Nasty, Brutish and (hopefully) Short

By Jeff Korzenik, *Chief Investment Strategist for Fifth Third Bank*

March 22, 2020

Note: The content in this article is based on Fifth Third's current assessment of global markets and economic signals. It reflects the same ideas shared in conversations with Fifth Third clients, but does not constitute investment advice.

Executive Summary

The phrase "Nasty, brutish and short" is an excerpt from a description of what life becomes in a society without order, taken from the work of philosopher Thomas Hobbes published in 1651. "Nasty" and "brutish" are also apt adjectives for the recent conditions in the capital markets, but the question remains whether this will also be "short," and in general what investors should expect going forward. This is a bear market and the early part of a sharp economic downturn, but acknowledging facts is only the start of developing a path forward for investors. At Fifth Third, we believe that the approach to the current market should focus on three key considerations, which we outline in this piece.

- This current challenge is not unprecedented. We've been through worse and survived, including a pandemic. History provides context and parameters.
- Have a balanced view. Weigh the evident and imagined negatives with potential positives, e.g. the potential for better health outcomes as antiviral trials proceed.
- Markets are forward looking – eventually markets look through the woes of the present and can trade off the future, a future which implies stronger growth than expected as workforce limitations are eased and productivity improves.

Consideration #1: This current challenge is not unprecedented

While every economic cycle has its nuances, we have the benefit of both personal experience and historical data that can provide perspective. **The coronavirus challenge is not unprecedented. We have historical experience with economic downturns driven by any number of factors, including pandemics.**

In terms of the magnitude of the challenge that lies before us, we do not believe that this is as large as many challenges we have successfully weathered: the Great Depression, World War II, or even the Great Recession of 2008-09. While a pandemic-driven downturn has particular characteristics, we have precedent here too, in the Spanish Flu Pandemic of 1918-19. The episode resulted in 675,000 deaths in the United States (in a population roughly a third of today's) and tens of millions abroad[1].

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Compared to that downturn, we do not think the present challenge is as great: we are responding faster, medicine is better, and technology makes social separation less disruptive to the economy. The Spanish Flu also had a greater workforce impact with unusually high mortality rates for the young and healthy that made up the backbone of the global workforce a century ago[1]. The Spanish Flu's high mortality rate for working age individuals meant that potential economic growth was impaired for decades, an outcome that will not happen with the relatively low mortality rate for the young that is associated with the current pandemic.

We should also understand that the tighter the restrictions today, the lower the long-term health costs and long-term economic risks of this downturn. **We do not believe that this level of restriction will persist, but it will buy our country time to muster resources, an effort already well underway.** The degree to which our containment and mitigation strategies shift will ultimately inform near-term market performance, but again some perspective is helpful.

With the help of Cornerstone Macro, one of our independent research partners, we examined the history of market drawdowns, using both S&P500 data back to its start in 1927, but then extending our investigation to include the Dow Jones Industrial Average back to 1896. This study gives us a more comprehensive history of bear markets that included world wars, financial crises, and yes, even a global pandemic. Bear markets are defined as 20% or greater drawdowns. The straight arithmetic mean average of those bear market drawdowns (performance from cyclical market top to bottom) was 38.5%. The median average (equal number of greater and lesser drawdowns) was 34.8%. The range of outcomes, however, was quite wide. A bear market in the aftermath of the Spanish flu pandemic brought a drawdown of 46.6%. For contemporary reference, the S&P500, based on closing prices, was down 31.9% as of March 20, 2020 from its all-time high.

Most of the largest drawdowns were associated with conditions that simply do not correspond to our current environment: speculative stock market bubbles, existential banking crises, or oil supply shocks. While valuations in the S&P500 were certainly not cheap at February's market top, they were nowhere near the levels of the dot-com bubble or the leveraged speculative frenzy of 1929. We are also fortunate that the banking system and its regulators largely learned the lessons of the 2008-09 crisis. The widespread financial system and household leverage that played a large role in both the Great Depression and the Great Recession simply are not present, although corporate indebtedness has been elevated. Finally, the supply shocks in oil that were so damaging to investors in 1973 were from high oil prices and an artificial shortage; to the degree we have shocks today, they are from low prices and excess abundance, a condition, while not without its own complications, is on balance not a significant negative for the economy, and possibly a net positive.

