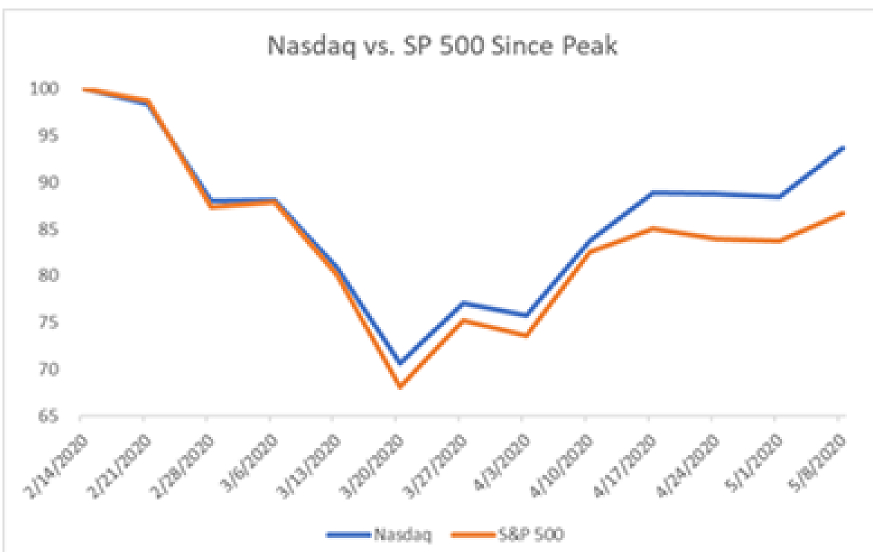
MONDAY, MAY 11TH 2020

THE BIG DIVIDE

Markets – now up over 30% since the March trough – are looking through the worst economic data since the Great Depression, to the other side of the health crisis. Getting there will be tough, and far from straightforward as long as Covid-19 continues. It will take political will to avoid a deepening of the divide between rich and poor, safe and vulnerable. Already, political divisions are reopening in the US over the way ahead.

The world's deepest recession in 70 years is likely to be worse than was expected just one month ago, IMF chief economist Gita Gopinath said last week. More than 30 million Americans have lost their jobs during the pandemic, with low income workers hardest hit. Covid-19 has now penetrated the White House, after making UK Prime Minister Boris Johnson dangerously ill not long ago. College graduates with massive debts are entering the worst job market seen in decades. Life has been turned upside down for many Americans, but markets don't seem to be that worried. Equities ended the week 2% higher than three weeks earlier, at the end of the sharp post-trough rebound. Seems investors are banking on early reopening and continued government help to turn things around.



As we puzzle over the big divide between market sentiment and the real world, a few key observations:

1. The world plunged into its worst post-war slump in a matter of weeks, but digging out will take longer.

Unemployment rose from a low of 3.5% in December to a post-war high of nearly 15% in April, significantly worse than the 10% peak after the global financial crisis. May will almost certainly be worse. But markets are focusing on second derivatives. A slower rise in unemployment claims last week, and a flattening of the upward curve in infections and deaths, have been enough to keep them elevated. Maybe that is not so strange. After all, the stock market hit bottom on average 5.5 months before unemployment peaked in other post-war recessions, and turned around in 2009 a full seven months before the October jobless rate hit its 10% high. But dynamics of recovery from a health-induced recession will be complicated. Massive central bank and government interventions have held off a financial crisis. But they will not hold off a resurgence of disease. Lockdowns are being lifted while the virus is still on the loose in the US and globally. Will consumer and business spending recover in that environment?

2. Consumer spending will be the bellwether of recovery – or continued slump.

The American consumer is famous for pulling along not just the US, but also the global economy. Even the 2008/09 crisis did not dampen spirits for too long. Since then, consumers have borrowed an additional $1.6 trillion, mostly in student, mortgage and auto loans, taking debt to a record $14.3 trillion, the NY Fed reported last week. The March shut-down put a stop to spending, not just on restaurants and travel but also on cars, furniture, consumer durables – all down by a quarter – not to mention clothes, where sales in stores dropped in half. April numbers due on Friday will be worse. Optimists expect that as stores and businesses open in May, consumers will venture out again. Pent-up demand could even boost sales of some items above trend in coming months, even if many people remain wary of going out to the movies, to sporting events or bars. That remains a big unknown. Eagerly awaited and hotly debated government decisions on reopening will in the end be less important than consumer and business behavior. That in turn will depend on how much damage has been done to both balance sheets and psychology. And, of course, on what the virus does.

