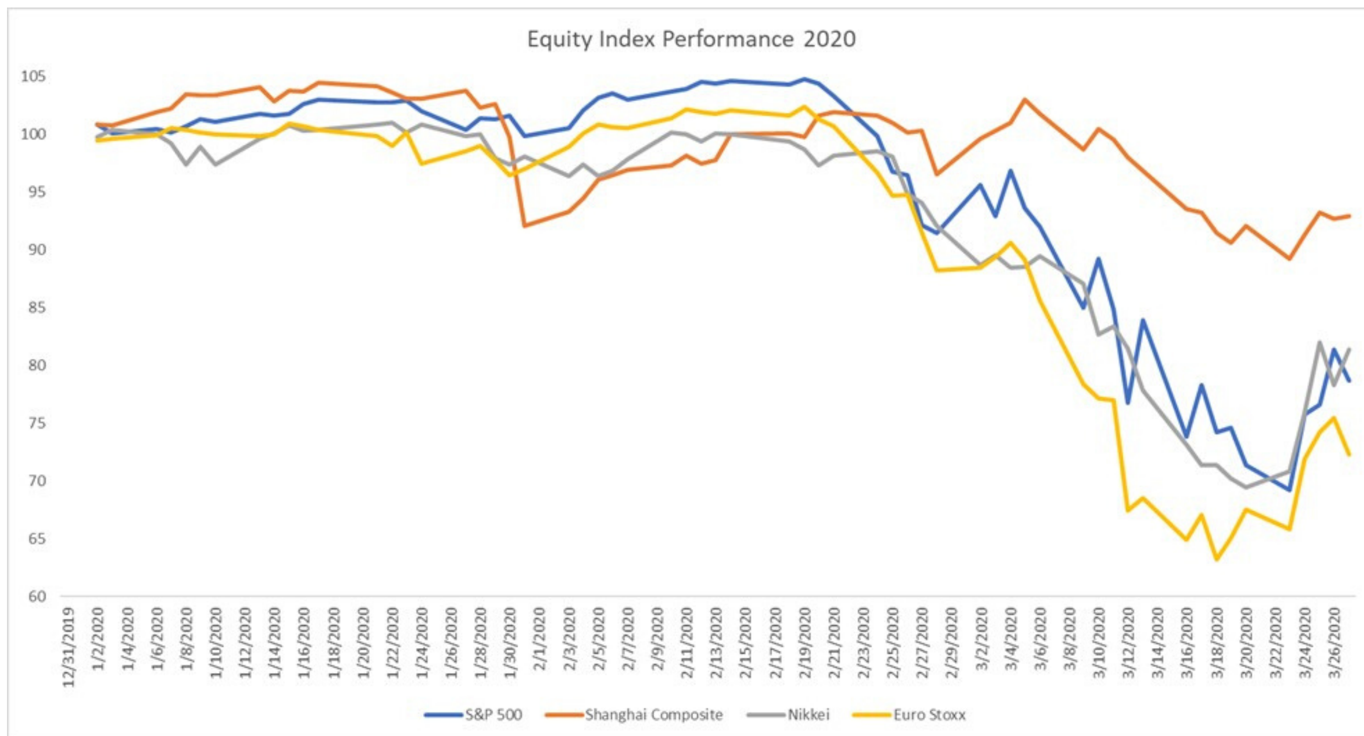
March 30, 2020

DEAD CAT BOUNCE?

Equities roared up out of bear territory last week. The three-day long rally through March 26 was steeper than any since 1933. But don't be fooled. We are in this for the long haul.

Listen to CEO Afsaneh Beschloss and former Deputy National Security Adviser Caroline Atkinson discuss navigating the pandemic.

The signal for a turnaround cannot be found in economic or financial data: it will be in health statistics. Only once the exponential rise in new infections has slowed -- and the crisis in our hospitals is contained -- can we expect to begin a sustainable recovery. Cultural change will also be key. In Japan, Korea, and other parts of north Asia, it is common to wear masks in public. Technology is increasingly allowing contactless buying and selling, even for a cup of coffee. Shaking hands -- never mind embracing – in those countries happens less than in the West. The experience with SARS and MERS made these countries much better prepared for a new pandemic, more disciplined when it arrived, and better able to chart a path to recovery.



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Market panic in the United States eased just as the costs of shutting down the economy became clear. Actions by the Federal Reserve, Congress, and Treasury stopped the freefall. However, the worst is yet to come. Unemployment claims in the United States rose by an astonishing 3 million last week and will continue to climb. Businesses large and small, and their newly laid-off workers did not need experts to tell them that the country was plunging into recession. Concerted action by central banks and governments, notably in the United States, reassured markets last week. Financial strains remain evident in some corners of the system. But the Fed began to get ahead of the curve. As important, the Fed and Treasury signaled clearly that funding the economy through the health crisis is their top priority. Congress approved and the President signed an unprecedented $2 trillion fiscal package to shore up incomes, forestall bankruptcies, and support businesses, from airlines to hotels, most obviously afflicted by lockdown. More measures to support recovery will likely be necessary, whenever America is able to go back to work. Unfortunately, electoral politics may complicate agreement on another mega stimulus bill.

