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# BLOG POST

## The Shape of Recovery: V, U, or L

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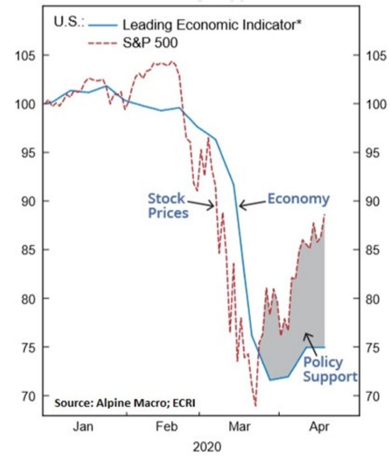
There is much debate on what the shape of recovery is going to look like following the unprecedented shuttering of the global economy. While some remain optimistic about the potential for future growth, some hopes have been dampened by economies in Asia that began opening up and experienced subsequent outbreaks of the coronavirus. What can be said definitively is that the greatest decoupling of the economy and equity markets in my lifetime has occurred in the last month. The S&P 500 fell 35% between February 19 and March 23, the fastest plunge into bear market territory in the history of the markets.

The uncertainty around the pandemic and corresponding impact on the economy justified the concern by stock investors, especially given that the markets were trading at all time highs. While the economy has remained essentially closed with shelter at home orders in almost every state, the S&P 500 has surged 20% off the market lows. While it appears the markets are pricing in V-shaped recovery, I think something else might be at play. The fiscal policy response exceeding $2 trillion, along with the monetary policy response by the Fed, signals to the markets that investment gains will be private but losses will be socialized. This assumption, right or wrong, has resulted in a V-shaped market response even while the economy is declining.




The chart demonstrates the decoupling of the economy and stock market and how much reliance on policy support exists today. The data I have analyzed suggests investors are overly optimistic in the efficacy of the actions taken by Congress and the Fed. The economic recovery is far more likely to be U-shaped as the economy re-opens in stages and people slowly begin to be rehired. Consumers will be impacted by damaged balance sheets even as the service sector opens at partial capacity. If restaurants are required to operate at 50% capacity, their rehiring will be impacted, causing unemployment to recover more slowly than many expect.

Consumer spending, which accounts for nearly two-thirds of GDP, is largely driven by confidence about the future and it is hard to imagine with all the talk of a “second wave” of COVID-19 that confidence returns to pre-virus levels within the next 12 months. Much is made of the potential for a vaccine, but that seems misplaced to me. Everything from common colds to the flu are virus-based and no one has been able to come up with a vaccine that keeps those from occurring. I do expect an effective therapeutic to be available before the end of the year that should help with confidence. Additionally, there is some very exciting news about the ability to test for the virus and antibody that generates near instantaneous results. The ability to perform mass testing is probably the most important factor for a return to economic vitality.

The potential worst-case scenario involves an L-shaped recovery for the economy that would likely see the markets trade to new lows if it were to occur. In this scenario there would be a long-term behavioral change by consumers, starting with an effort to reduce debt and increase savings to be better prepared for a future crisis. As you read this you might be thinking, “wouldn’t less debt and higher savings be a good thing?” The answer is yes if it is your household, but not when looking at the entire economy. Increased savings means less spending that results in lower corporate earnings, fewer employment opportunities, and less growth. The risk of an L-shaped recovery would be mitigated with an effective treatment for the virus.

What seems inevitable from this crisis is that the solution to the dislocation created by government interference will be yet more government interference. Knowingly or not, the government will be determining which industries and companies recover the fastest. The government’s track record on these policies in the past have been dismal (Solyndra, A123, Fisker, etc.). The Wall Street adage, “Don’t fight the Fed,” has rewarded investors who have benefitted from the V-shaped recovery in equities but is unlikely to be sustainable. I expect a corresponding collapse in the velocity of money that will negate the impact of excess liquidity in the economy. Be prepared for a bumpy economic recovery and market volatility at levels not seen in years.