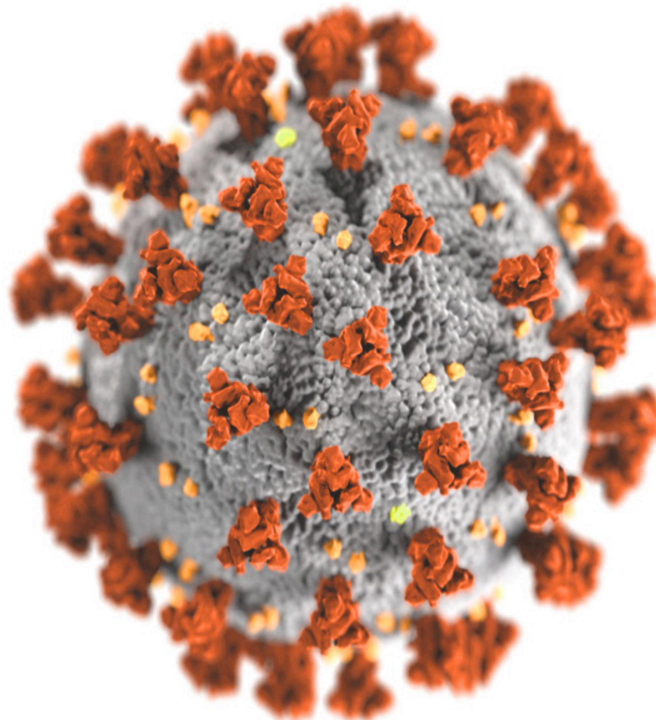
INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FIRST QUARTER 2020: COVID-19, THE SHOCK THAT SHOOK THE WORLD

I thought I was beyond being able to be shocked. I've seen everything.
But this case is in a class by itself.
--Daniel French

Those of us who toil in the investment business try to incorporate an all-encompassing perspective about economic and market variables that may bear upon financial markets. But it must be acknowledged that there are factors beyond those variables that impact markets too, that are outside the boundaries of finance. Factors that are unpredictable, that can't be seen around the corner. These factors are what former Defense Secretary Donald Rumsfeld referred to as 'unknown unknowns'—things we don't know we don't know.



The appearance and worldwide spread of the novel coronavirus represent just such an unknown unknown. From a markets perspective, it's an exogenous shock—an unexpected or unpredictable event that affects an economy. But before we examine the impact on the economy of this exogenous shock, let's look at the shock itself.

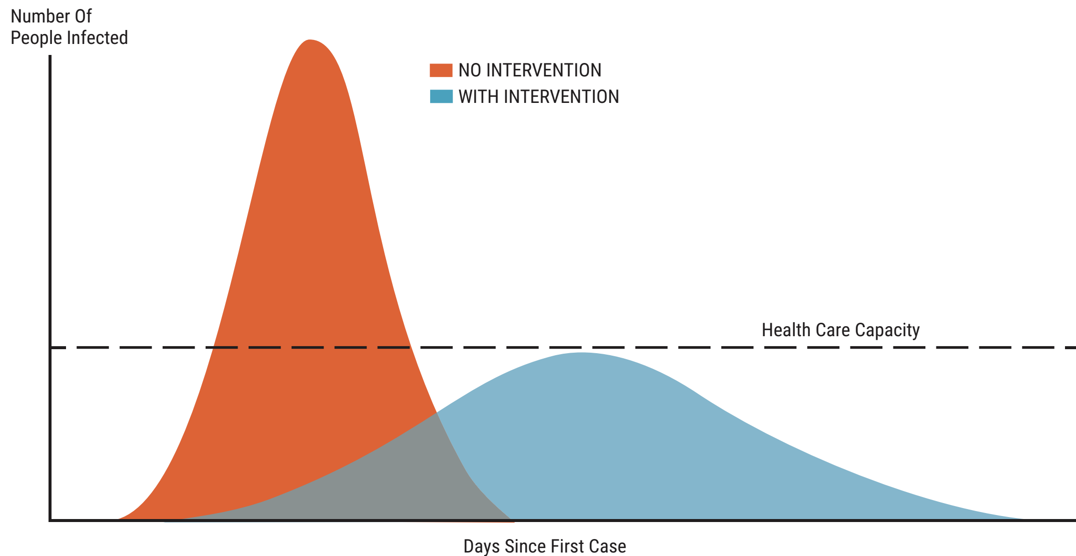
THE DIMENSIONS OF THE HEALTH CRISIS

There is only one kind of shock worse than the totally unexpected:
the expected for which one has refused to prepare.
— Mary Renault

While a few people like Bill Gates and Stephen King (believe it or not) have warned about the potential for a global pandemic, the world was not prepared for the emergence of this novel coronavirus. This is, first and foremost, a humanitarian tragedy—a global healthcare crisis. At quarter end, confirmed cases topped 880,000 and total deaths topped 44,000 people, according to Johns Hopkins University School of Medicine. In the US, cases topped 189,000—the highest in the world—and deaths exceeded 4,000 people.

