Looking Across the Valley: Visions of the Post-Pandemic Investment Landscape

MIRACLE MILE ADVISORS

APRIL 2020

With the COVID-19 pandemic, economies are facing their largest contraction since the Great Depression and financial markets are experiencing unprecedented disruption. While media reports remain focused on the daily case counts and the rapidly evolving policy responses to the crisis, investors are beginning to shift their attention to the post-pandemic world. Early expectations that things would return to normal after a few months have been replaced by recognition that the world will be different in many ways.

Throughout history, pandemics have long reshaped societies. Such black swan events push societies up against the wall, forcing deep changes, and at a shockingly rapid pace. We are at such a point now, with history on "fast-forward." While acknowledging the many unknowns in the path forward, we will share here our thoughts on how the pandemic and the policy responses thereto are likely to shape investors' post-pandemic world. Investors hate uncertainty, but can take some comfort as the outlines of the post-pandemic world come into better focus.

THE KEY VARIABLE: THE DEPTH AND DURATION OF THE ECONOMIC SHUTDOWN

The single most important determinant of the economic impact of the pandemic will be the depth and duration of the shutdown in economic activity, an issue which is generating strongly divergent views.

On the pessimistic side is the view that the economic shutdown will need to remain largely in place until we have a vaccine or herd immunity. Vaccine development is proceeding at an unprecedented pace, with multiple human trials already underway and manufacturing facilities being built even now before trial results. But very best case, a vaccine would see initial availability near year end, and more widespread availability in possibly 12 months. However, it is highly unlikely that current restrictions on economic activity could be extended for that period.

On the extreme optimistic side, a focus on economic costs has led to proposals for "re-opening" economic activity by near-term calendar dates. However, pushback from multiple quarters has led more to the view famously expressed by Dr. Anthony Fauci: "the virus makes the timeline."

Fortunately, evidence from Taiwan and others countries show realistic pathways to begin gradually easing the shutdown within a timespan that could be measured in weeks. The keys to this would be wide-spread adherence to social distancing, and expanded testing and contact tracing until case counts are suppressed to target rates. At that point, restrictions could be eased — not a full resumption of regular activity, but enough to allow schools and many businesses to re-open. In re-opened Taiwan, people are still required to wear masks on public transportation and in enclosed areas, and there are limits on the size of gatherings. Stores and restaurants may have to reduce the number of people they serve at a time so customers can maintain safe distances.

Two other keys to the pace with which restrictions could be eased:

- Tests to identify who has antibodies to the virus and who are probably immune might allow elimination of restrictions on such persons.
- An effective therapy for severely ill persons that would decrease death rates would shift the calculus as to the shutdown's cost/benefit ratio. Hopeful results for Gilead's remdesivir were announced, and results from several other studies are expected in coming weeks.

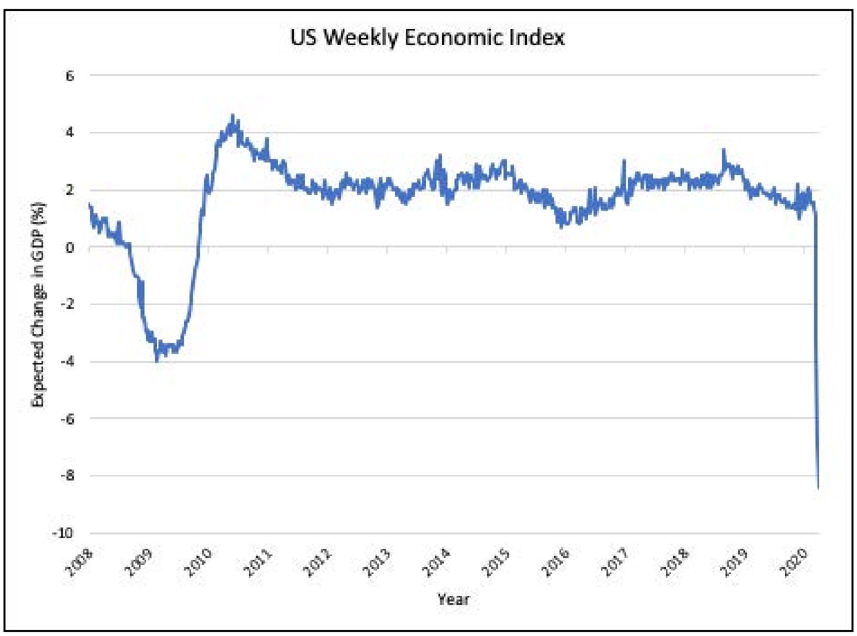
The central risk to the above scenario is a resurgence in case counts as restrictions are eased. China has seen flare-ups forcing reintroduction of partial lockdowns in some areas. If the coronavirus exhibits strong seasonality like many influenza viruses, that might help depress cases this summer, but add to the risk of new outbreaks in the fall.

