



WEEKLY MARKET UPDATE

May 11, 2020



A Case for Reopening: Two Guest Commentaries

First, a belated Mother's Day to all of you moms out there. We hope your day was special, even if it was kept distant from those that call you mom. I (Andrew) know that the isolation hit home when my 3-yr old sweetly moaned, "I miss Gaga...we all miss Gaga", referring to his maternal grandma whose presence we've enjoyed only via FaceTime for nearly two months now. Relational connections are being challenged. Public health considerations are being challenged. Economic well-being is being challenged. The decisions faced by policymakers are daunting.

As we look at the tough decisions that these policymakers are forced to make right now, we have to consider the health, relational, and economic dimensions of this crisis. Today's guest commentaries - one a video and one written (each from two different sources) take a close look at the economic justification for re-opening, and the video particularly looks at the second order public health damage that could ensue from a prolonged shutdown. We don't purport to have all the answers here, and simply want to present some well-considered ideas that we think you might find interesting.

Without further ado, we present a commentary from Francis Scotland, Director of Global Macro Research at Brandywine

Global. Before we get to that, however, we'll first share a link to a video from Finny Kuruvilla, M.D., PhD, the Founder and Chief Investment Officer at Eventide Asset Management. With an M.D. from Harvard Medical School, a PhD in Chemistry and Chemical Biology from Harvard, a Master's degree in Electrical Engineering and Computer Science from MIT, and a bachelor's from Caltech in Chemistry - you can say he is both significantly smarter than me and imminently qualified to talk on the intersection of health and economic matters. This segment from a recent presentation highlights what he sees as perhaps the most important learning to come out of the past two months, and its implications. We hope you find these two perspectives informative:

WATCH VIDEO NOW
(12 minutes)

DEPRESSION, RECOVERY, AND THE RISK OF TIME

Francis Scotland, Brandywine Global

Policymakers are beginning to worry about a depression. In a recent CNBC interview, St. Louis Federal Reserve President James Bullard put it bluntly: "The shutdown can't go on forever because if it does...you risk

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getting into a financial crisis or even a depression...and if you get into that I think even health outcomes would be way worse.” Bullard’s comment is a refreshingly balanced viewpoint from a credible official at a time when concern about overextending the lockdowns is condemned by some for selling out the public’s health to Wall Street. There are no easy decisions for policymakers and politicians, particularly with public opinion so polarized on the policy choices.

Bullard’s comment clarifies that the biggest economic risk is time. The economy will not breathe again before the lockdowns are phased out. What mattered most during the Great Depression and does again today is the duration of the contraction in incomes and spending. The hit to current economic activity has been so fast and deep that the longer it stays below normal, the greater the potential for irreversible deflationary feedback effects. Personally, I agree with Bullard and think that a calculated unwind of the lockdowns is the right thing to do.

From 1929 to 1933 the unemployment rate surged to 25% while real gross domestic product (GDP) fell 26%, based on annual data, or roughly 10% on average a year. The Congressional Budget Office expects real GDP to drop by as much as 10% in the current quarter alone. Bullard’s staff projected in March that the pandemic’s unemployment rate might rise above levels of the 1930s. At 14.7%, the April unemployment report suggests we have a way to go before reaching Great Depression levels. But the data are biased by the sharp drop in the participation rate and by government programs aimed at encouraging businesses to sustain employment. To date, 20% of the labor force has filed for unemployment insurance claims.

What many omit in their comparisons of current events with the 1930s is the behavior of prices. Deflation was systemic in the

1930s; most assume that will not be the case currently. That is also what most thought about real estate in 2007 just before the biggest bust in 80 years.

