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The Big Picture

- I remain skeptical of the rally we've had in risk assets (global stocks up 24% since March 23, IG & HY spreads significantly tighter).
- The market continues to underestimate the long tail of damage that the outbreak/shutdown will cause. (The subject of my ***Capital Market Note*** set separately). Investors seem to believe that this is a "temporary" state or a "short-term" event.
- It's hard to imagine that the deepest, broadest, and most simultaneous hit to global GDP in modern history would result in one bad month (Feb. 19 peak to March 23 trough).
- As of Friday (on the S&P 500), we need a 20% loss to get back to the lows and 20% gain to get back to the peak. I believe we'll see ***more volatility/losses in the coming weeks and months, but the damage may take a while to reveal itself***.
- The risk rally has been too optimistic on the medical front, the policy reaction, and macro implications. Over the coming months, risk assets may struggle as investors recognize some of these hurdles.

- Medical: ***Market loves every little piece of good news, but the outbreak has a long way to go.***
  - The outbreak will last longer and "re-opening" further delays ending the outbreak. Catch-22.
  - "Flattening of the curve" is important, but it is overemphasized. A flatter growth rate may still be associated with significant new cases which will determine consumer/producer behavior. For example, the curve is flattening in the US, but new cases have still averaged almost 30k/day in April. The growth rate is falling but the absolute # of new cases isn't yet and this will make businesses/consumers hesitant.
  - A vaccine remains a distant hope (a year away at best?). Other treatments like hydroxychloroquine and Gilead's remdesivir have, so far, been false hopes. A "quick fix" seems unlikely.
  - There is no conclusive evidence on reinfection – which is terrifying – because any notion of flattening the curve or "herd immunity" is irrelevant if reinfection is possible.
  - Medical experts fully expect potential 2nd and 3rd wave outbreaks into the fall. In summary, the outbreak will not be completely "behind us" for some time. Q3? Q4? 1H:2021? Later? The market seems more sanguine than this prognosis.

- Policy: ***Massive liquidity from central banks is an anesthetic, but it doesn't fix the problem.***
  - Central banks, particularly the Fed, are now providing direct or indirect support to every form of lending and every sector of the bond market. This has mitigated some panic in the corporate and overnight lending markets, but volatility remains elevated.
  - QE forever and massive lending facilities can support asset prices, but they do not change production (aggregate supply) and consumption (aggregate demand). Simply put, the actions do not fix the economy or the underlying problem (the virus shutdown).
  - US Fiscal policy has been big, but implementation has been poor. Not enough of the emergency funding is getting to families and firms fast enough. Reports continue to emerge that emergency lending to SMEs in the UK has also been very slow to roll out.

- In Europe, the fiscal purse is opening a bit wider, but structurally, the EC can't get everyone to sign-off on the budget implications – at least not on the scale necessary.

- Macro: ***The outbreak/shutdown scars will last longer than people think.***
  - Production will be staggered when it restarts. China's manufacturing is around 80-90% of normal, but where is that production going? The US and Europe aren't buying while in lockdown. Inventories will begin to build.
  - Social distancing will reduce capacity and demand in many industries even after the virus has been largely contained.
  - Many firms will have to "re-start", not reopen. That is longer and slower. Many businesses won't simply be able to flip the sign on the door from 'closed' to 'open.'
  - Many jobs will return quickly. *<u>Many will not</u>*. US unemployment may reach 20%. It will fall quickly, but will it get back to 3.5% anytime soon? Or 7.5%? Or 10.5%? Those with jobs are working fewer hours.
  - Some estimates have US unemployment remaining over 10% through year-end, still deeply recessionary. Not great for Trump's re-election hopes in November.
  - There is, and will continue to be, a pull-back in global trade as countries and firms change their supply chains or begin "in-sourcing" production. This could also have negative cost/inflation implications.

***As economies begin to re-open, investors will likely confuse stronger growth with base effects.***

- Major parts of the global economy are effectively at 0% - 10% capacity today. Airlines, hotels, restaurants, casinos, movie theatres, etc.
- When business re-starts, activity will jump, but to what? 50% of the pre-virus levels? 75%? 90%?
- A return to "90% of normal" might be a jump of 9x off the bottom (a huge growth rate), but it is still 10% below the pre-virus baseline. These would be recessionary conditions for almost any industry.
- ***It may be some time before the global economy looks anything like the go-go days of 2017 – 2019***. Again, this isn't the message coming from the 28% rebound in the S&P 500.
- Big picture – As the data arrives in the coming months, ***there is far more room for investors to be disappointed than there is for the info to exceed expectations***. The alternative theory is that policymakers – central banks and fiscal authorities – make it all the bad news disappear. I'm skeptical.

