ALTMAN INVESTMENT MANAGEMENT

BRIEF REFLECTIONS

JUNE 15TH, 2020

Market Update:

Mixed Signals: A Robust May Employment Report Versus Market Turmoil

The much-stronger-than-expected May U.S. employment report implied a faster reactivation of the economy than many had foreseen. The report was unexpected, given that most states had reopened only partially by the week ending May 12th, when the employment data was collected. Employment is generally a lagging indicator during recoveries, as employers wait for a definitive, sustained rebound in aggregate demand before expanding jobs. However, normal cyclical lead-lag relationships have generally broken down during this year's crisis according to many economists. After a policy-induced collapse in aggregate demand, and a simultaneous temporary removal of supply capacity from the economy in March and April, the pickup in hiring in May suggested that many firms either already sensed a bounce-back in demand, or foresaw a bounce-back in the near future as distancing restraints become further relaxed.

Given the magnitude of the upside surprise in job creation in May, many analysts raised concerns last week about errors in the employment data which roiled markets. Some have also noted that the gain in jobs could largely reflect firms "artificially" rehiring workers to meet the requirements of the Paycheck Protection Program, or PPP, (a lending program under which small businesses can eventually get loan forgiveness provided that they maintain their payroll). It should be noted that the sectors that created the most jobs in May were also the sectors that saw larger shares of firms reporting increased revenues at the end of May, according to the Census Bureau's Small Business Pulse Survey. In general, a firm is unlikely to have applied for a PPP loan unless it saw the funding as a temporary bridge to a still-viable business in the near future.

To what extent firms' expectations for a relatively rapid demand recovery will be justified over the coming months remains to be seen. It is likely that June payrolls will show a bigger bounce-back, reflecting a wider re-opening of most states. However, to maintain a decent pace of subsequent job gains, a sustained, strong aggregate demand recovery is needed.

For now, short-term demand indicators (i.e. payroll) are showing an upturn from historically depressed levels. Additionally, the public's motivation for social distancing, and the willingness of policymakers to enact mandatory shutdowns again in the future have decreased in our view. Both these factors portend demand to normalize at a faster rate over the coming months than seemed possible at the peak of the COVID-19 crisis in April. The bottom-line is that the employment report supports the possibility that as the remaining COVID-19 restrictions are lifted, both the demand and the supply sides of the economy may regain some lost momentum at a fairly rapid rate over the coming months. One should keep in mind that while the monthly gain of 2.5 million jobs in May was large, it amounts to just about 11% of the 22.1 million nonfarm payrolls lost since March. It would take job gains averaging at the May pace for the next nine months, to return to pre-crisis employment by early next year. This prospect still seems unlikely, even assuming that a second surge in COVID-19 infections doesn't occur. More complete labor market progress is more likely in the second half of 2021.

Consequently, a further extension of expanded unemployment insurance benefits is necessary in our view, once the current federal supplement of U.S. $600 per week stops at the end of July. Additional federal government aid to state and local governments will also most likely be necessary. Note that state and local government employment continued to worsen, with 571,000 jobs lost in May. This state and local sector, which accounts for about 13% of U.S. payrolls, is highly likely to generate future job cuts due to the fiscal cutbacks that will be necessary as a result of COVID-19's hit to revenues to-date. Meanwhile, note that the better-than-expected initial gains in the recent labor market data releases might have somewhat increased the risk of Congress being lulled into complacency, and of the still-warranted additional fiscal stimulus being curtailed or delayed.

Policy and Implications for Equity Prospects:

Despite these realities, policymakers have decided to reopen their economies, as the damage from lockdowns risked becoming permanent, and the fiscal costs have been spiraling upward. It is not quite full-speed ahead, but most of the major economies are restarting at varying speeds. Moreover, and critical to investor sentiment, the bar for renewed lockdowns now appears higher, as the authorities seem willing to tolerate rising infections. The financial markets have celebrated the restart and the initial signs of better economic activity, to the point where some sectors and sentiment measures suggested some speculative froth has returned – quite a reversal from the deep gloom in March. The danger is that some equity markets/sectors, undoubtedly fueled by massively accommodative monetary and fiscal policies, are discounting unrealistic earnings expectations. This is given what will very likely be a challenging economic backdrop in the coming year.

Consequently, we have been cautious on chasing equity prices in recent weeks with the anticipation that an uncertain period would develop - and indeed it appears that our expectation came through this past week. Many countries have indeed flattened their COVID-19 curve and it was time to restart economic activity. However, some countries/regions had not yet succeeded in terms of reducing new infections to near zero.

Political and economic demands have taken priority over health concerns. Setbacks in the fight against COVID-19 risk slowing what is likely to be a gradual and choppy restarting in any case. However, as with some policymakers, investors are still willing to take a calculated risk that economic activity will improve regardless of what occurs on the COVID-19 front. Their belief is that widespread lockdowns will not return, with economic activity resuming to pre-pandemic levels.

One of our main concerns, as outlined in previous commentaries, is that corporate profits will be unable to match the market optimism, putting risk assets at danger of short-term market corrections. Aggregate equity valuations, in particular, are vulnerable because an orderly return to the pre-COVID-19 world for corporate profits is still not clear.