Our current downturn is truly unusual, however, in that it came at a time of significant positive momentum in the global economy. Most market drawdowns and associated economic pullbacks come after months of weakening conditions. This cycle, the global economy had been accelerating and the U.S. had notable momentum. While this incoming strength will not eliminate the painful period ahead, it will provide some cushion. More significantly, recessions are usually long, drawn out affairs because it takes time to work through major imbalances (e.g., the oversupply of housing and debt in 2007). Currently, we see no such widespread private sector imbalances, which suggests a recovery can move at a faster pace. While we do see public sector imbalances, the ones that concern us the most are isolated: the severe underfunding of pensions and retiree healthcare benefits in a handful of states. Most economic downturns also come after a period of restrictive policies intended to restrain inflation, quite the opposite of the expansive fiscal and monetary regimes already in place. None of these factors will avoid the likelihood that our downturn will be nasty and brutish, but they open up the possibility that it will be short.

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Consideration #2: Have a balanced view

"If it bleeds, it leads" was long said to characterize newspaper reporting, and it continues to be true in our era of 24-7 reporting, seemingly infinite online news and opinion resources and social media clickbait. As investors, **it is important for us to recognize the risks of succumbing to the emotionalism of the leading stories each day, and there is no doubt that markets face "headline risk" with the coronavirus challenge. The inexorable math of a pandemic will ensure that bad news will be highly visible for weeks and perhaps months:** rising infections, overloaded healthcare systems and a tragic increase in deaths.

The bad news is clearly the focus of market participants, and particularly of those doing the wholesale liquidation that is characterizing this phase of the bear market. Investors are quite right to factor in the significant economic deterioration that lies ahead. However, we must balance this against positives, and remember that for every action there is a reaction.

Even if we were to use the Spanish flu pandemic or the Great Recession as a baseline, the policy responses to the coronavirus outbreak are simply better:

- Central banks are helping fight a liquidity challenge. The lessons of 2008/09 have been learned and we have structures in place today that had to be created from scratch back then. The central banks of the world have gotten in front of this. The lowering of interest rates also helps cushion the downturn and will make the eventual economic rebound more robust. Mortgage refinancing coupled with low energy prices eventually boosts spending.
- Fiscal policy: "helicopter money" is coming: relief for families and businesses to mitigate the kind of economic downturn we will see. It will not prevent all the damage, but these **interventions can limit the depth and duration of the decline, and will add strength to the eventual recovery.** In an election year, the character of the debate is not about whether to spend money, but how each party can outbid the other in support – given the nature of the problem, erring on the side of relief and expenditure is not a bad outcome. We'll still have to see if the relief offered can be funneled quickly and effectively, but early indications are not bad.
- We should not entirely dismiss medical mitigations. While there is widespread acknowledgement that a vaccine cannot be developed, approved and deployed in time, we should be open to the possible role that antiviral medication can play in alleviating both the health and economic outcomes. There are a number of human tests going on right now, including some with drugs long available for other viral infections, that are showing some promise. Even the shortage of ventilators needed to treat the worst cases may be addressed; the retooling of traditional manufacturing to meet this demand may take time, but there are several projects looking at 3D printing of components to speed production. Again, it is too early to do anything but wait for scientific validation, but if the Spanish Flu pandemic is our baseline, just consider how far our state of medical care and medical innovation has come in the intervening century.

Consideration #3: Markets are inherently forward looking.