There is a great deal we don't know about the virus. Scientists and researchers are working feverishly to develop effective treatments and ultimately a vaccine. In the interim, we know some important things: COVID-19 is highly transmissible, even when a patient is asymptomatic; that older patients and those with co-morbidities have much higher fatality rates, and that testing is critical.

A Sample Epidemic Curve



SOURCE: CENTERS FOR DISEASE CONTROL AND PREVENTION

The schematic above, from the Centers for Disease Control and Prevention, illustrates the imperative of slowing the spread of the disease. If we fail to "bend the curve," the projected sharp spike in new cases threatens to overwhelm the capacity of the healthcare system to care for the sickest patients.

RESPONDING TO THE HEALTHCARE CRISIS: CONTAINMENT AND MITIGATION

If quantum mechanics hasn't profoundly shocked you, you haven't understood it yet.
— Niels Bohr

The novel coronavirus has shocked us, profoundly. And with the arrival of COVID-19, we've had to learn a whole new vocabulary—respiratory droplets, herd immunity, WFH (no relation to WTF), social distancing. How did we get here? In a world in which the word 'unprecedented' is tossed about casually, is it really so?

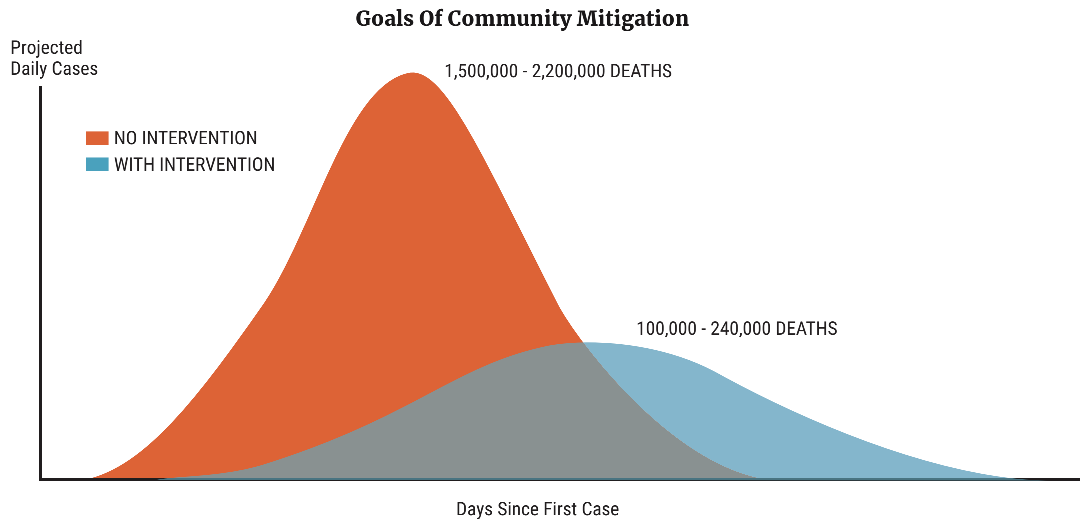
In fact, there are historical precedents for the coronavirus pandemic. Perhaps the best comparison is the Spanish influenza pandemic of 1918-1919. The Spanish flu is estimated to have caused over 50 million deaths around the world, and 500,000 deaths in the US. The death toll would have been even greater were it not for the steps taken to limit the spread of the disease. Those steps included closing schools and businesses, restricting travel, banning public gatherings—and maintaining social distance. Those localities that acted earlier and more aggressively recorded the best results. So we learned that where citizen compliance with these restrictions is high, the strain on the healthcare system is reduced, and time is bought to develop treatments and vaccines. One additional lesson from that era: relaxing intervention measures too soon leads to relapses.

