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The State of the Economy and Coronavirus

Given the volatility in the financial markets beginning the week of February 20, 2020, it’s helpful to review the state of the U.S. economy entering into this stressful period, what’s happened since, and some of the potential economic impacts. Here is our take on those topics.

1. At the beginning of 2020, the U.S. economy was in very strong shape, with unemployment falling and the labor force participation rate and wages rising.

2. Compared to 2008-09, this is not a financial crisis but rather a health crisis, which tends to be much shorter in duration (typically several months) and which should lessen in magnitude as the Northern Hemisphere approaches spring and summer. Banks are in the strongest capital positions ever, and strong banks with the ability to lend are obviously important to the sustainability and health of the economy. Further, the ratio of consumer debt to gross domestic product (GDP) is about 75%, its lowest since 2002, down from almost 100% in 2008.

3. Lower interest rates will help governments, consumers and corporations refinance debt, leading to lower debt burdens within those sectors of the economy. However, lower interest rates, along with lower stock prices, will put further stress on state and local pension plans, many of which are already severely underfunded. In order to minimize risk, we have been avoiding buying bonds from a significant number of these states. A sustained period of low rates will also impact savers, increasing the need for other parts of the portfolio to generate the returns needed to fund retirement and other goals. We also expect that we will see yields on short-term fixed income, such as money market funds, drop substantially as well, increasing the “cost” of cash.

4. While bad for energy companies, their stockholders and potentially their bondholders, collapsing energy prices are effectively a big “tax cut” for consumers. Also, companies that are heavy energy users (e.g., airlines) will benefit, to some degree offsetting the losses associated with lower energy prices in other sectors of the economy. However, there is significant risk to the high-yield corporate bond market, as there is $85 billion of high-yield debt issued by energy companies, and with oil prices below $40 a barrel, many of these companies will struggle to generate profits. Much of that debt matures in the next four years. In this type of environment, one can expect the high-yield corporate bond market to be highly correlated with the stock market, which is one of the reasons we generally do not recommend high-yield bonds as part of client fixed-income portfolios. High-yield bonds do not provide effective diversification within a portfolio that already owns stocks.

5. The U.S. has the lowest percentage of trade relative to GDP, at about 12% (country trade-to-GDP ratios). In comparison, most of Europe varies from around 50% (Germany) to the high 80s (Belgium, Netherlands). Japan is about 16% and the UK is about 30%. So, if there is a prolonged deterioration in trade, the U.S. should be less impacted than most countries.

6. If the economic disruption associated with the coronavirus worsens, governments are likely to take action to address issues, such as coming out with loan programs to bail out specific industries (as the government did during the 2008-09 crisis for General Motors and the banking industry) and enact fiscal stimulus (tax cuts or other programs to more directly help those financially impacted by the coronavirus). Given possibilities like this, one must also keep in mind that markets are forward-looking, recovering well before the economy does, just as they tend to fall before the economy is materially disrupted.

7. Markets generally do a good job of incorporating both good and bad news and anticipating potential impacts on the economy. When we see markets change, it is almost always because of new information that couldn't have been reliably forecast in advance. However, markets can also fall for noneconomic reasons due to a cascade of sellers who reach their get-me-out point, have margin calls, or are covering short put options positions; or market participants who are trading with the trend. These market participants can sometimes exacerbate downward trends in markets, but we still believe it's best not to try to predict these occurrences but rather to be aware they are possible. Further, if you sell, you have no way of knowing when to get back in or when trends like the above could reverse.

8. While stocks and risky fixed-income assets or pseudo fixed-income strategies, such as dividend paying stocks, REITs (real estate investment trusts), etc., are falling in value, safe bonds are rising in value, demonstrating their value as dampeners of portfolio volatility, which is why we include them in portfolios. Some "true" alternative strategies, such as marketplace lending, reinsurance and trend-following, have held up very well and have generally generated positive returns on a year-to-date basis.

Finally, remember that bear markets are periods when stocks are transferred from weak to strong hands, as does wealth when recoveries occur. We have recovered from every past crisis, which we tend to experience with great frequency, about every two or three years. Further, we recovered quickly in the past from the health crises of SARS, MERS and Ebola.