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TO REOPEN OR NOT TO REOPEN: IS THAT THE QUESTION?

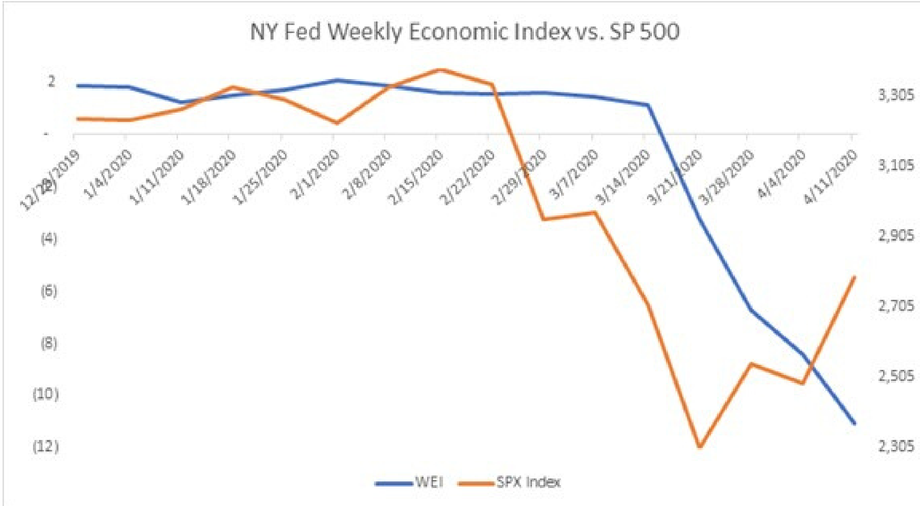
Around the world, governments are contemplating how to lift the Great Lockdown. Some are already doing so. Markets – still buoyed by the Powell Put discussed last week – are happy with the news. Should they be? Almost everyone agrees that the key to a successful reopening is success in containing the health threat. But science tells us that we have a long way to go, certainly in the United States. Are markets getting ahead of themselves? And what will investors care about, post-Covid?

Finance Forward: Listen to award-winning journalist Gillian Tett discuss sustainable investment, ethics and morality post-Covid-19 with hosts Caroline Atkinson and Afsaneh Beschloss.

From the beginning, this crisis has been confounding. It is time to remind ourselves: health is at the heart of it. As terrible economic data has poured in from March and early April, the disconnect between what is happening in the real economy and the financial markets has only grown (see graph below). Markets, helped by extraordinary support from the Federal Reserve and Treasury, with more expected any day from Congress, have seemed persuaded that what crashed so rapidly can recover quickly as well. But unlike in past crises, central bankers and finance officials are only the supporting act. A still little-known virus is on the main stage facing a health system unprepared to battle a dangerous global pandemic.

For investors, taking the long view remains the smart thing to do. At RockCreek, we still believe equity and credit markets have been too bullish since the turn on March 23rd. Liquidity support from the Fed can only take corporates so far. With J.C. Penney electing last week not to make its $12 million scheduled interest payment, and Neiman Marcus downgraded by S&P, we may be approaching the acceleration phase of the default cycle, at least for companies hardest hit by social distancing and collapsing consumer spending.

Long-term damage to incomes, earnings, and confidence could be limited – but only with an unlikely early return to a pre-Covid-19 "normal". Few experts believe a return to anything like normal will be possible unless and until the health threat is countered – globally. And for that, we need effective – and widely available – treatments and/or a vaccine. These are likely still months away, despite heroic efforts by scientists around the world to understand and combat the virus. In the meantime, even a gradual economic reopening – such as the phased approach President Trump has outlined – could lead to a resurgence of disease unless our health response improves dramatically. A slower reopening – calibrated to minimize the risk of further outbreaks of infection – means a slower recovery and more economic damage in the meantime.



Success depends on mass testing – yes, that is still the top priority. Other critical needs include training of thousands of personnel to do "contact tracing", effective isolation of those infected and a surge of equipment to protect health workers and others on the front lines. A new normal will settle in, likely with enhanced procedures for cleaning, routine temperature taking, wearing masks in public and distancing in offices. But that may take time, just as with airport security procedures after 9/11. More immediately, Germany and South Korea – which have kept infections and fatalities down – are gradually reopening, although wary of a new outbreak as may be happening in Korea. Marshalling an effective response should be possible in an economy as strong and innovative as that of the United States. But it is far from our current reality. Most suggestions – such as that from St. Louis Fed President James Bullard, for daily testing supported by government incentives to private manufacturers – rely on a coordinated national response, led by the federal government. And, as a growing chorus of voices is saying, to face a global pandemic we need global cooperation between governments as well as scientists.