The global response to COVID-19 has been national, regional, even local. There have been minimal efforts to coordinate policy responses. In the US, many states and cities have imposed restraints; the federal government has provided broad guidelines but has declined to mandate a national containment policy.

Containment is preferable to mitigation, as it's far less radical and disruptive. It involves testing, isolating, and social tracing of contacts. The lack of available tests in the US, early in the disease's appearance, has limited our ability to implement the containment strategy that was highly effective in limiting the disease's spread in Singapore and South Korea.

So we are left with mitigation, which is required when community spread has occurred. It involves social distancing, closing schools and businesses, staying at home. And it is critical.

Goals Of Community Mitigation



1) Delay Outbreak Peak.
2) Decompress Peak Burden on Hospitals/Infrastructure.
3) Diminish Overall Cases and Heath Impacts.
4) Decrease Fatalities.

SOURCE: WHITE HOUSE CORONAVIRUS TASK FORCE

As the chart above shows, the CDC has estimated that community mitigation has the potential to reduce projected deaths to a range of 100,000-240,000 people—1/10th the projected number of deaths without such an intervention. It's hard to come up with a more compelling argument for universal community mitigation.

THE MITIGATION IMPERATIVE AND ECONOMIC CONSEQUENCES

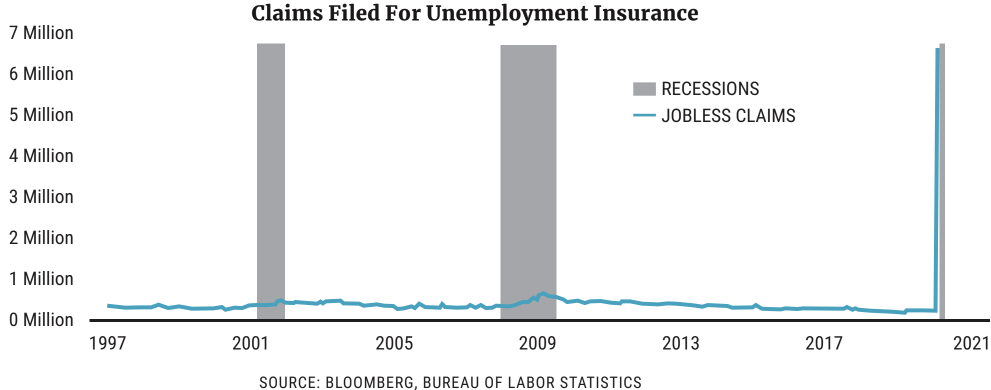
Capt. Louis Renault: *I'm shocked, shocked to find that gambling is going on in here!*
Emil the Croupier: *Your winnings, sir.*
Capt. Louis Renault: *Oh, thank you very much.*
--Julius Epstein, Philip Epstein, Howard Koch, Casablanca

Unlike Captain Renault's mock protestations, we all are genuinely shocked, shocked to discover the enormity of the pandemic and its consequences. From an economic perspective, what started as a supply chain disruption in China in the early phase of the outbreak has shifted into a crisis in global demand. After a delayed start, mitigation efforts are now under way around the world. More than 50% of global GDP is subject to one form or another of shutdown. Domestically, as of this writing, more than 90% of the US population is now living under stay-at-home orders.

State or local orders to adhere to social distancing have resulted in vast swaths of the economy operating at a fraction of their previous level or shutting down entirely. Some of the most severely impacted industries include travel (airlines, hotels, casinos and cruise lines), restaurants and bars, malls, gym clubs, and hair and nail salons. Workers in these fields are being furloughed by the millions, if not fired altogether.

Economic data generally are reported with a lag. So we don't yet have much data available to assess the economic damage from the enormous reduction in business activity. But some data points are available more quickly. Among the highest frequency indicators are labor statistics for newly unemployed workers, as new unemployment claims are reported weekly.

These data, it must be said, are stunning.



