US Equity Outlook

After a record long bull market and economic expansion, COVID-19 swept the foundations out from under the global economy. While only three months ago ongoing economic growth was the base case expectation, we are now contemplating how severe and extended the recession will be.

It is highly likely that the downturn in the US and Europe will break prior records, and the human cost—both directly from the pandemic and indirectly from unemployment—will be severe. Although markets have sharply repriced risk assets, we do not believe investors fully appreciate the gravity of the healthcare crisis. Most estimates of how quickly social distancing measures might end and the level at which confirmed infections will peak are overly optimistic in our view.

In this piece, we review the three critical building blocks that we believe are required to exit the crisis and gauge the progress to date on each of them. Then we examine the high frequency data for early clues as to how severe the decline in economic activity has been so far and assess the near-term outlook.

Three Keys to Exiting the Crisis

Turning the economy and markets depends on a combination of the following:

1. Implementing widespread testing and developing therapies that can mitigate the contagiousness and severity of COVID-19 so we can safely resume our normal lives.
2. Ensuring ongoing access to funding. By injecting liquidity into the economy, the Federal Reserve can keep financing available and affordable for both businesses and consumers.
3. Supporting domestic demand through fiscal stimulus. The decline in economic activity and increase in unemployment that will result from social distancing and lockdowns will shatter records. Fiscal policy can mitigate the effects of this decline in activity.

Testing and Therapies

Despite significant progress, testing in the United States remains focused primarily on people with severe symptoms of COVID-19. The level of daily testing has increased dramatically in the US with 2,400 tests per 1 million population. However, US testing significantly trails that of Italy (over 7,100 tests per million) and South Korea (over 7,200 tests per million). As a result, there are almost certainly many more people who are infected and unaware of their status circulating among the general population than confirmed case numbers indicate.

Fortunately, progress continues on the testing front. In late March, Abbott Labs received emergency approval for a new molecular test that can confirm COVID-19 infection in as little as five minutes and deliver a negative result in 13 minutes. Importantly, the Abbott test can be administered outside a hospital setting, in a doctor’s office or an urgent care center. Danaher also received approval for a rapid point-of-care molecular test with results in 45 minutes. More testing would make it possible for people who are infected but do not develop symptoms to isolate themselves from others, thereby slowing the spread of the disease.

Summary

- When only three months ago ongoing economic growth was the base case expectation, we are now contemplating how severe and extended the recession will be.
- We believe exiting the crisis will depend on the synergy of three critical factors: the development of wide COVID-19 testing and effective therapies; ample and readily available financial liquidity; and extensive and ongoing fiscal stimulus.
- The escape path from this crisis may also lead us out of secular stagnation. With interest rates at all-time lows, the productivity increases that result from the vast infrastructure spending required should far exceed the costs and could spell a new chapter for growth.
- We believe we are entering upon precisely the type of environment that creates the basis for active management to deliver alpha relative to markets for several years to come.
As for therapies, hydroxychloroquine and azithromycin have been promoted as potential candidates, but we still lack clinical proof of their efficacy. We are hopeful that we might learn more from a new large-scale trial in New York in April. Remdesivir is also a potential antiviral treatment, but the primary drawback of this therapy is that it is administered intravenously over several days while a patient is hospitalized. Our global healthcare research team is monitoring therapeutic advances, and we are posting our latest views on this topic at www.lazardassetmanagement.com where we provide weekly updates on the COVID-19 situation.

Until effective therapies are developed and deployed broadly, we believe it is critical that monetary policy provides abundant liquidity and that financing is available to creditworthy borrowers. It is also critical that the federal government provides fiscal stimulus to support consumption of goods and services while a large portion of the population cannot work. The good news is that monetary and fiscal policymakers have recently engaged the COVID-19 challenge.

**Funding**

The Fed has aggressively attacked the economic slowdown, cutting the fed funds overnight target rate to 0 – 25 basis points (bps) from 150 – 175 bps in only 12 days. The Fed also announced on 15 March that it would purchase at least $500 billion worth of Treasury securities and at least $200 billion of mortgage-backed securities (MBS). Only eight days later, it announced that there would be no limit to these purchases and proceeded to buy $375 billion of Treasuries and $250 billion of MBS in the subsequent five days. The Fed’s balance sheet has already grown by $1 trillion in the three weeks ended 25 March.

