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Traub Capital Management
Economic and Market Outlook Q3 2020

It looks like someone has pushed the fast forward button on the stock markets this year and now we are marching to COVID-19 time. The S&P 500 ended last year at 3230.78 and it was on the rise with a strong economy, record low unemployment, low inflation and low interest rates. Mid-February, the reality of COVID-19 set in, sending the world economy into a tailspin and triggering the sharpest, quickest major market decline ever, with the S&P 500 losing almost 35% in just over a month.

Since mid-March, the markets have seen a substantial rebound, closing the second quarter with the S&P 500 at 3100.29 – a gain of 39% from the bottom, leaving us at the end of the second quarter with an overall market loss of 4% (or a loss of about 3% if you include dividends received). In a normal year a loss of 3 or 4 % for six months would be a ho-hum event, but that is hardly the case this year. For one, the average stock in the broader S&P 1500 has actually declined over 14%, a large disparity due to the success this year of the five largest stocks in the S&P 500: Microsoft, Apple, Amazon, Alphabet (Google) and Facebook.

Our economic outlooks for some time have been looking forward to increased volatility and that has certainly been in evidence so far this year. With the markets on COVID-19 time, the normal declines of bear markets and the initial stage recovery of bull markets have been compressed from several years into about four months.

Looking at the US economic picture, or at the economic picture of any country in the world, you do not get a ho-hum picture. The coronavirus has wreaked havoc on every economy. Unemployment in the US is around 11%. The country is officially in a recession and corporate earnings are going to be terrible for this year. Global trade is down substantially and the gloomy picture is mirrored in every country around the globe.

So how does a very modest decline in the stock market square with a horrible economic picture? Is the market way ahead of itself? Is the other shoe out there somewhere and when is it going to drop? Yes, the markets and the economies of every country around the globe are out of sync. As such, should we be painting a gloomy picture for the stock market and dismal returns until the world's economies recover?

COVID-19 Review

Unlike every other recession since modern statistics began collecting data around the turn of the last century (i.e. 1890), this recession is not driven by economics, nor by excess credit, nor by loan defaults, nor by other economic factors. The last major world disease epidemic was the Spanish Flu in 1918 and in spite of being responsible for the death of about 6% of the world's population, it did not trigger a recession.

This recession is driven by the coronavirus resulting in the COVID-19 infection and the death of over 500,000 people worldwide thus far. The virus is quite contagious and to stem its infection rate, almost every country around the world shut down its economy, restricted movements of citizens, banned large gatherings, and took actions with which you are very familiar.

We, at Traub Capital, are not alone in believing that once the COVID-19 infection is behind us the world's economic picture will brighten measurably. The equity markets are looking to this as well. They are leading indictors of what is likely to happen. Clearly, a view of substantial recovery is what the markets are reflecting. So, we want to assess if a substantial recovery from COVID-19 is realistic, or is it a pie-in-the sky hope that will be burst as soon as the right pin appears?

The ultimate solution to the COVID-19 crisis is a vaccine that works to protect the vast majority of the population from the infection. Humankind has found these kinds of vaccines for smallpox, measles, chickenpox, mumps, polio, typhoid fever and a host of other world health scourges. A vaccine is one ray of hope and there are a large variety of opinions on if and when such a solution might be available. These opinions, all from very knowledgeable sources, range from availability in under six months, to many years. You can take your pick, but there are no vaccines that are going to be in the very short term and meanwhile the coronavirus continues to infect people throughout the world and immediate steps are needed.

Fortunately, there are avenues to attack the infection that can be implemented immediately, that are effective and that do not require a shutdown of the economy. These avenues of attack include widespread use of masks, social distancing, widespread testing, restrictions on large group gatherings - particularly indoors, and contact tracing. In every economic entity where these five steps have been effectively implemented, the rate of infection has been reduced to a very small percent of the population, in spite of reopening substantial portions of the economy.

Examples abound, including South Korea, Wuhan, New York City, Connecticut, New Jersey and Massachusetts.

Increased understanding of how to care for infected individuals coupled with recently introduced medications to stem the impact of the infection have also consistently and effectively reduced the death rate from the disease.

Stemming the spread of COVID-19 and providing better care for those infected is no longer rocket science. In locales where the disease has garnered the serious attention it deserves, the spread is on the wane. In locales that have not embraced the severity of the virus, the reverse is generally true. The steps to stem the spread are known, proven in numerous locations, immediately available, and do not require a major economic shutdown.

So, the real questions are two. The first question is, in areas where the infection rate is rising, when and will these areas realize the seriousness of the infection and take the known steps to stem its spread? The second is how open can the economies of those places be when the known steps are implemented. Let's look at these two questions.

Question 1) Early this year, when the virus was little understood, certain areas of the country were hit much harder and much earlier than others. In February, the disease was spreading unchecked with very little knowledge of the extent of the spread. Large areas of infection covered the Northeastern section of the country, notably New York City, southwestern Connecticut, New Jersey and eastern Massachusetts. The severity of the infection and the steps to quell the spread were being learned, and not implemented on a large scale. Infection rates in these heavily impacted areas exceeded 200 infections every day per million.

Economic lockdown via stay at home orders or advisories was the reaction to the unknown infection speed and unknown extent of those already infected. By mid-April, in these heavily impacted areas, the infection garnered the attention it deserved and the five steps mentioned above were in full swing – widespread testing, widespread use of masks, social distancing, contact tracing, restrictions on large group gatherings, and millions staying home as much as possible. These steps turned the tide. With their continued implementation, in spite of measured reopening of the economies in these areas, the rate of infection has been on the wane. That infection rate has declined from over 200 per million people per day to under 25 in the span of 10 weeks.

