and Major Conclusions:

- Last week's crash in world equity markets was a clear indication of the heightened levels of residual fear and anxiety among global investors. It was also a manifestation of the profound lack of conviction regarding the outlook for sustained economic growth.

- The catalysts for the steep stock market decline were fears of an imminent second wave of COVID-19 infections — resulting from a reopening of the economy — along with widespread disappointment over Federal Reserve Chairman Jerome Powell's cautious comments on the economic outlook.

- I believe that investors are misinterpreting the actual developments involved with each of these two areas. The media have exhibited a consistent negative bias with respect to the coronavirus pandemic, as several important positive trends have been either overlooked or misunderstood.

- Although Chairman Powell delivered a sober message regarding the short-term outlook for the economy, he offered a virtual guarantee of continued unprecedented monetary stimulus. The key takeaway is that the Federal Reserve will utilize all policy tools in support of the economic recovery.

- There continues to be misinformation, confusion, and heightened market sensitivity to ongoing developments regarding the coronavirus pandemic. News on the public health front is mixed but far less gloomy than generally portrayed in the media, in my judgment.

- Despite the proliferation of testing and increased pace of social mobility, the daily rate of new US cases has declined from a peak of 37,000 in April to an average rate of 20,000 in recent weeks. The daily rate of fatalities has also declined — from a peak of 2,700 to fewer than 1,000.

- The primary uncertainty in the outlook pertains to the high likelihood of a second wave of rising infections in the fall and winter, which is impossible to accurately gauge at this time, but which could seriously undermine economic activity.

- The primary concern is that the restarting of the economy — along with spreading complacency and premature relaxation of social distancing practices — will be accompanied by a significant rise in cases from current levels.

- The offset to this expected second wave is the expectation that the public health system will prove to be more robust and far better equipped to cope with a new outbreak, versus the initial wave in February.

- In addition, one or more vaccines are likely to be available later this year for use on an experimental and emergency basis. It is also likely that one or more antiviral medicines will be available, which could alleviate symptoms and reduce the number of hospitalizations and deaths.

- With respect to a second wave, it appears likely that both policymakers and businesses are likely to tolerate a higher level of infections. This suggests that another nationwide shutdown as occurred in March and April is unlikely, although regional lockdowns are probable.

- The shape of the economic outlook through yearend will remain in doubt until there is greater visibility regarding the future path of the pandemic. That said, the probability of a double-dip recession remains low at this time, with odds favoring a sustained U-shaped recovery through 2022, at a minimum.

- Investors should exercise caution over the next several months. The 40% rise in the US equity market since its March low was one of the strongest for any three-month period since 1950. History suggests that a temporary consolidation phase is probable, characterized by extreme day-to-day volatility.

- Prospects for equity investing should improve later this year in response to more widespread evidence of an improving economy, continued massive policy stimulus, increased optimism regarding corporate earnings in 2021 and 2022, and rising expectations of major medical and scientific breakthroughs.

- Although recent market trends have been ambiguous, it appears highly likely that 2020 will mark a major inflection point with respect to equity market leadership. The history of previous post-recession periods strongly suggests that value stocks are likely to outperform growth stocks over the next several years, possibly by a very wide margin.

"Stock markets were once dominated by bulls who thought stocks would go up and bears who thought they would go down. These days, another animal is on the rise. These new investors are focused on volatility, the amount of movement in prices over time. Investors big and small are wagering hundreds of billions of dollars on volatility, by betting directly on [the magnitude of] moves in measures like the S&P 500, the shares of individual companies, and oil prices.

The pandemic has cemented its arrival, luring fresh cash and investor interest as stock swings jumped to new levels. Since then, big moves in stocks have provided traders with abundant opportunity to profit. Volatility trading has grown so big that trading on expected market moves can itself move markets."

