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MACROCOSM

After the Crisis, the Work Begins

Monday, May 4, 2020
Donald Luskin

Equities haven't already discounted a V-shaped recovery – but more upside depends on it.

Shops and restaurants began opening Friday here in Texas, as did the first of thousands of magnolia blossoms around our Dallas townhouse. Joy and renewal are palpably in the air. We wish all our clients and friends the patience and good health to endure what we hope are the final throes of the Covid-19 crisis, and the resiliency to enjoy a speedy re-opening. *Now let's talk about where we go from here. Please forgive us if we ramble a bit.*

We're delighted that our S&P 500 equity risk premium model called the bottom in equities to the very day on March 23, when it registered an extreme reading almost precisely equal to that at the Global Financial Crisis bottom on March 9, 2009 (see the chart below, "On the Fed's Massive Intervention" March 23, 2020). The ERP is not intended as a market-timing tool, but at extremes it can be an effective one because it is reliably mean-reverting. *Now, from the March extreme, with the S&P 500 having rallied as much as 34.8%, the mean-reversion is complete, with the ERP sitting right at its GFC-era mean. The signal is clear: equity gains derived sheerly from the quelling of*

Update to strategic view

US MACRO, US STOCKS, ASIA MACRO: With the equity risk premium now mean-reverted from 2009-type panic levels, further gains in stocks will be driven by actually experiencing the V-shaped economic recovery we expect. The easy money is out. As the economy reopens, it will first be fueled by early adopters – mostly the young – who set the example for those to follow as fear quickly evaporates. It doesn't have to happen all at once. Typical…