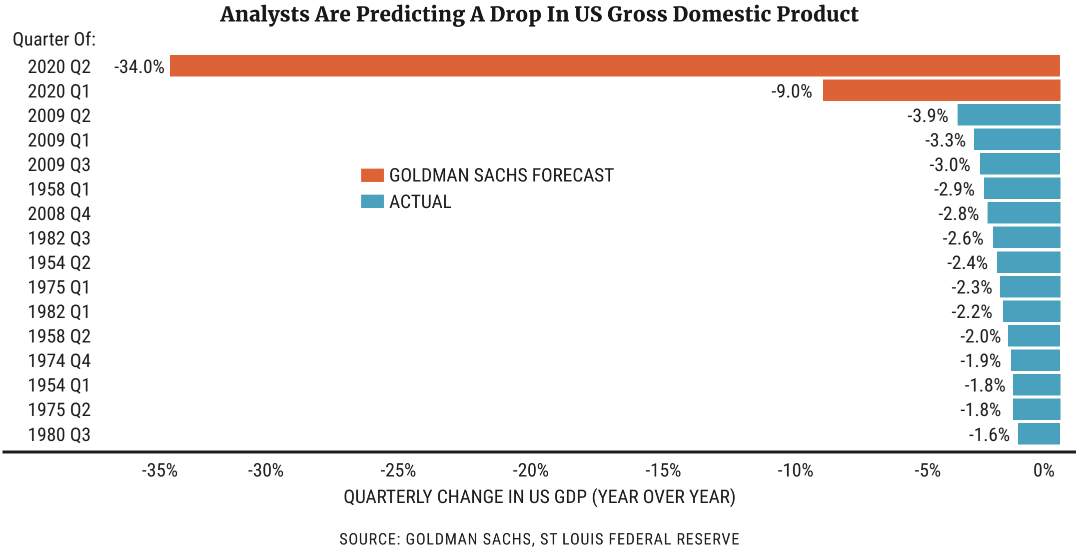
SOURCE: BLOOMBERG, BUREAU OF LABOR STATISTICS

After holding steady around 220,000 new claims each week, the two most recent reports indicated total new claims of 9.95 million. This is the most rapid rise in unemployment ever recorded.

Unfortunately, data on labor markets are likely to worsen before bottoming and turning up. Economists vary widely in their estimates of just how bad the labor market will get, but there is general agreement that the unemployment rate will rise from a recent low of 3.5% into the mid-teens; job losses could approach 20 million people. For context, we note that 8.7 million jobs were lost, and the unemployment rate reached 10%, during the financial crisis of 2008-9.

We also have current data on auto sales for March. While shutdowns occurred mostly in the second half of the month, the data are pretty dreadful. US light-vehicle sales crashed 27% to under 1 million in March from 1.4 million in February. This equates to a seasonally adjusted annualized rate for US cars and light trucks sales of 11.4 million units, down from 16.8 million units in February, according to Wards Intelligence.

More broadly, the outlook for GDP in the second quarter is grim, as the projection from Goldman Sachs below illustrates. Their estimate for a 34% contraction is without precedent in the postwar era.



SOURCE: GOLDMAN SACHS, ST LOUIS FEDERAL RESERVE

Other forecasts are not quite as dire, but nonetheless consistent in predicting a very sharp recession. Bank of America predicts the deepest recession on record, with economic growth not resuming until the fourth quarter. This will result in severe economic pain for millions of American households.

The recession cannot be avoided. The question then becomes not just how severe will it be but perhaps more important, how long will it last, and how quickly will the economy recover?

COVID-19 INFECTS THE MARKETS

When I beat Sonny Liston, I shocked the world. When I joined the Muslims, I shocked the world.
When I beat George Foreman, I shocked the world. I am from the House of Shock.
– Muhammad Ali

Ouch. That hurt. A lot.

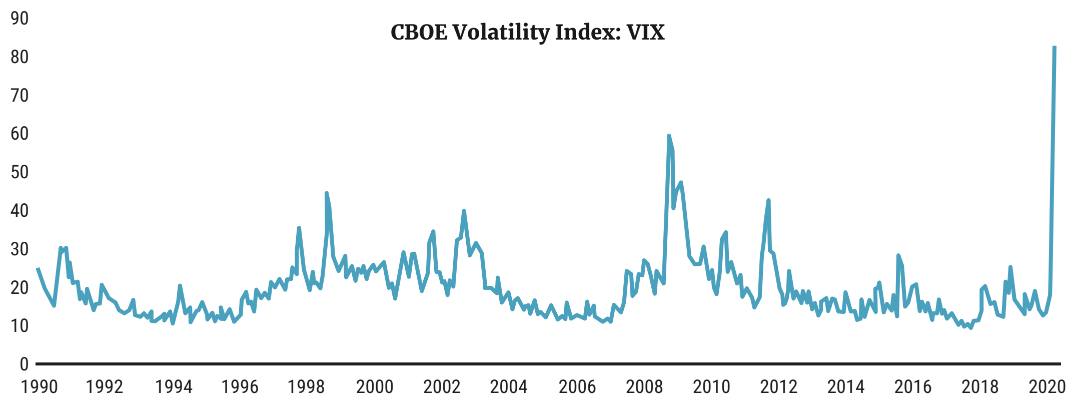
Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	-19.6%
US Small Cap Stocks	Russell 2000	-30.6%
International Developed Markets Stocks	MSCI EAFE	-22.8%
Emerging Markets Stocks	MSCI EM	-23.6%
Real Estate Securities	MSCI US Real Estate	-27.0%
Commodities	Bloomberg Commodity Futures	-24.0%
Bonds	Bloomberg Barclays US Aggregate	3.1%
Cash	FTSE 3-month UST Bill	0.4%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

