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Investment Outlook

The advent of the COVID-19 virus in the first half of 2020 may go down in history books as a "black swan event"—an occurrence with extremely low probability (three standard deviations from the norm or about 0.3%). This may be an exaggeration, because the world has been afflicted by pandemics before, but the combination of surprise, the speed at which the infection spread, and the lack of preparedness and political will to respond wreaked devastating consequences. As of April 15, more than 131,000 Americans had lost their lives due to the coronavirus, and there is good reason to believe this number is understated.[1] Beginning in March, the U.S. economy went into free fall, compared by some to the Great Depression of the 1930s. Significant portions of the government and the private sector shut down. More than 20 million Americans lost their jobs. The pain and suffering have been widespread, with more to come.

Under these circumstances, one would have expected equity markets to be crushed. Initially the S&P 500 Index did collapse. From its record high level of 3386 recorded on February 19, the S&P lost one-third of its value in less than a month to 2237. But then almost as dramatically, the market roared back. Between March 23 and June 30, the S&P rose nearly 40% to a level just short of yearend 2019. All investors had to do was to hold on and keep their wits about them. Any selling, even a modest reduction of equity exposure, during this downturn penalized performance. The total return of the S&P, including dividends, for the first six months was around -3%. This loss was arguably within the range of equity return expectations at the beginning of the year, when our principal concern was a moderate deceleration in the growth of U.S. GDP and corporate earnings. From the standpoint of equity markets, it is hard to believe a black swan event has taken place! Never have we seen such a disconnect between economic realities and stock market valuations.

Interest rates plunged in the first half owing to (1) the extraordinary liquidity injected by the Federal Reserve and (2) fiscal stimulus to stabilize the economy, particularly the finances of businesses and households. The 10-Year Treasury benchmark fell from 1.92% at yearend to 0.67% at June 30, a drop of nearly two-thirds. The 30-Year Treasury rate similarly declined from 2.39% at the end of the year to 1.41% at June 30. These downward moves were unprecedented and resulted in fixed-income returns exceeding equity returns over the last 12 months.

**Our Take on the Investment Outlook**

- The biggest challenge to investors is the lack of predictability in containing and ultimately defeating the COVID-19 virus and in projecting the recovery in the economy. Forecasting based on trends is relatively reliable. But due to the coronavirus and a depressed economy, we are largely reduced to guessing what will happen, which means our estimates are subject to much higher error than normal. Bear this in mind as you read this letter.

[1] World Health Organization, Coronavirus Disease, Situation Report-162, June 30, 2020, https://www.who.int/docs/default-source/coronaviruse/20200630-covid-19-sitrep-162.pdf?sfvrsn=e00a5466_2

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- We are generally optimistic about containing the COVID-19 virus, mitigating the severity of the illness, and reducing mortality rates. But clearly, temporary setbacks as the coronavirus flares up suggest that reopening America will likely be a bumpy process.

- The measures taken thus far by Congress, the Treasury, and the Fed to alleviate the impact of unemployment and to provide liquidity as a result of the pandemic are impressive, but more federal support likely will be required. Our government learned well from the experience of the financial crisis of 2008–2009.

- The U.S. economic recovery has already begun, but we believe it will take until the end of 2022 and possibly beyond for the economy to recuperate fully. Not all sectors have been impacted to the same extent. This means that the rebound in corporate profits will be uneven and for many companies very challenging. We project that the recovery of S&P 500 Index company profits will take until 2023 to surpass 2019 levels.

- The consequences of the pandemic will affect the economy and private sector. Globalization, which has been an important driving force for companies to reduce costs and increase profitability, may actually go into reverse. Companies will give greater preference to domestic supply chains, which will increase investment but adversely impact margins.

- We are concerned about the unprecedented level of federal deficits and the ballooning of federal debt. Even though low interest rates make it relatively easy to finance the debt and there is no shortage of investor capital, we worry that the fiscal situation is not sustainable and could be a source of future instability in capital markets.

- We note that if the Democrats win in November, the environment will be less business friendly, with higher taxes and more regulation posing risks to the stock market.

- We conclude by indicating that while equities may be the best investment among poor alternatives, common stocks are vulnerable.