As of this writing, with the exception of one big jump in initial unemployment claims and weakness in a few regional manufacturing surveys, just about every economic release has been favorable. Yet the stock markets, after posting all-time highs, have tumbled precipitously. Quite rightly, no one is surprised - just after U.S. stocks posted all-time highs a mere month ago, prices started reflecting economic activity that would, with increasing certainty, be expected to decline sharply in coming months. Markets reflect not the present, but the expected future. It is true that the "expected future" is hard to discern at this stage in the pandemic when so little is known about the virus itself and our

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policy responses, and uncertainty tends to depress stock prices. Gradually, however, the uncertainty factor will give way, and the path forward will become more evident. It is possible that the route through to the end of the pandemic justifies even lower prices, but eventually markets will look through the bad headlines to the recovery and renewed expansion beyond.

If this cycle follows the script of previous recoveries, the eventual market rebound will not occur amidst evident good news, but rather will start during a period of maximum pessimism. The old Wall Street wisdom, "If you're going to panic, panic early," suggests that investors should be wary of selling at this point in the bear market – it may simply be too late for such a move, particularly since it will place even greater burden on the investor to know when to reenter the market; not just one decision has to be right, but two (i.e., when to buy and when to sell). Ultimately, we will only know in hindsight when and from what level the move higher will begin.

When the market can look beyond the coming economic decline, what might investors expect future growth to look like? The short-term outlook will depend on how much damage is done to consumer and corporate balance sheets, the workforce and financial institutions. Investors should remember that 2008-09 was somewhat of an anomaly – deep recessions usually result in fast recoveries, -the post-'09 recovery was hampered by excess consumer indebtedness that took years to work off. At least at this point, consumer debt burdens relative to income are relatively tame, offering the possibility of a more traditional snapback.

Besides the aggressive stimulus measure, being put into place, two major cyclical sectors of the economy, housing, and manufacturing may be unusually supportive once the decline ends. Housing activity will benefit from a homebuilding industry that has struggled to keep up with demographics, suggesting pent-up demand, particularly as the millennial generation become and increasingly important source of homebuying. U.S. manufacturing, once again globally cost-competitive, can benefit from a more skeptical view of globalization's supply chain risks.

For long-term investors, the news is even brighter. Long-term potential growth in any economy is the sum of workforce growth and productivity growth. Our workforce growth challenges were starting to ease as labor force participation rates were rising. Much of this rise was due to new corporate flexibility in employment, whether facilitating the needs of stay-at-home parents or marginalized workers. The benefits of such flexibility, particularly remote work options, have become quite apparent to employers and are likely to continue to support growing labor force participation.

Long term productivity growth also looks bright as American entrepreneurship rates have soared in recent years, sustaining a culture of innovation. The progression of the millennials from entry level positions in the economy to roles of greater contribution will foster greater productivity, incomes and spending. With this generation making up the single greatest cohort within our workforce, this group's economic ascendance bodes well for long-term growth.

Stein's Law

Investors do well to remember Stein's Law: "If something cannot go on forever, it will stop." This wisdom from American economist Herbert Stein offered a great "reality check" in times of excess investor enthusiasm: the real estate frenzy of 2005-07, the dot-com bubble, etc. It is also a useful reminder not to get overly pessimistic.

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The lockdown of much of the global economy is not meant to be a long-term solution. Slowing the spread of the coronavirus though social distancing and the resultant economic slowdown has bought time to build a strategy, increase hospital capacity, research antiviral treatments and deploy support measures for the economically and medically vulnerable. However, it cannot go on forever.

Impoverishing a nation does not support good long-term health outcomes. Our policymakers know this. We should not extrapolate the near-term shutting down of economic activity too far. In the coming weeks, Stein's Law will come into play. We do not yet know what combination of policies designed to protect the medically most vulnerable, or expand healthcare resources, or implement better case treatment will come into play to shorten the duration of the economic shutdown, but any discussion of policies to reopen the American economy will be a healthy one.

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1. 1918 Pandemic (H1N1 virus) | Pandemic Influenza (Flu) | CDC https://www.cdc.gov/flu/pandemic-resources/1918-pandemic-h1n1.html