April 6, 2020

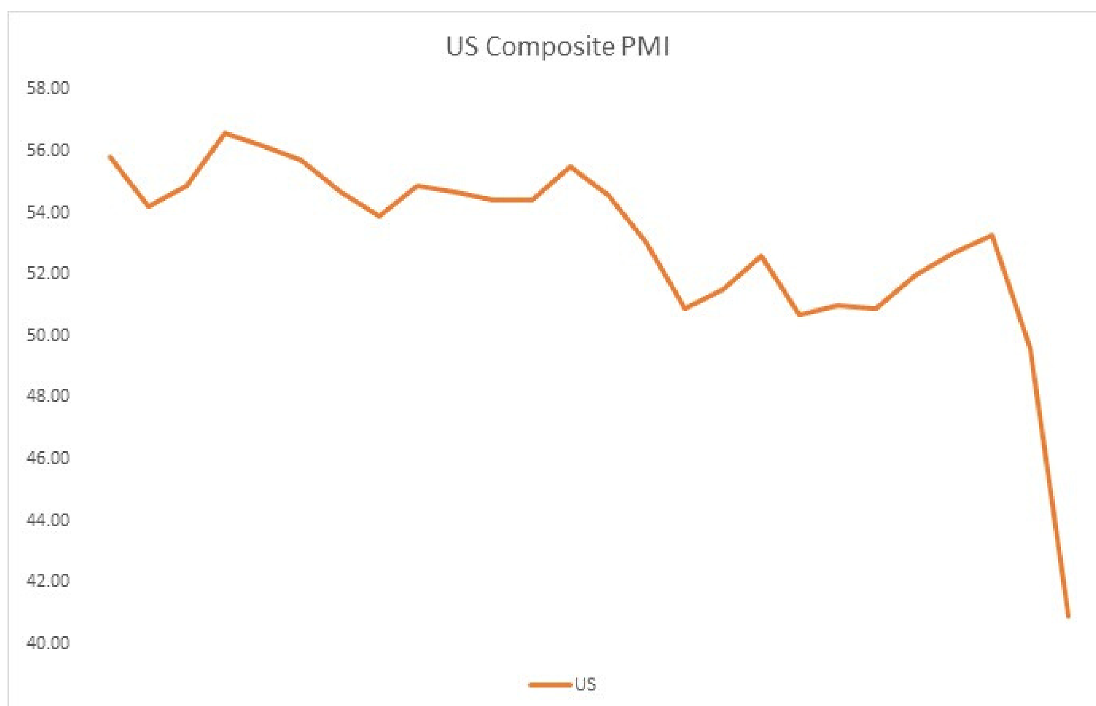
RockCreek

ECONOMY IN FREEFALL -- MARKETS UP?

The American economy is cratering. Layoffs in late March were far higher than expected. April will bring worse data. Can the government keep businesses -- and markets -- on life support until the health crisis is over? Markets hope so. And investors are scanning the horizon for glimmers of success against COVID-19.

Watch RockCreek advisory board -- including former FedChair Alan Greenspan -- on what lies ahead: it all depends on health.

Emergency action to support the economy is underpinning markets. The Federal Reserve has demonstrated its resolve to do whatever its mandate allows -- and more -- to forestall a financial crisis. Other central banks in advanced economies, now including the European Central Bank (ECB), are sending the same message. Fiscal support has also been swift and, in the U.S., many times bigger than envisaged just a few weeks ago. It is becoming clearer that more will be needed if we are to avoid cascading bankruptcies and a deepening economic crisis. Luckily, signs are that Congress and the White House agree. Look for Coronavirus bill #4.