We stress that we are not negative on economic prospects, but expect a tougher road ahead than what appeared to be the consensus a week ago – or at least until the stumble in stocks occurred in recent days. We do expect the global economy should slowly improve, but at a moderate pace after the initial reopening bounce occurs. We would expect the business sector will be cautious taking risk, until there is clarity on the underlying trend in demand growth. It is unknown how demand will be impacted going forward due to the unprecedented pandemic and health care countermeasures this year, and whether economic headwinds will return depending on the trajectory of future infections and policy responses. Successful treatments and/or a vaccine are still needed to provide such clarity.

Our Global View:

We think that the U.S. Dollar could be at risk, as overseas markets catch up and finally match the U.S. economy's pace after years of lagging. Global trade in particular has been weak for some time. Although the global economy is starting to recover, it also faces a tough road ahead based on the trend in the early-reopening countries. Some equity markets, especially that of the U.S. in retrospect, may have become stretched on a short-term basis, after hitting deeply oversold levels in late-March. A correction phase or at least a period of heightened volatility or churning is to be expected.

It appears that global credit markets are less at risk, since monetary policy directly targets these assets. A profound change in political attitudes, especially on the international stage, appears to be underway - one that predates the COVID-19 pandemic, but which seems to be moving more quickly as a consequence of the crisis. The risk premium in global markets ex U.S. assets have the potential to ease, if the risk of a breakup in the euro truly recedes.

It has been encouraging that the euro area monetary policy response has been so much quicker and aggressive than following the Great Recession. Today it includes sizable fiscal stimulus rather than the counter-productive austerity medicine that was delivered during and after the euro area debt crisis in 2011-2012, when periphery countries were in dire straits. The ECB has come a long way from the days when it raised its policy rate in both 2008 and 2011 because of a spike in oil prices - at a time when the region was mired in a recession. However, we doubt that the euro area will outpace the U.S. or global economies, nor is the level of interest rates appealing to foreigners. Though, the growth and interest rate gaps should narrow over time with the improved perception about unity towards the euro - and the political backdrop could encourage investor interest by those that are underweight regional assets.

A Note on Credit Conditions:

Encouragingly, credit conditions are seen as quite supportive, in contrast with past recessions, and thus a big win for the Fed: credit channels are staying open. The economic outlook would be much worse if such channels were closed. The key concern from the Bureau of Economic Analysis (BEA) was that sales expectations are still as grim as at the depths of the 2008 Great Recession, and much worse than most prior recessions. This suggests that the small business sector will be very wary of taking risk (expanding or opening new operations) - warning that the path ahead will be difficult and likely less robust than past recoveries, beyond the initial reopening bounce.

Equity investors should take note, since a sluggish small business sector would weigh on overall growth. This last point about the path ahead is why we have not chased equity markets in the past month. The world is, and will be, less positive than in January 2020, with a corporate profit outlook that is both less positive and considerably more uncertain. The counterargument is that monetary and fiscal policies are much more accommodative than in January. However, keep in mind that these conditions only came about because the economy came to a screeching halt, and therefore fiscal policy will become progressively less accommodative as economic activity improves. It is extremely difficult to argue that the global economic and corporate profit outlook is better today than in January, even if a vaccine is soon discovered.

An increasingly important, but hard to measure, economic risk in recent years has been the trend towards less international cooperation on trade. Isolationism and protectionism appeared to be headed for a period of calm in January, as the U.S. and China signed Phase 1 of the trade negotiations. Since then, the economic wheels have come off, and President Trump is again threatening trade actions. Trade and geopolitical issues look to feature as a major part of the U.S. election campaign heading into November, and the danger is that additional anti-trade (lose-lose) steps are taken given the challenging domestic economic and political landscape. More recently, there doesn't appear to be a direct correlation between the S&P 500 and Trump's approval ratings - even a rising equity market and growing economic confidence may not be enough to get him re-elected. The danger is that the geopolitical backdrop, and not just between the U.S. and China, could reheat in a bearish direction.

In summary:

Equity markets had been celebrating prematurely, given the probable outcome for economic activity and corporate profits over 2020-2021. At present, the outlook is much better than it was in March, but not as positive as it was at the start of this year. This economic uncertainty in the 20-21 forecast is the main risk in the near term for most markets, and has already resurfaced in the recent sell off last week. A strategy of slow and steady will win the day. We strongly believe that during this uncertain transitional phase, patience is warranted as we await further clarity on the trajectory of corporate earnings. We prefer to remain cautiously optimistic, until broader economic data supports an underlying trend in economic recovery.

In terms of fixed income participation, in the short-term bonds will most likely have less risk than equities, given monetary policy. However, the low yields have already reflected this phenomenon and the total return upside is now only modest.

In the final analysis: global economic activity will remain below pre-COVID-19 levels for some time - and the growth rate (after the initial rebound) will be somewhat lower than was expected prior to the pandemic. Recent equity market optimism still remains at odds with the corporate profit outlook; stocks face a bumpy period in the short term before renewed gains develop. While a vaccine would be tremendously positive news, one should also keep a close eye on geopolitical developments, particularly with regards to protectionism.

ALTMAN INVESTMENT MANAGEMENT, LLC
33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com