Signposts for the Eventual Recovery

Blackstone

April 2020

By Joe Zidle, Chief Investment Strategist
With Taylor Becker, Associate

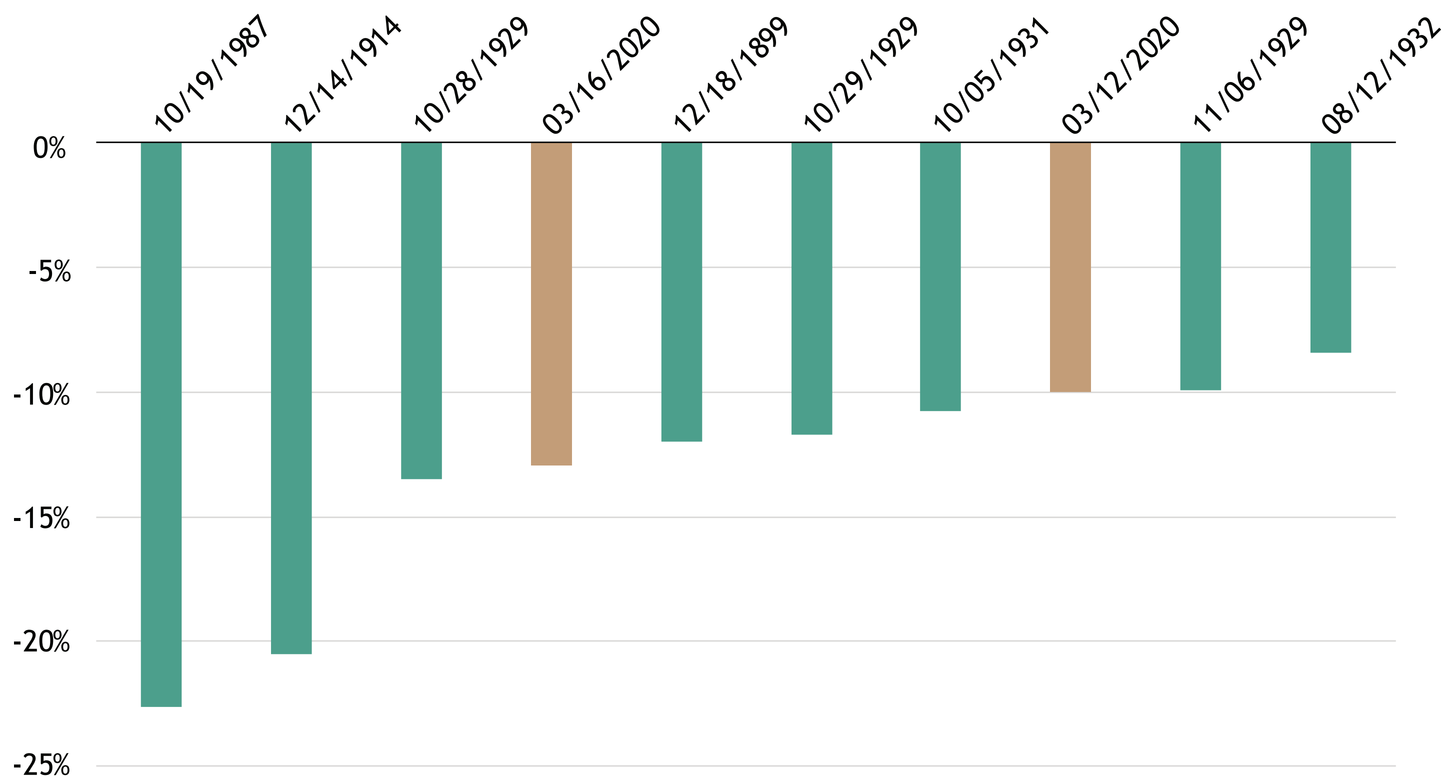
Over the next month, economic data from around the world will begin to reflect the COVID-19 pandemic and the scope of the global economic shutdown that the virus caused. The data will have something for everyone, from the biggest bulls to the loudest bears. Markets have moved drastically to price in much of the damage, with the MSCI ACWI falling 31%, the Bloomberg Commodity Index declining 20% and the Bloomberg Global Agg dropping 8% from recent highs.[1]

Eventually, scientists will produce a breakthrough vaccine, and the frozen global economy will thaw out. But before we're on the path to economic recovery, we need to see a peak in the number of new coronavirus cases, a clear decline trend and specific developments that signal we can heal. The stock market may anticipate these conditions earlier. Our goal here is not to predict when that will happen, or "call the bottom." We will leave that to others. No doubt, someone will guess right; most will guess wrong. What we want to do instead is provide insights that help investors orient themselves amid the information overload.

