



The Physics of Economic and Financial Distress

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Rick Rieder, Russ Brownback and Trevor Slaven contend that even as markets were rocked by uncertainty as the coronavirus lockdowns began, the seeds of stability were sown in the massive fiscal and monetary policy response. The key is to know how to manage through this period for the long haul.

Over the last several years, we have continuously referenced the incredible influence that technology and demographics are having on economies and markets. On one side, technological innovation is rapidly changing corporate investment and business models, while also delivering persistent consumer-friendly disinflation. On the other, aging and slower-growing populations in the developed world equate to more subdued growth profiles with significant shifts in consumption patterns, and to a tremendous demand for financial market income. Between these two forces, the result has been historic stability, with economic volatility at, or near, all-time lows. The COVID-19 pandemic has disrupted that relative economic peace in a generational manner, as we described in our May 7 call with clients, and summarize here.

For every action, an equal and opposite reaction...

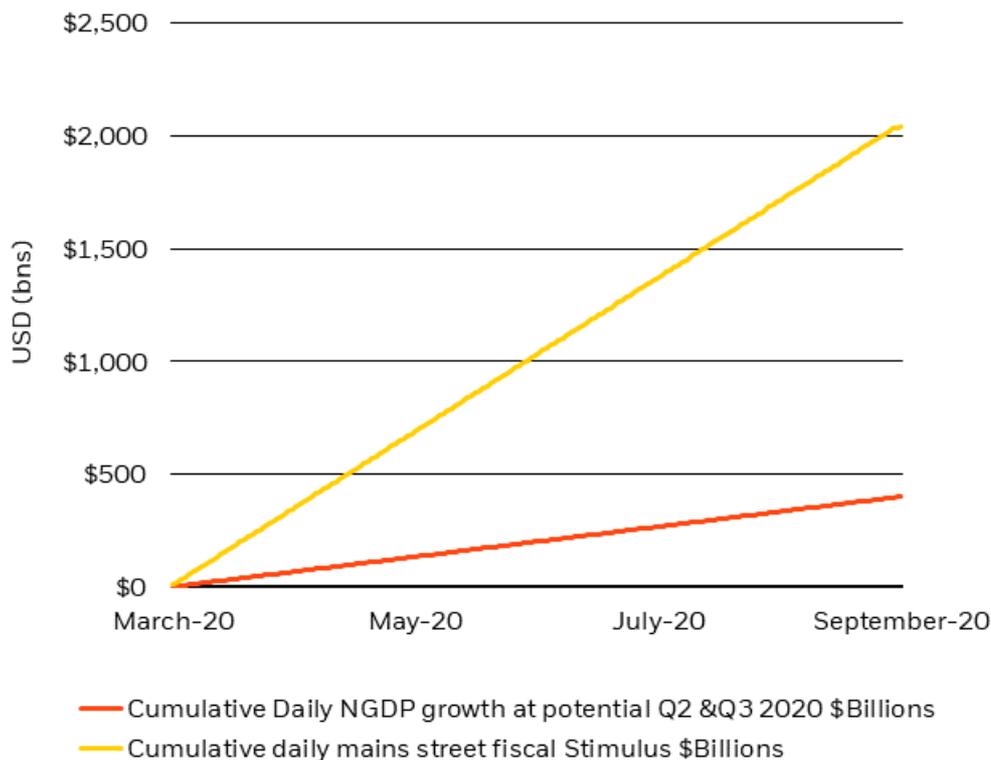
The economic steadiness of the last few years reminds us of Newton's cradle, a device named after 17th-century English scientist Sir [Isaac Newton](#), which demonstrates remarkable stability at its center, absorbing energy from forces that strike on the exterior. Using this analogy, under normal circumstances this feedback loop is fairly gentle and predictable; as policy, the financial markets and the real economy send benign reverberations through the economic system, ultimately maintaining an equilibrium. The COVID pandemic, however, hit the economic cradle so severely that it threatened to topple that entire framework.

Indeed, the COVID pandemic encircling the globe felt like an unstoppable force, throwing all the balls of the cradle into disarray, crushing the real economy and destroying wealth up and down the capital stack. Fortunately, Sir Isaac also taught us that every action has an equally powerful, and opposing, reaction. Over the last five weeks, financial markets strongly suggest that the unstoppable force met an immovable object in the form of an historic "whatever it takes" fiscal and monetary policy response.

In the U.S., which has nearly a third of the world's documented COVID cases, bipartisan fiscal initiatives have been delivered to provide immediate relief to households, businesses and local governments. Importantly, bold and truly historic monetary policy has been set to dovetail with these Federal programs. To be sure, real-economy demand will need to be rebooted in an organic way to get output fully restored; and while we believe this will absolutely happen eventually, the timing is nearly impossible to know with any kind of precision. In the meantime, however, this epic global policy response coordinating monetary and fiscal initiatives is providing a credible bridge over the real economy gap created by the shock resulting from the virus spread and subsequent economic lockdowns.

Main street-targeted fiscal outlays will provide support that is equivalent to roughly five times the organic growth of a normally functioning economy through the third quarter of 2020 (see graph). And the Fed will likely absorb nearly all of the additional Treasury borrowing, of roughly \$2.5 trillion, over the remainder of the year. Despite record issuance, the true amount of U.S. Treasury debt held by the public will remain fairly stable. In absorbing that supply, not only does the Fed help to keep a cap on borrowing costs for everything from municipal bonds to business loans, but it also keeps private sector capital freed up to seek out greater returns in risk assets, which has provided stability to financial markets over the last several weeks.