Successfully managing the exit from lockdown will require skill and resolve across many areas of government. Currently, the U.S. has a patchwork of federal recommendations and local/state regulations which is very different from Taiwan or South Korea which have benefitted from more coordinated responses.

HOW STRONGLY WILL ECONOMIC ACTIVITY REBOUND FROM THE SUDDEN STOP?

The world economy is experiencing a sudden stop that is without a peacetime precedent. No one really knows what a sudden stop looks like. OECD estimates that the median developed economy faces a 25% GDP decline during periods of economic shutdown. U.S. forecasts for Q2 range from a decline of 9% to as much as 50% (quarter over quarter, annualized rate). To put these numbers in perspective, the peak-to-trough decline in real GDP during the Great Financial Crisis ("GFC") was 4% over a span of six quarters.

The highest U.S. unemployment rate during the Great Depression was 24.9% in 1933. The unemployment rate for April is expected to hit 20%. While income supports to the unemployed are now much greater than in the 1930s, unemployment could easily surpass the Great Depression peak before the shutdown is eased.



If no one knows what a sudden stop looks like, neither does anyone know what the recovery from one looks like. The case for a strong recovery begins with the fact that fiscal and monetary policy actions to support the economy (described below) have been astonishingly swift and massive. Further fiscal support measures are in the works, and the Fed has signaled it will backstop additional segments of the financial system if needed. Many of these policy supports will continue well after the economic shutdown ends.

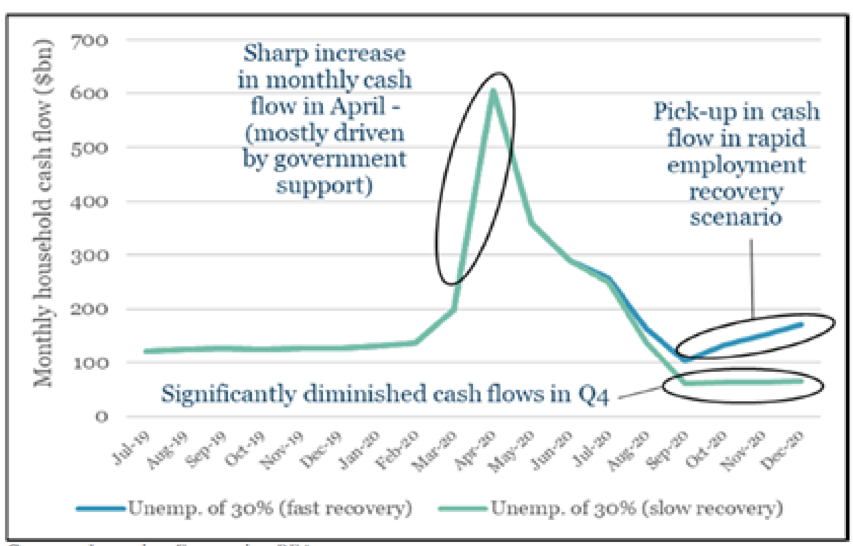
Will these actions be adequate? According to BCA "credible estimates of the first-round impact of con-tainment policies suggest that policymakers in advanced economies appear to have bought themselves roughly 4-5 months."[1]

Other evidence in favor of a healthy recovery include the significant pent-up demand expected coming out of the crisis and the fact that the U.S. economy was in good shape going into the pandemic. The excesses in cyclical sectors (housing, autos, business capex) usually seen heading into a recession were largely absent, balance sheets for U.S. banks were strong, and households had the lowest debt service ratios in more than 40 years. As with COVID-19 patients, the health of the economy going into the crisis is an indicator of the prospects for recovery.