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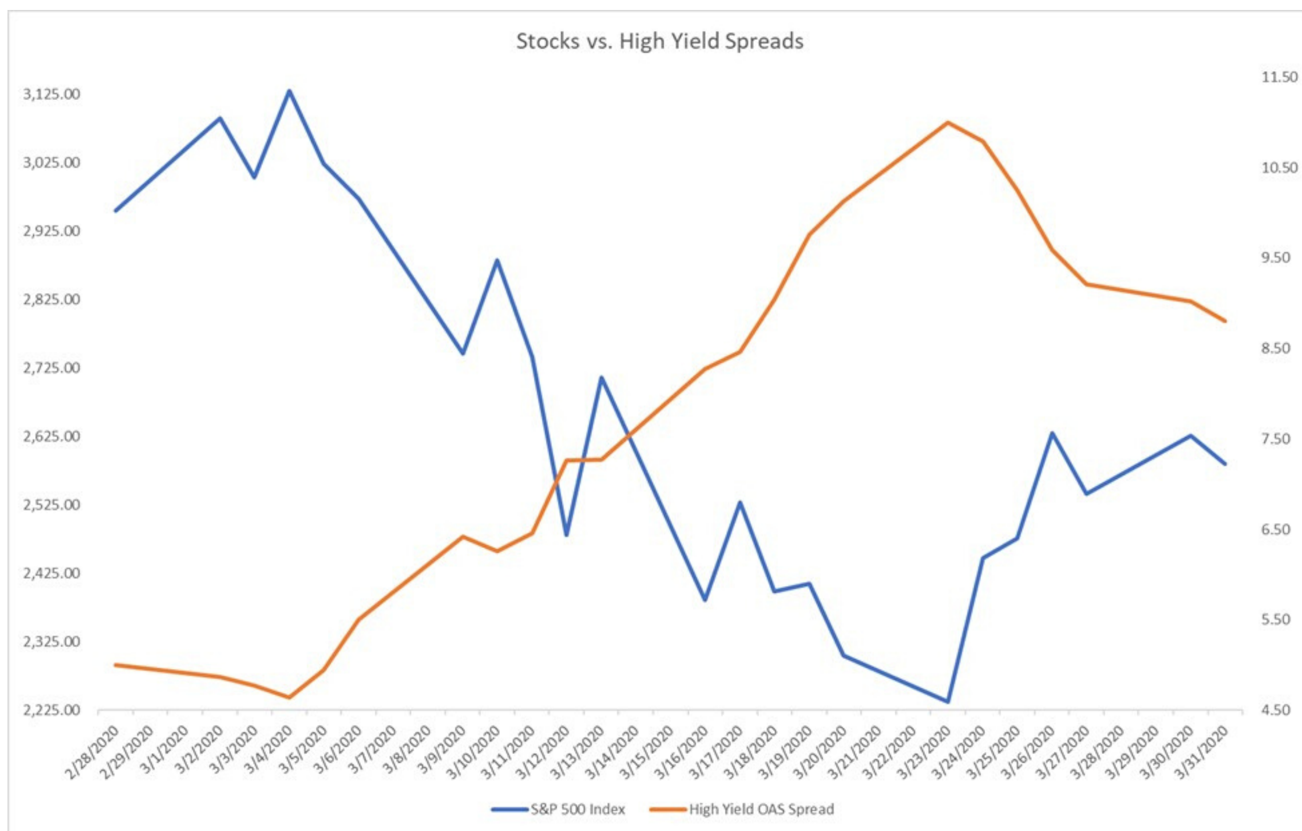
It's COVID-19, stupid! Paraphrasing the refrain about what drives politics helps to explain investor sentiment. As the economy is in freefall, market panic has eased. Investors are still running scared, but equity markets were off their lowest levels and U.S. investment grade and high yield credit spreads tightened last week. And this week began with hopes that the curve of new infections and deaths from COVID-19 might finally be flattening. As we have said, this is the signal that could herald the beginning of the end of draconian lock-downs. But the way ahead is fraught with risk. Retail investors may continue to buy on the dip. Some large institutions tell us that they are only "nibbling" Like RockCreek, they are steering clear of automatic rebalancing. Not surprising: more than 20% of the S&P 500 has already withdrawn guidance for next quarter earnings and EPS estimates continue to be lowered for 2020 and 2021. Other signs of stress: some investors started to renege on private equity commitments and there were rumors of big outflows from some asset managers by Saudi and other Middle East investors. Energy bounced back last week on hopes -- dashed on Saturday -- for OPEC agreement. Don't hold out hope for oil prices: RockCreek CEO, Afsaneh Beschloss told Bloomberg's David Westin in an interview that she sees the "new norm" post-virus in the $20-35 range.



