SMITH AFFILIATED CAPITAL

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INVESTMENT COMMENTARY

Lasting Scars from the COVID-19 Recession

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It won't be officially confirmed for at least several months, but the U.S. as well as the global economy has descended into the harshest recession since the Great Depression. The descent from positive growth has been more abrupt and unexpected than anyone could have imagined. About two months ago, when the Covid-19 coronavirus first hit the headlines we, along with most economists, thought the nation could weather the storm if proper policies were quickly implemented and the outbreak contained before becoming a global pandemic. Bolstering this optimistic assessment, the U.S. economy was cruising along, albeit at a lackluster pace, before the shock struck like a thunderbolt. The job market was humming, generating more paychecks in January and February than expected, consumer confidence remained elevated and the financial markets were pricing in continued growth in activity and earnings, although at a diminished pace. Indeed, stock prices hit a record high on February 19.

Simply put, it was thought that the economy had enough of a cushion to absorb a temporary setback, and only lower interest rates engineered by the Fed would be needed to keep the expansion going. But hopes for a "soft landing" came crashing down as cases of the virus spread like wildfire and fear gripped the public. Ultimately, social-distancing mandates by the Federal and local governments to contain outbreaks delivered the fatal blow to the economy, prompting households to self-quarantine, factories to shut down and small businesses to close for lack of foot traffic. Daily life ground to a halt, as did commerce, and the financial markets got swallowed up in a tumultuous firestorm. In the space of a few weeks, the stock market gave up all of its gains achieved since President Trump's inauguration and the Federal Reserve resurrected and then expanded the emergency measures employed during the financial crisis, including slashing interest rates back to zero, reviving asset purchases on a massive scale and establishing lending facilities to prevent critical sectors of the financial markets from seizing up.

Adding to the economy-crushing impact of the pandemic, another oil price war broke out between Russia and Saudi Arabia, sending oil prices plunging and leaving the energy industry in shambles. The precipitous fall in oil prices put more downward pressure on inflation and inflationary expectations, giving the Federal Reserve extra urgency and leeway to jump-start growth. But the Fed is already operating at full throttle, and more of the heavy lifting is now being passed on to Washington. While gargantuan package of fiscal measures announced in recent weeks should help contain the carnage, the crisis will not end until the pandemic is brought under control, something that requires the heroic efforts of health experts more than policy makers.

RIP: The Long Expansion

The longest U.S. economic expansion on record has come to a crashing end. After growing for over 10 years, the economy entered contraction territory in mid-March when a perfect storm of depressants on demand and supply coalesced to shut down virtually all forms of business activity. Not in recorded history, has the fall from grace been as swift and brutal as the one now unfolding. While the economy may have been in decent shape prior to the coronavirus outbreak, it certainly was not immune to its effects. We expect the economy to contract by a record double digit pace in the second quarter and unemployment to soar to levels not seen since the 1930s. The existential threat the pandemic poses to the economy has mobilized Congress, the Fed and the administration into a frenzy of policy moves that boggles the mind.

But while desperate times warrant desperate measures, these extreme policy moves are not designed to combat the pandemic wreaking havoc on the economy. Instead, they are meant to contain the economic fallout and provide all the ingredients needed to jump-start growth once the virus is brought under control. Until that outcome is realized, the depth of the economic downturn now unfolding can only be guessed at. The breath-taking toll it is taking on the job market was strikingly revealed in the latest weekly report on claims for unemployment benefits, which shot up to 3.3 million in the week ending March 21 and to a staggering 6.6 million the following week. To put this in context, the worst month of job losses during the Great Recession saw payrolls fall by 894 thousand in February 2009. That total has been exceeded by more than tenfold over the last two weeks alone.

Importantly, the ranks of unemployed are poised to swell considerably in the weeks to come. Keep in mind that the March employment on April 3 does not capture the full extent of the job losses, as the Labor Department's household and business surveys were conducted during the second week, encompassing the 12th of the month. The vast majority of business shutdowns and layoffs occurred since then. We expect that the April jobs report will be as ugly as they come, with 20 million workers cut from payrolls and the unemployment rate surging to 12%. Further job losses are expected in May as well, and the jobless rate, assuming the virus is brought under control by the summer will only gradually recede, ending the year at 7.5 percent.