The recession is fast becoming global, with emerging markets next in line. Just as COVID-19 has spread to every state in the U.S. and almost every country in the world, the economic and financial chaos that it brings will spread too. Emerging markets may be the next shoe to drop, as International Monetary Fund Managing Director Kristalina Georgieva is warning. Already, more than 90 countries worldwide are looking for emergency help from the IMF, threatening to overwhelm its resources. Governments in advanced economies have resources and the ability to borrow. Most emerging markets do not. Without help, they risk financial and economic collapse on top of a health crisis. Some estimate that the IMF needs a further $2.5 trillion to stave off a cascade of country crises. Addressing this gap needs to move higher up on the to-do list for richer countries. For investors, active portfolio management is critical.

What happens next depends on all of us -- and how we respond to the public health threat. Governments and central banks that reacted swiftly to economic and financial strains are still struggling in the face of the health crisis. Almost unbelievably, the United States does not yet have enough speedy testing to guide behavior and understand the pattern of disease.

Most importantly, and not yet fully appreciated, a woeful lack of protection for our front-line health workers and first responders is enormously risky, for them but also for the rest of us who rely on them. Unprotected doctors and nurses are getting sick and dying. A society that puts them in harm's way is not one to be proud of. Beyond that, the more people that are infected, the more the disease will spread.

Four observations looking ahead:

1. Fighting COVID-19 is the way to fight recession

Economists and public health experts are coalescing around the view that the best -- maybe the only -- way out of the economic tailspin is to deal effectively with the public health challenge. A bipartisan group including former Treasury Secretaries and Fed governors announced this week: "Our paramount concern at this moment should be to slow the spread of this virus …. Saving lives and saving the economy are not in conflict right now".

Scrambling to understand the long-term economic impact of shutdowns, many economists have been reading a just-released paper by Fed and MIT economists. Looking to the 1918 flu for evidence, the research shows that more aggressive and longer lockdowns in individual U.S. cities -- far from hurting economic performance -- delivered better outcomes over the medium-term.

In those days, cities were more easily isolated. Today, Bill Gates has called for a nationwide lockdown, to be lifted only when we have credible evidence that the rate of infection has fallen sharply, and medical staff are properly protected to take care of those that fall ill. Opening the economy before then risks a resurgence of disease, overwhelming of medical resources and a wider spread of infection across the country. This is especially true if the dearth of reliable tests for the disease persists. In Korea, Hong Kong, Singapore, and some other Asian countries, mass early testing meant that the authorities knew who needed to be in isolation. Plentiful supplies of masks and other protective equipment limited infection risks, allowing safer interaction and continuation of more normal life. The United States does not have that luxury. The White House has extended its social distancing guidelines to April 30. That is scarcely more realistic than the original Easter deadline.

2. Forget the V-shaped recovery -- L or M is the risk, and U if we are lucky

We have warned against expecting a quick return to normal economic activity. As the days of lockdown continue, the economic damage is becoming clear. Markets may have technical support from rebalancing around month-end as well as from a reduction in sheer panic. But risk remains difficult to price and the fundamentals of this pandemic will hurt markets and the economy at least through Q3 2020.

Experts warn that it will take weeks at best to contain the health crisis sufficiently for a safe return to work -- as eager as we all are to restart life. During that time, despite the best efforts of the Fed, Congress and the Trump administration, many small and medium-sized firms will be forced to close, families will struggle to make ends meet, and even big employers will continue to lay off workers. In many European countries, from Denmark to the United Kingdom, governments are providing support for firms to freeze employment during the crisis rather than lay-off workers who may then disperse. In the United States, that path is less likely for most companies. Rehiring and retraining new workers will increase the time needed to restart the engines of growth.

One wild card: the psychological impact of the economic shock. Consumers kept the U.S. economy going in 2019 while business investment lagged and CEO confidence was weak. People will not soon forget the trauma of this crisis. Dramatic job losses across the economy, fears of eviction, children going hungry without school meals together with pictures of overflowing hospital wards and morgues will make many think twice before spending on what may now seem like luxuries. On top of that, it will take a while before we are ready to go out to bars, ball games, restaurants; to jump on buses, trains or airplanes. Expect precautionary savings to rise and stay higher, depressing sales and earnings.

3. Now is not the time to worry about deficits and debt

Naturally there was some concern when Congress voted for the largest ever fiscal package, swelling future deficits and debt. Coupled with the extraordinary actions by the Fed and, this time, the European Central Bank (ECB), should we worry about inflation?

The clear answer for now is no. Even before COVID-19, there were growing calls for governments to take fiscal action to stave off stagnation and bolster the easy monetary policy that has powered the global economy since the 2008-09 financial crisis. Even many conservative economists agreed that investing in public infrastructure, in education and training and in research and development would pay off in the long-term, given today's low interest rates. With the economy now shuddering to a halt, there is a broad consensus that only governments can counter the dramatic fall-off in private demand and cushion the blow. And they are able to finance at such low interest rates that there need be little concern about passing a burden on to future generations.