But even if we see an initial surge in post-shutdown growth, there are good reasons why recovery could be weak and drawn-out. Consumers and businesses will be left with weakened balance sheets. Many small businesses will be gone. There isn't any government proclamation that will get 20 million people back to work. Spending and investing behaviors will stay cautious until business and consumer confidence recovers. A significant amount of future income will go towards past rent and unpaid credit card balances.

The latest U.S. forecasts from Goldman Sachs show the trough of recession occurring in this year's Q2 with a decline of 34 percent at an annualized rate for that quarter. They project GDP to subsequently rise gradually, not reaching its pre-virus path before the end of 2021.

Longview Economics has modeled monthly household cash flow showing an April/ May spike from the government support, followed by a decline through Q3 (see adjoining chart). But from Q3, their model shows two paths which diverge widely based on whether or not we are out of shutdown.



Source: *Longview Economics, BEA*

[1]BCA Research. "The Global Economic Expansion: (2009-2020) R.I.P.", April 3, 2020.

SWIFT AND MASSIVE FISCAL SUPPORT

In the aftermath of the 2008-2009 GFC, federal government fiscal support expanded the deficit to 5% of GDP before subsequently declining. Throughout most of the expansion, monetary policy took the lead role, with a series of measures to manage interest rates and encourage spending and investing.

With the virus shutdown, it was quickly clear that monetary policy could not address the immediate loss of income for individuals and businesses. Faced with little alternative, the warring factions in Washington promptly hammered out the $2.1 trillion Coronavirus Aid, Relief and Economic Security (CARES) Act providing income support, tax relief, and lending programs for individuals, small businesses, states and cities. An additional stimulus package that could exceed $1 trillion is nearing completion.

The programs enacted are well-targeted in the sense that they provide an immediate boost to the purchasing power of individuals and businesses. Furthermore, strong incentives for retaining employees increase the odds that aided businesses will survive the crisis. For now, no one is focused on the fact that the massive borrowing required to pay for these programs transfers economic activity from the future to the present.

Other developed countries are implementing fiscal support, albeit less aggressively than the U.S. Angela Merkel has pledged one trillion euros in aid for the German economy, but European leaders have not overcome resistance to aid for Italy where anger toward the EU is high. China faced down COVID-19 early, but their fiscal stimulus thus far has been below what they rolled out with other slowdowns in the past decade. However, Chinese policymakers are now sending clear signals that an aggressive ramp in stimulus measures is coming.

UNPRECEDENTED MONETARY POLICY SUPPORT

With the GFC, the Fed expanded its holdings from less than $800 billion to $4.5 trillion, some of which was unwound during the expansion. Now in the initial stages of the coronavirus crisis, the Fed has stretched its holdings from $3.8 trillion last September to $5.8 trillion as of April 1, and is on track to increase them by trillions more in the months ahead.

The Fed's actions to shore up the economy are unprecedented in both their size and scope. In addition to previously announced lending directly to states, cities, and mid-size businesses, last week the Fed announced expanded lending to companies below investment-grade status. The Fed has now announced nine lending programs totaling up to $2.3 trillion, and has signaled that it is prepared to expand its programs if needed to stem the damage to the economy. The announced programs will bring its total assets to $11 trillion within the next several weeks.

"Had the Fed not come in these past few weeks, we would have had a combination of the Great Depression and the 2008 financial crisis," said Mohamed El-Erian, chief economic adviser at Allianz.

For now, the Fed's immediate concern is market functioning. However, monetary policy will remain supportive of markets for a long time. If the bond market reacts poorly at some point, the Fed will likely be asked to cap yields as happened post WWII when – to reduce the cost of the debt accumulated during the war – the Fed was pressured to cap bond yields even as inflation rose. Irrespective of who is president, central bank independence could become a casualty as the federal government will need all the help it can get from central banks in terms of low rates and asset purchases. The Fed appears to have ruled out negative yields, the side effects of which have become better appreciated.