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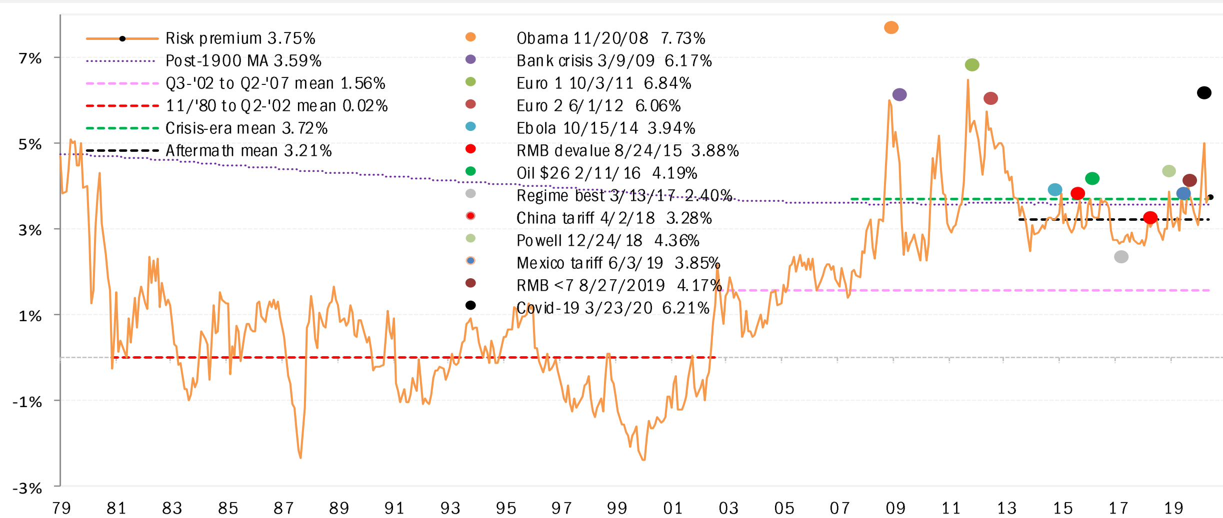
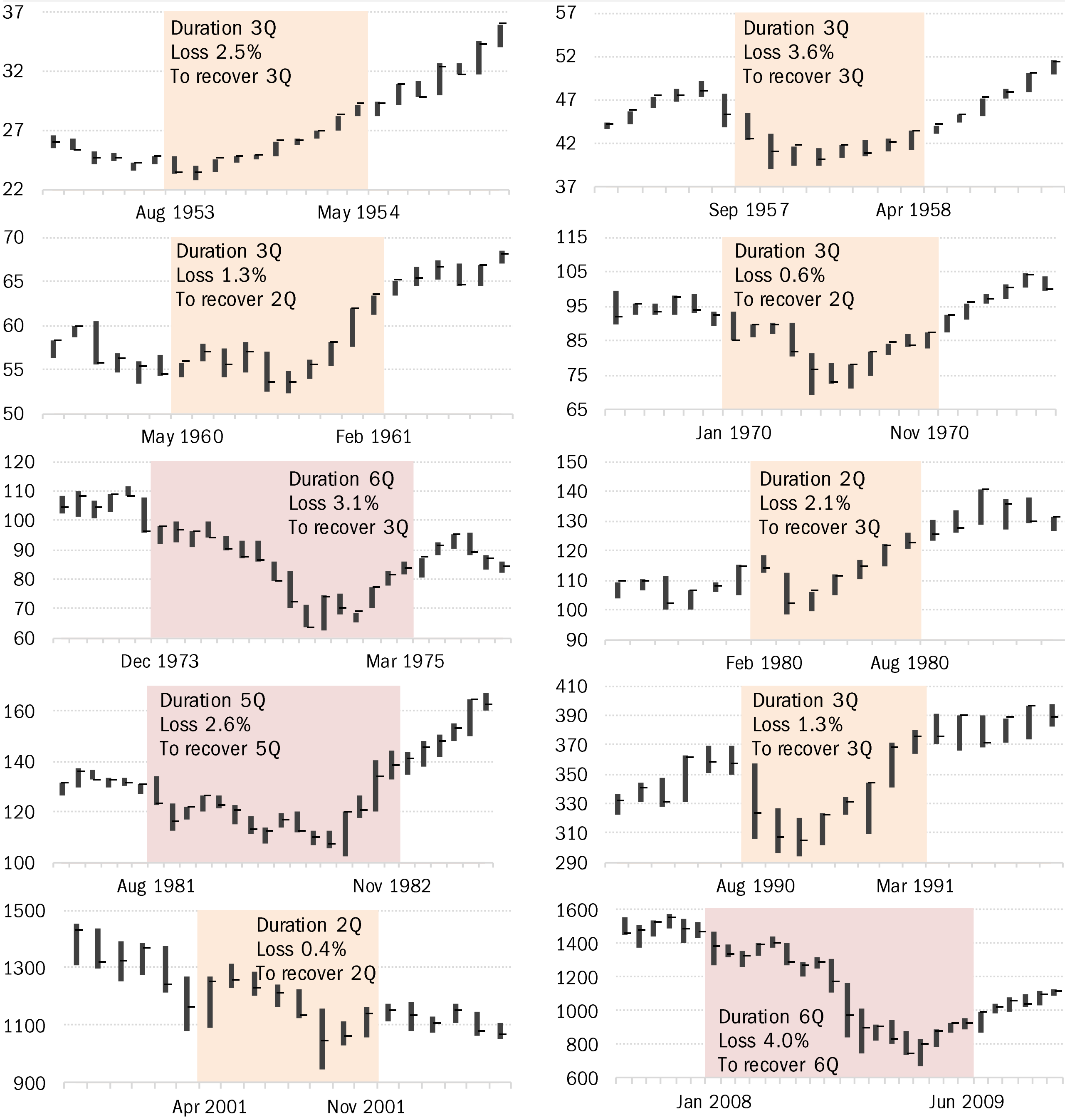
S&P 500 equity risk premium. month-end — Significant dates, and 3/23 datapoint are intra-month



Source: Various. TrendMacro calculations *panic are in the rear-view mirror. From here, we have to earn it the old-fashioned way – growth. We have to actually have the V-shaped economic recovery we've been saying to expect* (see [“On the March Jobs Report, and Being in Recession (Whatever that Means”]() April 3, 2020). *We're not saying it's been easy, but the easy money is out of equities.*