Markets reacted with unprecedented (there's that word again) swiftness and severity to the spreading pandemic and efforts to mitigate it. While bonds performed their portfolio stabilization function, all other assets classes nose-dived. Across the board, risk assets were down 20-30%--there was no hiding in domestic stocks over international stocks, in large stocks over small stocks. And real estate and commodities provided no diversification benefits. For commodities, the tumble in oil markets was exacerbated by a power struggle between leading producers Saudi Arabia and Russia.

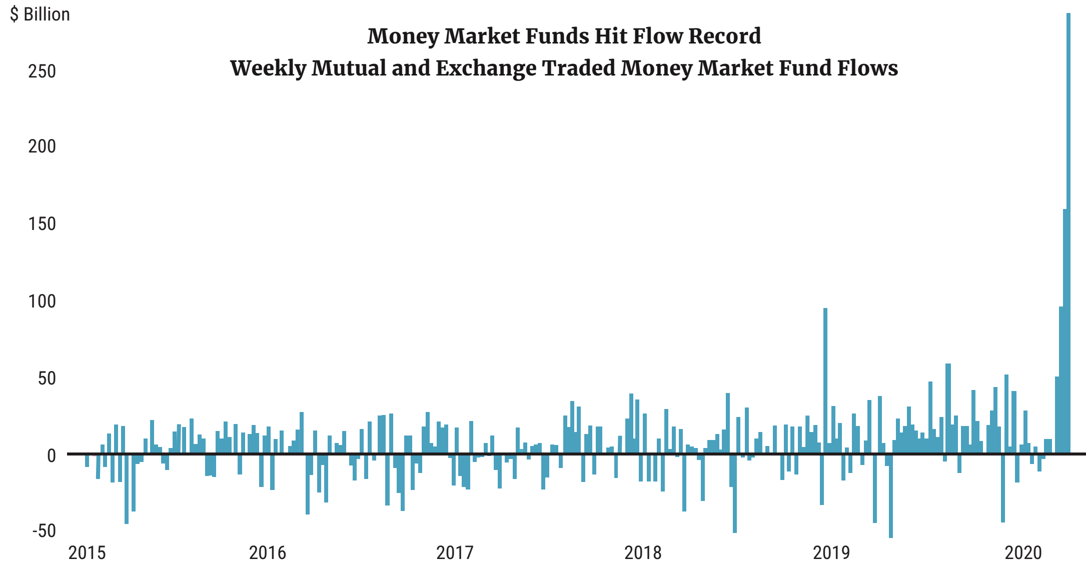
What's more, this was the fastest bear market in history. It took a mere 16 days for the market to fall 20%. And the downturn didn't stop there.

Losses of this magnitude are distressing. But if that weren't bad enough, the day to day, and even intraday, swings in the market are nerve-wracking for even the calmest of investors. As shown below, market volatility reached its highest level since the VIX index series began in 1990, above even the levels of the global financial crisis.



SOURCE: CHICAGO BOARD OPTIONS EXCHANGE

The relentless selling pressure came from all types of investors, and they were selling all asset classes. They eschewed risk, they deleveraged, and they rediscovered the safety of liquidity. As in other financial panics, investors engaged in a dash to cash. And, as has been typical of this downturn, they did so at historic levels.



SOURCE: INVESTMENT COMPANY INSTITUTE

Nervous investors are eager to know when markets will recover. And they are scared to know if markets may fall further.