The direct payments to households of up to $1200 plus the expanded unemployment benefits included in the stimulus package are aimed at keeping families solvent and provide them with the wherewithal to sustain spending. No doubt, for the broad swath of the population that lives paycheck to paycheck and has limited savings, those funds will enter the spending stream immediately. But it's doubtful they will have much of a lasting impact once the funds run out. What's more, the one-time payment will do little to spur increased spending by households who are still holding jobs and getting paid. Indeed, the latest personal income report reveals that consumers were already setting aside more of their paychecks in February, as the personal savings rate increased from 7.9 percent to an eleven-month high of 8.2 percent.

We suspect that this "precautionary" move to bolster finances even before the full intensity of the pandemic was known will only gain traction as households, even those still holding full-time jobs, continue to retain a mindset of anxiety and uncertainty regarding future employment prospects. Another sign of cautious behavior: households are hoarding cash, as currency in circulation has surged to the highest level since the Y2K scare two decades ago.

Amid the evolving policy and economic backdrop, Treasury yields across the maturity spectrum have fallen precipitously. However, there are host of reasons to expect that yields can still move lower. The global economic shut-down will force the Fed and other central banks to keep rates near the zero lower bound for the foreseeable future and will also force them to continue to purchase large amounts of debt. In addition, the economic crash and the oil price war will combine to push inflation even lower over the near-term, and the US markets will remain the safe-haven of choice. If the global central banks' gargantuan efforts to provide liquidity can begin to settle some of the market volatility, longer-duration Treasuries could again benefit from that safe-haven demand.

The debate over modern monetary theory (MMT) has moved out of academic circles into the world of reality. With the Fed's balance sheet expanding by trillions of dollars as part of its revived QE program, the central bank in all practicality is monetizing the fiscal stimulus coursing through the economy. Importantly, the budget-busting deficit spending will not put upward pressure on interest rates nor should it ring alarm bells regarding inflation. Inflationary expectations are deflating as quickly as yields are declining, and the collapse in oil prices to an 18-year low is dragging actual inflation down even further below the Fed's 2 percent target, something that will not be achieved as far as the eye can see.

Diminished Longer-Term Prospects

Whether or not the stock market has priced in all the bad news relating to the coronavirus remains to be seen. Even if cases of infection accelerate in coming weeks as health experts predict, the shock effects should diminish with each additional awful report. But the damage to the economy could leave long-lasting scars that the markets are not discounting. For example, the unprecedented plunge in economic activity in the second quarter could obliterate whole industries, such as the shale industry, as well as an army of small businesses that leaves millions of workers unable to find replacement jobs. The market may correctly anticipate a short-term rebound in GDP after the virus is brought under control; but it is not yet pricing in the realistic prospect of slower long-term growth that is sure to be the legacy of the coronavirus.

Should that turn out to be the case, investors will soon reassess longer-term prospects for corporate profits as well. As it is, the long just-ended bull market in stocks looked increasingly out of line with the trend in earnings in recent years. The third revision of GDP released in late March shows that corporate profits did increase slightly in last year's fourth quarter. But that simply returned the level to where it was in the first quarter of 2015. Put another way, corporate profits have gone nowhere for almost five years, even as stock prices advanced by more than 30 percent over the period. Meanwhile profit margins have come under sustained downward pressure, contracting by 20 percent over the same time span.

The consensus of Wall Street analysts expects earnings to decline in 2020, the most pessimistic outlook for a full year since the Great Recession. It is not hard to see why. The shock to demand from the pandemic will not only take a toll on revenue it will also further constrain the already-weakened pricing power of corporations. What's more, the persistent deflationary trend will receive an assist from the global recession and the collapse in oil prices now underway. Nor is it likely that improving productivity would rescue the grimmer profit outlook. For that to happen, the corporate sector would need to ramp up productivity-enhancing capital spending. But that's not in the cards. Both orders and shipments for nondefense capital goods fell again in February even before company fears of the coronavirus reached a boiling point.

