DBR & CO Market Commentary

2Q 2020

Narrowing the Range

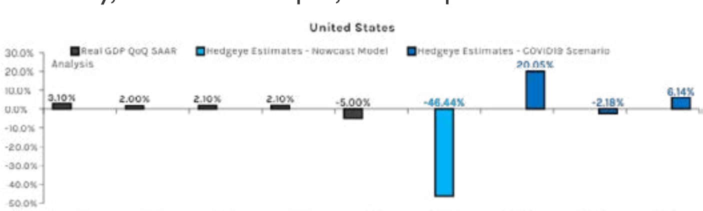
"If ever I should wish for a retreat whither I might steal from the world and its distractions, and dream quietly away the remnant of a troubled life, I know of none more promising than this little valley."
- Washington Irving, The Legend of Sleepy Hollow

Key Takeaways

- The 2010-2019 expansion ended abruptly with GDP contracting -5% in 1Q2020
- Our 2Q2020 forecast expects GDP to decline by an unprecedented -46% due to the pandemic-induced global economic shutdown
- Despite the historic growth and unemployment shock, equity and credit markets fully recouped losses and neared all-time highs in June
- Investors looked beyond the shock, focusing on fiscal & monetary stimulus, the trajectory of the pandemic's spread, progress toward a vaccine, and likelihood of future fundamental strength

Washington Irving's classic short-story, Rip Van Winkle, was published exactly 200 years ago. It follows a Dutch-American villager in Colonial America, who falls asleep in the Catskills and wakes up 20 years later having completely missed the American Revolution. Though there is something idyllic about being consumed by unconscious dreaming as the world turns upside down around you, the modern version of Irving's story might depict Rip falling asleep at the end of 2019 and waking only to find his investment account balances unchanged. "So, what did I miss?"

The 2010 – 2019 decade's long expansion certainly did not die with a whimper. While growth had been slowing for several quarters, the coronavirus brought the global economy to a screeching halt, unlike anytime in modern history. U.S. gross domestic product (GDP) fell -5% in the first quarter while a decline of historic proportions is likely to be printed in the second. At the time of writing, our expectations for 2Q2020 Q/Q GDP is -46%. Consumer spending, which accounts for about 70% of the U.S. economy, fell -13.6% in April, the steepest decline ever.



The human cost of this unprecedented decline in GDP is startling. Unemployment reached historic highs in May, and though it is receding more recently, it will likely remain high and have a lasting impact on the economy. In addition, according to a study from the National Bureau of Economic Research, over 100,000 small businesses may shut down permanently (NBER Study).

While the backward-looking data continues to roll in, the fastest bear market in history (S&P 500 was -34% in five weeks) gave way to a robust rally in both equity and credit markets. The markets rose 33 of the 55 trading days between March 24th and June 8th, completely erasing the losses incurred during the onset of the panic. The world continues to combat the worst pandemic in a century and the worst economic shock in over 80 years, yet the stock market (our best barometer of current conditions and future outlook) is fully recovered and approaching all-time highs – ***How does this happen?***

The possible reasons for the markets' recovery are many, and the list below is certainly not all-inclusive.

1. **The Monetary and Fiscal Response** – Investors placed a great deal of faith in the Federal Reserve's stabilizing impact with their monetary policy, and the Treasury's fiscal stimulus to provide a bridge to recovery. Even during the shutdown, there was steady progress toward a re-opening of the economy and a commitment toward normalcy that did not exist during the panic. Even now, as a second wave of the virus is beginning to rear its' ugly head, the consensus view is that while a powerful "V-shaped" recovery is unlikely - a recovery of some shape is assured.
2. **Flattening of the Curve** – The total number of cases and deaths from Covid-19 were (thankfully) lower than feared at the height of the panic. The statistics of daily new cases were brought to 0 in many places, and even in the hardest hit areas like New York and New Jersey, the worst fears were never realized. The availability of PPE and hospital beds were stressed, but never broke.
3. **Vaccine Developments** – Optimism about the development of a vaccine and widespread testing added to investors' willingness to write-off the health crisis as a temporary incident.

4. **Episodic, not Fundamental** – Positive economic announcements reinforced investor's belief that our current environment was an episode we would "get passed" in short order, and not a fundamental or structural impediment uncovered in our economy. Simply – investors were glad to "look across the valley" at a time when GDP and corporate earnings returned to its' former ascent. While 2020 will certainly reveal a historic decline in both, investors were and are willing to anticipate a time – maybe 2022 – when GDP and Earnings exceed those of 2019 and expectations for 2020.

During the market crash in 1Q2020, all scenarios were on the table. The pandemic was expected to be widespread and the resultant deaths from the virus was anticipated to be in the millions. Epidemiologic forecasts modeled a massive shortage of hospital beds and PPE, paralyzing our healthcare system. Economically, there was no visibility to when, or if, businesses would reopen their doors and in what capacity. Ultimately, the range of possibilities for a world consumed by Covid-19 were unlimited, and skewed to the downside.

What the list of positive inflections above has done for investors is Narrow the Range. When you have 100 potential outcomes, and the bottom 25 are removed, as an investor, you can begin to allocate accordingly. The question now is - are expectations too optimistic? In our view, probably. The virus has not gone away, and it appears a second resurgence has begun and may likely continue. There is a distinct probability that we won't have a vaccine as soon as hoped and the timeline could continue to be pushed out. GDP is projected to be at least -5% for the year and unemployment could be in excess of 10%. Permanent impairments to parts of our economy such as leisure and travel will likely challenge employment and growth into the foreseeable future. Although our country's technology leadership remains a bright spot and has powered the knowledge economy and segments of consumption through the pandemic, the broader impacts to the consumer economy and its resultant impact on employment cannot be "technologized" away overnight.

As a firm, we continue to recommend our most defensive stance when it comes to asset allocation, as we believe the road to recovery will be longer and bumpier than the market is currently pricing in. Navigating this uneven recovery will require diligence, patience and a courage unlike any time in the last 10 years. We are honored and thankful to be your partner as we continue work through these challenging times together.

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