- *Most recoveries from recession are V-shaped* (please see the charts below). In the post-war experience, seven out of seven

Typical short recession **Unusual long recession** **S&P 500**
Length in quarters, loss in real GDP from peak to trough (not annualized), length to recover peak GDP



Source: Bloomberg, NBER, TrendMacro calculations recessions lasting just two or three quarters took only two or three quarters from the trough to get back to prior-peak GDP. One six-quarter recession took three quarters to recover, as well. *Only two out of ten are exceptions* – a five-quarter and six-quarter recession (the 2008-09 "Great Recession") – took five and six quarters to recover, respectively.

- *Yes, by the numbers, this eleventh post-war recession* (it's not official yet, but it will be; after Friday's jobs report, it will have all the requisite unofficial macroeconomic markers) *will likely be the worst in terms of depth*. But it can be among the best in terms of short duration, in part because of the transient nature of the uniquely exogenous shock that caused it, and in part because of the uniquely massive and pre-emptive relief efforts mounted by the Fed and the Congress.
- It's no coincidence that the day of the bottom, March 23, was the day the Fed first announced its massive lending programs (again see "On the Fed's Massive Intervention"). Say what you will about what's right and wrong about details of these programs, or the other programs that resulted from the "stimulus bidding war" we predicted when this all first began (see "Powell Not to the Rescue" March 4, 2020). *We are most interested in the sheer power of throwing so much money at a problem, and its salutary effect on sentiment. Recovery is always about sentiment – the reflorescense of "animal spirits" – this one, perhaps, especially so considering the fears of physical well-being that could keep people from starting to participate once again in the economy.*
- **WHAT ABOUT RESIDUAL FEAR?** As we talk to clients every day, this is the most often-heard concern. We cannot assert any claim to superior judgment about human nature, but *it is our deeply held judgment that the fear of Covid-2019 has been decelerating sharply* even while it remains a media obsession – because most people's experience of it is not the disease itself, but the burdensome and immiserating consequences of the reaction to it. Polling shows that the vast majority of Americans don't even know anyone who has had it. *Now that social distancing restrictions are being relaxed in many jurisdictions, "early adopters" will exuberantly flood back into the marketplace, and both set an example and exert peer-pressure on those left behind.*
- The early adopters will be the healthy young, who have probably chafed the most under the boring and repressive rigors of lockdown, and who – it is now becoming known – are largely invulnerable to Covid-2019 anyway. The capper on that is new statistics released last week by hard-hit Italy, showing that only 1,121 out of 23,188 fatalities were persons below the age of 60. Of all fatalities, 95.6% had at least one comorbidity (60.1% had three!).
- *As the young flood back into the marketplace – you should see Dallas this weekend! – FOCI (fear of Covid infection) will be replaced by FOMO (fear of missing out).*
- FOMO will not only apply to people in their capacities as consumers, but even more so in their capacities as workers. As we have already pointed out, *the transcendent dynamic of this moment*

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…V-shaped recoveries take 2 to 3 quarters. Relaxation of social distancing won't trigger a second wave of the virus because, unintuitively, there is no evidence that lockdowns had any effect in the first place. A resurgence in the winter will likely not draw the same political response. Changes in consumption and work patterns will trigger creative destruction that will drive growth. Globalization will continue to be optimized, but backlash against China will lead to reforms that will make it a more attractive economic partner.

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will be, in fact, the replacement of FOCI by FOP – fear of poverty (see "Make America Open Again" April 17, 2020).

