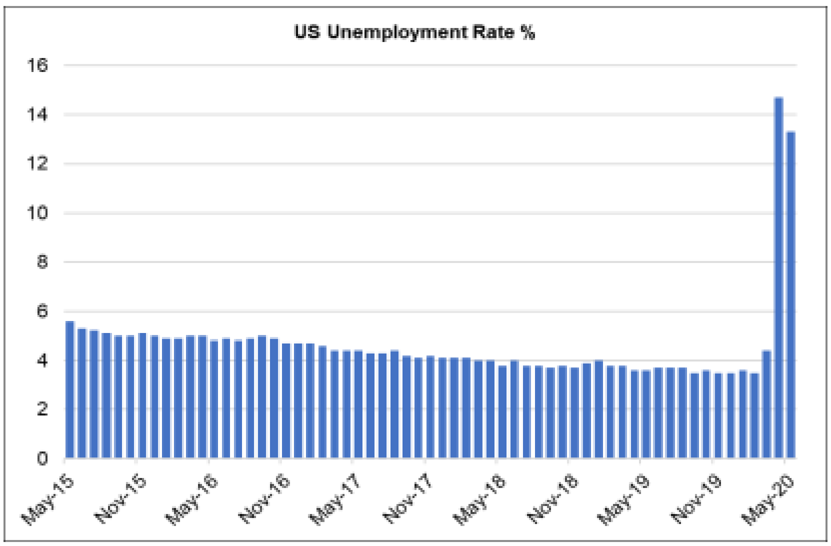
Financial Markets Perspective

July 2020

Escaping Armageddon

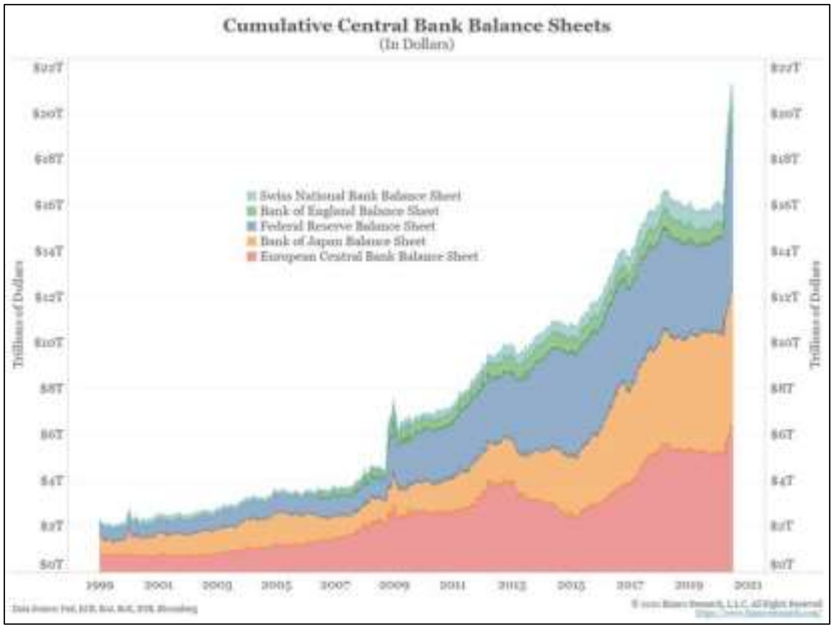
What Could Have Been

As the summer of 2020 begins, the world is recovering from the global economic crisis brought about by a combination of the spreading COVID-19 pandemic and a collapse in oil prices. In the U.S., the federal, state, and local responses to this situation were historic in that they forced a full-fledged economic shutdown. Due to the global nature of this pandemic, countries experiencing similar circumstances relating to the virus followed suit and closed their economies too. Such a decision threatened the onset of a depression as economic output virtually came to a standstill. The following exhibit provides the dramatic impact of the shutdown on the domestic unemployment rate that soared to nearly 15% in April!