THE LEGACY: MASSIVE GOVERNMENT DEBT

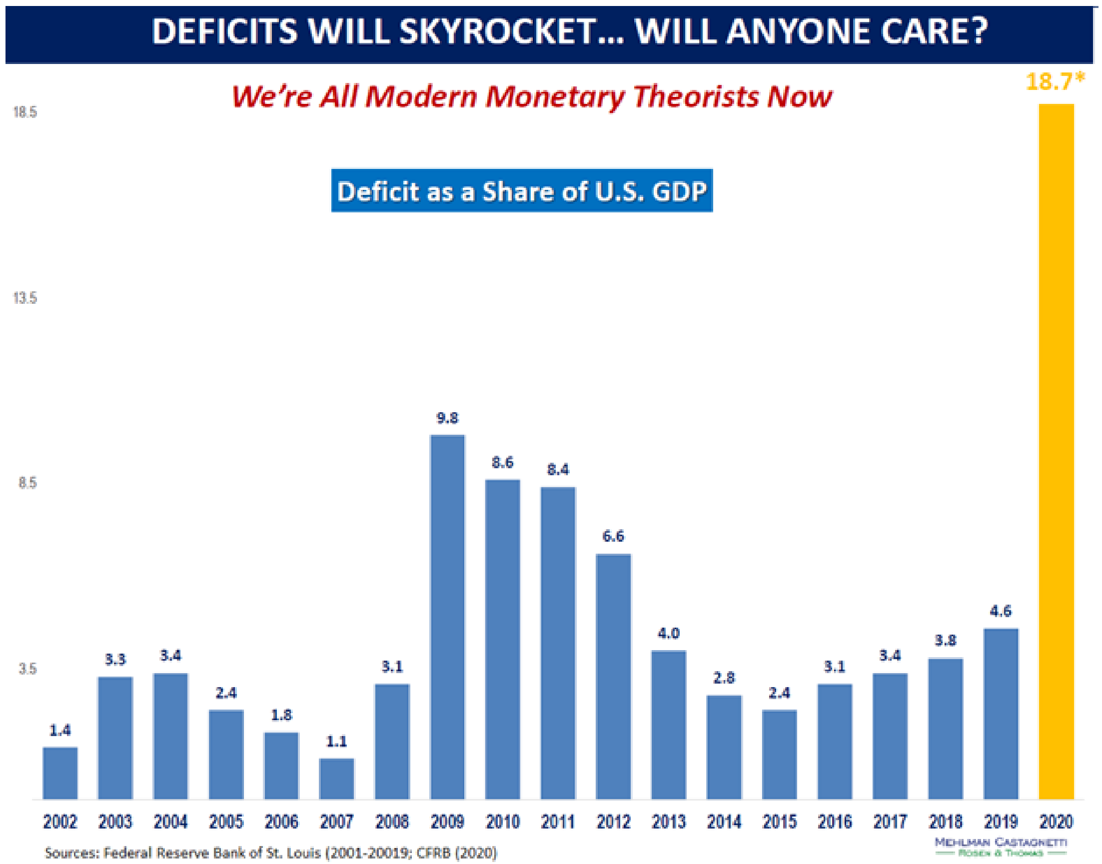
Budget deficits rise during recessions because tax receipts drop and spending on income support programs rises. In the past, deficits generally fell during expansions. But with the 2018 tax cuts, the federal deficit breached 5% even with the growing economy. Now, with the current recession set to be deeper than that of 2007-2009 and fiscal support packages likely to exceed $3 trillion or more, the deficit will far exceed the post-WWII peak of almost 10% of GDP in fiscal 2009. Data from the U.S. Senate Joint Committee on Taxation and Goldman Sachs suggests that the FY-2020 deficit will reach 18% of GDP exceeding all periods outside of WWII (see chart).

