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The "New Century" – Acceleration of the Digital Economy

July, 2020

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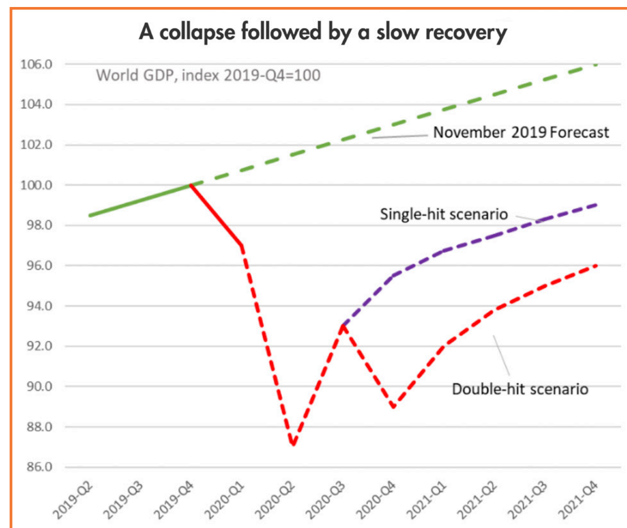
We label the post COVID-19 period the "New Century" to reflect acceleration of the digital economyas both businesses and consumers adjusted to the pandemic. Much of the past will remain just that – in the past – and less useful for forecasting the outlook for many sectors. The new forces will likely lead to major differences between corporate haves and have-nots. In our view, the haves will grow much larger and increase their dominance.

Maintaining healthcare protocols is key to speedy economic recovery

As the economy adjusts to aftershocks from the pandemic, Americans will need to adhere to current healthcare protocols until vaccines become broadly available – still an uncertain date. Such adherence will prove critical to both limiting the virus's spread and speeding economic recovery. Unfortunately, early in July the seven-day average in daily new cases increased to record highs. This resurgence, principally in the sun belt states as well as California, will likely slow the expected economic recovery in the third quarter as states roll back their reopening efforts.

The Organization for Economic Co-operation and Development (OECD) compared the November 2019 World GDP growth forecast (green dashed line) to the GDP growth forecasts in 2020 and 2021 based on either a "Single-hit" scenario or a "Double-hit" scenario. As the chart illustrates, the impact of a "Double-hit" scenario could further reduce economic growth by an additional 3% to 6%.

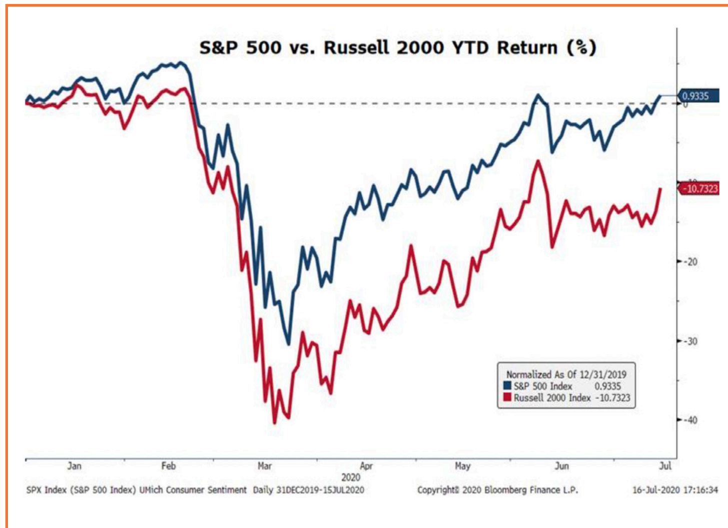


Source: OECD 2020

"V" shaped stock market rebound and a cloudy economic outlook – why the difference?

As investors, we scratch our heads seeing the "V" shaped equity market recovery marked against this cloudy economic outlook. Partially explaining this difference may reflect severe pandemic damage to small businesses – which contribute to half of U.S. GDP. This economic dispersion shows up when

comparing performance of the S&P 500 index – comprising large corporations – to the Russell 2000 – representative of the small business sector. So far this year through July 15th, the S&P 500 grew 0.4% while the Russell 2000 declined nearly 11.4%.



Source: Bloomberg Finance L.P. 2020

Management outlook is key to second quarter earnings

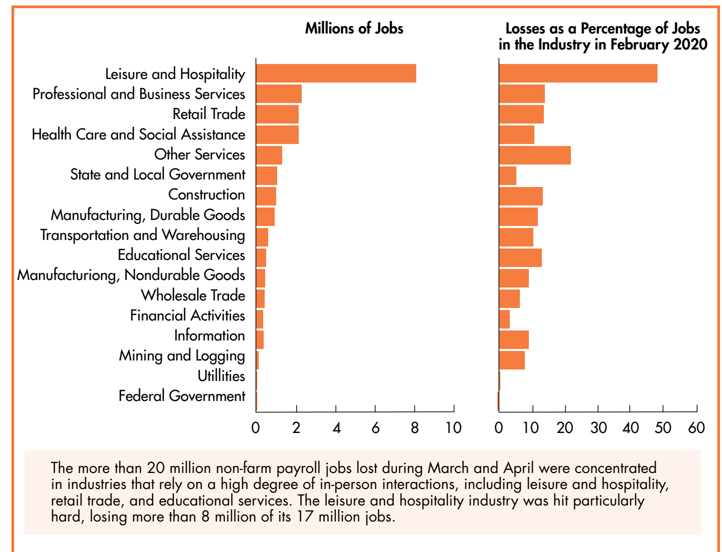
Second quarter earnings reports – or losses – will be rolling out this month. Consensus expectations look for quarterly earnings to decline 40-50% year-over-year. Investors will not likely dwell on expected poor second quarter earnings reports but instead focus on management's outlook for the remainder of this year and 2021. For the full year, a good percentage of companies will use 2020 as a "kitchen sink" year by writing off their past mistakes on top of already depressed operating earnings or losses.