To offset the impact of the shutdown, the federal government attempted to replace the loss of income by passing the CARES Act that partially funded lost wage income. Additional fiscal actions financed other sectors of the economy that could not function under the shutdown. The Federal Reserve stepped up with record “safety net” programs to support financial markets by committing to buy trillions of dollars of bonds -- both government and corporate -- if necessary. As Chairman Powell said: “We will do whatever it takes…”

Many market participants could not believe that the Fed committed to buying up to $3.5 trillion in Treasury securities. On 60 Minutes, Chairman Powell responded to a question about the origin of all that money. His response was that the money was digitally created! The Fed may create up to $5 trillion of new money between March and December of this year. This policy spread to central banks for G-7 nations that have spent record sums to aid market functioning as the coronavirus pummeled financial sectors. The world's leading monetary authorities have bought nearly $2 trillion of financial assets over the period pushing their balance sheets to record sizes to pad against economic collapse. The chart below shows the cumulative balance sheets of the European Central Bank, Bank of Japan, Bank of England, Swiss National Bank and the Federal Reserve that stand at nearly $22 trillion. All have joined in implementing quantitative easing programs while the central banks of Canada, New Zealand, and Australia kicked off their first such policies in the last two months as the coronavirus threat turned global.



Fixed income investors were sad to see the Fed’s commitment to no interest rate increases for two years. Such a policy means that low rates will penalize savers as producing a reasonable return from bonds will be almost impossible. If conservative investors decide to buy longer-term maturity bonds, their principal might be threatened in the short-term should interest rates increase. Traditional economists view the explosion in the money supply as a potential source of inflation that would penalize investors who bought long-term bonds with low interest rates. For those readers who have followed our periodic commentary on Modern Monetary Theory (MMT), this Fed action is consistent with MMT theory and the test for its veracity will be in coming months as the economy recovers and there is or isn’t a surge in inflation.

When the crisis hit full stride, many market observers said that we were heading for a depression. These people were fearing another 1930s experience where the economy and stock market collapsed. The major difference this time around is that the government responded positively not negatively to this crisis. In the 1930s there were two depressions, one that began with the stock market decline in 1929 and one that occurred in 1937. The first half of that decade was impacted by fiscal policy that was restrictive as the government substantially increased tax rates in 1932 and then, as the recovery seemed to be getting underway, the Federal Reserve raised interest rates. Then in 1937, the government introduced the payroll tax that was fiscal policy tightening that plunged the economy into recession for a second time in that decade. In today’s economic and market crisis brought on by the new coronavirus, the government is committed to providing support through both fiscal and monetary policy.

The coronavirus crisis continues, and we are confronted with another surge of cases as summer has begun and people head to bars and beaches. As of this writing, some stores are shutting down again after a brief period when it appeared that the environment was improving. We are faced with the uncertainty of the timing of a new vaccine or cure that can get us back on track. In the interim, financial markets are likely to be volatile swinging higher on favorable vaccine news and lower on rising numbers of coronavirus cases. Day-by-day, month-by-month. Time will tell but our expectation is that a resolution will come sooner rather than later.

What Has Changed?

Taking a step back and looking at the impact of the virus and the shutdown, the outlook for the economy and our lives has changed. Financial markets are usually a good precursor of major change and this time is no different. The strength in the technology heavy NASDAQ 100 which is up 16.3% this year compared with the S&P 500 that is down 3.1% and the DJIA that is down by 8.4% tells the story that the virus is having a different effect on stock prices so far this year. In every crisis there are opportunities.

The government-imposed mandates on how we live our lives is accelerating the importance of technology. The needs of individuals who are or were confined to their homes benefitted domestic companies such as DoorDash, Grub Hub, Uber Eats and Instacart who deliver either prepared meals or groceries. Foreign companies such as Delivery Hero, Just Eat and Takeaway have also thrived during this pandemic. Upscale restaurants had empty tables but brainstormed new models of business for their clientele in a bid to survive. Drive-thru pick-up and assemble-your-own options have allowed restaurants to keep inventory flowing and, in some cases, keep a small staff employed. Probably the biggest impact was on the videoconferencing community where many businesses had to find a way to continue functioning without employees in the office. GoToMeeting, Microsoft Teams and Zoom videoconferencing platforms benefitted from this business demand. We see a story emerging that reflects the success of larger companies that are benefitting from the shutdown and forced to implement new ways of doing things to survive as small, poorly capitalized companies disappear.

