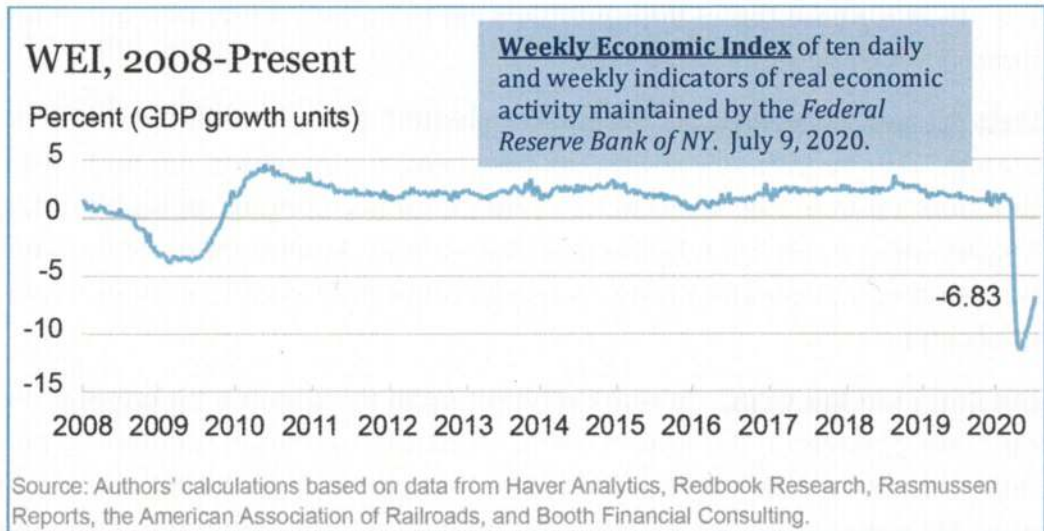


Investment Commentary—July 2020

In March, as governors urged residents to restrict activities and eventually issued sweeping stay-at-home orders, U.S. economic activity plummeted. The phrase “falling off a cliff” is overused but looking at the chart below¹ it’s hard to think of a more apt description. In the Great Recession of 2008 and 2009 the economy declined for well over a year before bottoming out. The much deeper COVID-19 economic free fall took only a fraction of that time--a mere six weeks. When states began to reopen in May a sharp rebound, which continued into early July, ensued.

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Of course, the \$64,000 question is where the economy goes from here. As with so much about COVID-19, the best answer may be: Who the heck knows? One hopes that the sharp increase in economic activity over the past two months will continue in a straight line until activity reaches pre-COVID levels. The result would be a “V-shaped” recovery, which would contrast with the “U-shaped” recovery following the Great Recession. For the following reasons, a V-shaped recovery seems unlikely.

Business Closures. A large wave of business closures is already working its way through the U.S. economy. While many businesses have gone under, many others are muddling through by drawing on credit lines, taking advantage of the Payroll Protection Program (PPP) for small businesses or cutting expenses to the bone. As each month of

¹ The Weekly Economic Index, maintained by the Federal Reserve Bank of New York, tracks the growth or decline in economic activity relative to the same period in the prior year. Because the comparisons are year over year, not month over month, the points when the blue line begins to increase (or decrease) may not precisely match up with the point when economic activity begins to increase (or decrease), but it’s close enough for current purposes.

the pandemic goes by though, more businesses will run out of options. Some will reorganize under bankruptcy protection, but others will simply fold. Each closure will send a small ripple of pain into the broader economy.

Business Capital Expenditures. Reuters recently estimated that large and mid-sized businesses in the U.S. will cut capital expenditures in 2020 by 22%. Cancelling projects takes time, so most of the hit will take place in the second half of the year when spending on equipment, factories and other structures could be down over thirty percent from the prior year.

Expiring Unemployment Benefits. In late March, Congress passed the \$2 trillion CARES Act. It included a \$1,200 one-time payment to most U.S. adults and a significant expansion of unemployment insurance. Some of the unemployment provisions are scheduled to end on July 31st. There is a good chance these provisions will be partially or fully extended. If not, consumer spending will be significantly impacted.

