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Darkest Before Dawn

Like an infectious rising sun, COVID-19 has spread across the globe East to West casting not light and hope but fear and uncertainty. Delayed recognition of the level of contagiousness of the disease and initially apathetic responses from Western governments allowed asymptomatic disease transmission to gain footholds globally, resulting in accelerating cases of COVID-19 in nearly all developed and emerging market economies. As discussed in our last communication, "COVID-19: Economically speaking, is the cure worse than the disease?", this has forced governmental and societal response to lockdown economies, similar to China's response, to create social distancing and manually slow spread. Record numbers of employees are now working from home, initial jobless claims were a staggering 3.3 million for the week ended March 21, spending on discretionary "fun" items has evaporated, and global equity markets have collapsed trying to gauge how long and deep this recession will be.

Economic data is dark today and expected to become darker as the disease unfolds. Q1 2020 GDP will undoubtedly be below Q4 2019 activity levels and more than likely mark the starting date of a recession. Wall Street GDP estimates for Q2 2020 are continually being updated and refined based on incoming data, but at this point look historically bad, ranging from an annualized contraction of GDP from 9% to 30% for the quarter (an absolute decline of 2.5%-7.5%) depending on how long the economy is expected to stay shut-in. However, trying to solve the riddle of exactly quantifying the depth of a recession misses the point of understanding what markets are focusing on when trying to find a bottom in that recession. At this point, while it's not clear exactly how strong the economic recovery will eventually be, the timing of when the recession will end is easy to pinpoint in our view: Q3. Since US economic growth is measured sequentially, any resumption of economic activity in June (Q2) or Q3 will mark a return to growth vs. the depressed levels of economic activity forced by the lockdowns of March, April and May. This is important because historically equity markets start to sell off before recessions start and also bottom and begin to recover before recessions end as confidence builds that economic and earnings growth will resume.

Recession Start Date	Length (months)	Drop in GDP	Prior Market Top	Market Bottom	Pre recession Market Peak (months)	Market Bottom to Recession End (months)	Market Decline	12 Month Market Recovery
1947-04-01	6	-0.5%	05/31/46	02/27/48	(10)	5	-27%	5%
1949-01-01	6	-1.7%	06/30/48	06/30/49	(6)	(0)	-15%	25%
1953-07-01	9	-2.5%	01/30/53	08/31/53	(5)	(7)	-12%	28%
1957-10-01	6	-3.5%	07/31/57	02/28/58	(2)	(1)	-15%	36%
1969-10-01	6	-0.6%	11/29/68	06/30/70	(10)	3	-33%	37%
1974-07-01	9	-2.5%	12/29/72	09/30/74	(18)	(6)	-46%	32%
1980-04-01	6	-2.1%	01/31/80	03/31/80	(2)	(6)	-11%	33%
1981-10-01	6	-2.6%	03/31/81	07/30/82	(6)	4	-21%	52%
1990-10-01	6	-1.6%	05/31/90	10/31/90	(4)	(5)	-16%	29%
2008-07-01	12	-3.9%	10/31/07	02/27/09	(8)	(4)	-53%	50%
Average	**7**	**-2.1%**			**(7)**	**(2)**	**-25%**	**33%**
2020-01-01	6	-7.5%	02/29/20		2			

* Using month end price data closer to flu mortality.
Source: fred.stlouis.org, Factset

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While this feels like anything but a typical recession given the speed of the COVID-19 contagion and concurrent market reaction, a 6 month recession with total economic decline of 10% and approximately 24%market selloff from end of February to date is actually very consistent with past recession data as seen in the table above. The fact that this is a health care driven recession, not one caused by fundamental supply/demand imbalances, is noteworthy as well, since it implies once the health issues are ring-fenced, the economy can return to more normalized levels. In our view, the market is currently looking for two things to set a bottom and determine the magnitude of the subsequent rebound: 1) signs the economy can return to growth at some level (i.e., the market needs confidence the lockdowns can be removed at some point); and 2) indications of what corporate profitability recovery will subsequently look like. Unfortunately, it's too early to tell on the latter with any type of clarity. Importantly, the Federal Reserve and other global central banks have clearly adopted a "do whatever it takes" mentality to keep markets orderly and liquid. From a fiscal stimulus perspective, the US Senate has approved a $2T stimulus bill that is likely to be passed into law (or very similar legislation will be) that targets relief for the most impacted parts of the economy, e.g., unemployment insurance, small to medium businesses and critical businesses from a US economic infrastructure perspective. Both the central bank and fiscal policy actions pave the way to keep the infrastructure of the US economy available for business post contagion and should help to limit long-term structural economic output gaps (an output gap is when the economy operates below it's potential for a sustained period of time). Additionally, since much of the current slowdown is business and discretionary spending in nature, once businesses and consumers are confident they can safely resume normal activities, discretionary spending should increase although it will likely take several quarters before travel and other activities fully return to historically normal levels.

