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Economic Insights: **The tide is turning**

Update for the month of June 2020

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The COVID-19 recession was short but deadly. Businesses didn't just lack profits; closures meant no revenue. After an initial bounce, China's recovery has slowed. The United States recession trough was likely April. Traditional economic data should improve in June, but alternative signs of activity are already ticking higher from low levels. Stock indices consolidated most of the month, but advanced nicely the last week of May. Credit markets rose on massive central bank support. A modest equity uptrend should resume as growth returns and reopening is sustained.

Is the worst behind us?

For weeks, traditional data for the Eurozone, U.S., and Japan has been horrific. Industrial output collapsed; retail sales plunged; business survey indices fell far below prior record lows; housing activity nose-dived. U.S. initial claims for jobless compensation kept rising, now to a 10-week total of 40.8 million from COVID-19-related closures through the week ending May 22, a number far outside any historic range. The U.S. unemployment rate for May could approach 20%, the worst since the Great Depression.

With widespread shelter-in-place policies, it was certain the economic tailspin would be of tragic proportions. Shutting down much of the economy meant businesses not only lacked profits, they had no revenue. Dire reports were anticipated, but they describe yesterday's crash. As reopening begins, we believe the worst of the economic contraction is behind us.

New cases and fatalities from COVID-19 continue to rise around the world, with the most rapid upsurge in Brazil and India.[1] But, for developed countries, the worst of the virus devastation may be in the past. Daily new cases of coronavirus and related fatalities are falling across Europe, Japan, and the U.S. And there's been no secondary wave of infection anywhere, yet. The reduced rate of infection is prompting economic reopening.

China was the first to suffer from the onset of COVID-19 in January and February and the earliest to restart its economy. It's had a remarkable rebound. Industrial companies have mostly reopened and are approaching normal activity. Home and vehicle sales, industrial output, real estate investment, and electricity consumption are all above last year's levels. The pollution level is nearing normal. Official surveys of manufacturing companies eased slightly in May but still show expansion with rising new orders.

Consumer activity in China, though, has been slow to normalize with overall retail sales still well below year ago. Even though people are returning to work, weekend travel remains subdued; traffic as of May 23 and 24 at peak times is still about one-third below 2019.[2] Encouragingly, May surveys of non-manufacturing businesses ticked higher suggesting better gains in consumer sectors are coming. However, with COVID-19 infections still rocking the rest of the world, China's external sector is weak; the survey section for new export orders is only modestly above its historic February low. Overall, China's economy has made incredible progress in just a few months. This should be the template for the rest of the world as it returns to normal.

Investors grow optimistic

April's financial market rally continued in May with a S&P 500 Index return of 4.8% including dividends. The MSCI All Country World index rose 4.2% in price. Corporate bond prices rose as credit risk declined and the spread between yields on corporate bonds and similar maturity U.S. treasuries narrowed. The Barclay's U.S. Long Treasury Total Return index lost 1.9% as yields on 30-year U.S. treasury yields rose 0.12%. Broad commodity indices moved higher in May, as did prices of metals, gold, and silver.

Investors seem optimistic, even amid the worst economic collapse likely ever, as they look beyond the recession to reopening and growth. Stock and bond markets are both supported by massive government largesse and central bank backstops. Investors believe governments have their back. They're not wrong so far. In April, we had expected a month or two of consolidation with a potential for a mild market relapse. It was not to be. With the restart coming sooner than many expected, there's likely more gas in the equity tank for the upturn to continue. The buy-the-dip mentality seems so strong that U.S. equities could challenge the February highs over the next few months. Selling pressure would be fierce, if that happens.

The data displays a restart

The Eurozone economy was battered by COVID-19 in March. In its largest economy, for example, first quarter German gross domestic product (GDP) plummeted 8.6% annualized with a steep 12.2% annual rate plunge in private consumption. Data for April was even worse, but the economy was trying to find a trough in May. Economic sentiment did edge up recently across the currency union but remains near the low of the financial crisis. After a historic two-month collapse from 51.6 to 12.6 in April, the Eurozone composite business survey by Market News moved up to 30.5 in May; 50 is the breakeven between expansion and contraction. The forward-looking results of current business surveys have rebounded substantially, suggesting companies are expecting conditions to improve.

More good news comes from a watershed European Union (EU) fiscal package to provide relief from the effects of the COVID-19 shock. The EU commission proposed borrowing up to €750 billion and dispersing €500 billion in grants and €250

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billion in loans to EU countries. The proposal would distribute the money for the first time based on need rather than the size of the country. If enacted, this could be a first step toward a real fiscal union, with shared risk-taking and responsibility. The bonds would be in the name of the EU with joint repayment obligation, so it would be acting as a unit rather than a collection of 27 individual countries. It's remarkable that Germany sponsored this move as its leaders have always resisted socializing risk. If this comes to fruition, it would be positive news for the currency by lessening the risk that the currency union would ultimately disintegrate.

In Japan, the Abe administration, not to be outdone, will add more than 10% of GDP in stimulus packages, well above the relief total during the financial crisis. That should help growth as the economy reopens. A few indicators have already edged higher. Consumer confidence and the composite Market News business survey both moved up a couple of points in May, even though both are in record low territory. The Apple measure of driving requests in Japan rose about 20% in late May from the April low. Tokyo subway ridership also increased the last few weeks, significant because the city was the last region for the state of emergency to be lifted. The recession trough could be in April.