Information Overload: More Isn't Better

Even the most thoughtful investment strategies can be overwhelmed when risk and uncertainty hit levels as extreme as those reached in recent weeks. In just three trading days, the Dow Jones Industrial Average experienced 2 of the 10 largest daily declines in the index's 124-year history (see Figure 1). The US Treasury market saw the most volatility since the Global Financial Crisis, while the value of global corporate bonds had its largest two-week percentage decline in the history of the data.[2]

Figure 1: Ten Largest DJIA Percentage Declines[1]



Reacting swiftly to such dramatic moves and the ever-changing flow of information that results can feel like, but seldom is, the right thing to do. In this case, history teaches us that global health emergencies—even ones as dire as the new coronavirus—are eventually transitory. That's why it's important to remember that changes to an investment strategy can have relatively long-lasting results. Adherence to proper asset allocation and a disciplined approach to long-term investing, not market timing, are what determine investment success. Amid uncertainty, staying disciplined often means eschewing information.

The importance of decision policy Human instinct is to believe that the more research and data we have, the better we are informed. So we turn to any number of high-frequency data points: foot traffic in malls, air quality readings over big cities, claims at state unemployment offices, Google search trends that may (or may not) have investment significance, etc. But the coronavirus pandemic is an example of how real-time information can whipsaw markets and spawn research that attempts to assign values to data. The counterintuitive truth is that more information does not always lead to better decisions.

Renowned psychologist Dr. Paul Slovic proved this lesson in a most unusual way in 1973. Slovic's area of expertise is decision policy. And in the early 1970s, he led a study into how people integrate quantitative information by means of human judgment. The subject matter was horse betting and the subjects were professional handicappers. Slovic challenged them to predict the winning horse in a series of races. The participants were given a list of approximately 90 data points, which included the weather, track conditions, weight carried in the race, percent of races in which the horse finished 1st, 2nd or 3rd, and the number of previous starts. From this list, the handicappers were asked to pick the top five variables they wanted to use. Then each participant chose which 10, 20 and 40 variables they would use to help handicap the races.

With 10 horses in each race, blind luck would deliver winnings 10% of the time. Using their top five variables, the subjects performed better, being correct 17% of the time; 70% higher than sheer guessing. In successive tests, the bettors could incorporate more information. The researchers measured the bettors' corresponding confidence in their picks and their subsequent accuracy. Surprisingly, their accuracy was as good with five variables as it was with 10, 20 and 40 variables. But their confidence doubled when they incorporated more information.

Confidence vs. Accuracy Slovic illustrated that, beyond a certain point, information does more to increase our confidence than it does our accuracy. His study used horse racing, but Slovic noted in his findings that "the results will generalize to any domain in which the skilled integration of large masses of quantitative information is performed by means of human judgment."[3]

We expect the current market dislocation will produce opportunities in all asset classes. But revisiting Slovic's study was a reminder of why it is so important for investors to remain disciplined. Factoring too many variables, especially untested variables, into investment decisions might boost confidence, but not necessarily outcomes.

There Are Signposts: What We Need to See

The coronavirus is a global health emergency first and foremost. We express our sympathies to all who are affected. This disease is a uniquely serious threat to our health. However, history does provide a roadmap for what needs to occur for everyday life to resume, and for the global economy and markets to function normally again. In our view, volatility will remain elevated across all assets classes until three conditions are satisfied: a solution to the underlying cause, the implementation of effective policies and a return of consumer confidence.

A treatment Slowing the spread of new coronavirus cases will reduce the strain on the healthcare system. However, reinfection rates and a potential second wave will remain a source of uncertainty. Reflecting back on the Global Financial Crisis (GFC), actions taken to reduce the severity of the recession included multiple interest rate cuts, the takeover of Fannie Mae and Freddie Mac, and the Troubled Asset Relief Program (TARP).