For now, fiscal stimulus provides economic support to Main Street



Sources: Bloomberg, BlackRock; data as of December 31, 2019 and April 22, 2020

Prior secular trends accelerate, and are key to investing

Importantly, not only has this collision of COVID and resulting policy response acted as a massive, but temporary, external “macro force” on the economic system, the disruption has also accelerated the two most important structural dynamics we follow today: the tech-driven redistribution of corporate cash flows and the demographic-led demand-for-yield. In this work-from-home world, the nascent shifts to online shopping, online food delivery, at-home exercise, etc. are being pushed into overdrive. And while the monetary policy response provides a near-term safety net for markets, it further exacerbates the supply/demand imbalance for high-quality yielding assets, as newly printed dollars soak up Treasury and corporate bond issuance.

The hastening of these two long-term trends has played a nearly unbelievable role in the remarkable recovery in financial asset prices from late March to today. As we write, the NASDAQ now has positive performance year-to-date, with contributions from each of the five largest companies. By contrast, the banking, industrial, and small-cap equity sectors are down between -20% and -40%, and near all-time record lows on a ratio to the broader indices. In fixed income, the current yield on the Bloomberg Barclays U.S. Aggregate Index sat at record lows coming into May. By year-end, the Fed’s purchases of financial assets will equate to nearly 45% of the size of the entire U.S. Agg. The investable cash flows in the world are seemingly either being bought by the Fed or are being concentrated in the hands of a few incredibly innovative technology companies.

This dispersion of cash flows is perhaps the most important investment conclusion today as we look to build portfolios for the remainder of 2020 and beyond. But how do you allocate assets when the top five U.S. equities comprise 20% of the S&P 500 Index market capitalization? The tech-heavy NASDAQ is nearly eight times the size of the Russell 2000, and amazingly, the combined market cap of MSFT, AAPL, and AMZN is now roughly the size of the entire U.S. high yield bond market! This concentration and dispersion are made even more extreme when you consider that the post-COVID economic path is almost unanalyzable with many sectors facing existential threats. Security selection is more difficult than ever; but that also makes it more valuable than ever.

So, how does one build an optimal portfolio that provides attractive yield, avoids credit left-tail risk, and achieves portfolio balance at a time when single companies are virtually the size of an entire asset class? From the bottom up, we are seeking out the companies that are most sustainably investing in innovative capital expenditure and research and development. Specifically, we’re looking to invest in firms that defend against, or takes advantage of, the disinflationary demographic trends we describe. Or, in companies that have developed business models placing them on the right side of technological disruption, and that makes their cash flows durably in both a COVID and post-COVID world. Through this lens, we can try to identify

which entities are able to generate attractive returns on invested capital at reasonable costs, which provides a great foundation for consistently outperforming the broader market today.

Portfolio allocation considerations

From a top-down perspective, there is not enough return potential in the highest-rated parts of fixed income, like U.S. Treasuries, mortgages and municipals to warrant a meaningful allocation. Except for the very back-end of the Treasury curve, Fed buying and the reach for quality have depressed these yields already. Long-end Treasuries should continue to provide a hedge, or balance, to an investment portfolio, but also could experience bouts of supply-driven weakness due to funding requirements for these extremely large fiscal initiatives being implemented. We also do like owning some Treasury Inflation-Protected Securities (TIPS), for which our colleagues make a very persuasive case. While we maintain our long-held view that inflation will be very well contained, current market pricing offers too great of a discount to ignore. As we will discuss further in a forthcoming Blog Post, we expect a diverse mix of “middle-quality” fixed income assets, with yields in the mid-single digits, to likely perform well in the year ahead, particularly if paired with adept security selection that accounts for the secular trends we have discussed. We see such opportunities in the U.S. investment-grade new issue market, as well as in parts of the high yield bond market. As noted earlier, the high yield market may not be large enough for building durable portfolios at scale, but the fundamental dispersion of its constituents presents a great opportunity to parse through and strategically accumulate the best placed assets. In fact, we think credit rating may not matter as much today as sector exposure, or asset collateral, and deal structuring will play a huge role in determining outcomes going forward.

This same thematic dispersion is true across the disparate pools of collateral that back securitized assets, as well as the varied fundamental fortunes within the emerging markets world, as those nations battle the ongoing pandemic. We are comfortable taking positions in these asset classes today, but again, through a filter of intense security selection, and generally at the higher quality ends of the spectrum. As for equities, while the ferocious April rally leaves major U.S. indices a bit stretched, tactically, we strongly believe that equities should be valued for the long-lived streams of cash flows they represent. With some conservative assumptions, the current valuations of U.S. equities, viewed through a longer-term lens, are fair at worst, and arguably appear quite attractive, and worth owning in a well-balanced portfolio. For the time being, though, we would keep those holdings at mid-level exposures to provide room to expand allocations in the event of potential market consolidation in the week and months ahead.

Finally, between elevated implied volatility in risk assets and record-low Treasury yields, hedges are quite difficult today. In fact, we like selling volatility as a source of income again. With rates market volatility having dropped precipitously, it stands to reason that the rest of the asset stack can in time follow suit, with ubiquitous monetary policy support in the background. Beyond that owning a bit of gold as a hedge, and keeping some extra cash on hand, also both make sense.

In conclusion, asset prices in 2020 have seen a Newton’s cradle dynamic in hyper-speed with extreme momentum to the downside being quickly offset by overt support from policy makers, leaving us now somewhere in the middle. While we see an eventual policy-led path back toward a fundamental equilibrium for our economic Newton’s cradle, we are not quite there yet. Along the way, identifying and positioning around the underlying dispersions we discuss will be the single most important factor in generating additional return as 2020 unfolds.

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