Alongside these measures, the Fed announced a host of liquidity facilities, the most important of which are:

1. The Primary Market Corporate Credit Facility (PMCCF) enables the Fed to buy newly issued corporate debt with maturities up to four years and provides for deferral of principal and interest payments for up to six months to allow companies to pay employees and suppliers.

2. The Primary Dealer Credit Facility (PDCF) permits primary dealers to post a wide range of collateral in exchange for recourse funding at the rate of 25 bps for 90 days. The collateral that can be posted includes AAA rated tranches of structured credit instruments (commercial mortgage-backed securities, collateralized loan obligations, and collateralized debt obligations), corporate bonds, mortgage-backed securities, international agency securities, commercial paper, municipal securities, asset-backed securities, and equities (excluding ETFs, unit investment trusts, mutual funds, rights, and warrants). All collateral must be investment-grade and US dollar-denominated.

3. Through the Term Asset-Backed Securities Loan Facility (TALF), the Fed can lend on a non-recourse basis for three years against collateral that includes AAA rated tranches of ABS secured by credit card, auto, student, and Small Business Administration (SBA) loans.

Other facilities include the Commercial Paper Funding Facility, the Money Market Mutual Fund Liquidity Facility, and the Secondary Market Corporate Credit Facility.

Taken altogether, we expect these Fed programs and quantitative easing to resolve issues across a range of markets. Quantitative easing has already led to a reduction in yields for 30-year MBS of over 125 bps in the first week after the Fed announced unlimited purchases. This reduction in funding costs has not yet reached mortgage borrowers but should eventually reduce costs for financing new mortgages and refinancing existing ones. At the same time as the federal government has agreed to a record fiscal stimulus, the Fed is able to buy Treasuries to ensure that the surge in the supply of Treasury debt does not lead to a sharp increase in interest rates.

**Fiscal Stimulus**

The bipartisan fiscal stimulus package signed into law on 27 March was unprecedented in scale and speed. During the global financial crisis, it took two months to negotiate the $787 billion American Recovery and Reinvestment Act of 2009 even with a single party in control of the House of Representatives, Senate, and White House. The Coronavirus Aid, Relief, and Economic Security Act (CARES) was negotiated in less than two weeks and allocates $2 trillion to support the economy. It follows two other packages: an $8.3 billion program focused on supporting the immediate response to COVID-19 and providing testing, and the $104 billion Families First Coronavirus Response Act, which aimed to increase the availability of free testing and paid sick leave for employees.

The CARES Act provides:

- **$300 billion in direct payments to households**, with a maximum payment of $3,000, based on income and the number of adults and children in the household. Payments are expected to reach consumers within three weeks.

- **$260 billion to extend and increase unemployment insurance benefits**. Benefits can now be paid for 39 weeks instead of 26, and were increased by $600 per week to attempt to cover 100% of former wages. Coverage has also been extended to the self-employed, workers who earn tips, and workers who are employed informally in the gig economy.

- **$377 billion for small business**. This aid includes the Paycheck Protection Program, which extends loans to small businesses with fewer than 500 employees. These loans are forgiven for companies that use the funds to pay employees, rent, mortgage interest, and utilities. The funding is capped at 2.5 months of payroll and is processed through banks working with the SBA. It also provides $10 billion for up to $10,000 of emergency funding for small businesses and covers six months of payments for businesses that have already received SBA loans, at a cost of $17 billion.

- **$500 billion for large corporations**:
  - $25 billion for loans to passenger airlines
  - $4 billion for loans to cargo airlines
  - $17 billion for loans to companies that are important to national security (e.g., Boeing).
We agree. Various policy officials have made it clear that this package might be
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In a separate section, entitled Pandemic Relief for Aviation
Workers, the legislation provides an additional $25 billion in
grants to support passenger airline employees, $4 billion for
cargo airline employees, and $3 billion for contractors to the
airline industry.
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The remaining $454 billion is allocated as capital that the Fed
can leverage through programs or facilities established to provide
liquidity to the financial system in support of lending to eligible
businesses, states, and municipalities. The legislation leaves a
surprisingly large amount of latitude to the Fed and the Treasury
Department as it relates to this portion of the funding. We
estimate the Fed could turn this capital into $4 trillion – $4.5
trillion of loans.