Past earnings will not be as helpful in forecasting 2021 results

Earnings reality will likely return to equity markets in 2021. Analysts as well as companies will likely base their earnings forecasts on historical operating, income, and balance sheet relationships. However, in the "New Century," the past will not provide as useful a basis for forecasting future results. Therefore, greater than normal earnings surprises – either positive or negative – seem likely through at least the first half of next year. Greater individual stock volatility will likely result with such earnings surprises.

Service industry offered less of a buffer to the economic decline

Typically, the service industry (approximately 70% of GDP) buffers cyclical declines experienced by manufacturing (11% of GDP). In contrast, mandated lockdowns brought consumer service industries including restaurants, entertainment, travel, tourism, and other consumer service sectors to a near halt. As a result, rather than acting as a buffer, services put greater downside pressure on the economy.



Sources: Congressional Budget Office; Bureau of Labor Statistics.

Service sectors are dependent on vaccines to resume "normal" business

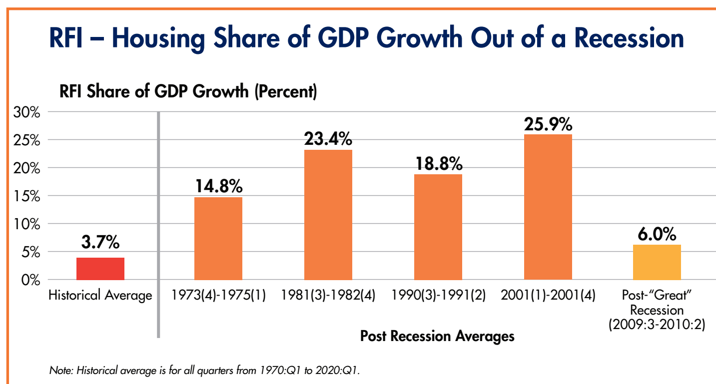
Many service sectors depend on customer density for their success. Unfortunately, such customer density can also act as a super spreader of the virus. Therefore, selected consumer service sectors, more so than other industries, will depend on widely available vaccines or therapeutics to resume more "normal" business levels. With the sizeable economic contribution of consumer services, the timing and speed of an economic recovery will depend importantly on when vaccines become widely available.

With restaurants and other entertainment activities not fully open, many consumers instead enjoy such activities at home with friends. Even when vaccines become widely available, many of these home-centered trends will likely continue in the "New Century."

Housing construction may provide impetus to economic recovery

As further focus on home centered trends, housing construction may provide a major impetus to an economic recovery. This impetus will depend, in part on stabilizing the virus outbreak or introduction of vaccines and therapeutics. In the past, housing contributed 18% to incremental GDP growth following each recession since 1970 – with one exception. That one exception was the 2008 Great Financial Crisis. In contrast, fundamentals today, particularly low mortgage rates, should enable housing construction to contribute importantly to an eventual economic recovery.

Since 2007, housing declined nearly 2 million units while households grew 12 million. This combined effect led to the lowest level of vacancies in decades. This low vacancy rate should provide a spur to new housing demand. An eventual stronger housing recovery than after the Great Financial crisis will likely benefit a broad group of sectors that support new and secondary housing. Once again, the influence from the pandemic will likely see Americans refocus on the home – in this case a new house.



Source: Harvard Joint Center for Housing Studies, NOTE: RFI-residential fixed income – spending on housing construction

Congress likely to pass Phase 4 stimulus spending

Beginning in March, the Federal Reserve made massive commitments to supplying liquidity to the financial markets, nearly doubling its balance sheet. Nonetheless, monetary policy actions can only lend not spend. In contrast, fiscal policy can provide focused spending to the economy. Therefore, at about the same time, Congress passed its Phase 3 $2.2 trillion fiscal program labeled the CARES Act.

An important part of this program added a $600 weekly supplement to state unemployment insurance and the one-time Economic Impact Payment. The supplemental unemployment stipend proved critical to stabilizing personal incomes and consumer spending in the second quarter. Critically, this supplemental unemployment income program faces a July 31st termination date.

To avoid this substantial hit to the troubled economy, Congress will likely pass a Phase 4 spending program of at least $1 trillion that will either modify the weekly stipend and/or add new spending programs. The presidential election year plus importantly, the resurging virus activity greatly increases the likelihood of this happening. Once Congress returns from its recess in late July, financial markets will closely watch its efforts to avoid this economic cliff. The outlook for the remainder of the year will importantly depend on additional fiscal spending. These substantial spending increases recall a quote from a former Senate leader – to paraphrase, "a trillion here, a trillion there, pretty soon you are talking about real money."

Recession – a political event in an election year

In our view, no matter the outcome of the election, surging deficits will ultimately force higher tax rates. However, tax rate increases may wait until signs that the recovery shows sustainable strength. Ultimate tax rate increases will force investors to reduce long-term earnings

growth expectations for corporations. Some analysts point out that each one percent increase in effective corporate tax rates could lead to reducing earnings growth rates by over one percent annually.

Investment conclusions

The dynamism and ingenuity of American businesses and workers should enable them to take advantage of opportunities created by changes wrought by the pandemic. The resulting outcome of their efforts will likely speed up introduction of more productive systems – to the advantage of long-term U.S. economic growth. Equities of such quality companies, leveraging these opportunities, should produce above-average income and dividend growth producing attractive total returns. In the case of fixed income, short-term credits make sense in this period to preserve capital. Finally, alternative investments fit ideally into the environment described in this commentary.

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