Not all areas of the country were as hard hit as the Northeast and these other areas reopened their economies without implementation of the five known steps - thinking they were indeed over the hump. As a result, positive cases are increasing in a number of other locales including Texas, Florida, Arizona, California and in the Carolinas. These areas have just recently reached the threshold of 200 daily infections per million people that seems to be the trigger point for the disease to attract the attention it deserves. Having reached the trigger point, we have seen these states beginning to seriously implement all five of the important steps to stem the spread of the infection and as such, we would expect to see a peak infection rate in these areas shortly after implementing the known steps and we would expect the spread of the infection to be checked.

Question 2) It is not yet completely clear to what extent the economy can be reopened with the five steps in-place, but the answer is certainly a large extent. It is hard to drink in a bar or eat in a restaurant while wearing a mask and these activities will most likely have to wait for quite a while before full resumption of normal activity can take place. Meanwhile, in Massachusetts, manufacturing is back to work as is the construction industry along with all the "critical services". So far, this reopening has shown no increase in the spread of infection as the five steps are fully implemented.

With the above analysis, we do not believe it is unreasonable for the markets to hold to the belief that the COVID-19 infection can be controlled and that substantial portions of the economy can be reopened with the known steps in place to stem the spread.

Economic Picture

The country is on the mend. After a total job loss of a phenomenal 25 million in the first quarter of 2020, there have been large gains in both April and May, totaling about 7 million net gain in jobs. The country entered a formal recession (as determined by the National Bureau of Economic Research) in February and with the May jobs report, we expect to see that the GDP for June will be higher than that for May, likely ending the recession. The end of recession means the economy has stopped contracting and unemployment has peaked- not necessarily that the economy is back to full health.

At the same time, the Federal Reserve (FED) has been active in support of the economic recovery. There is, in the press, a considerable line of reporting concluding that it is just the FED monetary injections that are supporting the recent rally in the stock markets. We respectfully disagree with this position. An analysis of the balance sheet of the FED shows that the $2.3 trillion that has been readily discussed is now in two places – namely the checking account of the US Treasury and in bank reserves, which have been redeposited at the FED. Basically, banks are hoarding cash and with interest rates at historically low levels, are reticent to make loans outside of the subsidized small business loans under the Payroll Protection Program. Banks are not the only ones holding cash. The household savings rate (which normally runs around 6%) skyrocketed to an astounding 33% in April, the highest savings rate on record by far. There is no wholesale flow of funds from banks, nor from the Federal Reserve into equity investments in the stock market. Banks, as well as individuals are holding high levels of cash and that cash will become available to support an economic recovery. In a similar vein, companies are generally conserving cash as well and corporate stock buybacks have dwindled considerably.

The US GDP should pick up about 14% (annualized) in Q3 compared to Q2 and another 8% in Q4, leaving an overall decline of about 3.5% for the year. Growth continues in 2021 to the tune of about 3% bringing the GDP up to match the level of 2019. A similar picture is on tap for automobile production and housing starts. Oil prices will be stable as demand continues to decline for oil. Available labor will keep the lid on wage inflation and overall inflation should be about 1% for 2020 and well under the goal of the Federal Reserve. The US unemployment rate will be sticky. Unemployment is very much a lagging indicator as businesses are loath to rehire people until the need becomes great. The unemployment rate is now expected to hold above 8% through 2021.

Outlook for Stocks and for Bonds

The stock market is a leading indicator and moves ahead of the general economy. The economy is on the mend, and the S&P 500 is not much below where it was coming into the year – clearly indicating an expectation of COVID-19 getting under control and continuation of the economic growth that began in May. The equity markets advanced under uncertainty. There is no "All Clear" signal announcement.

Being hopeful that a COVID-19 recovery is on the horizon, it is not unreasonable for the stock market to be looking over that horizon, reflecting the current levels. It is hard to argue for continued increases, especially at anywhere near the rates we have seen since April. Arguments for significantly lower values would need to be based on uncontrolled spread of COVID-19 or on continued economic shutdown. So without good arguments for higher or lower values, we conclude that where the markets are today reflect their level for the next year or so. So with an expected flat, but still volatile market, we are typically somewhat below what we consider our normal stock weight for our accounts. This is not because we anticipate a large decline, but with stock and bond returns likely to be similar over the next year, stocks are somewhat less attractive than normal given the higher than normal risks of owning stocks.

There is, however, an important wild card in the mix: the availability of an effective COVID-19 vaccine available in large quantities. There are roughly 100 entities around the world that are diligently pursuing a vaccine for COVID-19. We have not explored all of them. However, each of the efforts appears to be sincere and many are taking various different approaches. We doubt if there will be one magic bullet vaccine that works best for all situations. It is extremely likely that there will be multiple vaccines and treatments with varying effectiveness and that COVID-19 vaccine research will continue for quite a few years and long after the first widespread availability.

Conclusions

We believe that the coronavirus can be contained with five known steps and that locales taking these steps can reopen large portions of their economy and still keep the coronavirus under control. Newly implemented disease treatments will also keep the death rates manageable. The markets are looking past the infection and reflect the economy reopened, consistent with a widespread vaccine. In the meantime, the virus can be controlled. GDP will continue its trend up and large portions of the US and world economies can reopen.

The markets already reflect the forward looking view of a reopened economy and as such are not likely to see marked further gains. At the same time, we do not see arguments for a double bottom arising from the COVID-19 infection running out of control or from other economic factors that we see out there. And we do see a possible reason for a strong upside move if we get an effective vaccine in the near future, which is a reason to remain invested.

Hopefully, some of the volatility seen in recent months will abate as indicated by the market's volatility index (the VIX), which is down from an all-time high over 82 reached in March to a present value of 27 (still higher than normal).

As always, we do appreciate your continued faith in Traub Capital and look forward to offering you investment and financial advice going forward.