- In the early years of the Great Depression, the GDP deflator fell roughly 20%, contributing nearly half of the 45% contraction in nominal GDP that took place. There are plenty of theories about why this drop in price levels happened, but macro policy did not help. The dollar was handcuffed to the gold standard, and Treasury Secretary Andrew Mellon famously advised President Hoover to allow the liquidation to run.
- The deflation stopped in 1933-1934 after FDR revalued the dollar against the gold standard, the 1930s version of quantitative easing. By then, it was too late. A massive hole in nominal incomes and spending had been created relative to the economy’s nominal potential.
- The level of real GDP rebounded briskly at a 10% annualized growth pace and returned to 1929 levels by 1936. But nominal GDP took seven years, close to a 9% annualized growth rate, and the start of a war before it returned to 1929 levels. It took even longer, until the end of the war, for both the GDP price deflator and the unemployment rate to fully renormalize.

The destruction of wealth and the toll on human suffering from the Great Depression is well documented. What is not as widely discussed or agreed upon is the lingering influence of falling price levels. Deflation inflicts irreversible economic damage by depressing nominal incomes and spending, which in turn triggers systemic liquidation. Sustained illiquidity turns into insolvency: unemployment surges, wages retreat, and nominal spending stays below its high-water mark for years.

There was a whiff of liquidation during March. But Treasury Secretary Mnuchin is no

Mellon and President Trump is no Hoover. The Federal Reserve fully comprehends the policy blunders of the Great Depression and has intervened aggressively, so far. Policymakers in many countries around the world have adopted similar measures.

For the time being, the macro policy measures have been enough to fend off the signs of systemic deflation—barely. Breakeven inflation rates are off their bottoms but below levels that prevailed before investment sentiment cratered in February. The dollar has retreated from its March surge but is still firm. Corporate bond spreads have retreated to levels more normally associated with recession. U.S. stocks have rallied but on narrow breadth. The macro policy measures have been epic, but defensive.

Bullard's comments coincide with the beginning of a more general shift in policy sentiment toward reopening. The catalyst for the shift is the wreckage unfolding in the economy. Traditional but lagging data reports are catching up to the economic disaster. Get ready. The free fall in employment offers a glimpse of what is coming: a gusher of bankruptcies and potentially permanent job losses. These data are no surprise but still shocking, which explains why various states are relaxing restrictions before an official apex in the pace of infection.

There is an alphabet soup discussion taking place on what the profile of the economic recovery will look like. A simple chart of post-war, year-on-year growth in nominal or real GDP shows that all periods of economic contractions have been followed by equally sharp rebounds—once the recovery begins. The pace of the current contraction is about four times the average of any recession since WWII. There is plenty of potential for a major economic rebound. The key is to reverse the factors causing the contraction.

What will determine the beginning of the

coming recovery is timing the end of the lockdowns and gauging when people feel safe. That is partly a bet on winning the war against this disease, which seems inevitable. The entire world is in this fight and the firepower is incredible. It is only a question of time. But time is the crucial factor that the economy does not have. Waiting for a vaccine therapy with all its attendant uncertainties is not a practical course of action, at least for the next year or so.

How does it all play out?

Abraham Lincoln reportedly once said “I am an optimist because I don't see the point in being anything else.” That is probably my perspective at the moment as well. The depression tail risk grows bigger the longer the economy is kept in its public health-induced coma. Policymakers seem to be realizing this trade-off quickly. What is the point of erring on the side of too long a lockdown if the risks attached to that strategy are the same or worse than a pivot back to reopening? Time is of the essence. The restrictions need to end in days and weeks, not months, for the chance of a meaningful rebound in the second half of this year.

I think there is a good case for a faster-than-expected recovery in the latter half of the year—if the lockdowns phase out rapidly in coming days and weeks and even if scientists do not immediately find a silver bullet for the disease. That may seem like woolly-headed optimism given the high risk of a resurgence in the disease, which seems the norm for pandemics.

But cabin fever is beginning to overwhelm virus fear. People want out. They want to reconnect with family and friends. Fear is starting to shift to a more practical focus on figuring out how to live with this disease and minimize the personal risks of infection as we strive for a return to some semblance of normalcy. I do not know what the specific solutions will be but a sustainable policy for

managing co-existence with this disease probably includes widespread testing and monitoring, follow-up tracing, technology, better data and understanding. Disciplined hygiene is a given. It is always easier to see the challenges and risks while underestimating ingenuity and positive possibilities. I suspect that will be the case this time, too.

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