What to watch for: a few key observations

1. "Don't worry, stay happy" the new market mantra? Watch out!

Markets continue to baffle: at RockCreek, we believe the severity of the economic collapse – in the US and around the world – is not yet fully priced in. Last week, the US market advanced again on hopes for a new drug treatment and optimism that parts of the US may soon begin to reopen. But the jump in equities came alongside simultaneous bad news on health – a surge in virus related deaths, including China's revision upwards of deaths, and evidence of some resurgence of cases in Singapore and Japan – and on the economy, including further US job losses and plummeting sales, and gloomy new forecasts from the International Monetary Fund (IMF). North Asian equities, led by China, went higher despite lower GDP estimates. Sharp swings in risk appetite and high levels of uncertainty are now the norm, demonstrated nicely by a "Fear & Greed Index" tracked by CNN. The index was 71 – quite greedy – a year ago. After signaling "extreme fear" among investors with a low of 3 in mid-March, the index has now climbed back to 42. Where will it go next?

Look for further damage to sentiment as costs from the global shutdown sink in. Markets have yet to digest the near certainty of lower corporate earnings, higher debt and more bankruptcies, a complex and non-linear restart process. More permanent changes will also come to post pandemic-life and markets, with big differences between winners and losers. This makes a good case for a more active versus passive investing strategy. We have been using the policy-induced rebound to move our portfolios to higher quality credit and equity, sustainable impactful companies with stronger financials, lower debt, and at the intersection of technology and finance, banking, education and health. We also have held on to cash to invest in distressed credit and opportunities arising from further government interventions in markets.

2. Recovery will come, but when and how matters.

Forecasters agree: the global economy is in its worst shape since World War II. But for how long? The size of the initial global hit – the largest since the Great Depression – is evident in the IMF forecasts released last week. Global output is set to decline in 2020 across the world. Even China has admitted last week to a sharp drop in output in Q1, reporting a 6.8 percent annualized drop in output. According to the IMF's base case scenario, to which they only elaborated downside risks, the world will have lost $9 trillion in output over 2020-2021: more than the combined annual GDP of Germany and Japan. The fall in output represents lost income and earnings on an enormous scale, caused by the Great Lockdown. The IMF laid out three other scenarios: a later recovery, a recovery followed by a dip as health outcomes worsen, and a combination of both. They all showed a still deeper loss. This underlines the difficulty for policymakers the world over: keeping economies in lockdown will turn liquidity problems into solvency and leave deep scars; but opening too soon will also be damaging. We are walking a narrow path. More data is urgently needed to illuminate the way ahead.

3. Europe has not solved its fundamental dilemma: will markets overwhelm the ECB?

Europeans have continued to haggle over how freely to help one another to meet the costs of this crisis. The fundamental dilemma of managing a common currency without a common fiscal policy has returned. Last week, the German President of the European Commission apologized formally to Italy for the EU failure to provide early medical support when Italy's health system was in crisis. But the economic and fiscal solidarity Italy needs to avoid financial crisis is not yet assured. Some believe that this week's Eurogroup meeting of heads of government will be the make or break moment. But it is worth remembering that during the Eurocrisis of 2010-2012, political leaders time and again managed to duck similar moments of truth, doing just enough to calm markets and reassure them of political commitment to maintain the euro.

Northern European nations, in particular Germany and the Netherlands, have pushed back on ideas of fiscal support without conditionality, now exemplified by the call for common bonds – now Coronabonds. The ECB under its new President Christine Lagarde has moved boldly to provide more than $1 trillion in liquidity support. Its new program that allows it to support more freely the government bond markets under stress has helped bring in Italian yields. Monetary management by the ECB appears to be calibrated carefully to avoid overdoing the narrowing of spreads. But ultimately, the ECB needs political support to underpin its efforts. Before markets really believed former ECB President Draghi's famous "whatever it takes" promise in 2012, Chancellor Merkel gave a political nod. Lagarde is desperately looking for her to do the same again. With Italy in the crosshairs, rather than the much smaller Greece, the stakes are high.