Individuals, especially the low-paid, have borne the brunt of the costs of Covid-19 so far in the US, along with smaller and service firms. One indication is the size of the labor shake-out, which has been much larger in the US than in Europe despite similar declines in GDP and national income. Indeed, Friday's employment report showed that all the job gains since early 2011 have been wiped out. Many American families face more pain ahead. Renewed divisions in Congress and with the Administration are delaying additional federal support for states and local governments, threatening their ability to offset the impact of recession. Indeed, efforts by states and local governments to compensate for lost revenues and keep to balanced budget mandates have meant they are now cutting payrolls, adding some 1 million to the ranks of the unemployed already. Further budget cuts will hit social programs, unemployment insurance and Medicaid, as well as jobs, pay and benefits for firefighters, police officers and teachers. If consumers are subdued, businesses will also think twice about investing. New research published by NBER shows that – over the sweep of centuries – pandemics have curbed economic activity and lowered real returns in their wake, unlike wars.

3. Division between regions of the world, and within the US, on health and economics, will impact the shape and pace of recovery.

Asia – including Australia and New Zealand – has been notably more successful in the fight against the pandemic than Europe or North America, with less economic damage as a result. Although not immune to further outbreaks, as we have seen in Singapore and South Korea, these nations have effective systems to test, trace and isolate the infected, making them less susceptible to further economic scarring. They do not need to rely on the blunt tool of mass quarantine and shutdown. In the US, there are wide divergences in behavior across the country. For example, in Georgia, google mobility trends data show a drop of just 45% in travel to work, whereas in the District of Columbia travel to work was down by 71% in April from the January-February average. The states that are opening up the soonest – Arkansas, Florida, Georgia, Texas to name a few – are the ones that closed down last. It is understandable: they have been hit harder on average by the economic crash than more urban, coastal and blue states and, at the same time, less affected by disease – at least so far. Reopening now could spread Covid-19 more deeply into these largely red areas. It is likely that confined populations – elderly care homes, prisons, factories with associated worker dormitories – will be most vulnerable.

4. The pain from both disease and recession in the US is concentrated on those already disadvantaged in society, exacerbating inequality and social divides.

The rate of infection and fatality is significantly higher among people of color who already have higher rates of unemployment than average. In DC, there are so far 226 reported deaths among African Americans as of May 7th, compared to 30 among whites. The sad tally for Hispanics is also low in DC, at 22, but higher in other parts of the country where low-wage jobs in closely confined settings are dominated by Hispanics. And while unemployment has risen across the board in the US, the April data showed a big gap between joblessness among professional and management employees, now 7.7%, and that of service and construction workers, 27% and 19%, respectively. That stands to reason: office workers can more easily stay home and work remotely than unskilled and service workers. Some low-paid workers face a different problem. Told to show up to jobs that carry especial danger of infection – such as meatpacking – they stand to lose desperately needed pay and benefits if they choose to stay home. There is a real danger that the crisis and the response will reinforce older patterns of inequity. Government decisions on who should be allowed, or made, to work while Covid-19 is still a threat may be driven more by the capacity of health systems to cope, without pictures of overwhelmed hospitals and morgues, than by the number of infections or even deaths. Some businesses are stepping up to protect their employees, and the public, in the absence of clear public safety guidelines. Will investors, notably those supporting ESG, reward them?

5. Businesses, educators, governments are rethinking their models: investors need to as well.

Investors are settling, somewhat uneasily, into the "new norm" where the gap between the economy and markets widens each day. Institutional investors are now looking at how to reconcile a deep global recession, of uncertain length, with a V-shaped recovery in financial markets supported by an extraordinary central bank back-stop. A new approach to portfolio management going forward will be key – one in which investors are nimble, thematic, opportunistic, and deliberate in identifying the companies, sectors, and countries best placed to generate returns in a new world order. As well as treading lightly in case another leg down is still to come.