**The COVID-19 Virus**

The economic outlook depends importantly on how successful the United States, indeed the world, is in containing the coronavirus and developing a vaccine that provides immunity. Notwithstanding the recent surge in infections in certain southern and southwestern states, there is reason for cautious optimism. First, a massive effort is underway in the United States, China, Western Europe, and Japan to develop treatments that will reduce the severity and mortality of the coronavirus. As of April 15 there were some 131 antibodies, antivirals, other therapies, and treatments under investigation and 86 vaccines in development. By June 24, the Milken Institute that tracks these efforts indicated total treatments and vaccines being investigated have about doubled.

Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases, recently stated that three vaccine candidates will be studied in large-scale clinical trials in the next three months. It is not unrealistic to expect that a vaccine will be available in 2021 in quantity. However, the first vaccines

available may not be 100% effective. Dr. Fauci indicated that he would "settle" for a vaccine that only provides 70% to 75% immunity, which is not too unlike flu shots.[2]

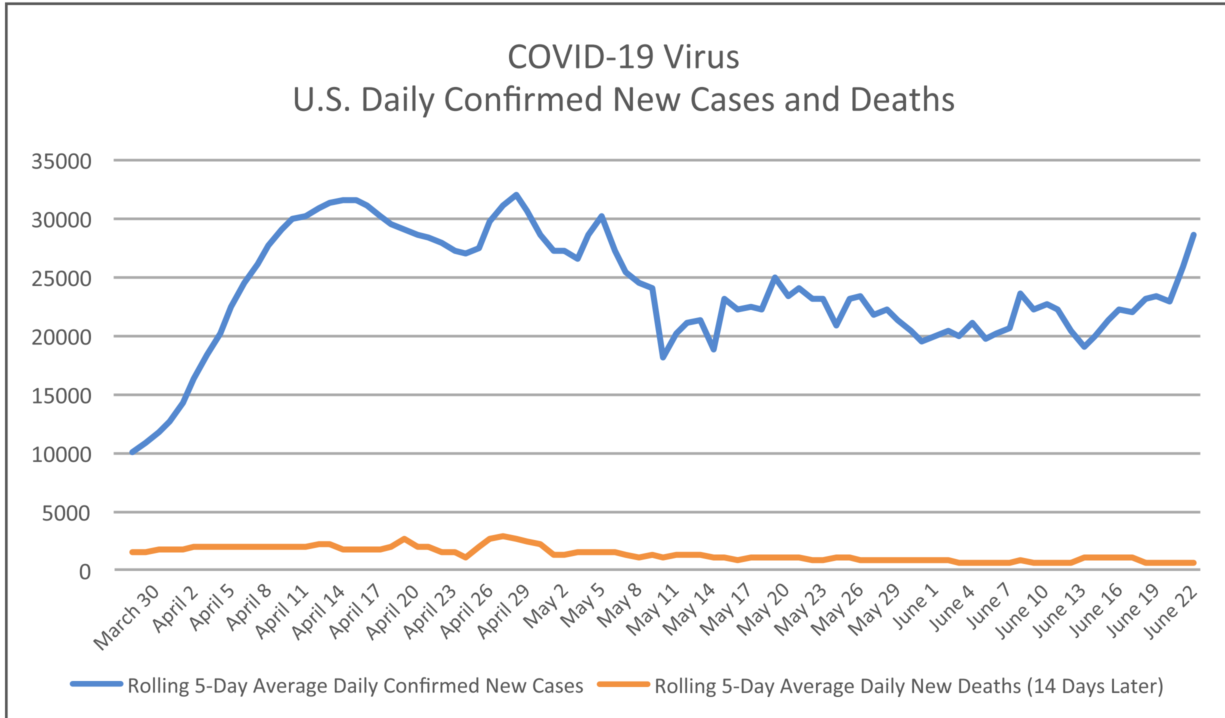
| **Table 2** | | | |
|---|---|---|---|
| **COVID-19 Treatment and Vaccine Tracker** | | | |
| | 24-Jun | 15-Apr | % Change |
| **Treatments** | | | |
| Antibodies | 70 | 42 | 66.7% |
| Antivirals | 25 | 19 | 31.6% |
| Scanning Compounds to Repurpos | 21 | 11 | 90.9% |
| Cell Based Therapies | 17 | 7 | 142.9% |
| RNA-Based Treatments | 6 | 5 | 20.0% |
| Devices | 8 | 3 | 166.7% |
| Other | 107 | 44 | 143.2% |
| Total Treatments & Devices | 254 | 131 | 93.9% |
| **Vaccines** | 172 | 86 | 100.0% |
| Source: Milken Institute, https://covid-19tracker.milkeninstitute.org/ | | | |