After nine consecutive weeks of outflows, emerging markets saw small inflows last week, particularly in Asia. However, trading volumes in Asia remained light. Generally, the markets of North Asia continued to outperform. Again, it -- mostly -- comes down to health. Countries with weaker balance sheets, greater USD strength sensitivity, and -- crucially -- a lackluster response to the crisis did not do so well. India, Brazil, Indonesia, and South Africa were markets experiencing the greatest losses. China's recovery continues to be slow and markets may face further pain if demand globally does not return but remains best positioned relative to other emerging markets.

Recovery depends on winning the war against COVID-19: so far, the U.S. has been losing. President Trump laid out to the American public the terrible toll that the disease could take: 100,000-240,000 deaths by this summer, his scientists warned on March 31. Maybe this can be lowered. New York Governor Andrew Cuomo has said that the death toll could be slowing in New York, while warning that the signs were still very preliminary. Experts still believe that we need a nation-wide lockdown, widespread adherence to guidelines on behavior, notably social distancing and handwashing, and a well-functioning health system to contain the pandemic and avoid a resurgence of disease. This week more than 90 percent of Americans will be under state-wide orders to shelter in place. But with no federal order, there are still a handful of states holding out, leaving decisions to local communities and individuals. Air traffic and driving are way down, but as long as people are crossing boundaries, the virus has been moving with them. States are also largely on their own in sourcing essential equipment to protect health workers and provide for rising numbers of the sick and dying. Scenes of distraught and overwhelmed doctors and nurses dominating TV screens will likely get worse this week. Only when hospital conditions improve, and the number of new infections stops increasing every day, will we see a true glimmer of light.

The health crisis will be contained and the economy restarted: the question is when and how. We need a government strategy -- now -- for how to manage a safe return to work. Reopening too soon, or without a plan rooted in science and expertise, risks a second wave of infection. We still do not have enough testing in the US to know for sure where the infection is, who has been ill and recovered, and even how many deaths it has caused.

These data are essential to support a successful economic restart. The global scramble underway for drug treatments and, eventually, a vaccine will most likely succeed. Even before that, experience in Asia shows that a return to work may be possible without new drug discoveries. Other methods -- non-pharmaceutical interventions (NPI) -- can also curb the spread of disease as the latest evidence from Italy and Spain -- and now New York -- shows. Leadership and community spirit are needed for those to succeed. As RockCreek senior adviser Laura Tyson lamented last week, in the U.S. "we haven't mobilized as a nation to fight this war". Surely, we can learn?

The longer it takes to contain the disease, the worse the economic fall-out. Here again, government actions can make all the difference in cushioning the blow and helping to support recovery, as Director of Brookings Hamilton project and former member of the Council of Economic Advisers Jay Shambaugh lays out here.

So, what lies in store and how should investors prepare? Four key observations:

1. The U.S. went into the crisis with a stronger economy than most, but a weaker safety net.

With unemployment low, profits strong and stock markets at record highs, the United States began this year in good shape. True, growth was expected to slow to a somewhat sluggish 1.8 percent. But the years of recovery led to strengthened balance sheets and buffers against distress. This is the good news. The bad news is that the pandemic has caused an economic breakdown on a scale and with a speed unimaginable just weeks ago. Take the 6.6 million figure for new unemployment claims in the week to March 28: this was ten times higher than reported in the worst-ever week in history. The contraction in GDP projected in the current quarter -- 20-30 percent -- would be three times as steep as the worst quarter during the 2008-09 financial crisis.

