For Public Distribution in the U.S. For Institutional, Professional, Qualified and/or Wholesale Investor Use Only in other Permitted Jurisdictions as defined by local laws and regulations.

Principal Global Investors

Principal[SM]

Economic Insights: **A push to reopen**

Update for the Month of May, 2020

Commentary by **Robert F. Baur, Ph.D.**, executive director, chief golobal economist

The recession from Covid-19 mitigation roared into reality with April reports. United States and Euro area business surveys and data showed huge declines. But China's economy reopened as virus injury faded. European countries have been restarting for two weeks and some U.S. economic activity is ticking higher. April stock markets looked past the crisis to recovery; markets were boosted by monster fiscal and monetary relief packages. A few months of equity relapse or consolidation is likely until the shape of the economic rebound becomes clear.

Tiptoeing into recovery

The U.S. and Euro area recession that was obvious after pervasive business closures and lockdowns has been ugly. Business surveys plunged with service companies hit harder than manufacturing. First quarter Eurozone gross domestic product (GDP) plummeted 3.8% from the prior quarter, a staggering loss which doesn't yet include the worst phase. In the U.S., more than 30 million people applied for jobless compensation in the last six weeks, a number without historical parallel. March U.S. consumer spending tumbled 7.5% from February, a stunning 61% annualized nosedive. More dreadful data will be coming, but it's expected; the reports will be stale.

The real news is how different this contraction is from what's typical. A recession is usually caused by problems created during the economic expansion that preceded it. Interest rates rise; inflation soars; profits plunge; defaults, bankruptcies surge; layoffs begin. That's the normal sequence.

This recession resulted from a desire to constrain a medical danger by closing businesses and pushing people to avoid crowds. Since the cause was unique, it's likely the downturn and aftermath will be quite different (see "Four ways this recession is unique").

Some of these differences can be an advantage. Confidence falls to really low levels if the layoffs, problems, and defaults of the recession drag on and on. But, in a short downdraft, consumer sentiment should hold up much better. And it is; recent surveys show household confidence, while down from the peak, remains well above the sour level of the financial crisis.

Further, in a classic recession, it's often months before anyone is aware it's started. As a result, official action to lessen the disruption arrives late. This time, the onset was so obvious that the U.S. government set up gigantic monetary and fiscal relief packages up early and fast. So, the income lost during the closures could be made up fairly quickly.

In this environment, economic forecasts depend on Covid-19 contagion. That pattern was established earlier in China and South Korea. It's a two to three month rise and fall in daily new virus cases and fatalities. Euro area countries are following that framework. Daily new cases and fatalities topped in Italyin late March and Spain and France in early April.[1] In the U.S., daily new cases and fatalities have flattened and trended lower since mid-April, likely the peak.

Many people worry about a second infection spike in Japan and Singapore. But a closer look at the data suggests the first wave was just slightly extended. New cases and fatalities are falling now, and adjusted for population, are very low.

Four ways this recession is unique

1. Deeper, a much bigger loss of GDP: We're not visiting restaurants, gyms, or airports less frequently … we're not going at all!
2. Selective in who it hurts: This is a small business recession concentrated in service industries. Manufacturers are holding up better. Some large companies are hiring big numbers of people.
3. Shorter: It will likely follow the three-month pattern of virus activity.
4. Obvious onset: As businesses closed and people stayed home, a recession was guaranteed.

Looking ahead at reopenings' modest effects

With cases and fatalities receding, officials turn to reopening. It will likely follow the shape of activity in China. Businesses there have restarted operations but are not necessarily at capacity. For example, 98% of Starbucks stores are open. Leaders at Caterpillar noted that all of its facilities in China are operating. Traffic monitors show rush hour traffic is mostly back to normal. Official April business surveys showed further mild expansion and a modest improvement from March. The National People's Congress is scheduled for May 22, a vote of confidence in mitigation.

While businesses have mostly restarted, China's households stay cautious. Weekend traffic, mostly consumers, improved but remains below normal. Restaurants are open, but seats are empty. Vehicle sales bounced off the bottom but are well below normal. March industrial output was only 1.1% below a year ago, but retail sales were 15.8% under last year, a minor gain compared to the January–February loss of 20.5%. Households in the U.S. and Europe will surely mirror this wary attitude even as activity picks up.