- **WON'T IT TAKE A GREAT DEAL OF TIME?** It doesn't all have to happen at once. Reopening can be phased, both as a matter of mandate and of individual preference. One is always myopic in a crisis – understandably so – focused on the dangers immediately at hand. But we continue to think that March and April will probably stand as the most intense months of the recession, with the trough probably occurring in June. *That will make this a two-quarter recession, tied for the shortest on record. If it takes three quarters to get back to peak GDP – which, from our present foxhole, and experienced as it plays out one uncertain day at a time, will feel like forever – that will actually meet any reasonable historical definition of V-shaped.*
- **WHAT ABOUT THE INEVITABLE SECOND-WAVE OF INFECTIONS ONCE LOCKDOWNS END?** We acknowledge that this is highly counterintuitive, but we think *it is a demonstrable fact that there is no actual evidence that the severity of lockdowns is correlated with reduction of confirmed cases or prevention of fatalities* (see "Video: What you're not hearing about bringing the economy out of lockdown" April 27, 2020). *The straightforward corollary is that exiting lockdown won't itself trigger a second-wave of infections or fatalities.*
- Our further research on this – underlying which are several very helpful and challenging suggestions from clients – is just as counterintuitive. *We have found that fatalities across states are not correlated with population density, age or health*. We believe we have hit on one underappreciated factor, which we will discuss in an upcoming video. But basically the nihilistic conclusions several weeks ago of Tel Aviv University's Isaac Ben Israel are being proven out – Covid-2019 seems to have an agenda of its own, an eight-week cycle of exponential growth, then exhaustion, that you just have to out-last. Last week Thomas A. J. Meunier of the Woods Hole Oceanographic Institute published similar findings.
- *We predict there will be much more along these lines, and in a matter of weeks it will be conventional wisdom to question the efficacy of lockdowns*. Already, *New York Times* columnist Thomas Friedman broke ranks with fellow liberals and heaped praise on Sweden's lighter touch on social distancing. A *Times* roundup yesterday of global expert opinion emphasized the role of "sheer luck" in determining outcomes. *As opinion shifts in this way, lifting of lockdown mandates will accelerate, in parallel with the accelerating willingness of people to re-engage in the economy.*
- **WHAT IF THERE IS A SECOND WAVE ANYWAY? OR WHAT IF COVID-19 COMES BACK IN THE WINTER NATURALLY?** We can't rule those things out. But we believe strongly that *politicians are going to find it harder and harder to justify having immiserated the global economy with no* ex ante *evidence that lockdowns would work; now with no* ex post *evidence that they did work, they will not likely do it again*. Our guess is that any social distancing mandates in the back half of the year will be symbolic and voluntary, or focused on at-risk groups (the old and the unhealthy). For that

matter, by then [there will surely be at least something](#) – compared to nothing, now – by way of vaccines, preventives, palliatives or cures. *Never sell short human technological ingenuity in a crisis*.

- **WHAT ABOUT PERMANENT CHANGES IN CONSUMPTION AND PRODUCTION PATTERNS?** We can be sure that people will wash their hands more from now on. That alone could lead *to a surge in global labor productivity as people miss less work due to colds and flu*.
- Economic growth is the result of changes in taste and technology creating opportunities for adaptations leading to greater well-being. *The Covid-19 crisis is a shock that will change tastes*, not necessarily so much because people will forevermore not wish to mingle with each other, but because *the experience of coping with the crisis revealed hitherto unknown preferences enabled by new technologies that had previously been underutilized*.
- For example, there are people who had never tried Amazon or Netflix before. They have now, and some of them have discovered they like them, and will now continue to use them. *That will hasten the demise of movie theaters and brick-and-mortar retail establishments which were doomed anyway. Creative destruction. That's where growth comes from.*
- Amazon's earnings conference call last Thursday was ironic, and captures some of the complexity and depth of this simple paradigm. The crisis has caused Amazon's sales to surge – but its retail operations are not where most of its profits come from, and gearing up for new demand there is going to be costly, so its earnings are being eroded. But it's not that simple. As we see it, the behemoth Amazon has been given the golden opportunity to go back to its high-growth roots. It wasn't so many years ago that founder Jeff Bezos used to brag that Amazon never needed to show a profit so long as it was always reinvesting in growth – no coincidence, perhaps, that Bezos himself is back at the helm.
- There are people (and their employers) who find it advantageous to work from home and interact with colleagues and customers via telepresence technologies like Zoom. As employers and employees re-optimize their officing habits, there will be some experimentation, but much will have been learned in the present crisis experience. So new configurations are likely to be more productive.
- But there's creative destruction here, too. *It may turn out that the world has too much office space, and that people's homes have too few bedrooms. A decade of reconfiguration of residential and commercial structures may be upon us. Creative destruction. That's where growth comes from.*
- For us the most exciting possible development is in education. To be sure, much of the purpose of education – especially for the youngest children – is socialization that can probably only be learned in person on the playground, preferably with some rough-and-tumble free-play that is decidedly unsanitary. *But the lockdown experience may have cracked open the gates, for most students, to distance-learning. To the extent that education is actually about imparting knowledge, distance-learning offers students access – especially under-resourced students – to the handful of the best*