THE CAVALRY TO THE RESCUE: THE FED, CARES, AND OTHER RESPONSES

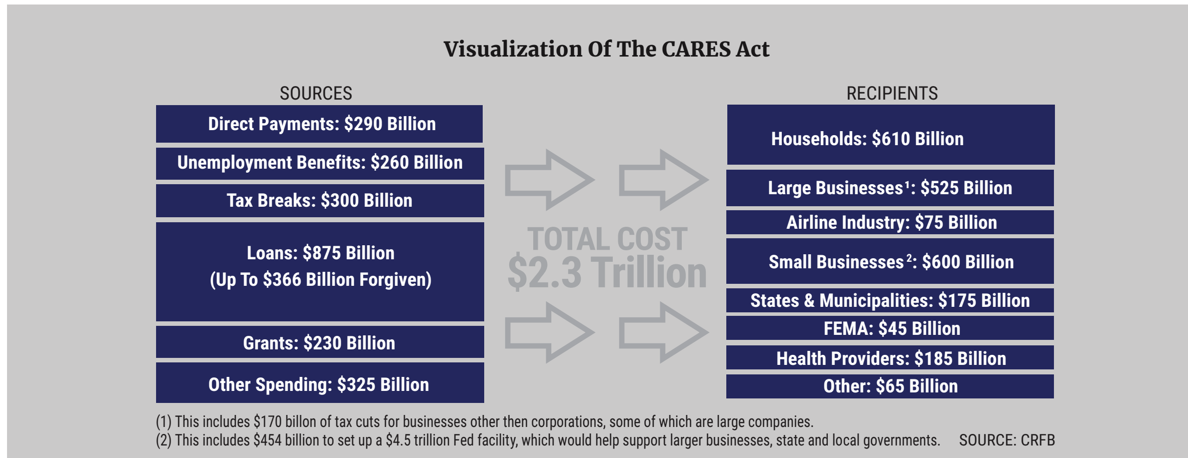
Those who are easily shocked should be shocked more often.
— Mae West

If the COVID-19 pandemic and its containment efforts are of shocking proportions, so too are governmental responses to the crisis.

First to act has been the Fed, unleashing an awesome arsenal of tools. These include lowering interest rates to essentially 0%, re-starting the bond buying regime known as quantitative easing, and instituting a wide range of credit support facilities. Among others, the Fed is providing a backstop for money market funds, commercial paper, foreign exchange, investment grade bonds, municipal bonds, asset backed securities, and residential mortgages. It's the playbook from the global financial crisis, greatly enlarged and enhanced, and put in place in advance of markets freezing up. The idea is to minimize disruptions in the smooth operation of financial markets, keep credit flowing, and avert a freeze in liquidity. If the Fed is successful, preservation of liquidity can limit solvency issues.

Photo: Jerome Powell, chairman of the Board of Governors of the Federal Reserve System.

Fiscal policy initiatives have followed swiftly in the footsteps of the aforementioned monetary policy actions. In rapid order, lawmakers have approved three bills: $8.3 billion for healthcare resources, $100 billion to expand paid leave and improve affordability of COVID-19 testing, and $2.2 trillion to try to offset the economic consequences of pandemic containment measures. The multi-trillion-dollar CARES Act, passed unanimously, includes aid plans for individuals and families, small businesses, large companies, hospitals and public health, state and local governments, severely distressed industries—well, you get the idea—just about everybody. Treasury Secretary Steven Mnuchin has estimated that the stimulus would tide over the economy for three months.



Even before the ink dried, critics complained that the stimulus is inadequate, and additional proposals—for a $2 trillion infrastructure bill, for instance—have begun to circulate. And Secretary Mnuchin has promised if additional economic support is needed, the Administration will go back to Congress to obtain it.

One can't help but recall former Senate Minority Leader Everett Dirksen's tongue in cheek commentary on profligate Congressional spending: "A billion here, a billion there, and pretty soon you're talking about real money." Everything is bigger today, and so it is with economic rescue plans. A trillion here, a trillion there. Shocking expenditures, shocking more often.

All told, this is a most impressive "all of government" effort to blunt a medically induced economic trauma. We can all hope that in the aggregate these policies meet their objectives. But even at their most successful, they cannot address the underlying healthcare crisis itself. This is palliative care, not curative care.

INVESTING IN THE TIME OF CORONAVIRUS

It's discouraging to think how many people are shocked by honesty and how few by deceit.
— Noël Coward, Blithe Spirit

Market pundits often opine with great authority, bringing to mind the expression, "Often wrong, never in doubt." But we are living through an extraordinary time, and at this very juncture—at what may prove to be the point of maximal uncertainty in both the healthcare crisis and the economic contraction—let's be shockingly honest. Humility is called for.