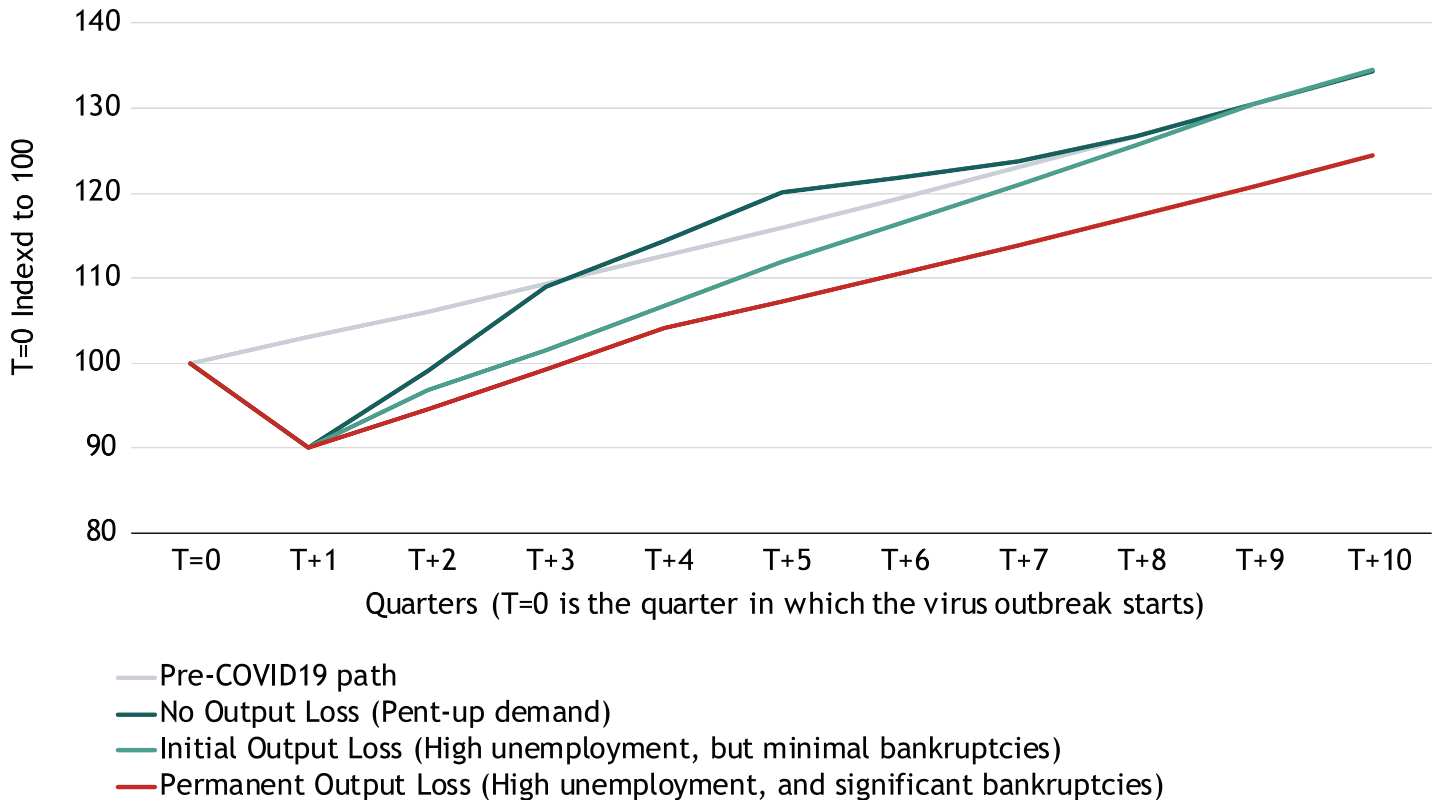
But these measures only addressed symptoms of the GFC. It wasn't until the American Recovery and Reinvestment Act of 2009 that we saw the underlying causes addressed, confidence restored and a bottom found for the economy. Today's problem is a health issue. Fiscal and monetary stimulus will help, but only a vaccine or cure for the coronavirus can lift the uncertainty and put a floor under capital markets.

Policy implementation, not policy announcements The second condition that needs to unfold is the implementation of fiscal policy. At the time of this publication, we've seen three fiscal stimulus bills in the US, as well as pronouncements across Europe and the UK. Central bank activity like bond-buying is immediate. Conversely, there are lags between an announcement of a "protective shield" to be placed around companies (such as the protocol Germany announced on March 13th), the crafting of the policy (currently ongoing) and its implementation. In the US, the government is poised to pass its third stimulus package, with an estimated $2 trillion in fiscal relief.

We don't dispute that this package will have positive impacts. Stimulus payments under two very different types of recessions in 2001 and 2008 boosted consumer spending immediately. Stimulus payments in 2001 resulted in households spending 20%–40% of their rebates on non-durable goods within three months.[4] But we don't underestimate the enormity of distributing checks to approximately 130 million American households.