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What about the timing to end lockdowns and return to work? We expect that to be different based on which part of the globe and what the isolation/quarantine and testing protocols put in place in that part of the globe were. However, we can learn some early lessons based on China and Italy's experience so far.

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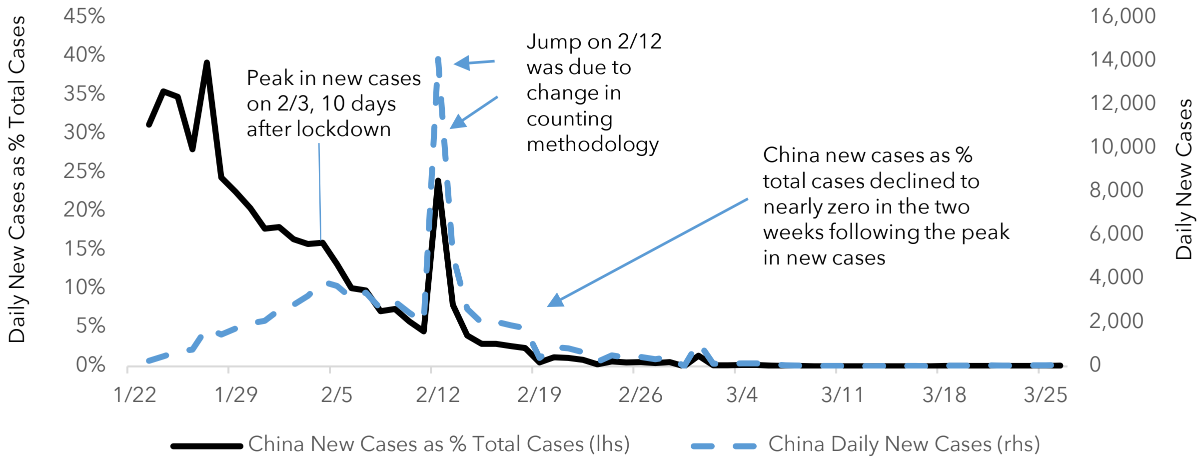
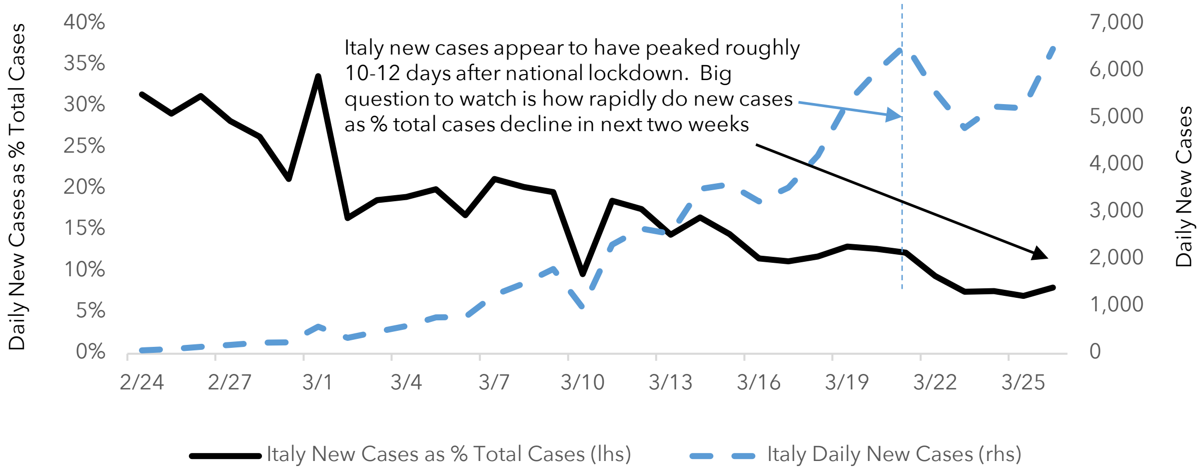
China declared a lockdown for Wuhan City, the epicenter of the virus on January 23. Growth in new cases peaked 10 days later on February 3rd, which makes sense given the typical 2-14 day incubation period. New cases as a percent of total cases declined to less than 1% in the next two weeks and China has begun to reduce lockdown measures and officially plans to lift the lockdown entirely on April 8th, a 76 day lockdown.