Humility involves acknowledging what we don't know, and there are some critical matters that we can't know today. They include:

- When will we bend the curve on new cases?
- How will researchers progress in developing treatments and discovering vaccines?
- How long will social distancing requirements be in effect?
- How deep will the recession be? How long will it last?
- Have we seen the market lows?
- When will market volatility subside?
- When will markets recover losses from the bear market?

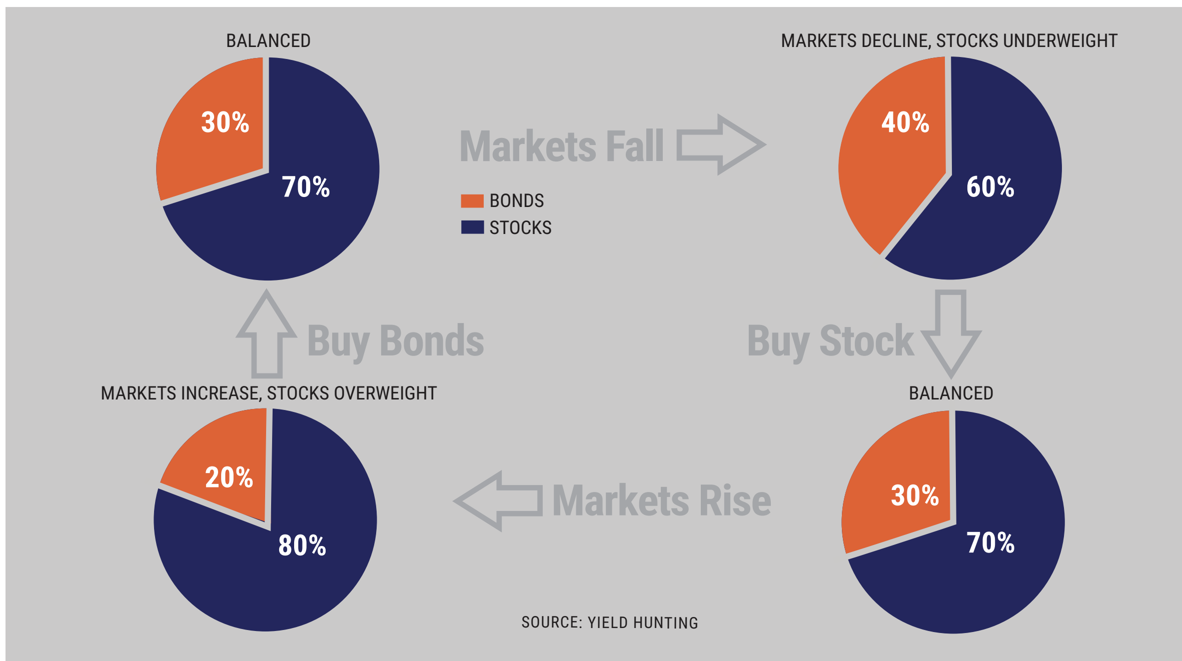
These are significant limitations as we seek to develop and execute investment strategies in the face of uncertainty. But there are also some variables that we know or can reasonably project, that are informative. We know that the Fed will remain at maximum accommodation levels throughout the crisis. We know that corporate earnings will decline sharply in the near term. And we know that in an election year both the legislative and executive branches will go all in to restore economic growth.

On the healthcare front, here's what we can say. Mitigation and social distancing work, testing is expanding, and scientists are working feverishly, as it were, to develop solutions. It appears reasonable to hypothesize that significant progress will have been made in coming months. There won't be a national all-clear signal, but rather a gradual relaxing of restrictions is like to roll out, state by state and region by region. Advances in testing should then permit the deployment of narrower containment methodologies instead of mitigation strategies, until vaccines become available.

On the economic front, the economic dislocation in the near term will be substantial. Businesses will fail, and many households will bear financial strains. This will be a deep recession. If our supposition about progress on pandemic mitigation plays out, it may not be a long recession. But the recovery may not necessarily be "V" shaped either—it could be more gradual and extended, consistent with the rolling relaxation of social distancing orders.

For financial markets, uncertainty over the magnitude of the decline in corporate profits will weigh on stocks in the near term. A retest of recent lows is possible—indeed, the typical cycle in a bear market is retest, consolidation and then recovery—and volatility may continue at elevated levels until the level of uncertainty diminishes. That said, markets may well look through weak second quarter earnings reports. This is particularly likely if and as we see progress on clinical studies for COVID-19 treatments. But it's also true that if the economic recovery is gradual, a recovery in corporate profits will also be gradual.

