10 July 2020

LEADING THOUGHTS

The "Pandemic Put" Can't Last Forever

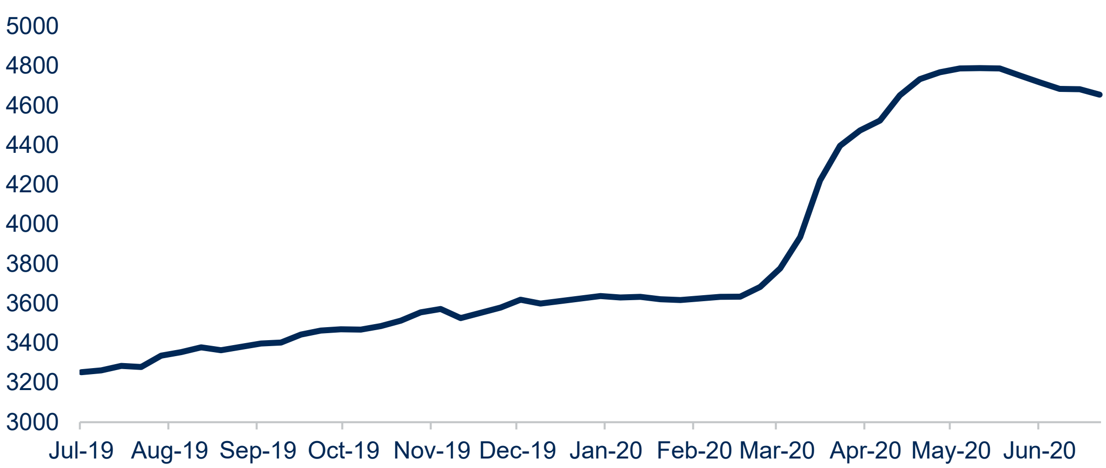
As the second half comes into focus, investors will have to contemplate a world in which the risks remain— and the backstops come with strings.

The first rule of investing is that if it looks too good to be true, it probably is.

Having posted the best quarterly performance in two decades at the height of a global lockdown, the S&P 500 seems increasingly in the thrall of what might be called the "pandemic put." Either COVID curves flatten and economic activity returns (see China and much of Europe), or extended infections (see Florida, Texas, etc.) will simply unleash more government support (see Jay Powell and Nancy Pelosi). With a vaccine arriving at some point, financial markets might just emerge unscathed even if large swaths of the economy remain badly damaged.

The logic is that good news is good news and bad news is good news. Given the amount of liquidity on the sidelines, especially in money market mutual funds, the story could persist for a while. The closer we get to more normal levels of activity, however, bad news will once again be bad news. We may not be headed for a sharp correction, but markets will become much more discriminating in picking winners and losers.

U.S. MONEY MARKET MUTUAL FUND ASSETS



Source: ICI. Bloomberg. As of July 9, 2020.

What is increasingly clear is that there isn't a choice between more COVID-19 outbreaks and more economic reopening. We seem headed for a world that will deliver both in uncertain and uneven doses. Even after the appearance of a vaccine, it will be months or years before enough people have access to it so the risks disappear.

Meanwhile, as more ordinary activity continues to rise, so do the odds that extraordinary government support will begin to fall. Without a whiff of inflation anywhere, central banks may not be tightening soon, but they may feel more constrained in their market purchases. On the fiscal side, the deficit hawks look like a vanishing breed, but further government spending will face limits and come with strings. The next emergency package that Congress considers this month may get a boost from recent reports of the latest COVID surges, but the relief will only get smaller from here.

More importantly, the economic news from the pre-COVID world has already begun to creep back in. You will recall that it wasn't very good even then.

- U.S.-China trade, which was basking in the uncertain hopes around a "Phase One" deal, now faces fresh risks as Chinese orders for American goods are behind schedule. With new disputes about human rights and technology, it's hardly surprising that China's foreign minister just declared the relationship at a historic low point.

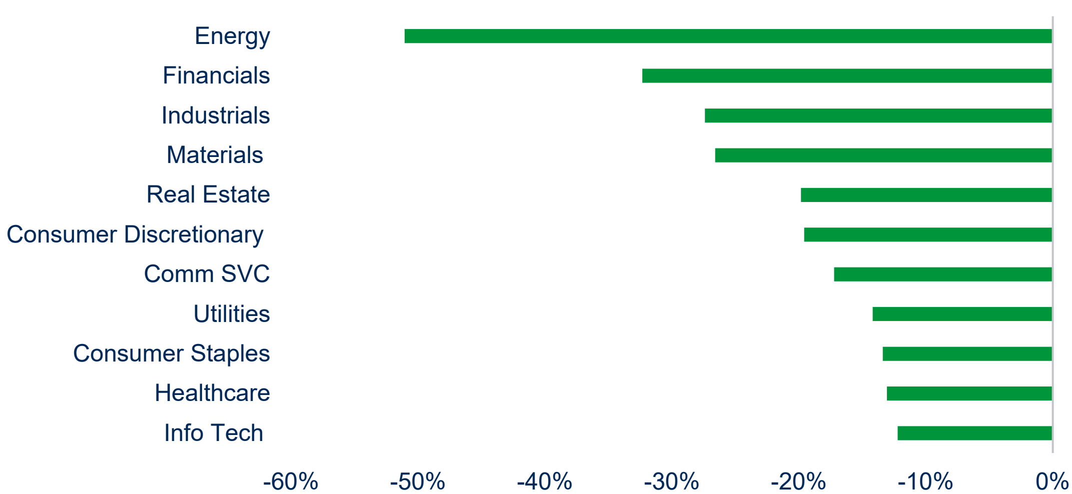
- Trade tensions with Europe are back as a tentative agreement among developed countries on fairer and more predictable taxation of multinational firms has come unraveled, possibly triggering European tariffs on U.S. digital giants and retaliation from Washington.