China New Daily Cases vs. Total Cases



Italy seems to be experiencing a similar new case peak pattern once it implemented a national lockdown (March 9th) and closed restaurants and bars (March 12th), potentially seeing a peak in new cases reported on March 21st. The important factor to watch over the next two weeks is Italy can achieve the same post-peak decline in new cases as percentage of total cases.

Italy New Daily Cases vs. Total Cases



Source: WHO Worldometer Coronavirus site

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Germany, Spain and France are about 6 days behind Italy from a lockdown perspective, indicating we may see a peak of new reported cases within days.

In the US, multiple states and roughly half of the country's population went into lockdown on 3/20-3/22, additionally when possible many citizens had begun working from home the week prior, indicating a peak in new cases may occur as soon as the beginning of April, a first glimpse of a new dawn on the horizon.

China's experience can also be instructive in terms of where global economies go from here but caution needs to be taken not to draw too tight a parallel with Western countries given China's ability as a centrally planned economy to more tightly lockdown city and regional borders. While new cases peaked on February 3rd in China, total active cases did not peak until February 17 and China did not generally begin reopening borders until 30 days after no new cases were reported. Stores and businesses have mostly re-opened, but are operating well below pre-COVID-19 levels, in part because of China's economic reliance on exports to the rest of the world where demand is being negatively impacted by COVID-19 lockdown measures, but also due to hesitancy on the part of the consumer. China also continues to experience new cases of COVID-19 originating from individuals who have travelled abroad and returned back to the country, highlighting the importance of aggressive testing for inbound travelers.

Ultimately, we think the peak between active cases and new cases may take longer in Western countries due to the more porous nature of their lockdowns, e.g., in the US, it is still very easy for an asymptomatic carrier to travel from State or City A to State or City B and potentially create a new cluster of infection. However, as testing capabilities are ramped up and new case activity declines, it will allow for more surgical containment of infected individuals and provide confidence for the developed world global economies to restart. In Europe, developing and maintaining stringent testing protocols on inbound populations until a vaccine is developed or the contagion is eradicated globally will be critical given the economic interdependence of the Euro countries. Tourism will likely remain depressed until that point, creating more fiscal challenges for economies like Spain and Italy who are heavily dependent on tourism. Multinational companies located in Europe should be able to resume operations while cross border infections controls are in place though, so it is likely in our view that European stocks outperform their respective economies and potentially other developed equities for a period of time. Emerging market economies are generally behind the curve in quarantining and isolating infected individuals (although on a positive note India just instituted a lockdown on their 1.3 billion citizens), which means emerging market economies likely underperform those of their more developed counterparts relative to economic potential for the time being.

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In the US, lockdowns are not consistent but social distancing is being generally practiced in non-stay-at-home states at this point. Given the less strict nature of the lockdown on a national level, the peak between new cases and active cases may take a couple weeks longer than China's experience, and the decline in new cases will likely be more gradual. COVID-19 testing capabilities are ramping up and in our view will be pivotal to employers and employees gaining confidence to resume work and travel and for consumers to resume spending. Targeted reopening of economic activity in the next 60-90 days (the last month of Q2) appears increasingly likely based on the social distancing measures currently being put in place. Travel and discretionary spending should begin to improve as the economy slowly recovers, but the US and global economy could likely take 12-24 months or more to fully recover absent an effective vaccine, with quicker recovery achievable if a vaccine is brought to mass market earlier.

From an investment perspective, portfolio construction decisions are inherently individual decisions due to differences in taxation, spending requirements, risk aversion and time horizon among other factors. The sudden and severe global equity market sell-off has likely erased many existing gains in portfolios, allowing many taxable investors the opportunity to revisit their portfolio construction with no or limited taxable consequences. While US treasury interest rates may rebound slightly from current stressed levels, we see interest rates in general remaining low for the next several quarters since economic output will remain below economic potential in our view. With the economy getting closer to resuming growth, we believe risk assets in general are more attractive than they have been recently and we think that taking advantage of market weakness to rebalance back to targeted asset allocation levels make sense in the current environment. Larger rebalancing measures when needed should be taken over the next couple months given the likelihood of continued volatility as the market digests disease progression and potential cures to evaluate the likely upside trajectory from the bottom. Please contact your advisor to discuss your individual situation.