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Pandemic Road Map:
Planning for the Next Phase

April 7, 2020

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Executive Summary

- Science determines the recovery, not fiscal or monetary policy
- Expect immediate surge in unemployment yet slow rehiring process
- Equities not cheap; look for more certainty before adding
- Continued opportunity in fixed income

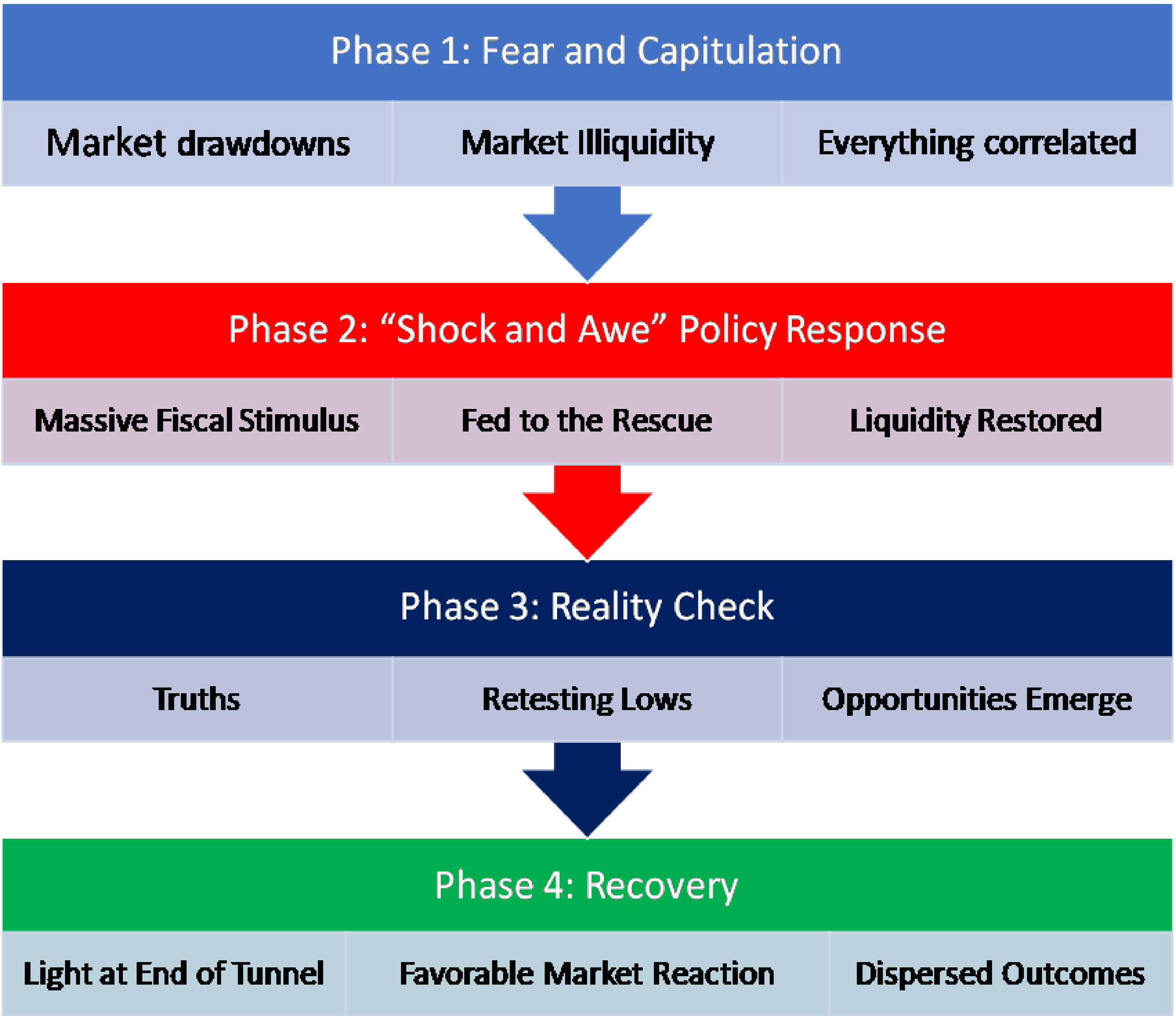
Pandemic Road Map:

Planning for the Next Phase

Markets continue to violently react to the uncertainties of these troubling times. Our framework for mapping out the likely course of the current crisis is shaped by our experience in previous events – 1987's Black Monday crash, 1993's Savings & Loan crisis, 1998's Long Term Capital Management meltdown/"Asian Tigers" currency crisis, 2002's bursting of the "Tech Bubble" and 2008's Great Financial Crisis.

Our experience in managing capital through these earlier episodes informs us that they tend to have certain patterns, which we've already partially seen unfold in the past few weeks. By applying these lessons to today, we can create a playbook going forward.

The Four Phases of the Market Crisis

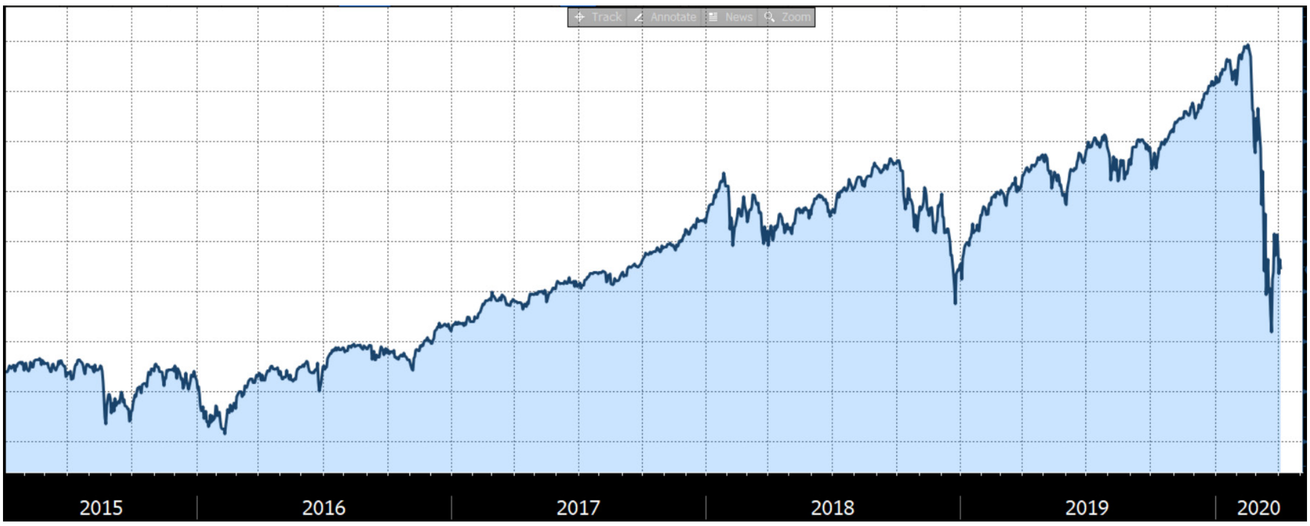


Phase 1: Fear and Capitulation

The initial phase of this crisis followed a well-established pattern of rapid pain and panic, albeit faster and more severe than imaginable:

- Volatility spiked as the market swiftly processed the magnitude of the pandemic and its harsh impact on business conditions. The S&P 500 dropped by a third in just 3 weeks, erasing years' worth of gains as investors immediately priced in the likelihood of a severe recession.