And what about all the loans that the Fed is guaranteeing? In a Bloomberg Opinion piece, Jim Bianco laid it out as follows:

> *The Fed will finance a special purpose vehicle (SPV) for each acronym to conduct these operations. The Treasury, using the Exchange Stabilization Fund, will make an equity investment in each SPV and be in a "first loss" position. What does this mean? In essence, the Treasury, not the Fed, is buying all these securities and backstopping of loans; the Fed is acting as banker and providing financing.*
>
> *The Fed hired BlackRock Inc. to purchase these securities and handle the administration of the SPVs on behalf of the owner, the Treasury. In other words, the federal government is nationalizing large swaths of the financial markets. The Fed is providing the money to do it. BlackRock will be doing the trades. This scheme essentially merges the Fed and Treasury into one organization.*[3]

[2]Wall Street Journal, "Coronavirus Crisis Legacy: Mountains of Debt." April 9, 2020

[3]Jim Bianco. "The Fed's Cure Risks Being Worse Than the Disease." March 27, 2020, Bloomberg.com



Traditional thinking has been that government spending is constrained by tax collections and the bond market's willingness to finance deficit spending. Last quarter in this space we discussed Modern Monetary Theory (MMT) which in essence says that for a government with its own currency, spending is unconstrained as long as the central bank will monetize the debt by buying bonds directly from the Treasury. With a few nuances, this is essentially where we are now. While MMT is not sound long-term economic policy, but very few are focused on the long-term right now.

State and local governments are coming under extreme financial pressure. Along with sharp increases in their expenditures for virus-related emergency measures, they will continue to see steep declines in tax revenues, increasing their dependence on the federal government. Because states generally run balanced budgets, they are likely to quickly turn to cost cutting or tax increases to the extent that federal support falls short. Moody's Analytics sees $90 billion to $125 billion of such cuts or tax increases coming which will put further downward pressure on the economy.

In sum, the ratio of federal debt to GDP will soar past 100% within the next few years, a burden which will shape how governments function long after the virus is tamed.

IMPACT ON CORPORATIONS AND THEIR EARNINGS

Corporations will suffer steep declines in sales and profits this year. Profits for 2020 are impossible to estimate, and analysts are now largely focused on the only somewhat less hazy 2021 profit picture. Likely impacts on corporations include:

- Balance sheets. Initially, credit quality will generally weaken and defaults will rise, especially in hard-hit industries like energy, retail, travel, and certain areas of real estate. What will landlords do when their banks want payment and their renters can't pay? The recent monetary and fiscal policy actions will mitigate these problems, but credit losses will ultimately be a function of the duration of the efforts to contain the pandemic. Eventually, balance sheets will be rebuilt as companies and investors find comfort in lower leverage levels.
- Dividends and stock-repurchases will be reduced or suspended by many companies.
- Rising rewards to labor vs. capital. The multi-year trend of a rising share of GDP for capital relative to labor may reverse. While it is not terribly surprising that governments across Europe are subsidizing wages and paying workers not to work, such is now happening in the U.S. under the CARES act. Sympathy for workers and rising bargaining power could persist despite elevated unemployment.
- Reduced workforces. The chairman of Disney, which has just furloughed 73,000 U.S. employees, was quoted in the New York Times as asking associates to "look across the business and permanently change how it operates," targeting a smaller workforce.
- "Deglobalization" trends will increase as companies seek simpler, more secure supply chains, moving more manufacturing back to the U.S. Companies will deemphasize "just in time" inventory levels.
- A mixed picture for capital costs. Interest rates will remain low and monetary policy accommodative. However, equity premiums could stay elevated, pushing up the cost of capital for many companies.
- More "working from home." Adoption of "WFH" will persist, supporting investments in cloud-based systems and related IT infrastructure. Demand for office space will suffer.
- Travel budgets will fall as employees, customers, etc. are more accepting of virtual meetings.
- Corporate tax rates could rise when focus inevitably shifts from making it through the crisis to dealing with the bill.

One of the safest predictions for the post-crisis markets is that the strong will get stronger. Companies with robust balance sheets and strong market positions will take market share and improve profitability as weaker rivals exit or are too cash-strapped to invest for growth. This pattern happens after every downturn and will recur this time even if anti-trust sentiment rises.