Euro area countries are about two weeks into gradual reopening. Sweden, for example, did not have a general lockdown. Austria, Denmark, Norway, and the Czech Republic

Expressions of opinions and predictions are accurate as of the date of this communication and are subject to change without notice. There is no assurance that such events or prospections will occur and actual condition may be significantly different than that shown here.

began to restart a bit earlier. The revival brought no new infection spikes so far.

U.S. resumption is underway. Some high frequency data already show gains. Motor gasoline demand has recouped about a fifth of its drastic loss from mid-March. Applications for home purchase mortgages recaptured a fourth of their plunge. Smith Travel notes that U.S. hotel occupancy nudged up to a still horrid 26% in early April. TSA travel counts have risen a bit after an earlier 96% plummet. J.P. Morgan researchers point to tentative increases in "requests for driving directions in Apple Maps, global flights tracked by FlightRadar24.com, consumer spending tracked by 1010data.exabel.com, and restaurant revenues tracked by Womply.com." Some of these are anecdotal, but it's clear people want a semblance of normalcy.

Data for second quarter growth in greater Europe and the U.S. will show monster contractions due to April lockdowns and closures. U.S. monthly reports should show decent progress in May and a solid revival in June, followed with a sharp rebound in July and August. We expect a mammoth plunge in U.S. GDP of 20% to 25%, annual rate, this quarter with a snappy third quarter recoil near 10% up.

Beyond that, the U.S. recovery will be protracted. Some small businesses will never reopen regardless of fiscal relief. As in China, fear of infection will linger and the desire for more savings will trim any spending boom. The jobs lost during the crisis may not be fully replaced until early 2022. Late this year and early next, growth should be 3% or so, dwindling back to trend the rest of 2021, subject to whatever harm the virus may create next fall and winter.

We expect the Eurozone revival to be less substantial and more delayed. The rate of virus infections and fatalities was very high in Italy, Spain, and France and the closures particularly severe. Disagreements over the contours of fiscal policy have made relief slow in coming and less generous than needed. Help for businesses is the forte of the European Central Bank (ECB). Its loan programs and bond purchases were massively scaled up. While third quarter Eurozone growth will surely be positive, the rebound will be more lackluster than hoped.

We've gained some clarity on the questions listed last month. China's relationship with other countries has markedly deteriorated. Widespread questions about the true source of the original infection will keep any rapport at a low ebb. It will be difficult for China to broaden its alliances in Asia and Europe. The danger of far-flung supply chains for certain goods like pharmaceuticals has become evident. So, the ongoing anti-globalization trend may intensify. Some of the lifestyle questions, like working from home, online schools, brick and mortar stores, will take more time to sort out.

Focus on markets

For most investors, April returns were nearly the opposite of a horrid March. All the markets we track, except Mongolia, had a gain in April; the Nasdaq Composite was second of 47, up 15.4%. Those who owned the S&P 500 Index had a gain of 12.7% in April after a March loss of 12.5%. From the March 23 low, they gained a healthy 30.2%. Of course, that was only after enduring an excruciating loss of 33.9% from the peak of February 19. Bond investors experienced similar reversals. Whipsaws happen.

Equities were buoyed by the super-fast Fed response: the immediate fed funds rate drop to 0.0% to 0.25%, the colossal backstop of U.S. bond markets, and the eventual expansion of all Fed support. Added fiscal spending well north of $2 trillion, plus talk of even more, enhanced the rally.

The huge upturn since late March says investors are looking past the crisis and focused on earnings gains from reopening. History shows that stocks often retrace 50% to 62% of the loss from a sharp decline. The S&P 500 Index close on April 29 hit the upper end of that range. Further, first quarter earnings estimates for the S&P 500 Index have already plunged but may still be too optimistic given the economic data to come. Current estimates for only a small decline this second quarter also seem far too hopeful. And until the last week of April, the rally was too narrow, driven only by past leaders. This all suggests any further up move will be very difficult. Much of the eventual improved growth and virus news is already priced in.

