Factors that Could Change Our Viewpoint to Bearish

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Since the coronavirus outbreak began, we have consistently viewed the economic impact in the U.S. as a "U-shaped" progression where the economy turns down rather sharply, levels off for some time, and then rebounds as the virus wanes, and social mobility restrictions are relaxed. Over the past few days, we have received numerous questions about what would cause us to change our viewpoint to more of an "L-shaped" recovery with an extended lull in the economy into 2021 and continued market volatility. Essentially, what would turn us bearish?

Here's what we're monitoring closely in order of significance that could alter our perspective:

- **Path of the Virus**

  The "flattening of the curve" in China after six weeks of limited social mobility is encouraging. Conservative estimates, based primarily on electric power generation and consumption, indicate that 60%-70% of the country has returned to work, and production has resumed. As the Chinese resume their daily lives, a resurgence in cases is a distinct possibility. If this occurs, U.S. authorities would likely extend the current social gathering restrictions. Despite the 30% decline from last month's peak, the equity markets most likely haven't priced in longer mobility restrictions that could deepen the economic contraction into the third and fourth quarters.

  With mobility restrictions only recently taking effect and greater testing, the case count is expected to increase markedly over the coming weeks. We are watching for a leveling off of cases by the end of April and would be discouraged if they continue to increase. A lesser but not insignificant concern is understanding who in our government is responsible for determining when it's safe to reduce the restrictions. The medical professionals advising government officials may rely on the "abundance of caution" approach and be hesitant to give the go-ahead. Additionally, the battle between state and federal authorities around shutting down businesses and limiting mobility may resurface again as we emerge from the medical part of the crisis.

- **Sufficiency of the Fiscal Policy Response**

  The markets are pushing policymakers for a more creative and sizeable response. Any undue delay, shrinking of the magnitude, or outright defeat of the fiscal policy proposal in Congress would be a bearish sign. Aid to individuals affected by the business closures should not be subject to partisan politics and passed rather easily. On the other hand, aid to corporations is a highly charged political issue. However, if many businesses, both small and large, are driven into bankruptcy, the economic rebound would be further delayed and less expansive. Reports that the U.S. administration and Congress have increased the Phase 3 fiscal policy program from $1.2 trillion to $2.0 trillion may alleviate some of these concerns for now. Still, the two branches of government will likely need to do more. The outcome depends in part on whether policymakers can put their differences aside and come together for the good of the American people.

- **Liquidity Issues Becoming Solvency Concerns**

  We have discussed the strength of bank balance sheets in 2020 compared to the 2008-2009 recession. However, capital can evaporate quickly in the highly leveraged banking industry. What now appears to be a liquidity problem, which the monetary policymakers are feverishly addressing, can turn into a financial crisis, and ultimately a credit freeze. We are monitoring the three-month LIBOR (the benchmark interest rate that indicates borrowing costs between banks) compared to the fed funds rate to see if banks are restricting lending despite very aggressive Fed easing. The spread widened last week by 0.40% (40 basis points). To provide perspective, the spread rose as high as 4.0% (400 basis points) during the credit freeze of 2008.

The widening of credit spreads (interest rate compared to the same maturity, risk-free Treasury notes) is a usual byproduct of economic duress. It's only when there are no or very few buyers willing to bid for a security that we have real liquidity issues. For example, certain short-term municipal securities have shown an unusual spike in yields. These securities are often utilized by tax-exempt money market fund managers, which has raised concerns that some funds may not be able to maintain the traditional $1.00 per unit. In 2008, a financial services company that didn't have access to a bank credit line valued its money market fund at less than a dollar. This action contributed to the equity bear market during the great financial crisis. While many money funds are managed by banks that can and have backstopped their funds with credit injections, the Federal Reserve has resurrected a crisis-era plan to provide liquidity to money funds that aren't part of a global banking institution.

On Friday, the Chicago Mercantile Exchange was forced to auction off a portfolio of securities for a member firm that could not meet margin requirements due to a loss-making position on the market volatility index. This action may have been a catalyst for that day's market sell-off. While relatively small in scope, this news didn't help the currently fragile market psychology and stoked speculation that other similar, larger, and more distressed firms and investment strategies may be at risk.

Investors should expect weak economic statistics over the next few months. We believe the markets have priced in this weakness to a large extent. We will continue to monitor the factors listed above to determine if both the medical and economic outlook are likely to suffer another leg down.

Please contact a Cerity Partners advisor if you have any questions or wish to discuss this topic further. Additional insights are available at ceritypartners.com.

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