The point is that contracting the coronavirus should be an acceptable risk as with the flu. Bear in mind the flu influenza kills between 30,000 and 60,000 Americans each year.[3] It is impossible to know how close we are to that point. World Health Organization data makes clear that new cases in the United States have increased in recent weeks, attributable most likely due to the highly publicized relaxation of social distancing, self-quarantining, and similar measures. One hopeful result from this surge of infections is that more of our national, state, and local leaders may finally be on the same page.

It is worth noting that mortality levels, which lag infections, have not increased…at least not yet. One explanation is that there has been a shift in the infected to younger age groups who are less vulnerable to the coronavirus. Other factors include broader use of more effective antivirals, therapies and other treatments, expanded availability of personal protective equipment (though still not perfect), improved procedures in hospitals (such as a steep decline in ventilator use, which in some cases may have caused more harm than good), greater precaution taken by the elderly, and possibly better procedures at nursing homes and other hot spots. In the period, February 1 through June 20, 2020, persons 65 and above accounted for around 80% of total deaths. It is believed that most of the elderly that died had underlying conditions. The younger and most productive segment of the U.S. workforce should be able to return to work while exercising reasonable precautions.

The following chart displays the WHO data showing a rise in infections but continued low mortality:

[2] CNN, https://www.cnn.com/2020/06/28/health/fauci-coronavirus-vaccine-contact-tracing-aspen/index.html
[3] Center for Disease Control, https://www.cdc.gov/flu/about/burden/index.html




**The Response to the Pandemic by Congress, the Treasury, and the Federal Reserve**

While the U.S. government fell significantly short in leading and managing the public health aspects of the pandemic, Congress, the Treasury, and the Federal Reserve acted boldly and swiftly to mitigate the financial and economic fallout of the crisis. In large part, they profited from lessons learned in the 2008–2009 financial crisis.

Congress has passed three separate bills in connection with the pandemic. The first was an $8.3 billion bill to fund vaccine R&D; the second was a $104 billion program to provide paid sick leave and unemployment benefits, and the third was the CARES Act, a $2.3 trillion package that provided one-time payments to individuals, forgivable loans to companies to maintain employment, and a variety of other measures. Much of the relief provided by the CARES Act will end this summer. It is likely that Congress will have to approve another round of major fiscal stimulus and support to prevent the economic recovery from stalling.

The actions of the Federal Reserve have been massive and fall into five major categories:

- Near-zero interest rates managed through the Federal Funds rate and forward guidance.
- Financial market operations to provide liquidity to financial institutions—no Lehman Brothers this time.
- Incentives to banks to increase lending.
- Support to corporations and small businesses through loans and purchases of their securities.
- Support to state and municipal authorities through loans and purchases of their securities.

Chairman Powell has repeatedly stated the Fed will take whatever actions may be required for as long as needed to stabilize and to promote economic recovery. On June 10, the Fed released its latest “dot plot,” a graph that shows the forecasts of individual members of the Open Market Committee that sets

the target interest rate for Federal Funds. Not one member projected an increase in the current 0.0%–0.5% range between now and the first half of 2022.[4]

**The Economic Outlook and Corporate Profits**

The good news is that following a really depressed second quarter (to be announced on July 30), the economy will most likely begin to recover. The bad news is that visibility is dreadful due to uncertain progress dealing with the coronavirus and the challenges American businesses face in restarting. The Bloomberg consensus (consisting of around 80 institutions) holds that real GDP will decline by 5.6% in the current year, but will advance in 2021 and 2022 by 4.2% and 2.9% respectively. These estimates are comparable to the projections through 2022 of the Congressional Budget Office and the Fed and imply that the U.S. economy will regain 2019 levels at the end of 2022. Normally forecasts are based on discernable trends in the economy. However, in this case where the economy has plunged, much more guesswork is involved in the shape and timing of a recovery. Accordingly, investors should be prepared for the recovery period to extend into 2023 or longer.