S&P 500



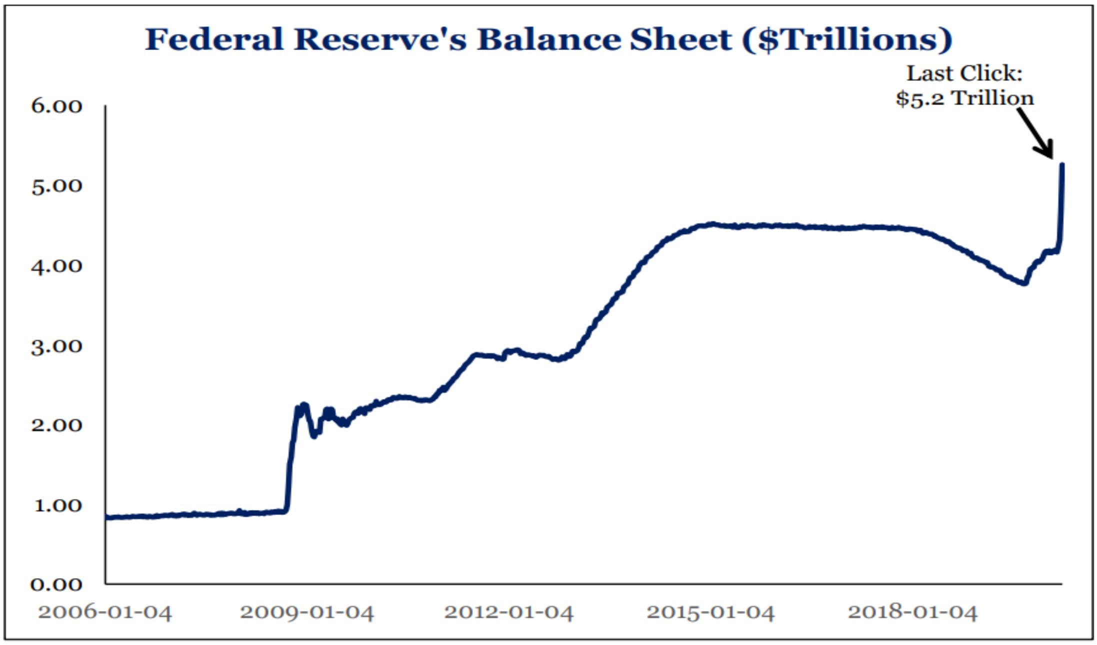
Source: Bloomberg

- A painful phenomenon also apparent in 2008's Great Financial Crisis reasserted itself as **correlations between asset classes "moved to 1."** That is, in the panic of the moment, nearly all asset classes sold off, leaving almost nowhere to hide. Indeed, within our three-dimensional portfolio structures, our less market-related positions generally provided downside protection. In addition, active outperformed passive and bonds provided the expected portfolio ballast.
- Extreme volatility lead to **evaporation of liquidity in fixed income markets.** Forced sellers experienced exceptionally challenging conditions (see our last communication Client Alert: Weathering the Market Storm, 3/11/20) and while progress has clearly been made, some markets have still not fully recovered and yields remain elevated.

Phase 2: “Shock and Awe” Policy Response

Governments and central banks can hardly be expected to sit idle as economies and markets melt down. In the US, we saw massive coordinated actions to support the economy and provide liquidity to financial markets:

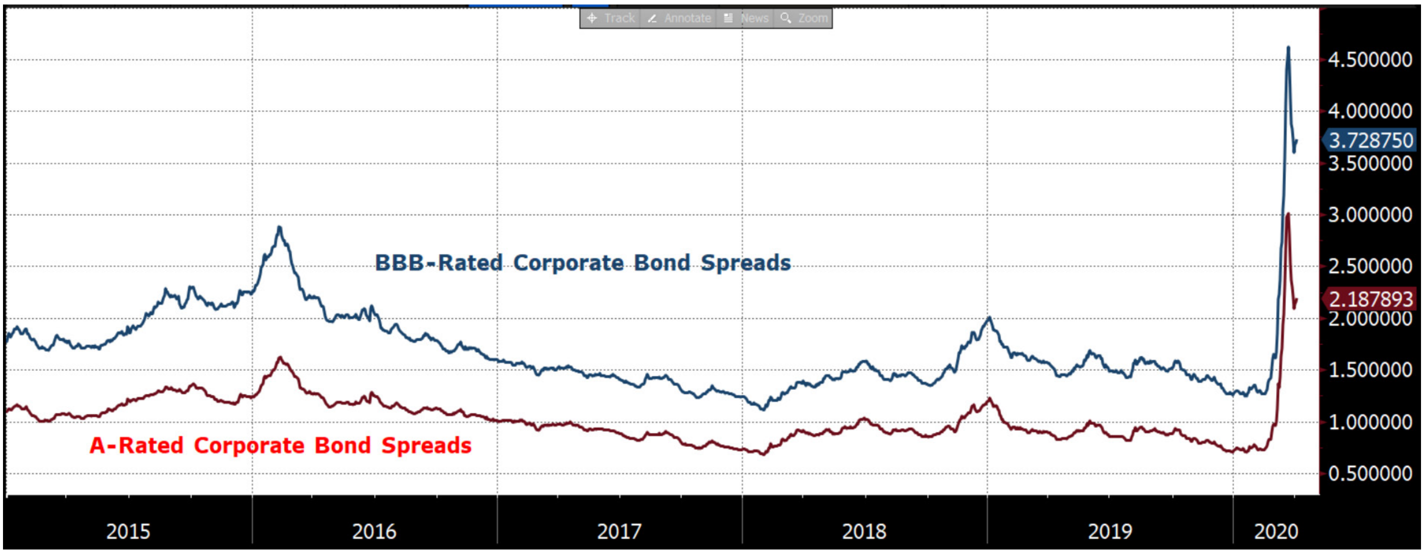
- Congress passed a gigantic $2 trillion fiscal stimulus, equal to nearly 10% of GDP (for reference, 2008’s then-record stimulus was approximately 5% of GDP). Designed to quickly funnel money into the most severely-disrupted parts of the economy, it provides hundreds of billions of dollars for companies, consumers, and state and local governments to partially defray the unprecedented loss of income and revenue. The Fed decisively intervened in Treasury and short-term markets, restarting Quantitative Easing (QE) and adding $1.5 trillion to the $4.3 trillion of existing Treasury and mortgage-backed securities already on its balance sheet. Moreover, for the first time ever, the Fed will soon expand the reach of QE and buy up to $4.5 trillion of corporate and municipal debt; for scale, the entire municipal bond market is $3.9 trillion.



Source: Strategas

- The combined force of fiscal and monetary stimulus has helped equities bounce off their lows. It's also restored liquidity in many fixed income markets, causing bond credit spreads to walk back some of their panic-driven spikes.

Corporate Bond Credit Spreads



Source: Bloomberg Barclays A-Rated and BBB-Rated Corporate Bond Indices

Phase 3: Reality Check

By our estimates, we're currently in the middle stages of Phase 3. The length of the shutdown and its consequences have already taken a toll on expectations; businesses have lost revenues and spent down reserves, workers have lost income which they won't get back, and confidence has taken a severe hit. While markets have already priced this in, we believe the news can deteriorate further before it starts to improve.

- Extended lockdown conditions are leading to surging unemployment. The past 2 weeks have seen over 9 million Americans file new claims for unemployment, and we think the jobless rate is quickly heading to at least 15%. If social distancing restrictions and business shutdowns largely persist into the summer, we could be confronted with a catastrophic 20-30% unemployment rate. At the start of 2020, the US labor force totaled 165 million people. The odds that an unemployment surge of this magnitude could be quickly reversed with a rapid post-lockdown economic boom are low. The unfortunate reality is that companies tend to shed workers much quicker than they rehire. Rehiring occurs to meet demand, and demand will likely return gradually: this means we should expect the pace and size of rehiring will be much slower than the downsizing.

- Sadly, we expect increasing infection and mortality rates. Combined with dramatic increases in unemployment, this would further pressure already severely-depressed levels of consumer confidence and spending. As this news emerges, we expect disappointed equity markets will begin incorporating this information via increased volatility and further declines reminiscent of what we just witnessed in March.

- As financial markets deteriorate, we expect to see the Fed aggressively deploy it's $4.5 trillion of dry powder to stabilize certain markets.