The key to recovery will be keeping consumers and workers afloat, companies alive, and the shutdown as short as possible, while still ensuring that the health crisis is contained.

This crisis hits more directly than the 2008-09 financial crisis at the heart of Main Street and the source of most employment -- the services sector. Consumers kept the U.S. economy going in 2019, while business investment was disappointing. Recovery will depend on rebuilding consumer confidence and incomes.

In Europe, government support for business has mostly been tied to maintaining employment. Not so in the United States. That makes public support essential for the unemployed, including those newly without health insurance, and for the many Americans living close to the financial edge. The CARES Act, signed barely more than a week ago, rightly focused on that. But it did not envisage an economic slump of this severity, nor the likely period before a safe reopening of the economy. The longer and deeper the economic pain, the longer until a return to normal and the greater the need for additional fiscal action to support incomes and protect the vulnerable.

2. States urgently need more help, and so do small businesses

States and local governments struggling with the health emergency are also suddenly facing budget problems. The economic shutdown means unexpected -- and large -- revenue shortfalls at the same time as states face sharply higher costs for unemployment insurance and Medicaid. Without increased federal aid, many will be forced to cut spending -- essentially putting on the fiscal brakes -- just when the opposite is needed.

This is already starting to happen. As Bloomberg reported last week, Ohio state agencies are planning to cut spending by 20 percent, Cincinnati is furloughing 1700 city workers and Georgia may renege on a $1000 pay raise for teachers budgeted for next year. This is how recession deepens and spreads. Boosting federal funding for states and localities not only halts this vicious cycle but is also one of the quickest ways that the federal government can get money into the economy. The CARES Act support under various provisions falls far short of what is needed. Investors may wonder how municipal bonds will fare post-COVID-19.

More broadly, it is not enough for Congress to vote for stimulus -- new measures must also be clear and straightforward enough to be implemented swiftly. Administrative hiccups -- some called it chaos -- marred the start of the new federal support programs last week.

Concerns about the neediest Americans -- who may be unable to access Treasury funding or file for unemployment at overwhelmed state offices -- and the often-small firms that employ them are most serious. Perhaps more surprisingly, private equity firms, worried about the businesses they invest in, are also looking for help. Big corporations have many employees, lawyers and experts to help access credit and puzzle out new regulations. The same is not true of most medium and small companies, and the local or community banks that are often their main sources of funds. We saw in the 2008-09 crisis that some special programs -- for example to help home-owners -- ended up little used. They were simply too complicated for recipients to decipher and access. Administrative and computer problems also threatened to stall the Affordable Care Act before it got started.

3. We are all in this together? Governments are not yet acting that way

The new coronavirus knows no bounds. And, as former IMF chief economist Maurice Obstfeld notes, the response to it would be more effective if governments at all levels cooperated in the fight. Even in Europe, countries have been slow to recognize that. Help for Italy came first from China, before Germany, France and other EU members. In the United States, New York -- and probably other states -- have also turned to China when the federal government was slow or unwilling to provide needed ventilators and other equipment. At the same time, some countries have threatened export restrictions on essential supplies while others --including the United States -- maintain tariffs on the soaps and disinfectants that we now know are necessary to stay safe. Building stockpiles before the next pandemic is wise. Putting barriers on trade that inhibit efficient production in response to market signals is not.

4. Continuing dilemmas for Institutional Investors

A big sigh of relief was heard by most investors as we hit the end of March. Tough decisions were debated across endowments, foundations, pensions, sovereign funds, and family offices. While there was much debate and discussion on meeting operational needs and large private equity draws, scenario planning, and positioning for a new norm, most investors were able to hold steady. Many took a longer-term view as markets whipped portfolios up and down.

We continue to hold liquidity in order to be opportunistic while slowly adding to existing investments that are consistent with our long-term themes in the intersection of technology with health, education and distance learning, payment systems, clean energy, real estate and logistics.