Politics more than economics has been keeping the two sides apart. Italy hates the idea of going to the European Stability Mechanism (ESM) for money that would in turn allow more ECB lending. The ESM insists that it would not repeat the austerity conditions imposed on Greece, but the stigma remains. Conversely, citizens in Germany, the Netherlands, Finland and Austria are even more fiercely opposed now to anything that smacks of a bailout for their southern euro area partners. Look for a European-style fudge. The question is whether it will be enough to avoid political mayhem in Italy.

4. Covid-19 is a disaster: for effective disaster relief, we need governments – at all levels – even more than central banks.

The extraordinary government spending and loan programs put into place in the US and some other countries have been labeled fiscal stimulus. This is a misnomer. They are mostly aimed at limiting pain from the Great Lockdown, keeping the economy on life-support or "deep freeze", until a safe and sustainable reopening takes place. Central banks can provide liquidity lifelines. But governments need to take on the political task of making good, so far as society and politics dictates, the real losses from the hit to incomes and earnings.

It is already clear that even if the money governments are providing makes its way to the individuals and firms in most distress, it will fall short. Congressional leaders know that, but they have been slow to reach an agreement on just who needs help the most. The answer: everyone. Hopes are high for a deal this week, that adds to the planned refueling of the small business loan program that has already been exhausted. Just as after a disaster, states and local governments also need federal help, probably on a larger scale than will be agreed on in this package. Governors estimate that between the lower tax revenues and higher spending caused by the crisis, the hit to state budgets could amount to $500 billion over coming years, with the bulk of that frontloaded.

Whether Q2 output declines by a measured 30 or 50 percent in the United States, whether unemployment reaches 20 percent – already twice as high in the global financial crisis – or just above or below, millions of Americans will suffer. We have seen during this crisis that the costs of this pandemic have fallen unevenly, with the poorest and most vulnerable in the US bearing the heaviest burden on their lives and livelihoods. Large companies are also receiving more rapid support than smaller ones, even through the special loan programs designed to help smaller players.

5. After the crisis, impact and sustainable investing will still matter and thrive.

Investors have asked us whether impact strategies will remain in vogue throughout, and after, the current crisis. Our answer is yes. Political divisions and the rise of populism in many countries have triggered much debate about capitalism and concerns of growing inequality. The pandemic has demonstrated deep inequities in the US. The health system has been shown to be ill-equipped to protect vulnerable Americans, including many health workers themselves, despite the huge share of health expenditures (and profits) in the economy. Low income workers, with few benefits, are those most likely to have lost their service sector jobs during the shutdown, or to be the "essential" frontline workers that must continue to go out in public, often taking public transport, rather than sheltering safely in place and working remotely.

Whether we use the language of the Business Roundtable, as it called for a broader view of company interests, or Gillian Tett's term Moral Money, or talk about impact and ESG investing, the idea is the same: long term value creation for shareholders means investing in companies that are healthy and care about multiple stakeholders.

Even prior to Covid-19, we espoused opportunities in companies that have better governance and invest in sustainable growth, education and healthcare – servicing students through technology and delivering care virtually. To complement these investments in a post-Covid world, there will be added awareness of the importance of broadening access to communications and information infrastructure. We have discussed the downside protection of affordable housing in real estate portfolios and the renewed necessity to support affordable, and safe communities in our country.

Our conviction in these areas is unchanged, and our perspectives have been borne out more quickly than we expected. We have started to see increased investor interest in companies – public and private – that offer sustainable solutions, products and business models. As we emerge from the vantage point of our home office, we hope and expect to see that the move to sustainable and impact investing represents a real shift, not merely fashion. That requires a purposeful and steady analysis of data and opportunities to make sure that the sustainable label is well applied.

RockCreek Update

We hope that you, your families and teams continue to be healthy and safe in these challenging times. We continue to work with and assist our communities. 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. The RockCreek team is fully operational at this time as we continue to work remotely and have been in constant dialogue. We are also engaged in formulating our plans for returning to our offices in the most safe and sensible manner. Our entire team is especially grateful to have strong, trusted relationships with our clients and partners which are more important than ever.

Team RockCreek