INVESTMENT BRIEF

Q3 2020

Strategic Investment Group®

Disconnects and Uncertainties

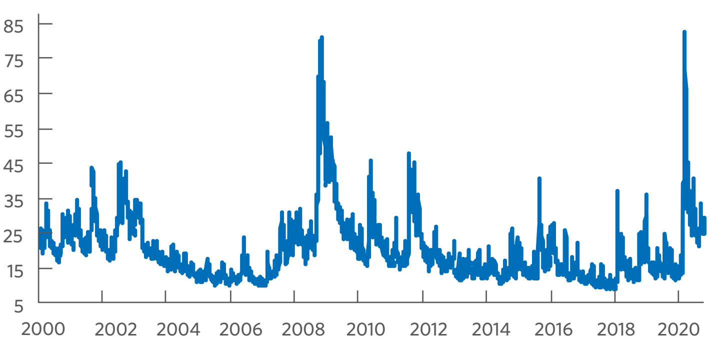
Unprecedented has become an overworked word this year. Yet, since the onslaught of COVID-19, its frequent use seems justified. Notable developments meriting superlatives include: Most rapid collapse in U.S. output and employment. Deepest decline in U.S. output since the Great Depression. Largest and most rapid policy response resulting in the largest Fed balance sheet and widest U.S. fiscal deficit since WWII. Biggest expected decline in global GDP since the Great Depression encompassing the highest proportion of countries. Most rapid U.S. equity market collapse followed by the strongest rally in history resulting in the shortest U.S. equity bear market of all time. Highest reading on the VIX index, a gauge of near-term expected U.S. equity market volatility (Exhibit 1). Most concentrated U.S. equity market since the 2001 tech bubble. Highest level of corporate bond issuance. And this far from exhaustive list does not consider the unprecedented extent of wildfires in the West, the number of hurricanes in the U.S. (three shy of the record set in 2005), or the magnitude of the global health crisis (worst since 1918). It is little wonder that such extremes have resulted in disconnects and uncertainty.

EXHIBIT 1:

Record U.S. Equity Market Volatility (VIX Index)

Source: CBOE

Data through October 20, 2020



Ailing Economy, Hale and Hearty Market

The U.S. economy has experienced wide swings this year. After falling off a cliff in the first quarter, output has rebounded sharply. Nevertheless, output and employment remain well below pre-pandemic levels and this shortfall is likely to persist. However, lingering economic weakness has not deterred the U.S. equity market, which touched an all-time high in August and remains above pre-pandemic levels. The U.S. is the only major equity market besides China to have experienced gains so far this year, yet the U.S. economy is projected to decline by 4.3% in 2020, compared to GDP growth of 1.9% in China.[1]

[1] International Monetary Fund. "World Economic Outlook, Oct. 2020" and "People's Republic of China at a Glance."

There are several plausible explanations for this apparent disconnect between the fortunes of the economy and the market. The unprecedented size and rapid deployment of the policy response has supported equities. Despite widening deficits and rising debt levels, U.S. Treasury securities yields remain near record lows, further boosting equity prices. Some speculate that investors are looking beyond the pandemic in anticipation of a rapid economic recovery in a post-COVID world. Others point to the highly skewed nature of the market rebound led by a few mega-cap growth stocks in the tech sector, while the retail, travel, hospitality, financial, and energy sectors remain sharply lower. In this view, the pandemic has mainly hurt contact-intensive service sectors, while tech stocks have profited from the pandemic-induced trend to work, shop, and be entertained at home. Despite these reasons, the near record price level, lopsided market action, and high valuation of the U.S. equity market seem unsustainable in the face of the wide range of near- and long-term uncertainties investors face.

Uncertainties in the Short Term

In the near term, the main source of uncertainty is the path of the pandemic and the response to it by households, firms, and governments. The recent resurgence of COVID-19 in areas where the virus seemed contained and its spread to areas previously left relatively unscathed highlight the unpredictable nature of how the global health crisis will unfold. The containment measures imposed by governments have varied widely across and within countries and over time, amplifying uncertainty. The response of individuals to the pandemic has also varied as evidenced by highly divergent standards of compliance with containment measures to widely differentiated attitudes to an eventual vaccine (the timing of which is itself unknown). Even when these near-term uncertainties are resolved, the long-term impact of the pandemic will remain a lingering unknown.

Uncertainties in the Long Term

The risk of long-term economic scarring from the pandemic is the main source of medium-term uncertainty. Whether the tens of millions made jobless by the pandemic will return to equally productive employment when it passes is unknown. The economy may also experience lingering ill effects from the high level of bankruptcies triggered by the pandemic. Changes in consumer preferences and business practices may necessitate a reallocation of resources that could pose a long-term drag on productivity. The rapid accumulation of debt from already high levels is a further source of instability that may eventually require a painful adjustment. Taken together, these near- and medium-term uncertainties suggest that global growth may remain below its pre-pandemic trend for many years to come. Compounding the years of lost life from COVID-19 deaths, currently estimated at 2.5 million for the U.S., the ongoing output loss due to the gap between the pre- and post-pandemic global economic growth path could well be the most costly legacy of a year of superlatives.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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