Investment Perspective

KANAWHA CAPITAL MANAGEMENT

7201 Glen Forest Drive, Suite 200 / P.O. Box 18490 / Richmond, Virginia 23226 / (804) 359-3900

LOOKING ACROSS THE VALLEY

July, 2020

Covid-19 represents a globally shared crucible, the first since the second world war. Contemptuous of borders, the disease has spread to the four corners of the earth. The ensuing health crisis spilled into economic and financial realms, leading to severe societal disruptions and a global downturn. Although uneven, the policy responses have been dramatic.

First is worst

The outbreak has hit the United States particularly hard and our country now leads the world in both confirmed cases and fatalities; the U.S. is still near the top of the list even after adjusting for population size (cases per million). To contain the spread, many public officials engineered shutdowns, prompting an economic hard stop. Over mere weeks, the collapse in GDP and surge in unemployment hit levels that took years to reach during the Great Depression.

Obviously, the current downturn did not stem from typical cyclical forces moving to redress economic imbalances. The *Great Covid-19 Recession* emanated from an unprecedented external shock to an otherwise healthy economy. Similarly, the corresponding market meltdown was not due to the unwinding of investor euphoria and madness like the last three asset bubble bursts (housing/finance in the 2000s, technology in the 1990s, Japan in the 1980s). Instead, the plunge in equities and other risk assets reflected a stampede to safety in an unnerving environment.

The International Monetary Fund recently forecast that global GDP will end up falling 4.9% in 2020. And that institution expects economic activity in the United States to dive 8%. For the first time, *all* geographic regions may experience an annual contraction. The International Labor Organization estimates that the first quarter drop in work hours equated to the loss of 130 million jobs worldwide; that figure could have topped 300 million in the second quarter.

Pandession

In theory, once the source of the shock — the coronavirus — is under control, the stage should be set for recovery to begin. Businesses have started to gradually reopen in many locations so the second quarter could prove the low-water mark. However, due to deep economic scarring, it may take several years to return to pre-pandemic levels of activity. Many businesses and some industries will never fully recover.

Despite an uncertain backdrop, stock markets have recouped most of their losses from the February-March swoon. Investors have been cheered by the massive global policy response as well as initial progress in the battle against the virus. But much work remains to be done with some observers warning that markets have gotten ahead of themselves, as the world waits for a vaccine.

Incubation day

After flattening this spring, the trend in new confirmed cases began spiking after Memorial Day, following the easing of social restrictions in many localities. This uptick cannot simply be attributed to the ramp-up in testing: The infection rate, or percent of positive tests, has also jumped, indicating a worsening spread. As of early July, three-quarters of states were experiencing rising caseloads. The epicenter has shifted from New York to four new hotspots: Los Angeles, and cities in Florida, Texas, and Arizona. Some formerly reluctant state and local officials have made a 180-degree turn on lockdowns and distancing.

Fortunately, the lethality of the disease has waned with the drop in the average age of those infected. The over-50 crowd seems to be staying away from bars and crowded beaches. And through much trial and error, hospitals have become more adept and innovative at managing symptoms. Treatments like the antiviral remdesivir, steroid dexamethasone, and blood thinners have helped reduce mortality rates.

Politics unmasked

As pundits debate the likelihood of a second wave later this year, the first one has yet to crest; it has just surged down the coast. Mixed messaging on appropriate mitigation efforts and the lack of a coordinated national strategy has extended the reach and life of the virus.

Politicians must heed the lessons of the Great Financial Crisis. The decision to tighten policy prematurely in favor of budget austerity hampered the subsequent recovery. This year, loans/grants to businesses, stimulus checks to taxpayers, and expanded unemployment benefits to workers have been critical lifelines. These initiatives have been exhausted, or soon will be over the next few months, with shutdowns still looming.

Policy thrust

Globally, fiscal policy is as loose as it has been since World War II; the response significantly greater than that following the 2007-09 recession. So far this year, G7 stimulus measures have been equivalent to 12% of the group's GDP with the United States in the front of the pack.

We expect the administration and Congress to enact additional rounds of support. After all, it is an election year while few seem concerned about the potential long-term impact of rising public debt levels. And unlike the housing crisis, there should be no reticence due to fears of "moral hazard" whereby the prudent bail out the reckless. We should all be in this fight together.

Meanwhile, after unprecedented actions by the Federal Reserve and other central banks, monetary conditions have become extraordinarily stimulative. Yields remain extremely low and the Fed's array of lending programs has kept credit markets functioning smoothly. Powell and company do not anticipate tightening policy until 2022 at the earliest.

Global distancing

Well before the current crisis, rising economic nationalism had been chipping away at globalization. The erection of trade barriers and backlash against immigration are two noteworthy examples of impediments to the free movement of people, goods, and money.

The pandemic will only hasten the reassessment of globalization's costs and benefits. Nations are moving as never before to protect domestic industries. And the coronavirus has changed the very definition of what constitutes a critical national resource. Witness the frenzy to secure swabs, PPE, and ventilators. Individual countries will seek to find a better balance between globalization and self-reliance.

Additionally, businesses will reconsider their extensive supply chains, designed with the preeminent goal of minimizing costs. These networks may have appeared "efficient" but clearly the tradeoff was fragility, and an inability to absorb shocks. Companies will look to reduce their reliance on single suppliers for critical components.

Hangover down the road

While the immediate impact of the pandemic is quite visible, it could unleash some longer-term ripples that bear watching. The very remedies prescribed to combat the financial effects of the coronavirus will set the stage for new policy challenges in the years ahead. The combined fiscal and monetary response has been massive in scale and scope. But such largesse will lead to a more pronounced hangover than that following the Great Financial Crisis.

Deficits naturally widen during recessions but the significant (and necessary) federal response to the current crisis has compounded that phenomenon. The Congressional Budget Office forecasts that the 2020 budget deficit will approach $4 trillion. Such deficits will aggravate a public sector debt load that had already been on an unhealthy trajectory over the past decade. After yields reset to more normal levels, the cost of servicing the federal debt could become rather onerous.

In the near term, investors should expect choppy markets until the tenor of covid-related headlines improves. The sharp rebound this summer has stretched valuations, also suggesting a need for stocks to digest their gains. However, the combination of ultra-loose fiscal and monetary policy should ultimately serve as a pillar of support for both the economy and equities.

— Christopher J. Singleton, CFA, Managing Director

July 15, 2020