Phase 4: Recovery

While we have no unique insights about when the public health crisis will peak, at some point, the economy and markets will inevitably begin to recover.

- It's reasonable to assume the lockdowns will begin to ease after infection and mortality rates decline. Equity markets are likely to improve in advance of this data.

- While there's certainly a degree of "pent-up demand" waiting to be unleashed, it won't immediately fill the holes that have formed in the leisure, travel, hospitality, gaming, and restaurant industries. Much of their foregone revenues won't be replaced, and therefore we expect a very slow uptake and lagged recovery in these industries.

- That's not necessarily the case for larger discretionary purchases - someone who was already thinking about purchasing a car or household appliance isn't likely to forego these purchases. Depending on the pace of rehiring workers, companies specializing in commercial and consumer products with longer-term purchasing cycles (e.g. washing machines, bulldozers, solar panels) may not face the same degree of demand destruction.

- The wild card in this phase is fiscal policy. We expect it'll soon become clear that the ultimate economic cost of this crisis is likely to be far greater than originally anticipated. This realization could invite the federal government to launch an additional stimulus package that may improve the trajectory of the recovery.

Current Outlook

Its unlikely financial markets begin a durable recovery until the main (scientific) problem is resolved. We're in the middle of a global pandemic that has no precedent in modern times. Although massive, all the fiscal and monetary stimulus won't jump-start the economy while large numbers of people are in quarantine. Discovering a vaccine or effective treatment protocol would mark a clear turning point and change the course of the recovery.

The most probable trajectory is uneven, with different parts of the country at different stages of lockdown and recovery. In the age of intricate and dispersed supply chains it's difficult to predict the extent of the resulting disruptions.

What is clear is that the course of events thus far has already incurred enough damage to ensure the long-running economic expansion is over. We're already in recession, and a deep one at that – we expect Q2 GDP will ultimately show a 20%+ quarter-on-quarter drop, a staggering decline comparable with the Great Depression. Look for companies to add more bad news for already-sinking Earnings-Per-Share estimates for Q1 and Q2, along with no guidance for Q3.

Assuming life begins slowly returning to normalcy by midsummer, look for the bleeding to tail off in Q3, with GDP declining a more moderate 5% and setting the stage for Q4 to mark the end of the downturn. However, don't expect a much-ballyhooed "V-shaped recovery" at this point; given the depth of the damage to the economy we expect just a modest 2-3% GDP growth in Q4.

Investment Playbook

Compared to their levels at the beginning of the year, equity prices are obviously much lower. But are they attractive? Since the market is already reflecting the uncertainty of 2020, we'll look to 2021 for insight on valuations.

Let's assume a $150 S&P 500 Earnings Per Share ("EPS") estimate for 2021 (which is a very benign 10% haircut to estimated 2020 earnings at the beginning of this year). The S&P 500's current level of approximately 2,600 implies we're already trading at a 17.3x forward earnings multiple under this optimistic case. For reference, the 25-year average is 16.5x. Given the uncertainty of the health crisis, we're inclined to only add equity exposure at more attractive valuations. However, within the overall market, many individual stocks are attractive on a valuation basis.

To summarize, our current playbook is to stay patient and aggressively take advantage of bond market opportunities instead of rushing into equities at current levels. Both corporate and municipal yields have spiked and present excellent opportunities given our outlook for interest rates. From a risk-management point of view, if this health crisis ultimately lasts longer than anticipated, the fixed income positions should be well-positioned to benefit from what we expect will be a "lower for longer" yield environment.

These are clearly unprecedented times. On behalf of the twenty-seven team members of Treasury Partners we'd like to take this opportunity to thank our clients for their continued support, trust and friendship. We greatly appreciate the respect and confidence you place in us in managing your assets.

For over 37 years, corporations, high-net-worth individuals, family offices, trusts, foundations and endowments have sought our help to construct diversified portfolios positioned to perform throughout market cycles. Among other industry recognitions, Barron's has ranked us in the top tier on its annual listing of "America's Top 100 Financial Advisors" every year since the survey was introduced in 2004.

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