SHIFTS IN CONSUMER BEHAVIOR

- **Personal savings rates** following the depression of the 1930s soared as a generation of depression survivors built precautionary savings. It is a high conviction bet that a similar pattern will to some degree result from the job losses and negative wealth effect caused by the pandemic. The U.S. personal savings rate could easily return to the double-digit levels of the early 1980s.
- **Working from home** which now has its own 3-letter abbreviation (WFH) will remain common. Business people at multiple levels have grown more adept and comfortable dealing online with customers, employees, vendors, etc. When the kids are back in school, the preference for this mode will only grow. And irrespective of low gas prices, almost no one misses their commute.
- **Housing** will face cross-currents as job losses and depleted savings negatively impact demand. These forces will be countered by lower inventory levels, stronger preferences for living in one's own home, and demand for homes large enough to facilitate working from home. Whether there is a reversal of the trend in recent years towards urban living vs. the suburbs remains to be seen.
- **A preference for some degree of social distancing** may persist leading to expanded spacing in restaurants and shops, and to lower attendance at sporting and entertainment events.
- **Leisure travel** will remain depressed as people avoid the risks and hassles of travel. This will apply to the Chinese who have made up the largest set of international travelers in recent years.
- **Personal bankruptcies should remain well below past peaks** (1.5 million in 2010). This prediction is based on better consumer balance sheets at the outset of the pandemic, strong income support in current stimulus measures, and an assumption that the lockdown is eased within several months.

THE U.S. DOLLAR: UPWARD INITIAL PRESSURE, BUT DOWNWARD PRESSURES WILL GROW

With the explosion of the pandemic in March, the U.S. dollar spiked due to "safe haven" flight and a short squeeze on the dollar. Demand for U.S. dollars rose massively as foreign currency markets faced deleveraging pressures and corporations drew down their credit lines. At the same time, lenders that typically provide short-term dollar loans stepped back. The Fed's actions in providing liquidity, notably their swap lines with the major foreign central banks have gone a long way to relieving the squeeze conditions, alt-hough dollar scarcity persists.

Looking forward, the dollar is highly correlated to the trade and fiscal deficits. The trade deficit will decline with the weak U.S. economy, relieving this source of upward pressure on the dollar. With the fiscal deficit rapidly accelerating, "the dollar should go down a lot" according to Jeffrey Gundlach. "We are flooding the system with dollars."[4]

DEFLATION OR INFLATION

The economy faces severe near-term deflationary forces as evidenced by dramatic drops in oil prices, industrial metals, used car prices, etc. The massive expansion in the monetary supply imparts an inflationary impulse, but this will be countered by the collapse in the velocity of money as spending remains at depressed levels for some time.

The above said, the combination of extreme monetary and fiscal stimulus is inherently inflationary and will eventually debase the currency. The current generation of central bankers has fought deflation for the past 20 years which will shape their views moving forward. After the 1930s, deflation fears persisted into the 1950s, resulting in a complacency toward inflation and the inflation spike of the 1970s. We may be at a similar point.

Globalization was a major force behind disinflation as production shifted to low-cost producers. A reversal of this trend will contribute to an eventual resurgence of inflation.

IMPACT ON OUR POLITICS

Already, the pandemic is reshaping political views and long-held assumptions. Some on the political right are alarmed by the rising appeal of leftist positions. Universal health care and social safety nets once deemed radical, are becoming more mainstream. Deficit hawks are silent as policy makers spend trillions to stabilize the economy. Andrew Yang's universal income is now a reality, at least short-term.

While in some ways the crisis is increasing support for government's role in society and in markets, it is also intensifying distrust of government. We will be lucky if these conflicts are resolved peacefully.

Pre-pandemic, the U.S. was already heading to its most-divisive presidential election since 1860. Trump's disapproval ratings were at unprecedented levels, but he had the backing of a strong economy which has historically been the decisive factor in presidential elections.