The margin of error seems even greater with respect to estimates of corporate profits. Most companies have suspended providing forward guidance to the investment community, because managements themselves do not know and certainly do not want to risk missing their estimates. S&P 500 index earnings in 2019 were around $163. Twenty-two institutional strategists project earnings to decline in 2020 to around $125, a decrease of nearly 25%.[5] Our best guess is that earnings will partially recover in 2021 to perhaps the $140 to $150 range and equal or surpass 2019 earnings in the 2022–2023 period. Earnings performance is decidedly uneven. Information technology and health care are doing the best and will show positive earnings growth in 2020. Energy, consumer discretionary (think travel and entertainment), financials, and industrials are faring poorly.

**Some Risk Factors Worth Pondering**

We think of recovery as restoring conditions as they existed before the pandemic. However, in some important ways the economy and businesses will not be the same. For example, the vulnerability of globalization manifested itself during the pandemic. Dependency on critical goods manufactured abroad affected various industries, most importantly in health care devices and equipment. Companies are reassessing the risk of foreign sourcing in their supply chains. Some jobs will return to the United States, which means labor costs will increase and corporate margins will compress.

Working remotely will be increasingly adopted, since many companies discovered during the pandemic that employees could maintain their productivity outside the office. Depending on how widely the remote model is employed, there could be pressure on office occupancy and rents.

One of the lasting consequences of the pandemic has been the explosion of federal debt owing to trillion-dollar deficits. The Congressional Budget Office, considering the programs responding to the pandemic, estimated that the FY2020 federal budget deficit will amount to $3.7 trillion. This is more than 2.5x the peak deficit in the 2008–2009 financial crisis of $1.4 trillion. Federal debt in public hands, which was around 79% of GDP in 2019, is expected to exceed GDP in FY2020 (over $21 trillion), a condition that had not been previously expected by the CBO until the end of the 2020s. Can the United States borrow massive amounts to finance its deficits as well as to refinance the maturities on its existing debt

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[4] "Economic Projections of Federal Reserve Board Members…," June 10, 2022, https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20200610.pdf

[5] Bloomberg, Strategists' S&P 500 Index Estimates for Year-End 2020, June 17, 2020.

without disrupting bond markets? Thus far there seems to be no shortage of appetite to absorb these financings. In any case, the Fed is already buying a significant portion of each financing and would be expected to buy more if demand is inadequate. There is also the risk that investors may demand higher interest rates to reflect the increased debt burden of the United Sates and the decline in the country's credit worthiness. Thus far there appears to be no problem here either, as interest rates have remained depressed. The low cost of borrowing has made financing the record deficits substantially easier. There has emerged a body of economic thought that holds that as long as the U.S. economy is growing faster in nominal terms than the weighted interest cost of borrowing, the United States can continue to borrow without cause for worry.[6] This whole area cries out for more study. It does not stand to reason that the United States can continue to borrow without consequences. The situation will worsen in 2020s as the cost of Social Security, Medicare, and Medicaid rise at a much faster rate than tax revenues.

The deficit financing has significantly increased the money supply. Is there a risk of inflation? Given unemployment and the under-utilization of factors of production, both of which are expected to persist, the risks here are considered low. Most economists are forecasting inflation rates at 2% or below through the end of the decade.

The forthcoming elections raise concerns that if a Democratic administration is elected, its budget will be more progressive and more expensive, leading to higher than normal deficits. The Trump administration unleashed higher valuations of equities, in part, due to a reduction of taxes and the removal of regulations. Investors should expect these policies to be reversed in both areas if a Democratic administration comes to power.

The venerated Harvard economist (and chess grandmaster) Kenneth Rogoff noted in a recent interview that our present circumstances are like "The Wizard of Oz, where Dorothy got sucked up in the tornado with her house, and it's spinning around and you don't know where it will come down. That's where our social, political, and economic system is at the moment. There's a lot of uncertainty, and it's probably not in the pro-growth direction."[7]

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[6] Olivier Blanchard, Public Debt and Low Interest Rates, Peterson Institute for International Economics, February 2019.
[7] "Harvard's Reinhart and Rogoff Say This Time Is Really Different," Kennedy, Bloomberg Markets, Vol. 29, Issue 3, May 18, 2020.