Recent conversations with a number of investors have highlighted their biggest concerns. Rebalancing continues to be a frequent topic. Most larger institutions with automatic or regularly scheduled rebalancing programs were quick to slow the speed and amounts of rebalancing. The three-day rally from the lows on March 23 was the largest three-day move since 1933 for the S&P 500. It is difficult to rebalance in such short periods of extreme moves. Investors with larger ranges around their target allocations were less likely to get whipsawed. Whatever approach taken, it is clear that how you implement your rebalancing matters in this environment. We continue to be conservative and deliberate in case of another 10-15 percent drop in equity markets or continued dislocation in credit markets. While markets have flirted with short-term positive moves, news on both the human and economic costs of this pandemic continue to worsen, and markets may retrace some or all of their recent gains.

The value of active management has become increasingly apparent during this market volatility. Most institutions were considering moving toward larger allocations to active management after such a strong 2019 market. Distinguishing between companies based on valuations, fundamentals, and future growth is even more critical now. Current thinking across investors favors a larger bias towards active management across asset classes. It is evident in this market that there is considerable value in being able to be opportunistic around security selection, geographic exposure, hedging, and timing, among other factors. While equity valuations may look attractive today in certain sectors and particularly relative to bonds, depressed valuations are not always a catalyst to higher stock prices - especially as markets adjust to a slower growth rate. The use of options, thematic and concentrated investments, and other active strategies are areas to consider moving forward.

Strong relationships with top smaller and mid-sized firms that can move more nimbly will be critical to take advantage of market dislocations caused by this crisis. A common theme has been the differentiation that smaller and mid-sized funds can offer in being opportunistic and nimble.

Many have launched dislocation funds in anticipation of calling capital to start deploying if warranted.

With the S&P falling 27 percent from its February peak, landing us right in the middle of the distribution of selloffs seen historically around recessions and the likelihood of a longer term recession high – whatever letter shape you predict – institutions are scenario planning in earnest. When our Advisory Board, consisting of Alan Greenspan, Laura Tyson, Dame DeAnne Julius, Jessica Einhorn, Caroline Atkinson and Liaquat Ahamed, met last week, no one saw a V-shaped recovery and most saw a W at best.

Endowments and universities are also concerned about operational needs and may need to take higher distributions from their endowment portfolios to fund operations. Pensions that have enough cash to pay out monthly liabilities for only a limited amount of time are thinking carefully about their investment policies. The probability of non-market stress on investment portfolios is high and a topic widely being discussed. RockCreek continues to use scenario planning and cluster analysis in portfolio construction taking into account the liquidity of portfolios, unexpected externalities that may put pressure on an existing strategic asset allocation and how to stay defensive in light of an array of potential outcomes. Some investors have started to push back on private equity and real estate funds that have announced large capital calls.

Overall, a defensive posture continues to be at the forefront of RockCreek's thinking. We anticipate social, economic and health challenges that inevitably have market implications for investment portfolios – short and longer term. Staying the course with adjustments along the way as new data on global growth, fiscal and monetary stimulus and other economic factors change is prudent. Long-term themes, rebalancing, cash and liquidity levels, active investing, and appropriate risk profiles will be important ongoing topics of discussion for institutions. Keeping portfolios in line with longer-term objectives will allow returns to continue to be generated while the world returns to a better place and asset prices start to reflect this progress.

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RockCreek Update

Everyone at RockCreek is full of sorrow over the unspeakable loss suffered by our beloved friend and colleague Kathleen Kennedy Townsend. Our deepest thoughts and prayers are with Kathleen and her family over the loss of her cherished daughter, Maeve, and grandson Gideon.

We express our concern for all those affected by this terrible pandemic and look to support our community during this difficult time. Whether it be ways to support local small business, community non-for-profits, food banks and other areas hardest hit with limited resources. We look forward to the day when our communities can return to a new normal.

Team RockCreek