MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Now What?

The ongoing Covid-19 pandemic will be remembered and studied for decades to come, particularly by economists and investors. It produced the sharpest downturn in the economy since the 1930s; the recession will also likely have been the shortest ever. Similarly, the equity market decline in February and March was one of the steepest bear markets ever, followed by one of the most breathtaking 10-week rallies of all time. In describing these events, use of the word "unprecedented" reached unprecedented levels. If there is one positive result from this volatility, it ought to be that everyone involved in the markets emerges with a bit more humility and a greater appreciation for the fact that almost anything is possible.

Alas, during the worst of the decline and to this day, there has been no shortage of overly confident forecasts, both dire and exuberant, about the progress of the outbreak and its effect on the economy. But good investment decision-making involves assessing probabilities, allowing for a range of outcomes, and positioning accordingly, not simply making forecasts. This is a very good time to tune out pundits, and heed the words of Federal Reserve Chairman Jay Powell, who wisely noted on the day of this writing that the trajectory of the economy is "extraordinarily uncertain".

There should be little doubt that a rebound is underway. In fact, were we to extrapolate from recent high frequency data on jobless claims, miles driven, reservations on OpenTable, credit card spending, and air passenger miles, we would conclude that a very robust recovery was occurring. It's certainly a possibility. But at the same time, states that avoided the worst of the early outbreak, and have now fully reopened, have seen a meaningful increase in cases. While we think it is extremely unlikely that any state would shut down a second time, the daily drumbeat of negative news regarding caseloads could have a depressing effect on consumers' willingness to resume normal activity and spending patterns.

The latter observation is a reminder that the economy likely would have fallen into recession even without lockdowns; people did not have to be told to stay away from bars, restaurants, airplanes, and theaters.

In the popular vernacular of the investment community, the current debate is not about whether a recovery is happening, but about its shape: V, U, W, or maybe L? There are several good arguments for "V", including:

- A stunningly aggressive fiscal and monetary response to support workers, businesses, and financial markets. The economy surely would be much worse off in the absence of these measures. The Fed, in particular, has left no doubt that monetary policy will remain accommodative until employment and inflation have made a complete recovery – a process that could take years. This is a powerful message in support of risk-taking.

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- A surprisingly large share of the economy was not hit very hard during the recession, and with leaner cost structures in place, company margins and earnings could improve much more quickly than commonly believed.

It's not difficult to imagine a rockier path, either:

- Despite a massive effort, there can be no telling when an effective vaccine will be widely available. Once discovered, it will take time to ramp up production, and there can be no assurance that everyone will participate. The virus will be with us for years to come.
- Without a "quick fix", consumer and business behavior may be permanently altered, with ramifications for growth that are hard to assess. For example, work-from-home arrangements, the movement of people away from urban centers, and the acceleration of existing trends such as e-commerce may benefit certain sectors but prove devastating to others, with no net benefit to the larger economy.
- Research published by the Federal Reserve Bank of San Francisco in March addressed the long-term economic consequences of pandemics from history. Unlike wars, where physical destruction leads to higher real interest rates and elevated investment spending, pandemics seem to cause real interest rates to slide for many years afterward, as households and businesses hoard their savings.

At the moment, what we don't know about the shape of the recovery seems overwhelming. But we do know that with the Fed holding risk-free interest rates near zero, acceptable income returns are going to be extremely hard to achieve without also accepting higher portfolio volatility. And with low rates having driven up valuations on every other asset class, expected returns in general must be similarly lower. We are constantly aware of this pressure and are always working to identify great companies that can grow strongly despite these conditions.

We are beginning our next economic cycle with an equity market that is much closer to its highs than its lows, making the current investment environment more challenging than in 2009, for example. Returns have been pulled forward, and a tremendous amount of potential good news is already reflected in stock prices. Then again, valuations alone are not a sufficient reason to expect trouble, and the optimistic view may well be the correct one. We will remain vigilant and open to all outcomes over the course of what will likely be a very interesting period ahead for investors.

Sources: FRB of San Francisco