<u>Bonds and Yields</u>

- We can safely assume that central banks will continue to hold overnight rates at their negative/0% level until at least mid-2021, probably even longer.
- In the short run, rates out the curve will remain low - and might go lower as oil collapses, inflation pressures fall, and the world goes risk-off again. ***Basically, yields are pricing the economy – more or less – correctly for now***.
  - Central bank buying and liquidity facilities will keep rates from moving too much higher in the short run.
- However, in the longer run (2H into 2021), ***rates appear too low for whatever level of growth returns***. The US-10 year at 0.6% is currently pricing 1.0% inflation and -0.4% in real yields (a proxy for real growth).
  - Both of these estimates, inflation and real rates, are too pessimistic (i.e., too low). Rates will eventually begin backing up in 2H and into 2021.

- Central bank bond-buying will fade slowly, but it will fade eventually. At the margin, this will also create some modest upward pressure on yields, particularly as budget deficits and sovereign issuance skyrockets (i.e., more supply to soak up).
- Current super-low rates, with the potential for gradually rising yields paints an ugly picture for high quality bonds.
  - The US Aggregate Bond index yields 1.42%. Global Aggregate yields 1.12%. Investors are starting from low base yields with a lot more potential for market value losses (rising rates) than gains (falling rates).

<u>Credit & Equity</u>

- In equities, it's impossible to assess valuation metrics because the earnings (P/E) and revenue (P/S) are dropping like stones. These metrics are no longer capitalizing the near-term (coronavirus) outlook. They are capitalizing equity values AFTER the outbreak – the "return to normal."
- Equity markets are looking past the current earnings season (Q1) and past Q2. We know Q1 is the downturn and that Q2 is likely to be the trough. What we don't know is what the 2H or 2021 will look like. As a result, the forward guidance companies are offering (if any) is far more important than the current earnings beat or miss. (To some degree, this always true, but more so now with everyone assuming the recession is deep but short).
- Per the macro disappointment highlighted above, ***expect equities to remain volatile with more downside than upside***.
- The risk/return trade-off of equities has deteriorated again. After the 25% rally, stocks are hardly cheap relative the macro outlook. Significant equity gains from here would have to be a function of overly optimistic earnings expectations for 2021 and/or a continued rally in P/Es. I think the hope for either of these is fading. The best short-run hope for stocks is just more and more stimulus, but again, this doesn't solve the problem and just sets up a bigger reckoning later.
- Credit sectors of the bond market (IG, HY, bank loans) arguably offer better relative value as they have retraced far less of the sell-off than stocks. However, credit and default risk are rightfully skyrocketing, so wider spreads are justified.
- Moreover, with central banks propping up everything, the implied backstop to credit is far more convincing (i.e., direct) than it is for stocks (indirect).
- Neither stocks nor credit are attractive in the short run on a broad market basis. Bargain hunting today may be appropriate, but only for professionals. ***This is a market for alpha and active management, not broad market beta***.
  - Dispersion across equity and credit has increased dramatically. Government bailouts – who gets them and who doesn't – will bifurcate winners from losers.
  - Many assets and productive capabilities will not be destroyed, they will simply change hands. Airplanes, cruise ships, oil deposits and infrastructure will all still exist. They'll simply be owned by the "winners" who make it out the other side.
  - The winners get secondary benefits of scale, lower funding cost, and less competition after the outbreak.
- My summary views separate by horizon:
  - In the short term (next 2-3 months), I remain concerned/pessimistic that the market hasn't fully grasped the economic damage and remains vulnerable to disappointment.
  - In the intermediate term, I am optimistic that the outbreak/shutdown will partially cleanse the system. Valuations will reset lower, earnings will trough, froth will be taken out of markets. This should set up a nice rally for stocks & credit in late 2020 and/or 2021.

- Longer term, the eventual rally will send us back to previous highs, where valuations remain stretched and yields are abnormally low. These factors both imply poor long run capital market estimates for years to come (after the rally).