

Coronavirus, the Economic Outlook and Equity Markets
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We wanted today to give a brief update on our latest thoughts around the global economic situation and equity markets in light of the developments over the past week. You'll recall from a week ago that, from an **economic perspective**, we are thinking about the situation through the lens of three different channels. First is the public health policy response. The second is the monetary and liquidity policy response. And the third is the fiscal policy response. And there have been significant developments on all three over the course of this week.

From a public health policy perspective, we have seen increasing shutdowns and requests from various cities and states that workers stay home and an increasing push towards social isolation. While that is obviously disruptive from an economic standpoint, the best available evidence suggests that that's the right approach in terms of slowing the spread of the COVID-19 virus and in terms of preserving public health to the extent possible.

From a monetary and liquidity policy perspective, we have seen the Fed initiate a variety of different programs, each with its own acronym, to support various parts of the financial markets. I've likened it over the past few days to a game of Whack-A-Mole, where every time a problem pops up in financial markets, the Fed responds with a program targeted at that particular area, to make sure that the financial system stays liquid.

From a fiscal policy perspective, the developments have been even more dramatic. The House of Representatives has just completed passage of the stimulus bill with a total size of roughly US\$2 trillion. I find it, and we as an economic team find it, encouraging both that the bill was passed so quickly and that the size was so large. Indeed, the size was larger than was discussed originally. And that's unusual. Typically, stimulus packages, even in the teeth of a crisis, tend to take a little bit longer than this. And more time seems to be spent in Congress debating what to cut out of it rather than what to put into it. So, it is good news from a policy perspective and from a forward-looking economic perspective, that in this case, Congress moved quickly. We anticipate that the president will sign the bill as soon as is practical.

So, where does that leave us from an economic perspective? The truth is that we do feel a little bit better this week than we did last because we have seen developments on all three fronts that point in, what we think is, the right direction. But despite that, it's still far too early to declare victory. It's far too early for us to talk with real clarity about what we expect to happen over the course of the next six months. And while developments on the policy front have been positive, we've started to receive incoming data that can help us dimension the depths of just how bad this crisis is going to be.

Most specifically, we received on Thursday morning data on the number of workers filing initial claims for unemployment insurance. And from a number that has been in the low 200,000 range, over the course of one week it jumped by more than 3 million workers, to 3.3 million workers filing for unemployment claims. And that means that more than 3 million workers lost their jobs over the course of one week. We think there's more to come on that front. Remember that not all states have shut down on the same time horizons. There have also been reports that many of the systems for processing those claims were not fully operational. So, we anticipate seeing more damage there.

We also saw consumer confidence plummet in data released this week. That isn't unexpected, obviously, but it's just the tip of the iceberg in terms of what we expect to see in terms of the economic damage. We will have the ability as we get more data over the next few weeks to have a more tangible sense of what it means. But even in the here and now, we can state with confidence that the hit to the economy is going to be massive.

Our basic paradigm is that we're going to see a sharp period of economic contraction. As long, however, as the public health policy response proceeds in a reasonable way, we do think that there is a possibility that the economy could restart, to one degree or another, by the second half of the year. As long as that happens, we think that the economy will be able in time to regain the previous rate of growth. Which is to say that if the economy was growing at around 2 percent per year, we anticipate that it will once again grow at around 2 percent per year. But we think that the level of the economy will be lower than it otherwise would have been.

What that means is that there will be some permanent loss of activity. And it's a similar pattern to what we saw during the financial crisis, where, over time the economy, helped by monetary and fiscal policy, resumed the previous growth trajectory, just at a lower level. So, I know it's popular in the media to talk about what shape this recovery looks like. Whether it's a U or an L or a V. And the truth is, I don't think there is a letter that particularly represents it. Because while it might look like a V in the early stages, we don't expect the second side of the V, if you will, to get back to the top. So, it's sort of a truncated V-shaped recovery where we end up with an economy that is operating at a normal rate of growth, but on a lower trajectory.