In addition, the decline in service-related hours and pay means that the country won't immediately bounce back as the economy normalizes. People won't take extra vacations this fall to make up for the vacations they didn't take this spring. As a result, activity will recover more slowly. GDP growth rates will bounce back relatively quickly, but the period of time that it takes for the size of the US economy to exceed Q1'20 levels depends on your assumptions for the depth of the recession and subsequent pace of growth. Based on current consensus expectations for the decline in GDP (approximately 20%) and rebound growth rates, a peak-to-trough recovery to pre-COVID-19 GDP levels could, in conservative scenarios, take several years.

***Figure 2: Various GDP Growth Recovery Paths*[5]**
(Illustrative Only)



The Return of Confidence A subdued virus, once and for all, is the third precondition for the US and global economies to start building back toward trend line growth. Currently, expanded testing, social distancing and home isolation are the only options we have to suppress the spread of the virus. But even after we have seen a peak in the number of cases and authorities relax some of these policies, we will all be on a heightened state of alert. If reinfections occur, we can expect these policies to be quickly reinstated. Any post-crisis peace of mind will be fragile until science finds a vaccine. Until then, we can expect structurally lower activity that restrains earnings and keeps economic growth trajectories below recent levels.

After Coronavirus: Secular Changes

We can trace some of society's greatest productivity gains to the aftermath of our most severe economic upheavals. Such was the case after the Great Depression, World War II and other periods of extreme dislocations. From radar to penicillin, electric razors to car radios, we are exceptionally good at innovating under stress. The novel coronavirus exposed serious weaknesses in the areas of medical preparedness, supply chain dependence and dollar-based funding around the world. These are a few areas, among others, that we believe are set to undergo secular shifts.

Strategic R&D One possible and welcome change would be a reversal in the decline of government-led investments in critically important sectors of the economy. The decrease in spending on healthcare and biotech R&D as a percent of GDP put the US at a noticeable disadvantage to our competitors globally. New programs should be funded to increase preparedness for future disease outbreaks. Policies should also be implemented that encourage companies to return medical supply chains to the US. We may realize that "redundancy" is not always a dirty word in critical parts of our economy.

Better connectivity The trend towards working from home is likely to become more deeply entrenched in our culture as a result of recent shelter-in-place policies. This would serve to increase demand for internet bandwidth and encourage further development of 5G technologies. Internet traffic and wireless networks threaten to swamp our existing networks, with important business implications for companies that rely on the internet to deliver their services. Netflix was recently asked to reduce its transmission volumes in order to allow millions of displaced workers to communicate with one another online. The federal government is escalating its fight with China over 5G; it's not a battle the US can afford to lose.

Modernized consumption The recent boost in e-commerce penetration is likely permanent. Some trends borne out of necessity might be less likely to continue once the necessity fades. But other trends will endure as consumers experiment with new services and realize the benefits. Anecdotally, drugstore chain CVS said its prescription deliveries are up nearly 300% after the company waived fees in March.

Supply chain reset Look for acceleration toward localization and regionalization, and moves away from globalized supply chains. China became the world's factory floor, and that model succeeded in delivering lower prices to US consumers in a world of low tariffs, stable currencies and the promotion of free trade. But the US–China trade dispute started to pressure that model, and the rolling closures of so many economies around the world will compound that pressure. Companies might be forced to choose between efficiency and supply chain security. Their decision could result in higher-paying manufacturing jobs, but at the expense of lower profit margins or higher prices.

Yes, the coronavirus pandemic is a massive stressor on the economy and, of course, our psyche and health. But from it, we expect resilience, strength and new ways forward to emerge.

Stay safe. We'll talk soon.

Endnotes:

1. Bloomberg and Blackstone Investment Strategy, as of 3/22/20.
2. Bloomberg and Blackstone Investment Strategy, as of 3/20/20. Treasury volatility represented by the ICE BofA MOVE Index; global corporate bonds represented by the Bloomberg Barclays Global-Aggregate Market Value Index.
3. Paul Slovic, "Behavioral Problems of Adhering to a Decision Policy," unpublished manuscript, 1973.
4. Johnson, David, S., Jonathan A. Parker, and Nicholas S. Souleles. 2006. "Household Expenditure and the Income Tax Rebates of 2001." American Economic Review, 96 (5): 1589-1610.
5. Blackstone Investment Strategy. GDP paths are illustrative only.

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