"Investors Bet on Volatility"
The Wall Street Journal
Page One
June 12, 2020

Last week's crash in world equity markets was a clear indication of the heightened levels of residual fear and anxiety among global investors. It was also a manifestation of the profound lack of conviction with respect to the outlook for sustained economic growth. The volatility of the stock market in most recent weeks is also a reflection of widespread speculation, day trading, and momentum investing. *As measured by the S&P 500, the equity market surged by 15% from the middle of April to the middle of May, only to retrace 50% of that gain in just three trading days in the middle of last week*.

Equity Market Catalysts: The alleged catalysts for the steep stock market decline were fears of an imminent second wave of coronavirus infections — resulting from a partial reopening of the economy and relaxation of social distancing practices — and widespread disappointment over Federal Reserve Chairman Jerome Powell's comments on the economic outlook. *I believe that investors are misinterpreting the actual news on each of these two fronts*.

Glass Half Full: Although current developments pertaining to the coronavirus pandemic are mixed, the media have arguably emphasized the negatives. There are distinctly positive trends that have been overlooked or misunderstood. With some offsets, public health trends are slowly ***moving in a positive direction***, as discussed below. And the primary message from Fed Chairman Powell was bullish for risk assets: Monetary policy will remain at maximum accommodation throughout 2022, at a minimum, thereby providing strong support for financial assets.

The Fed Is Your Friend: There were two overriding themes contained in Chairman Powell's message last week: (1) A cautious short-term outlook for the economy and the challenges to a speedy economic recovery; and (2) A virtual guarantee of continued unprecedented monetary stimulus. *The clear implication is that the Fed will use whatever tools are necessary for as long as it takes to support the economic recovery*.

PUBLIC HEALTH TRENDS

There continues to be misinformation and confusion with respect to ongoing developments pertaining to the COVID-19 pandemic. *The medical news is mixed, but less negative than generally portrayed in the media*. Here are the key facts:

- The *number of new cases, deaths, and hospitalizations* has been in a generally declining trend ***nationwide***, and previous outbreaks in hot spots such as New York and New Jersey have declined significantly. Testing has also successfully ramped up to three million tests per day, versus 1.5 million only one month ago.

- Nationwide trends have been relatively consistent. Despite the proliferation of testing, *the daily rate of new US cases* has declined from a peak of 37,000 in the middle of April to an average rate of fewer than 20,000. The daily rate of fatalities has also declined, from a peak of 2,700 to fewer than 1,000 since May 30.

- While confirmed cases in the US have surpassed two million, ***the positivity rate*** has remained constant at 5% — although an uptick would not be surprising as the economy restarts. The trajectory in hospitalizations has also flattened. Domestic production of N95 respirators is rising rapidly.

- There has also been positive news regarding development of *new medications*: More than ten large pharma companies are on track to have a vaccine by early next year, led by Johnson & Johnson and AstraZeneca. At the same time, progress toward an effective therapeutic before the fall appears promising, led by Eli Lilly.

- These positive trends are partially offset by *several negative considerations*. The US has been far less successful in reducing the trend in new infections when compared with countries such as Germany, France, Australia, South Korea, and even Italy. Each of these countries has seen a collapse in both new cases and deaths.

- More bad news comes from recent outbreaks in various southern states — including Arizona, Texas, Florida, South Carolina, Georgia, and North Carolina — as a result of widespread reopenings of commercial, social, and recreational activities.

- Seldom mentioned in the media are the steep declines in both new cases and deaths in key states in the Northeast and Midwest, including Connecticut, New York, New Jersey, Pennsylvania, Massachusetts, Michigan, Iowa, Kansas, and Illinois.

- The ultimate source of fear and anxiety involves the potential for a powerful second wave of COVID-19 in the fall and winter. The severity of this second wave is impossible to predict at this time, but markets seem to be anticipating the worst case scenario.

More Robust Health System: An offset to this expected second wave is a public health system that is much better equipped to cope with a new outbreak than was true for the initial outbreak in February. In addition, one or more vaccines are likely to be available later this year for use on an experimental and emergency basis, although mass inoculations will not be available until 2021. There is also the likelihood of an antiviral medicine to augment Remdesivir, which has proven to be only a moderately effective therapeutic.