So, what are we looking for over the course of the next few weeks? As mentioned a moment ago, we are going to see data that can help us make a more tangible assessment of how deep the economic damage is going to be in the near term. We're looking for continued progress on the policy front, certainly from a public health perspective. We, like everyone else, are watching the incoming evidence on the progress of the virus and the progress that we are making in containing it, as a country and from a global perspective. And we expect that the Fed will continue to provide liquidity as necessary. And I would point out that the stimulus bill passed in Congress provides the Fed with the ability, if they use leverage, to provide as much as several trillion dollars of additional liquidity support to financial markets. We expect them to use that.

From a fiscal policy perspective, we don't have a strong opinion on whether the two trillion-dollar stimulus bill is or isn't enough until we know the extent of the damage and until we know how long this period of socialized isolation lasts, it's impossible to say whether that is enough or not enough. So, what's important to us, isn't so much the size of the bill, it's that policymakers continue to be flexible. And we do take some comfort from the fact that several important members of Congress have indicated that if more proves to be necessary, they will be willing to do more. And right now, I think that that willingness and that flexibility is more important than the mechanics or the details of this particular stimulus bill.

This is an unprecedented situation and it requires everybody, but most especially policymakers, to be flexible in responding to it. And that, more than anything else, is what we're looking to see. And as I said, over the course of the last week, we've been heartened by the flexibility shown by the Fed, by the sense of urgency and the flexibility

shown in Congress. And we need to see that continue until we get more information about what's going on from a public health perspective.

Equity markets were obviously up this week, on hope based on many of the things that we're observing on the public health and the policy front. But I would be careful not to overestimate this as we're likely to continue to see a back and forth as markets continue to digest the situation.

We have seen a shift, though, in the behavior in the market. In the early stages of the crisis, we really only saw stocks with low beta and low financial leverage being able to hold up. That has started to spread out a little bit. And we're seeing increasingly attention paid to companies with more profitability and more growth, especially in the US. And so this is yielding a little bit more dispersion in the types of performance we're seeing across different types of sectors.

There have been some surprises, frankly, in how this has developed over the last three or four weeks. Typically, defensive sectors like utilities, food, beverage and tobacco, real estate, have actually performed much worse than you would expect in these types of sell offs. And what's done well, surprisingly, has been tech, both hardware and semis, software, all performing better than you might expect.

And some other areas have been surprisingly bad, such as commercial and professional services—businesses which typically have less economic sensitivity but are being hurt by the reduction in human interaction that we're seeing in response to the virus. So as a result of this, the focus on, you know, balance sheets and the like, has helped tech because they've got good cash flow and low asset intensity, and that has favored growth styles over other styles of investing during this period.

So you're seeing growth in defensive strategies, with core strategies more in the middle. And value, which has the biggest footprint in energy and financials, obviously struggles the worst in this environment. So it's not really surprising at the aggregate level, but within some of the sectors, it's perhaps playing out a little differently because the cause of the crisis is so different from prior ones, as is the response with social distancing and changes in employment patterns, and so on.

Turning to a little bit of hope on this front, we had a great conversation with our portfolio managers this week, including John Lin, who runs our Chinese services. And we're seeing over there, signs of resumption of economic activity in greater China. You're seeing it in terms of activity industrially. You're seeing it in terms of credit conditions, where they don't face nearly the credit crunch we've had here in the United States; and companies are able to refinance. You're seeing it in consumer activity as well.

So it does give you some hope that, you know, months into this process, you can see a resumption of economic activity. And as a result, the Chinese A-share market is down by only about 10 percent this year, which might be surprising given that's where this whole thing really got started. So, our portfolio managers as a whole continue to focus on balance sheet strength and the ability to weather this storm. But increasingly, we're starting to look at what are the longer-term impacts on businesses and trying to be opportunistic to see those that maybe are mispriced and, and where we think we'll, we'll see economic activity recover. No matter how long it takes, these businesses will survive.

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