One result of a rethink may be to throw out old assumptions of the 60/40 equity/bond portfolio. Institutions and investors have been wedded to this allocation for the last century – with reason. These broad asset classes have generally acted as natural hedges to one another and delivered positive returns over time. But this paradigm is becoming obsolete in the new world of investing. In an environment of low interest rates that may or may not turn negative, fixed income no longer acts as a sufficient hedge to equities and there are few fixed income alternatives. Instead, it may be more appropriate to include a diversified mix of tail hedges and volatility risk premium strategies in a portfolio for the upcoming periods.

So, what else should investors be contemplating in this new world portfolio and where are the opportunities?

Inflation – a sleeper issue as investors focused on recession and potential recovery – is now under debate. Should portfolios be protecting for future inflation or is it too early? Economists across the spectrum mostly dismiss inflation fears, at least for now and some years to come. The depth of recession and consequent hit to demand will contain wage and price pressures, which have anyway been subdued for a decade. Indeed, in the short-term, deflation may be a bigger risk to the system. Already leveraged businesses, households and governments are taking on massive amounts of new debt to survive. Deflation makes those harder to repay.

Longer-term, that is just what worries some. Could Inflation become a more meaningful risk as the economy and markets reconcile a growing mound of debt? Some market participants fear that excessive debts could encourage governments and central banks to look to engineer inflation. Even if not deliberate policy, others see inflation as an eventual by-product of the huge monetary expansion by central banks and deficit spending by governments, exacerbated by supply chain disruptions from coronavirus and a longer-term de-coupling.

Whether due to longer term inflation fears or general flight to safety, investors have gravitated towards gold. Recent weekly ETF flows highlight record interest in gold (and developed rates) ETFs. Holdings of gold have expanded by more than 400 tons so far in 2020, eclipsing the inflows seen in each of the last three years. We would expect gold to continue to be attractive as investors look for a safe haven in an uncertain market.

Bitcoin and other digital currencies may also be part of a new world portfolio. You don't need to be a crypto nut to agree: Bitcoin is up 100% off its March lows with one bitcoin equal to $9,765 as of the 9th. The upcoming May 12th date for cutting the reward per miner in half will likely reduce bitcoin supply and boost prices, as in previous halving events. While bitcoin has gone in and out of fashion over the years it has remained a viable financial asset. China has taken the digital currency theory and is looking to use its own e-RMB. Tensions between China and other countries may increase the appeal for China to have its own digital currency, as a means of extending government control over its economy and, perhaps, making it easier to insulate its economy and financial system from the rest of the world.

The bedrock of portfolio opportunities and returns we see going forward remains around technology and sustainability, with an accelerated shift to on-line products and sales in a rapidly expanding global e-commerce world. Unsurprisingly, online shopping has risen around the world over the last two months. This is an area to have exposure to in a new world portfolio and a theme that can be invested in through multiple ways across public and private asset classes. Even in countries like Italy where sales of online goods pre-Covid-19 were around 5%, post virus online sales are hitting 25%. And in China, where online sales were already 35% of consumer sales pre-crisis, they are now hovering at 55%. Interestingly, e-commerce is attracting a new consumer base in this lockdown environment – one that is likely here to stay. Older consumers have discovered that they like shopping online: new on-line consumers skew in the 60+ demographic.

Going forward, successful online commerce will be more profitable, better executed and more favorable to the consumer. Brick and mortar businesses may continue to decrease in interest, except where linked to profitable on-line channels, where they can add value by reducing customer acquisition costs. A trend of consolidation, with more store closures and unemployment in the sector and less ability for real estate to create value in the short term, will also clear the way for winners in these sectors to gain more. Of course, there will be losers even within a successful segment like tech. These include businesses that may suffer along the path to post-Covid-19 recovery, or were questionable models even pre-pandemic. Witness the uncertainty around Uber and Airbnb. A continued strong case for active management, as the real economy and markets continue to puzzle investors who are managing a new world portfolio.

RockCreek Update

While the RockCreek team continues to operate remotely, we are working on appropriate re-entry plans. There will not be a one-size fits all re-entry roadmap, so we will put in place what works best based upon the advice of medical experts and the best practices that are developing. RockCreek is committed to a re-entry plan that provides for the health and safety of our team and our community.

Team RockCreek