Dynamics of a Changed Economy

The first quarter has delivered investors quite a roller-coaster ride following years of steady and blissfully boring gains. After reaching an all-time high on February 19th, the S&P 500 recorded its fastest plunge ever into bear market territory – a drop of 20% or more – on its way to an eventual 34% decline. After the market bottomed on March 23rd, the market reversed course on investor hopes of passing of the CARES act (Coronavirus Aid, Relief, and Economic Security Act), and the Dow Jones Industrial Average recorded its best week since 1938, up 12.8%. Before the market again dropped on Friday the 27th, the Dow had briefly entered back into bull market territory, at least using the bull market definition of a rise of 20% off its low.

The catalyst for the rebound, the two trillion-dollar economic rescue package, is the largest economic-relief package enacted in history. The emergency legislation seeks to make the greatest impact possible through targeting the seven areas – individuals, small businesses, big corporations, hospitals and public health, federal safety net, state and local governments, and education. Its enactment, even with all the inherent flaws of legislation crafted exceedingly quickly, calmed investors enough to reverse the market freefall, at least temporarily.

Yet no government program can compensate for the damage inflicted by a forced economic shutdown. For the week ending March 21, 3.28 million workers applied for unemployment benefits, nearly five times the previous record high,

Daniel Wildermuth
CEO, Wildermuth Asset Management

> *"The current plan is to pause the economy, save lives, and then simply release the economy again, and hope it returns to its former strength."*

and the numbers were likely higher because many state systems were overloaded. In Pennsylvania, 5.8% of the total labor force applied for assistance, and the increase in claims was 17 times higher than the previous record one-week jump. In Rhode Island, 6.4% or nearly 1 in 15 workers sought benefits, the highest percentage of workers in the country. Not surprisingly, U.S. consumer sentiment dropped sharply to near a 3-1/2-year low.

Yet, less than six weeks ago, unemployment stood at 50-year lows, and markets were hitting all-time highs based on numerous positive indicators. The global economy was improving, interest rates were low, job growth remained extremely strong, and the outlooks for most countries, including the U.S., looked promising for 2020. Even concerns surrounding Covid-19 were relatively sanguine. The Federal Reserve noted that supply chains were relatively unaffected, activity was actually a bit better than the month before, and China's slowdown was viewed as relatively minor and hopefully short-lived. Obviously, circumstances have changed as restrictive policies seeking to blunt the spread of the disease have taken affect.

During past pandemics in medieval Europe, some economic activities were abandoned as people tried to escape plagues. Disruptions to social order were often severe, and some societies in ancient times simply disappeared or morphed into very different versions of themselves. In more recent pandemics, such as the Spanish flu of 1918, economic activity continued with limited quarantine measures, and society accepted contagion and death as the price of continuity.

Now, most nations are trying to accomplish both – maintain economic activity in the longer term while avoiding severe health impact. The current plan is to pause the economy, save lives, and then simply release the economy again, and hope it returns to its former strength. If it works, it will be an incredible feat illustrating the tremendous flexibility of advanced capitalism and modern government.

However, the challenges to successfully shutting down and re-

Continued ...

starting something as complicated as the contemporary, globally interconnected economy are enormous. We are in uncharted territory and there is a lot of guesswork. Investor reactions to progress will be unpredictable given the unique nature of the economic interruption.

Looking forward, there are likely a few themes or common developments that will both impact the economy and investor interpretations of developments.

Most obviously, healthcare progress will shape our future. The ability to test, identify anti-body existence, treat, and potentially cure the disease will all affect people's outlook and perception of risk. As the medical community learns more, science will take a larger role in driving discussions which should displace many of the current tactics that are based largely on guesswork and politics given the lack of clear data. As uncertainty declines, better decisions and more productive actions are likely to follow. This should happen fairly quickly – within weeks – as private enterprise is now ramping up to provide research, diagnosis and treatment.

A natural outflow of increased knowledge should be more considered government policy, hopefully resulting in relaxation of current restrictions as more is learned about plausible and effective means to deal with the virus. Depending on progress, changes in personal behavioral should follow including reopening of various business ranging from restaurants to sporting events.

In the meantime, unemployment numbers could skyrocket with some analysts predicting levels last seen during the Great Depression. Similarly, gross domestic product could shrink by as much as 20% in second quarter, which is nearly as much as the 25% contraction suffered during the Great Depression. Earnings season will also be awful with numerous companies reporting horrific losses and terrible near-term projections.

While these could be personally and professional catastrophic, the impact on equity markets is less clear. Investors look at the future, usually focusing on a vague timeframe between 6 and 18 months, making expectations for the duration of the virus's impact particularly critical. If the disruption is seen as mostly temporary, and recovery is expected in the near to mid-term, even disastrous numbers in multiple areas may not cause a severe reaction in markets. In contrast, if little medical progress occurs over the next several weeks and hopes for a near-term recovery fade, we could see investors again head for the exits, driving markets down again.

Still, long-term investors can be confident that the U.S. will eventually overcome this challenge, likely faster than any other sizable country. The ingenuity and capabilities of the U.S. to innovate give us confidence that progress is inevitable and coming soon. This economic challenge is also unique because we have chosen to inflict it on ourselves as a trade-off to hopefully preserve more lives. The unique circumstances suggest that we could recover dramatically faster than during more typical contractions, especially given the strength of the economy before the downturn. However, in the near-term, markets are likely to remain volatile until the level of uncertainty declines significantly.