We and others have likened today's crisis to a war. For comparison: government debt was more than five times as large as today by the end of World War II. And with much of the additional spending temporary by its nature, the deficit will automatically go down when the economy recovers, unemployment insurance claims diminish, and businesses are able to repay emergency government loans.

4. Portfolios, Positioning, and Opportunities

Last week reminded investors that cash and liquidity are king once again. While equity markets were up for the first time since they hit the bottom on March 11, most investors remained cautious. With so much uncertainty around the length and impact of the global pandemic and the severity of a recession, investors continue to reposition their portfolios to be flexible and opportunistic. We expect to see small, intermittent rallies, some because of automatic rebalancing and short-lived euphoria across retail investors, but we do think the "sugar high" of the last ten years is over.

Across global equity markets we see opportunities in longer-term themes in specific sectors and countries. In developed markets, healthcare, technology, and staples all have some stocks down significantly more than the market, for non-fundamental reasons. Driven by liquidity dislocations, passive outflows, rebalancings and factor rotations these companies remain attractive opportunities in anticipation of a prolonged, sluggish economy. Although there were net inflows into some financial sector ETFs this past week, cyclical exposure including financials, energy, industrials and materials continue to see massive selling pressure on down days.

These sectors may also have pockets of opportunity longer term. Think of companies increasing manufacturing of essentials for hospitals or in the longer term, airlines that were able to preserve cash and come out of the travel shutdown on the other side with a stable balance sheet relative to peers and gain market share.

In emerging markets, we are partial to an overweight in North Asia. Despite fears of a second wave, we think that the rest of emerging markets, especially Latin America, is yet to feel the pain experienced by most emerging market countries. Eventually the recovery from a global recession will begin and be led by the economies of North Asia, including China, South Korea, and Taiwan. An overall solid response to the COVID-19 crisis, attractive stock valuations, and stable currency regimes will give the economies of North Asia an edge over much of the rest of the world. We particularly like technology enabled themes in the areas of telemedicine, online education, biotech, and e-commerce.

Last week, there was a rebound in fixed income markets with spreads tightening in classic fixed income relative trades. As more liquidity was pumped into the market it was a chance for investors to reposition their fixed income exposure. With 3-month Treasury bills returning negative yields -- as we had expected in earlier letters -- there are few "safe" assets for investors to park cash temporarily. Longer dated treasuries, funds with little to no exposure in investment grade, and no high yield have been the bright spots in our fixed income exposure. However, as fixed income markets return to stability, we are actively looking at the right time to incrementally increase exposure in investment grade and other higher yielding fixed income instruments. Areas within corporate credit such as leveraged loans, high yield bonds and CLOs as well as the residential mortgage markets have seen material dislocation that is providing opportunity for institutional investors. Illiquidity in the credit market has resulted in wide bid offer spreads and decline in prices. New investors that can come in and take advantage of these prices and offer liquidity will see high returns as the markets normalize.

At RockCreek, we continue to stay nimble in our portfolios. The markets remain uncertain as reflected by the 10-day realized volatility of the S&P 500 index that remains close to the peak values of 113% (annualized) hit earlier this month. Statistically, this implies a 33% probability of the S&P500 moving either up or down by 6.5% on any day. Consequently, we continue to be deliberate in portfolio rebalancing decisions and spread them out over longer periods. Automatic rebalancing based on a single data point with no attention to volatility levels have resulted in some investors getting whipsawed. Also, current markets have started to reward active strategies that don't get burdened with the unwanted exposures that are part and parcel of passive investments. Moreover, we are diligently seeking opportunities across equity, fixed income and credit markets that are well positioned to generate returns and preserve capital in these markets.

We believe, there will be many long-lasting effects from this crisis that will have consequences for investment opportunities. Therefore, we have focused on how behavior, sentiment, and habits change across countries, sectors and companies to identify investments arising from massive shifts in practice. For example, will commercial real estate be less attractive as companies realize they can save on physical space given the success of their remote work during the pandemic? Will insurance companies be forced to revisit their role in the U.S. healthcare system as some hospitals go bankrupt in the wake of financial stress from the pandemic? How do non-profits partner with private investors globally to advance their missions related to inequality? Many effects of the current situation will be long lasting, and every day, as we see new highs and lows in the markets, we are constantly thinking of new products, companies, and sectors that may arise as a result of the COVID-19 pandemic.

We hope that you, your families and teams continue to be healthy and safe in these uncertain times. The RockCreek team remains actively communicating with each other and our partners. We have been in touch with many of you over the weeks and hope that you will reach out if we can be of any help to you and your teams.

RockCreek

We continue to work remotely and our regular virtual town hall meetings for the entire RockCreek team provide new opportunities to communicate and collaborate even more effectively. Our RockCreek COVID-19 steering group continues to monitor and update our preparedness plans and we remain vigilant and mindful as this global crisis continues.

We all appreciate the brave work of our first responders putting their lives in danger for all of us. They are the heroes in this crisis. We at RockCreek are working with our communities and research groups to provide assistance, including to finance new supplies of masks and PPEs. We are reaching out to our partners and other investment firms to join us to leverage our resources. Please let us know if you have any ideas.

Team RockCreek