From a portfolio management perspective, there are a number of takeaways. First is to reassess and confirm risk tolerance, time horizon, and utility curves for risk. Diversification and asset allocation are the building blocks of sensible portfolio construction, and it's a worthwhile exercise to review and confirm the appropriateness of your allocation.

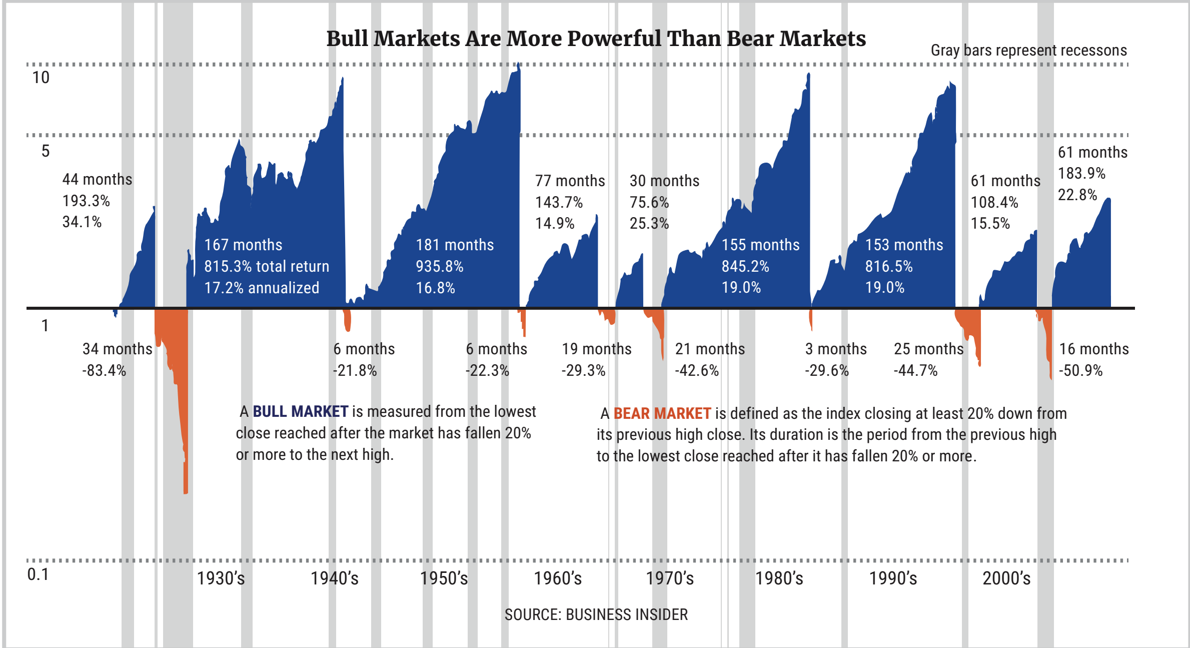


SOURCE: YIELD HUNTING

It is also timely to consider rebalancing portfolios. The outperformance of bonds in the downturn makes them logical candidates for harvesting gains (read: sell high), as portfolios will have become over-weighted in fixed income. Conversely, it's logical to prepare to purchase equities, as they will have become under-weighted.

In a challenged economic and market environment such as we are experiencing, our bias is toward investing in high quality stocks and bonds. Companies that exhibit strong balance sheets, generate high and recurring cash flow, field strong management teams, and possess sustainable competitive advantages are best positioned to both survive the downturn and take advantage of opportunities that will emerge as the economy recovers. Lack of short-term earnings visibility helps us rightly focus on the long-term prospects of the businesses we invest in.

We know from market history that financial markets recover before economies recover, before economic data turn up. We can't say when that will happen, but we can say that that is likely to happen again. And we recommend being there to participate when that occurs.



We live in an era of hyperbolic statements—the greatest, the best, the most, the worst. And everything happens more speedily than in the past. None of that, however, invalidates sound long-term investing truths. Bull markets last longer and move further than bear markets, as the graphic above makes clear. Time, patience, and adherence to a well thought-out investment strategy provide enormous advantages to investors. So, let time work in your favor. Be patient. And stick with a well thought-out plan.

It should come as no shock that sound, time-tested strategies succeed. Over time.

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