Market Commentary

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Emerging Themes as the World Slowly Gets Back to Business

It is startling how abruptly the world has changed in just a few months' time. With a large share of the global working population placed on lockdown, it's been hard to form a clear picture of what may happen going forward. However, while the situation is unclear and changing rapidly, there are several emerging themes that we anticipate will shape and affect the global investment landscape in the weeks and months ahead.

LOCALIZATION

While globalization isn't going away anytime soon, some are expressing a strong interest in redirecting business to U.S. companies and locally owned enterprises. Making the case that national and economic security are at risk, proponents have advocated for more protectionist trade and tax policies amid a growing populistic sentiment.

In every crisis, it's natural for people to want to assign blame, and in this case, China may well be the focus of backlash. This could translate to higher tariffs, restricted access of Chinese products into U.S. markets, or more reshoring to the U.S. Any such policy changes will encourage businesses to address over-concentrations of Chinese imports in their supply chains. For example, did you know that China supplies 95% of ibuprofen imports and 70% of acetaminophen imports into the U.S.? If businesses reevaluate how they diversify their suppliers, the U.S. and other emerging market countries could benefit from these reconfigured supply chains.

INCREASED OR NEW REGULATIONS

It's been said that, "government always fights the last battle," meaning that whole new departments and systems can suddenly emerge as the government forms a response to the last threat it faced. For example, the events of 9/11 forever changed how people travel; the Department of Homeland Security was formed, and the TSA implemented extensive new security measures that we now accept as normal.

Likewise, there's no doubt that the coronavirus (COVID-19) pandemic will necessitate new oversight of sectors such as healthcare, food chains, pharmaceuticals, and financial institutions. We may not start to know what this looks like until the economy is completely open again. The FDA's drug approval process, food supply, domestic energy production, banking, healthcare supplies, and employee workplace protections are just a few of the numerous other areas that could see revised regulations. Some areas of regulatory focus could also include increased protections for dealing with future pandemics, including systems for monitoring threats (perhaps contact tracing) and protocols for continuity planning in schools, courts, local governments, and private businesses.

CHANGING CONSUMER HABITS

The crisis has only served to hasten the integration of technology and flexibility into consumer habits and business models. Whether it's Zoom, telehealth, or curbside delivery, we're seeing a greater acceptance of more efficient service delivery options. While Zoom meetings won't replace face-to-face meetings, in all, we believe corporations and consumers will gain efficiencies out of this time that benefit everyone. These things don't replace what we had before, but the face of business has definitely changed. There has been a lot of speculation that airlines and leisure won't recover for an extended period, but we have lower confidence in this view. Once business operations are fully functioning, we see no reason why the competitive nature of capital markets and restored consumer incomes won't continue to drive activity in these economically sensitive areas.

EXTRAORDINARY FISCAL AND MONETARY POLICY

The government financial support and stimulus in response to the crisis has been unprecedented. The fiscal component is expected to reach 20% of U.S. GDP by the end of 2020, driving deficits to a level only seen during the Great Depression. Likewise, the Federal Reserve has implemented between nine and 12 monetary programs and added more than $2 trillion to its balance sheet, which is expected to reach 50% of GDP by next year.

There's a question of whether we expect these fiscal and monetary policies to be inflationary. They most certainly are, but in what way and to what extent is not straightforward. Does "helicopter money" (money from the U.S. Treasury to individuals that is not expected to be repaid) lead to consumer inflation? Does Fed money printing drive asset price inflation? Or do both cause the U.S. dollar to decline and import prices to pick up?

For now, a disinflationary effect from too much debt and the impact of the shutdown is more likely to overwhelm the inflationary impulses of the fiscal and monetary responses. Our view on this could change significantly based on the path of future Fed policy and Congressional actions.

In general, all of this is likely to lead to corporations and households shoring up their balance sheets. As corporations seek to make their operations more robust and competitive, they're likely to experience higher costs and lower profitability. Global debt will continue to grow (primarily due to government spending) and economic growth should recover, but slowly.

IS NOW A GOOD TIME TO INVEST?

We continue to emphasize a strategy of diversification, valuation, and quality growth, especially in the current environment where valuations are affected.

- **Diversification** remains important because the range of possible outcomes is too great to try to pick winners and losers right now. Investors should stay broadly diversified across geographies and asset classes. As always, we would also recommend adopting a time-based approach in which money is diversified according to the time horizon in which it is needed, with shorter duration assets for near term cash flows and longer duration assets for cash needs further out.
- **Valuations** are important, and we recommend paying attention to the price paid for an asset with respect to its characteristics. We aim for a margin of safety by buying at a discounted price relative to fundamentals.
- In this environment where growth is scarce, **quality and strong company management** become more important. We tilt toward quality companies with stronger balance sheets and higher free cash flow to improve the long-term durability of the portfolio.

Disciplined execution is also key. Markets are volatile right now and we believe it's impossible to time the highs and lows of the market. Systematically controlling how you invest based on a repeatable process should improve outcomes over time.

So, is now a good time to invest? Yes. While we don't know what the near term holds, we are confident that the spirit of human innovation and adaptability will shine through. Holders of long-term assets will be rewarded by that productivity. As always, we will continue to monitor the economic and investment landscape in search of opportunities that will enhance our portfolios.
