## Special Report

# A TENUOUS BRIDGE BETWEEN A VACCINE AND PERMANENT LAYOFFS

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*The US economy will be at maximum risk over the next three to six months until medical breakthroughs allow the economy to fully reopen. The primary concern over this period involves a potential vicious negative feedback loop among personal income, employment, consumer confidence, and household spending. Household spending is weak because of a widespread sense of job insecurity; employment remains weak because businesses have little confidence in the propensity of consumers to spend.*

<u>The following is a brief update of the most recent economic, public health, and policy developments along with a summary of critical variables in the investment outlook</u>:

- From the onset of COVID-19, the central theme in my investment outlook has been that the economy and financial markets remain ***hostage*** to the pandemic. According to Moody's Analytics, the private economy is operating at only 80% of pre-pandemic levels because of restrictions and partial lockdowns in key sectors of the economy. Health officials have been frustrated by the inability to effectively prevent a resurgence in infections following a relaxation of social restrictions.

- A healthy economy and a pandemic that continues to escalate appear to be ***mutually exclusive***, meaning that a durable self-sustaining economic recovery is not possible without a resolution of the public health crisis. The health crisis in turn will not be resolved without major scientific breakthroughs to immunize the population against COVID-19.

- Developing reports on the scientific research front are encouraging, although financial markets appear overly optimistic regarding the timing of implementation of medical advances. In practice, there is a big difference between FDA approval of a vaccine and ultimate distribution to the US and world populations.

- The process of development, approval, manufacturing, and distribution of a vaccine is far more involved and complex than generally appreciated. The expected onset of mass inoculation during the first half of next year assumes that the ramp-up of manufacturing and distribution of hundreds of millions of doses proceeds without pitfalls along the way.

- Approval of one or more therapeutics could come sooner, but once again, actual production and dissemination could require several months following FDA approval. Both Regeneron and Eli Lilly are in late-stage clinical trials of antiviral medications using monoclonal antibodies that alleviate symptoms of COVID-19 in non-hospitalized patients. *<u>However, there is unlikely to be adequate supply for widespread distribution until early next year</u>*.

- Meanwhile, current trends associated with the pandemic remain worrisome, with new cases on a clear upward trajectory nationwide. *<u>Epidemiologists expect the recent resurgence in COVID-19 infections to be sustained into the winter months</u>*, resulting in a reinstatement of partial lockdown restrictions. Medical experts expect a ***doubling*** in the number of US deaths by the end of January.

- The catalysts for the rising trend in infections include openings of public schools and colleges, the onset of colder weather, widespread failure to observe CDC safety guidelines, and a return to indoor activities. Most recent data depict a rising trend in new cases and hospitalizations nationwide. In addition, more than 30 states are reporting a sustained uptrend in COVID-19 cases, with only three states reporting a sustained improvement.

- Signs of a gradually weakening economy continue to proliferate: Weekly and monthly data pertaining to employment, household income, retail sales, and the broad service sector all point to weakness ahead. The two exceptions to this trend are residential construction and manufacturing, which in combination comprise only 15% of total US output.

- The US economy will be at maximum risk over the next three to six months until medical breakthroughs allow the economy to fully reopen. The primary concern over this period involves a potential vicious ***negative feedback loop*** among personal income, employment, consumer confidence, and household spending.

- The negative interaction between consumer spending and employment remains worrisome. Household spending is weak because of a widespread sense of job insecurity; employment remains weak because businesses have little ***confidence*** in the propensity of consumers to spend. At the core of this vicious circle is depressed confidence, on the part of both consumers and businesses.

- A closer examination of labor markets reveals a worrisome dynamic involving permanent employment: Recent additions to nonfarm payrolls have been modest, coming mainly from a recall of furloughed workers rather than hiring of new permanent workers.

- Permanent unemployment remains at record high levels and continues to worsen as layoffs continue to mount. A combination of declining business confidence and rising business failures would further impact permanent employment, with negative implications for household income and spending.

- In theory, another sizable fiscal spending package would provide invaluable support to the economy in the form of badly needed *temporary income support*. The economy desperately needs a ***bridge*** to support the finances of struggling households and businesses until the arrival of medications to combat COVID-19, thereby facilitating a reopening of the economy.

- Although a compromise deal between Senate Republicans and House Democrats should not be ruled out, the odds are low and will steadily decline as the election approaches. Partisan politics continue to undermine adoption of helpful initiatives to support the economy.

- Absence of a new spending bill would significantly raise the probability of another economic contraction during the next two quarters. *It also seems reasonable to assume that a Biden victory would result in a deferral of a new spending bill until next February or March*, which would have dangerous implications for economic growth during this six-month period.

- The equity market has been overly optimistic regarding a return to public health and economic normalcy. While prospects for a viable scientific solution remain favorable, investors should be prepared for an ***interim worsening*** of both public health and economic conditions.

- Assuming mass availability of a vaccine next year, *I am optimistic regarding the prospects for solid economic growth during most of 2021 and 2022*. The economy is at an early phase of a classic business cycle recovery, which has been the fastest-growth years of a traditional economic expansion throughout history. Company earnings also tend to grow most rapidly during the early-recovery years.

- The domestic economy is characterized by massive pent-up demand for consumer goods and services, single-family homes, and business equipment. Monetary policy will also remain an economic tailwind for years: The Federal Reserve has promised not to reverse its highly accommodative policies until a rising trend in inflation becomes a threat to economic and financial stability.

- However, equity investors have been looking over the valley to a viable medical solution and strong earnings growth in 2021 and 2022. *It appears that the stock market has moved ahead of the economic fundamentals*. Equities are expensive: At its current index price, the S&P 500 is valued at a price-to-earnings (P/E) ratio in excess of 22x, leaving very little margin of safety.

- In addition to economic, policy, and public health concerns, the equity market is vulnerable to an abundance of domestic political concerns pertaining to the November 3rd election. In addition to an uncertain outcome in the presidential and Senate races, there is a meaningful risk of counterproductive policy actions prior to the election.

- Of greatest concern would be a contested election in which the final outcome remains in limbo for days or possibly weeks. Most worrisome for financial markets would be a disputed election and belligerent transition of power if President Trump fails to win re-election.

- The equity market is attractive ***relative*** to fixed-income assets, commercial real estate, and cash, but slightly overvalued on an ***absolute*** basis. The multiple risks cited above suggest a rising probability of a temporary sell-off in coming months. Long-term buy-and-hold investors should maintain an overweight position in common stocks versus bonds and cash, but should await a more attractive entry point to augment current common stock holdings.

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**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.