A New Normal: Slower Long-Term Growth

Even if the collapse in stock prices is overblown, there is little chance that the market will replicate the extended rebound seen after the Great Recession and financial crisis. For one, the just-concluded 10-year bull market was heavily powered by stock buybacks, takeovers and dividend payouts. These drivers will not be present going forward. Unlike the corporate tax cuts following the financial crisis, which were primarily recycled into share buybacks and dividends, the funds from any government handout this time comes with tight restrictions regarding their use. Even President Trump and business-friendly Republicans have publicly turned against such self-aggrandizing corporate behavior.

For another, the post-crisis period did not include a running daily mortality rate that is steadily eroding investor sentiment, impairing household confidence and embedding fears of a mysterious enemy into a nation that its residents have never before confronted in their lifetime. Until that fear abates, perhaps when a vaccine or treatment is found, Americans will refrain from activities that involve social interactions, including shopping at malls, recreational outings, such as going to movies, theaters and even restaurants. The cruise ship industry along with casinos will be licking their wounds for years to come.

With a commercialized vaccine that covers most of the population not expected until next year, the economy will be slow to return to normal. Even then, we can expect to see a new normal, as the disruption to economic behavior has been profound, heralding structural changes at the workplace and shifts in consumption preferences that will require a long adjustment process for the economy. The Great Recession that ended a decade ago left deep scars that slowed the pace of the expansion, as memories of the wealth destruction and high unemployment prompted consumers to restrain spending far more than they had in previous expansions. The legacy this time will be at least as pervasive, as the devastation of the current crisis on jobs and balance sheets are shaping up to be considerably worse.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
6-Mo. Bill	2.44	1.57	0.10	0.93	2.80
2-Yr. Note	2.29	1.56	0.23	2.82	5.19
5-Yr. Note	2.23	1.68	0.38	6.78	10.92
10-Yr. Note	2.41	1.91	0.70	11.93	18.26
30-Yr. Note	2.82	2.38	1.35	25.80	39.52

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
Barclays GO Bond Index	2.19	1.64	1.73	0.11	4.51
Barclays State GO Bond Index	2.13	1.54	1.68	-0.02	4.07
Barclays Local GO Bond Index	2.25	1.73	1.78	0.24	4.98
Barclays Revenue Bond Index	2.43	1.89	2.20	-1.01	3.66

Equities	Levels			US $ Terms (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
S&P 500	2834.4	3230.78	3230.78	-19.67	-6.97
DJIA	25928.68	28538.44	28538.44	-22.74	-13.38
NIKKEI (Tokyo)	21205.81	23656.62	23656.62	-19.29	-8.92

Commodities	US $			Percent Change (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
COMEX Gold Active Monthly	1293	1523.1	1583	3.93	22.43
CRB Future Com. Pr. Index*	183.7511	185.787	121.7868	-34.45	-33.72
West Texas Intermediate Crude ($ per bbl.)	60.14	61.06	20.48	-66.46	-65.95

Currencies	Levels			Percent Change (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
Yen	110.86	108.61	107.54	0.99%	2.99%
Sterling	1.3035	1.3257	1.242	-6.31%	-4.72%
Euro	1.1218	1.1213	1.1031	-1.62%	-1.67%

Global Bond Markets**	Levels			US Dollar Terms (%)	
	12/31/2018	9/30/2019	12/31/2019	Last Quarter	Last Year
German 10-Yr.Bond	-0.21	-0.28	-0.55	2.06	2.56
Japanese 10-Yr.+ Bond	-0.16	-0.08	-0.07	-0.01	-0.62
UK 10-Yr.+ Bond	0.91	0.71	0.24	3.79	6.24
Emerging Market (USD)	5.32	4.89	7.19	-9.48	-2.89

Source: Bloomberg Financial Data
*Thomson Reuters/Jefferies CRB Commodity Excess Return Index
** Global Bonds Represented by Bloomberg Barclays Indices