We are witnessing a retail apocalypse that began in 2010 when brick-and-mortar stores started to close. Retailers are shrinking their physical presence because more of their business is now taking place online. Today, many retailers achieve 35% or more of their sales through increasingly more sophisticated e-commerce—via their websites and other social platforms. At this writing, Forbes Magazine lists 9,252 store units that will close this year. The author states: "The figure is most certainly going to rise by the end of the year and surpass 2019 levels when 9,302 stores closed their doors. In 2018, 5,700 stores closed, and in 2017, 8,000 stores were shuttered". Some companies that have filed for bankruptcy this year include: Brooks Brothers, Chuck E. Cheese, GNC, J. Crew, JC Penny, Neiman Marcus, Pier 1 Imports and Tuesday Morning.

Working from home will take on a new meaning. Companies that feared moving in that direction were forced to adapt to an at-home workforce because of the virus. Once the experience was viewed in a favorable way by management, then the work from home decision was easier to make. Businesses have been cutting back employee travel and entertainment expenses—something that does not threaten an employee's job. According to Korn Ferry, businesses spend more than $1.3 trillion a year on travel alone. Trimming travel and entertainment might be inconvenient but is also are something most employees understand. Firms have changed the timing of product launches and marketing pushes have been delayed; for instance, the release of the next James Bond movie, initially planned for April, has been pushed back several months.

The coronavirus is also dividing the equity market into winners and losers as you can see in the chart below.

The divergence is also apparent when dividing the market into growth versus value. Growth stocks are up 8% while value stocks are down 16% as measured by S&P 500 Growth and Value indices. The divergence is likely to continue if the coronavirus remains a threat. Also, if OPEC continues to disintegrate and oil prices fall again the energy sector is likely to deteriorate.

Some additional concerns are the national protests and riots over police brutality and the backlash against historic monuments that are triggering repercussions across state and local governments. Political attitudes appear to be changing as efforts to defund the police or to shrink police departments in personnel and budgets are being implemented in many large states and cities. While surveys indicate that most Americans support the police and fairness for individuals accused of crime, the minority's voice is having a greater impact on our lives. The experiment--with less police unwilling to take concerted action because of perceived negative responses from the public--may contribute to higher, not lower crime rates across the country.

Another uncertainty is the outcome of the November elections only four months away. The status of the virus and the health of the economy could weigh heavily on the outcome. The virus has inhibited the ability for both candidates to campaign and, as a result, we still do not have a picture of what direction each candidate would take if they become president. We do know that Joe Biden has promised to raise taxes by reversing the Trump tax rate cuts. However, any decisions the new president would make will be affected by the outcome of the Congressional elections and whether there is a one-party majority in both the Congress and the Administration. The planned October debates between the two candidates could weigh heavily on the vote in November.

Conclusions:

In our first quarter update in April, in the full force of the stock market decline, we said the following:

> *In April of 1942, some four months after the U.S. entered World War II, the stock market bottomed and rose by well over 100% over the next four years -- even though the outcome of the war wasn't decided until 1944. Maybe the recent rally in the stock market is a forecast of better times ahead. The parallel is that equity markets anticipate solutions to problems well ahead of the resolution. April showers could very well bring May flowers.*

As we reflect on the economy and stock market condition, we may be reliving the crisis of 1942 just with a different enemy. The rally in stocks in the second quarter where the S&P 500 rose 21% may be the beginning of a similar recovery for the full year. Even though there are continuing uncertainties that can impact financial markets on a day-to-day basis, the clouds over financial markets appear to be clearing and continued improvements in economic metrics could keep us on an upward trend until the economy is off of life support.

Diane V. Nugent, *President/CEO*
Thomas E. Nugent, *Executive Vice-President*