ECONOMIC IMPLICATIONS OF THE RESURGENCE IN NEW COVID-19 CASES

by **Robert F. DeLucia, CFA**
Consulting Economist

Recent economic data have been generally favorable and point to continued economic growth in coming quarters. Monthly reports on retail sales, housing, and employment for both May and June have been especially encouraging. These signs of strength can be attributed to the phased reopening of the economy beginning in early May. The problem for investors is that these positive data points are to a large extent obsolete, and constitute lagging, rather than leading, indicators. The resurgence of new COVID-19 infections in the south and west raises the risk of renewed implementation of shelter-in-place practices in regional hotspots.

Developments surrounding the economic and investment outlook continue to unfold at a frenetic pace. Investors continue to focus on four powerful forces that are currently dominating the economic and investment landscape:

1. Incoming economic data continue to show marked improvement in comparison with the cycle lows of April and May

2. The coronavirus epidemic appears to have entered a second wave — with worrisome signs of exponential growth in infections and hospitalizations among more than 25 states in the south and west

3. Scientific progress toward developing a vaccine and/or therapeutic continues to gather momentum, although major breakthroughs are unlikely prior to 2021

4. Policymakers continue to contemplate new initiatives to support the economy and the financial system

<u>This confluence of forces has resulted in widespread uncertainty among investors and a continued flight into perceived safe-haven assets</u>, most notably US government bonds, money market funds, mega-cap growth stocks, gold, and the US dollar. This special report is an update on each of these four issues, along with an analysis of economic and investment ramifications.

- Most recent government data have been generally favorable and point to continued economic growth in coming months. Although there is strong evidence that the recession ended in April, the speed of the recovery remains unclear. Monthly reports on retail sales, housing sales, factory orders, and employment for May and June have been encouraging, generally beating consensus economist estimates. These signs of strength can be attributed to the phased reopening of the economy beginning in early May.

- *The analytical challenge for investors is that these positive data are to a large extent obsolete, and constitute lagging, rather than leading indicators*. The obvious risk is that the resurgence of the coronavirus epidemic in southern and western states since mid-June could disrupt the continuity of business and commercial activity, if rolling regional shutdowns are reinstated.

- These developments would soon be reflected in weak economic data in the summer months and possibly beyond. The number of new cases across the US reached a record of 60,000 per day in early July — up from a low of 18,000 as recently as June 15 — and nearly double the previous peak of 35,000 in April.

- *The sudden and severe reversal in COVID-19 trends since the middle of June is transforming the outlook for economic growth*: The surge in new infections and hospitalizations is triggering a new wave of social distancing practices along with a shutdown of vulnerable commercial establishments.

- Assuming a continuation of the current surge in infections in coming weeks and months, data for retail sales, industrial production, factory orders, and employment, will weaken once again. *The bottom line is that the outlook for the economy has suddenly darkened, with increased risk of a major slowdown or possible double-dip recession later this year, as surging infections trigger a pullback in consumer spending and business expansion plans*.

- In addition to public health trends, there are other critical variables in the outlook for economic growth and investment strategy. These include the thrust of fiscal and monetary policy; the pace at which the currently dysfunctional labor market heals; the magnitude and extent of business failures; the willingness of banks to lend; and level of confidence for businesses and households.

- There is a very high probability that the Federal Reserve will continue to deliver whatever monetary stimulus is needed to support the economy and the financial system. The Fed has signaled that an increase in policy rates is unlikely until 2023, with purchases of government debt expected to persist well into the future.

- Although there is greater uncertainty regarding fiscal policy, it appears likely that the House and Senate will agree on another stimulus package, most likely in August. A further extension of unemployment benefits, another round of payments to individuals, and financial assistance for beleaguered state and local governments are necessary to avoid another economic downturn before yearend.

- The outlook for the bond market is grim. *Virtually all segments of the fixed-income market are massively overvalued, with interest rates near their lowest levels on record*. Corporate bonds are also overvalued. With a market yield to maturity of 2%, investment-grade corporate bonds are unattractive for long-term investors.

- *The domestic equity market is at an important crossroads*. The recession has ended and the economy is on a recovery path, but the pace and consistency of recovery is very much in doubt. Most importantly, it is impossible to determine the extent to which the current surge in coronavirus infections, hospitalizations, and related regional shutdowns will impact the economy in coming months.

- *The most likely path of the equity market over the next three to six months is sideways*. Following the record surge in stock prices since mid-March, a *digestion/consolidation phase* seems likely. A moderate correction in the vicinity of 5% to 10% is also possible. Investors should be prepared for a volatile ***trading range*** as financial markets strive to determine the impact of the epidemic on economic growth and company profitability.

- Expectations for a trading-range equity market can be justified on numerous fronts. A firm ceiling in stock prices is predicated upon the following factors:

  1. The rising risks of an uncontrollable spread of new COVID-19 infections, leading to a far-reaching lockdown of the US economy

  2. Rising political risks associated with the November election

  3. Exceptionally low visibility regarding the future path of company earnings

  4. Elevated equity market valuations

In combination, these four factors constitute formidable obstacles to a runaway bull market over the next three to six months.

- There are also powerful forces that are likely to provide a durable floor for stock prices in the short term, even as the headlines darken:

  1. The generally improving trend in economic activity, along with a high likelihood that another nationwide lockdown will be strongly resisted

  2. Virtually unlimited monetary support from the Federal Reserve

3. The likelihood of additional fiscal support, as Congressional Democrats and Republicans eventually agree on another government spending package prior to the end of August

4. The unprecedented mountain of cash reserves on the sidelines earning close to zero

5. The possibility of a major scientific breakthrough, which will almost certainly spark a massive rise in equity prices

These five factors should provide a durable cushion for any decline in stock prices that might occur as public health conditions deteriorate.

- The upshot is that a sideways trading range in stocks will likely persist over the short term, with unusually high day-to-day volatility. Leadership will likely continue to be concentrated among a very small group of mega-cap technology, communications, and media stocks perceived by many investors as invincible.

- However, the outlook for equity investing should turn favorable later this year and in 2021. The combination of one or more vaccines along with various new therapies would accelerate the timing of reopening the economy, and therefore lay the foundation for a faster growth rate in GDP and company earnings as the year unfolds.

- A combination of a rising trend in company earnings along with very low inflation, historically depressed bond yields, and continued large liquidity injections from the Fed should prove highly supportive of stock investing in 2021 and 2022.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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