Reopening is underway in the U.S. Data will be improving (some is already). April capital goods orders and shipments were down substantially, but far less than forecasters expected. Consumer confidence is creeping higher and has held well above the depths of the financial crisis. Mortgage applications for home purchases have risen for several weeks and are up about 9% over the last year. April new home sales rose a touch from March with prices holding firm. May regional business surveys are mostly up from April and better than expected.

Non-traditional data has been trending higher for several weeks, albeit from severely low levels: TSA travel counts, American Staffing Association weekly temp index, new auto sales from Wards, real estate open house traffic by ShowingTime, business formations from the Census Bureau, global flights from Flightradar24, revenue per available hotel room from Smith Travel, hours worked at small business by Homebase.[3] There's no question; restarting has begun.

Worldwide mending underway

The U.S. labor market is improving faster than pessimists anticipated. Yes, initial claims for jobless payments rose another 2.1 million for the week ending May 22 as more jobs vanished. But continuing claims plunged by more than four million, suggesting that a substantial number of temporarily furloughed employees have been called back to work. Ongoing claims should rapidly diminish over the next few weeks as the restart gathers steam.

We expect a 20% to 25% annual rate plunge in U.S. GDP to be reported for the second quarter with most of the damage in April. Recovery began in May and will gain robust momentum in June. The third quarter should see a powerful bounce near 10%, maybe more. After that, the U.S. rebound may turn more gradual with a couple of quarters of 3% plus growth, falling to a bit over trend the rest of 2021.

This follows the pattern in China, where industry normalized fairly quickly, but households remained fearful of infection and were slow to return to regular behavior. In addition, some small U.S. businesses will stay closed, so lost jobs may not all be regained until sometime in 2022. OpenTable, for example, estimates that one out of every four U.S. restaurants will go out of business because of the impact of COVID-19. Still, consumers are staying confident overall, perhaps thanks to checks from the government. Personal income soared 10.5% in April when a 5.9% fall was the consensus. With few places to spend the windfall, the household savings rate skyrocketed to 33%.

Further recovery in China will depend partly on reviving its export business, which of course is contingent on a rebound in the rest of the world. The second quarter GDP crash in Europe and Japan will likely be even deeper than the monster one-quarter U.S. loss. Japan was in a huge slump even before the virus crisis which only added to its woes. The Eurozone has been slow to respond to COVID-19 troubles so the third quarter rebound may be shallow.

Nevertheless, worldwide mending is underway. Taiwan industrial output rose in April thanks to tech production, often a harbinger of robust world growth. Commodity prices are percolating, well up from their crisis lows, another sign of normalization. Copper prices are up 14% from the March trough; prices of raw industrial products edged up a few percentage points; the price of a barrel of Brent crude oil has jumped 82% since April 21. So far, so good.

One big uncertainty is whether COVID-19 creates a second wave of infection when the flu season in the northern hemisphere begins anew in late fall and winter. Even so, we're optimistic the economic fallout will not be nearly as devastating.

Investment ideas

It's probably time to reduce one's overweight to the tech stocks that have outperformed for so long. One positive for the overall market is that the advance broadened out the latter part of May to include more stocks beyond the technology behemoths. Small cap and value stocks outperformed as did the materials sector. More of that rotation is needed for the advance to persist. We think it will occur. So, on a six- to nine-month basis, we'd stick with stocks that do well when growth picks up: cyclical sectors like materials, financials and industrials, small caps, value stocks.

The broad trade-weighted U.S. dollar index peaked in March and has since traded sideways at a slightly lower level. We expect the dollar to weaken further over the next year. If that happens, it could make the case for emerging market stocks. They have long underperformed developed country indices, especially those in the U.S. But, if growth is bottoming and the dollar peaking, the upturn could pull emerging market stocks with it. Last month we suggested overweighting emerging market stocks versus those in non-U.S. developed countries. It didn't pan out in May and it's still a risky bet, but we'll stick with it a while longer.

For bond investors, the Federal Reserve (Fed) and other central banks will keep short-term yields at super-low levels, at or near zero, probably through 2021. Long-term yields on U.S., German, or Japanese government bonds may also stay low from large central bank purchases. Still, those long-term yields should be under modest upward pressure as growth quickens. So, we'd avoid investing in long-term safe-haven government bonds

The Fed backstop for certain corporate, municipal, and high-yield bonds seems nearly unlimited. Yield spreads between those bonds and similar maturing U.S. treasury bonds should narrow

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further. Rather than government bonds, we'd prefer high quality bonds in those fixed income sectors. One should stick to short or intermediate maturities to avoid the risk of rising interest rates.

Once again, these are tactical suggestions with a time horizon of a year or less. The rotation into value and cyclical stocks could be a long-term decision, but there's potential for more typical economic troubles to develop late next year or in 2022. In the long-term and with current valuations and expectations so high, returns to broad, passive stock market indices may not be very rewarding. What equity gains may be available will likely come from active managers able to profit from internal market rotation as the new investment climate of this decade comes to fruition. For now, as growth picks up, we'd stay fully invested while respecting each investor's personal risk tolerance. Stay positive for the near term; it's a time to be optimistic but a bit wary.

[1] All COVID-19 data is from Worldometers.

[2] From Ned Davis research

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