[4]Jeffrey Gundlach. "U.S. Stocks Have Not Bottomed. April 1, 2020, AdvisorPerspectives.com

The public may or may not end up blaming him for how COVID-19 was handled, but in any case he will not have a strong economy at his back. If Trump's reelection chances start looking weak, he may seek a foreign conflict (China) as imperiled leaders sometimes do. All this sets up for an election prone to extreme tactics and for potential challenges to the legitimacy of its results beyond anything we have seen before.

No matter who wins the U.S. presidential election, their challenges will be severe. "The next president is going to face a situation where the coffers are empty, many businesses are bankrupt, the social safety net has been ripped, and we have a rising power in China." said Kurt Campbell, CEO of Asia Group and former assistant secretary of state.[5]

High on the list of such challenges will be rising dissatisfaction with our country's economic inequality. Levels of income, student debt, and healthcare access that might have been tolerable in a strong economy may not be so in a post-pandemic economy.

OUR SOCIAL BONDS WILL HOPEFULLY EMERGE STRONGER

Stressful times have torn many societies apart (Germany in the 1930s). However, in America we have a long history of – more often than not – coming together in times of crisis.

It is not hard to see the pandemic bringing forth the shared resolve and strengthened sense of community that followed 9/11. We see it in healthcare workers and first responders risking their lives on a daily basis. We see it in teenagers volunteering to get groceries for seniors or sewing face masks. We see it in pharmaceutical companies pulling out all the stops to develop treatments, knowing their odds of success are not great, and that in past epidemics even effective treatments and vaccines have not yielded riches for their developers.

Lastly, an irony of social distancing is that for many of us, efforts to stay connected with important people in our lives have actually increased. If this behavior stays with us for a while, it would be a silver lining to the cloud we are now living under.

[5]Kurt Campbell, "The coronavirus outbreak will forever change the world economy," April 7, 2020, www.axios.com

LAST THOUGHT…

Long term investors in stocks and bonds have been well-rewarded, and we have little doubt that they will again as we move past the pandemic. As to the timing and path along the way, we note the remarks of famed investor Howard Marks of Oaktree Capital in his most recent client memo:

> *"Most of what we have today is opinion…If you read just the optimistic pieces, you'd think the virus will soon be eradicated and the economy brought back to health, and if you read just the negative ones, you'd think we're all done for."*

We expect that the reality will most likely fall somewhere between the extremes of current forecasts.

IMPORTANT DISCLOSURES:

Past performance is no indication of future results. Investing in securities involves risk and the possibility of loss of principal. Investing should be based on an individual's own goals, time horizon and tolerance for risk. The views of Miracle Mile Advisors, LLC ("MMA") may change depending on market conditions, the assets presented to us, and your objectives. This research is based on market conditions as of the printing date. The materials contained above are solely informational, based upon publicly available information believed to be reliable, and may change without notice. MMA makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in this report change. MMA shall not in any way be liable for claims relating to these materials and makes no express or implied representations or warranties as to their accuracy or completeness or for statements or errors contained in, or omissions from, them. This report does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The securities discussed in this report may not be suitable for all investors. MMA recommends that investors independently evaluate particular investments and strategies and encourages investors to seek the advice of a financial adviser. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. This report is not an offer to buy or sell any security or to participate in any trading strategy. In addition to any holdings that may be disclosed above, owners of MMA may have investments in securities or derivatives of securities mentioned in this report and may trade them in ways different from those discussed in this report. The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in your securities transactions. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data. The information and analyses contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal, investment or other advisors, at both the outset of any transaction and on an ongoing basis, to determine such suitability. Legal, accounting and tax restrictions, transaction costs and changes to any assumptions may significantly affect the economics of any transaction. MMA does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws. The projections or other information shown in the report regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Physical precious metals, real estate, emerging markets and other more opportunistic credit investments are subject to unique risks which include but are not limited to liquidity, rate volatility, currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. In addition, the securities markets of many of the emerging markets are substantially smaller, less developed, less liquid and more volatile than the securities of the U.S. and other more developed countries. This report or any portion hereof may not be reprinted, sold or redistributed without the written consent of MMA.