teachers in the world. Such teachers may be a "non-rival good" – that is, something that one can consume without diminishing it for others.

- Yet the infrastructure of the physical campus has kept that good artificially scarce (and correspondingly overpriced). *If education, especially in so-called STEM fields, is the key to success in the new global knowledge economy, then college campuses are a monopoly bottleneck – which the world has just learned it may be able to eventually do without.*
- **IS THE AGE OF GLOBALIZATION OVER?** The age of globalization already ended – or at least its phase of thoughtless headlong exploitation – in the summer of 2016 with the Brexit referendum (see "On the Brexit Referendum" June 24, 2016). It ended again when President Donald J. Trump started a trade war with China (see "Sympathy for the Tariff Devil" May 17, 2019).
- Those two events signaled that globalization would have to be more gradual and more thoughtful. They signaled that the well-being of domestic middle-class workers had to have more political weight than the maximization of supply-chain efficiency. And they signaled that supply-chain efficiency had to be risk-optimized to diversify against the possibility of political interventions.
- *Has the Covid-19 crisis really added anything to the calculus?* What good would it do for businesses to decouple from China, in the aftermath, unless we were to abolish travel to-and-from? *We still have to share the planet with China*, and we will still have to the next time they generate an infectious pathogen.
- We think it is not inappropriate for the world to be upset with China over this – whether the virus began with unsanitary practices in a Wuhan "wet market," or sloppy practices in a Wuhan level-4 biocontainment facility.
- Trump has set the ball in motion – going so far as to say he's seen evidence Covid-19 escaped from that lab. Incidentally, media claims that the US intelligence community refutes it are simply lies – click here if you want to read for yourself the actual statement about it from the Office of the Director of National Intelligence. There is movement in Washington to punish China in various ways; even sclerotic Europe is getting agitated.
- Such mobilization against China is more likely to enhance engagement than diminish it, because *it is in China's own advantage to clean up its act*. Compared with the costs that are now so obvious, China has no motive to maintain sloppy lab practices, or continue to sell infected wild animals in public markets. Assuming it can assure the world that those risks have been reformed – without having to admit fault, of course – China will be a better business environment, which will redound to its own benefit directly and by making itself a more attractive global partner. Does this explain why the Chinese equity market has been the world's best performer this year?

Bottom line

With the equity risk premium now mean-reverted from 2009-type panic levels, further gains in stocks will be driven by actually experiencing the V-shaped economic recovery we expect. The easy money is out. As the economy reopens, it will first be fueled by early adopters – mostly the young – who set the example for those to follow as fear quickly evaporates. It doesn't have to happen all at once. Typical V-shaped recoveries take 2 to 3 quarters. Relaxation of social distancing won't trigger a second wave of the virus because, unintuitively, there is no evidence that lockdowns had any effect in the first place. A resurgence in the winter will likely not draw the same political response. Changes in consumption and work patterns will trigger creative destruction that will drive growth. Globalization will continue to be optimized, but backlash against China will lead to reforms that will make it a more attractive economic partner.