Consequently, the strength of the economic outlook over the next six to nine months will remain in doubt until there is greater visibility regarding the future path of the pandemic. It appears that policymakers and businesses will be more tolerant of any resurgence in infections that might occur in the future, strongly suggesting that another nationwide shutdown as occurred in March and April is unlikely. *As such, the probability of a double-dip recession remains low at this time, with odds favoring a sustained U-shaped recovery through 2022, at a minimum*.

CRITICAL ECONOMIC VARIABLES

The direction of financial markets over the next year is ultimately dependent upon the outlook for growth in US GDP and corporate earnings. There is no change in my analysis that the recession ended in April and that a U-shaped recovery is already underway. My conviction in a sustained economic expansion rests upon the following key factors:

- Monetary Policy: Fed Chairman Powell has made it clear that policy will continue to support the economy and financial system with whatever tools necessary. From its 2019 base of $4 trillion, the Fed's balance sheet — primarily holdings of government bonds — has increased to $7 trillion and could soon exceed $10 trillion.

- Fiscal Policy: Congress and the Treasury have responded aggressively to the crisis with massive spending programs exceeding $3 trillion in the form of greatly expanded unemployment benefits, generous transfer payments to households, and loans and grants to small and medium-sized businesses.

- Government outlays have increased by 100% and the federal budget deficit has ballooned from 5% of GDP to 10%. Additional spending is needed — in the form of an extension of unemployment benefits and assistance for state and local governments — and should be forthcoming before the end of the summer.

- Credit Markets: The availability of credit for businesses and households remains plentiful, thanks to the extraordinary policy support of the Federal Reserve. The amount of corporate bond issuance has shattered all records.

- Foreign Governments: Major foreign governments have responded to the crisis with breathtaking speed. The amounts of fiscal stimulus authorized by policymakers in Germany and Japan are ***triple*** those provided in response to the 2008 financial crisis. Monetary stimulus in Europe, China, and Japan has also been aggressive.

- New Housing Cycle: Preliminary data suggest that a new housing cycle is set to begin. Mortgage applications are soaring, sales of newly built homes are in a rising trend, and homebuilder optimism is on the rise.

- Household Income: Although wage and salary income has declined, total household income rose sharply in April and May as a result of massive federal government transfer payments to households.

- Pent-Up Demand: The sharp pullback in household spending has resulted in considerable deferred demand, which could be unleashed in coming months as employment, incomes, and confidence improve. The personal savings rate is at an all-time high of 33%, more than ***double*** the previous high in 1975.

- Employment: The surge in job losses peaked in April, as did the unemployment rate. Nonfarm payrolls rose by 2.5 million in May and should continue to trend higher in coming months, as temporarily furloughed workers return to their jobs.

The key point is that the recession ended in April and fundamental conditions are supportive of a sustained economic recovery. Only a massive second wave of coronavirus infections can abort the in-process recovery in spending, output, and employment.

INVESTMENT CONCLUSIONS

Investors should exercise caution over the next several months. The 40% rise in the US equity market since its low on March 23 was one of the strongest for any three-month period in modern history, suggesting that a temporary consolidation phase is probable. Market fears regarding second quarter company earnings reports — to be released in July and August — along with widespread expectations of a surge in new infections could keep equity investors on the sidelines. The recent surge in market volatility should persist for the foreseeable future.

Prospects for equity investing should improve later this year and during the first half of 2021. The combination of a gradually strengthening economy, continued massive monetary and fiscal policy stimulus, increasing optimism regarding corporate earnings in 2021 and 2022, and potential scientific breakthroughs with respect to one or more vaccines and therapeutics for COVID-19 should act as catalysts for higher stock prices.

Although recent market trends have been ambiguous, it appears highly likely that 2020 will mark a major ***inflection point*** with respect to equity market leadership. Value stocks appear poised to outperform growth stocks over the next several years, possibly by a very wide margin, consistent with all investment cycles since 1960. Cyclical stock groups such as industrials, financials, transports, and materials should register strong returns relative to the utility, consumer staples, real estate, technology, and communications sectors.

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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: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) 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.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

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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