- Japan, which had pinned some of its recovery on successful Olympic Games this year, now looks trapped once again by unfavorable demographics, vast public debt and ineffective monetary policy. Much slower global growth won't help, either.

Then there are continuing worries around Argentina's default, OPEC's unity, Israel's annexation, Russia's sanctions, Turkey's impetuousness and America's elections.

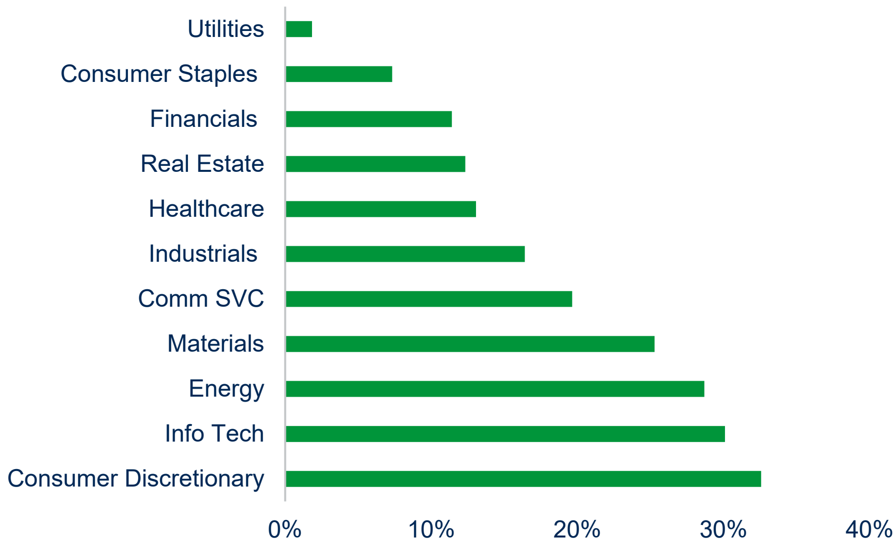
After stocks collapsed together on the lockdown and boomed together on the government response, investors have already begun to be much more careful in their choices. Over the last month, both technology and copper have prospered while hotels and oil have lagged. Look for even more differentiation ahead as the post-COVID world comes into view.

SPX INDEX 1Q20 BEST AND WORST PERFORMING SECTORS



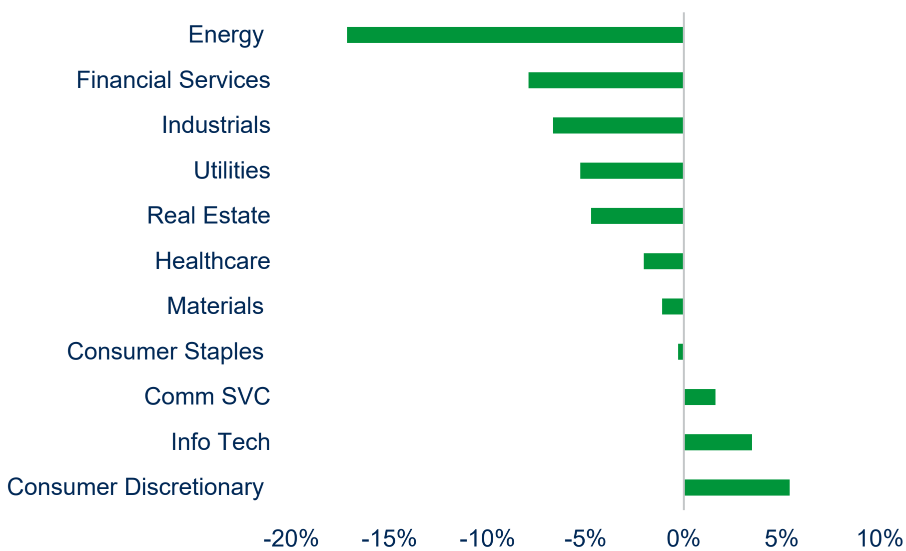
Source: Bloomberg. As of July 9, 2020.

SPX INDEX 2Q20 BEST AND WORST PERFORMING SECTORS



Source: Bloomberg. As of July 9, 2020.

SPX INDEX LAST MONTH BEST AND WORST PERFORMING SECTORS



Source: Bloomberg. As of July 9, 2020.

This doesn't necessarily portend a big market sell-off. Valuations are steep, at roughly 22 times for the S&P 500, but bond yields have been testing historic lows. With a lot more money chasing much lower returns, most investors don't have many choices.

Meanwhile, the macroeconomic data continues to recover with jobs returning, shops filling and purchasing manager surveys brightening. It will be a long way back to January's levels, but for now markets are focused on the positive trends and the continuing warm embrace of fiscal and monetary accommodation. The assumption remains that even fresh COVID outbreaks will mean only isolated lockdowns or delays in reopening.

The warning, therefore, is not that the end is nigh, but that some risks are mounting. Governments won't tighten, but they won't get any looser. This year's earnings won't matter, but next year's will. Investors can't count on momentum alone to avoid the forces of gravity that will drag some investments back to earth. The "pandemic put" won't last forever.

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*As of March 31, 2020

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