State & Local Governments. States and municipalities are generally required to run balanced budgets. Thus far governors and mayors have relied heavily on rainy day funds and other one-time measures to counter the impact of sharply lower tax revenues. Going forward, unless Congress steps in, payrolls will have to be slashed to get budgets aligned. States and municipalities accounted for twenty million jobs before the pandemic, so these layoffs could take a significant toll.

The Course of the Virus. Perhaps the biggest cause for concern is the course of the virus itself. Right now, governors and mayors in several states are beginning to backtrack on some aspects of reopening. How exactly that impacts the blue line in the chart on the first page remains to be seen. But it seems reasonable to think that the upward trend in economic activity could be dramatically slowed if not halted altogether. Whether and to what degree schools and colleges will successfully reopen in the fall is a huge question mark. Poorly executed school re-openings might spark another resurgence of the virus. Even if another major lockdown akin to March and April is unlikely, continued progress toward a resumption of normal levels of activities could be jeopardized.

Taking the list of considerations above into account, a V-shaped recovery is doubtful. A more prolonged and unsteady recovery seems likelier, even if the exact course of the pandemic and its economic effects are unknowable. If that's the case, what can we make of the chart below? It plots the course of the S&P 500 Index over the last twenty five years, including the bear markets associated with the 2001 recession (and bursting of the Tech Bubble) and the Great Recession of 2008-09. Those bear markets were deep and protracted. It took years before two-thirds of the stock market decline had been recovered. In the case of the Covid-19 recession on the other hand, two-thirds of the decline was recovered in two months! Some of the rapid rebound was attributable to a handful of giant companies like Amazon, Apple and Microsoft, that could be

helped-- or at least not badly hurt--by the pandemic. But even if we took these companies out of the index the chart would look roughly similar; the rebound would be a bit less pronounced but still nothing like the two prior recessions.



What could account for the speed with which most of March's stock market losses have been recovered? Three answers come to mind. First, it's possible that investors believe in a V-shaped recovery, i.e. that the rapid growth in activity shown in the chart on the first page will continue into the months ahead and that the economy will recover all of the lost ground by some time in the fall. As articulated already, we're highly dubious on that score. We also doubt many investors are anticipating a V-shaped recovery. If faith in that outcome accounted for the rapid rebound, then recent backtracking on re-opening in states like Texas and California should be hurting the stock market and that hasn't been the case.

Another possibility is that investors are responding rationally to extraordinarily low bond yields. As we've noted countless times in these pages, low bond yields make stocks look more attractive on a relative basis. The rebound in share prices from the March lows has reduced dividend yields, but it's still possible to put together a basket of diversified blue-chip stocks with very safe dividends yielding close to 3%. When the 10-year U.S. Treasury yields 0.65% that looks pretty good!

The third explanation for the big bounce in stocks over the last few months is that investors have gotten greedy. Gripped by FOMO (fear of missing out) and assisted by trillions of dollars that Congress and the Federal Reserve have poured into the economy, investors may be funneling money into stocks in the hopes of making a quick buck. Some evidence for this possibility comes from activity in stocks like Hertz, which filed for bankruptcy protection on May 22nd. Within a few days, the share price climbed almost tenfold in a speculative orgy totally divorced from the reality that Hertz shareholders are extremely unlikely to ever see a dime.

We suspect the truth about the rally lies in some combination of the three explanations. It would be helpful, though, to know how much of the rebound is a rational response to low interest rates and how much is based on either expectations (misplaced in our view) of a V-shaped economic recovery, or on speculative trading. If the sharp rebound in stocks since the March low is primarily driven by paltry expected returns on bonds, it may be sustainable. After all, the prospect of higher bond yields is a long way off. Suppose on the other hand that the vigorous rally is based on some combination of greed and wishful thinking about a quick return to a robust economy. In that case the stock market is dependent on investor emotions and investor perceptions of economic conditions. Either of those is subject to significant revisions at any time, which could lead to a rapid undoing of much or all of the rally. While we hope recent stock market gains are founded primarily on dispassionate assessments of likely future returns from stocks vs. bonds, we're managing portfolios on the assumption that recent gains may have a less solid foundation.

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