We are now just past the worst phase of recession. As growth picks up in summer and fall, equities should be able to move modestly higher. Because so much future growth and uptrend potential is priced in, we expect a period of relapse and consolidation through June. Even though stocks often retest recent bear market lows after an initial upsurge, the S&P 500 Index trough of 2200 seems well out of reach given the enormity of the Fed's backstop. Earnings pessimism should return at some point and we can envision a relapse to 2600 or below, a likely good entry point for those underweight stocks.

What to do with your investments?

For one or two months, we like large cap growth and tech stocks; those past leaders should continue to outperform as markets consolidate and thrash about before the next move higher. If growth returns, the uptrend should broaden out to include a wider group of winners. On a six-to nine-month basis, we like stocks that do well when growth accelerates: small caps and sectors like energy, materials, consumer discretionary, financials. With the U.S. dollar likely to weaken, we prefer select emerging market stocks over those in developed countries outside the U.S.

For bonds, the Fed and other central banks will keep short-term rates at super low levels for a long time, surely through most of next year. Even long-term U.S., German, and Japanese sovereign bond yields will stay low with massive central bank bond purchases. However, those long-term yields could be under modest upward pressure later this year as growth improves. That steeper yield curve would be good for financial stocks. We advise avoiding long-maturity safe-haven bonds.

With nearly unlimited Fed backstops for investment grade and some municipal and high-yield bonds, credit spreads are unlikely to widen much further. We like the higher yields on high-quality corporate and municipal bonds at short to intermediate maturities.

All these suggestions are tactical, short-term in nature. This is not a time to make long-term investment decisions. It's possible that equity returns, even over several years, may not be very rewarding.

Expressions of opinions and predictions are accurate as of the date of this communication and are subject to change without notice.
There is no assurance that such events or prospections will occur and actual condition may be significantly different than that shown here.

One reason to be wary is that recessions have a job to do: cleanse the economy of imbalances, eliminate debt, scare people into frugal behavior, and move assets from weak to strong hands. That won't happen in this atypical recession; problems existing before the recession will still be challenges after. Total U.S. economy-wide profits have been flat for five years, profit margins shrinking. Thus, there's potential for a second downturn after the rebound, perhaps late next year or 2022. This is not a prediction, more a reminder to consider the odds of a surprise double-dip or unexpected earnings decline over the next couple of years. We're still fully invested for now. Be positive for this year but stay vigilant for a major change in the investment framework.

[1] All Covid-19 data is from Worldometers.info/coronavirus.

Disclosures

本資料は情報提供のみを目的として作成されたものです。適用法令で規定されるものを除き、本資料中の情報・意見等の公正性、正確性、妥当性、完全性等を保証するものではありません。本資料は一般的な情報のみを含んでおり、あらゆる投資家の投資目的及び経済状況を考慮しておらず、特定の投資助言や推奨、ないし、一般的な市場等に関する将来の投資成果を示唆または保証するものではありません。本資料中の見解及び予測等は本資料作成時点のものであり、事前の予告なく変更される場合があります。特定の投資や有価証券に関するあらゆる言及は、売買または保有等を推奨、示唆するものではありません。
いかなる場合にも、PGI 及びグループ関連会社、またその役職員等は、本資料及び本資料中で提供される情報やデータの誤り及び内容に起因して発生した損害については、一切の責任を負いかねます。

本資料は将来の予測情報を含みますが、完全な史実に基づくものと見做すべきではなく、それらの予測が将来実際に起こる保証はありません。また、投資に関する完全な情報が記載されているものとして依拠されるべきではありません。

本資料中の情報は、弊社の文書による事前の同意が無い限り、その全部又は一部のコピーや配布はご遠慮ください。

プリンシパル・グローバル・インベスターズ株式会社
〒100 0011 東京都千代田区内幸町１ １ １ 帝国ホテルタワー
電話：03 3519 7880（代表） ファックス：03 3519 6410
代表者：代表取締役社長 板垣 均
ホームページ：http://www.principalglobal.jp
金融商品取引業者登録番号：関東財務局長（金商）第 462 号
加入協会：一般社団法人 日本投資顧問業協会
一般社団法人 投資信託協会

マーケットレポート：1184815