- $340 billion for state and local government assistance and aid to
tribal governments
- $151 billion in aid to healthcare systems
- $44 billion in aid to educational institutions
- $26 billion for safety net programs such as the Child Nutrition
Program and the Supplemental Nutrition Assistance Program

The most important question surrounding the CARES Act is whether
the small business assistance package can be deployed rapidly enough.
The JP Morgan Chase & Co. Institute surveyed almost 600,000 small
businesses and found that only half could sustain cash outflows for 27
days. The COVID-19 crisis has already disrupted commerce for weeks
in many areas, and it is not clear how many businesses have already
closed their doors. The small business funding available through the
CARES Act could reach businesses starting in a matter of days by
using the existing SBA lending processes. However, if the new pro-
gram requires a different approach, it could be weeks before money
reaches borrowers. It also is not clear what documentation will be
required to validate which loans are forgiven.

We believe the CARES Act is a very good package of assistance and
praise the bipartisan compromises that were made to pass this legisla-
tion. However, we also believe this will not be the last fiscal stimulus
package. Unfortunately, the small business component will only cover
business interruption for about three months, and the household pay-
ments of up to $3,000 are unlikely to last beyond one or two months.
Various policy officials have made it clear that this package might be
followed by others. We agree.

The most effective aspect of the legislation is likely to be the large
corporate assistance, especially considering the Fed’s ability to leverage
$454 billion of capital to extend more than $4 trillion in credit. We
look forward to seeing details regarding how the Fed will utilize this
capital, in particular whether it might provide funding for non-invest-
ment grade borrowers.

Economic Implications

Whether through local regulations or voluntary precautions, consumption
patterns have shifted dramatically across the United States. With
50% of Americans facing some sort of restriction on social gathering,
demand has dropped for a wide range of goods and services. Thus far,
measures tracking the scope of the economic downturn have been lim-
ited to jobless claims, sentiment indicators, and reports from certain
sectors such as hospitality and restaurants. They paint a very negative
picture.

Jobless claims in the week ended 20 March shattered all prior records
with 3,28 million initial claims. We believe this figure was understated,
as the New York, New Jersey, Kentucky, Colorado, and Nevada state
systems reportedly crashed under the volume of claims during that
week. (For context, during the global financial crisis the worst report
was 665,000 claims for the week of 27 March 2009.) Even while
national claims increased by a factor of more than 10, claims reported
for New York only increased from 14,000 to 80,000, a slightly less
than six-fold increase at the epicenter of the COVID-19 outbreak.
Anecdotally, California Governor Gavin Newsom has indicated that
over one million people have already filed for unemployment in his
state since 13 March, even though filings for the week of 20 March
were only 187,000, implying more than 800,000 additional claims
over the course of the next two weeks (Exhibit 1).

Based on our analysis of the US labor market, there were 15.7 million
workers in retail, 16.9 million in leisure and hospitality, and 1.1 mil-
lion in personal services as of February 2020. The breakdown of leisure
and hospitality jobs includes 12.3 million in food services and drink-
ing places, 2.1 million in the hospitality industry, and 2.5 million in
arts, entertainment, and recreation. We consider these social consump-
the worst month of the global financial crisis, when occupancy fell 11.8% from the previous months and room rates dropped by 9.7%, making for a 20.4% reduction in RevPAR, and September 2001, with comparable month-earlier declines of 16.2% in occupancy, 8.4% in room rates, and 23.2% RevPAR (Exhibit 3).

For restaurants, the best data we have is from OpenTable, which shows that seated diner activity has declined fully 100% year-on-year on the OpenTable network, a global network of some 60,000 restaurants, across all channels including online reservations, phone bookings, and walk-ins. The decline was precipitous, with the United States showing year-on-year growth in seatings as recently as 1 March. By 16 March, seatings were down 56%, and by 21 March they had fallen completely to zero. While OpenTable is not the perfect proxy for the entire restaurant industry, as it typically serves the high end of the industry, it still offers a chilling commentary regarding activity levels.

Outlook and Implications for Markets

Forecasts for US GDP growth vary wildly at this point. In surveying the outlook for 2020, we reviewed forecasts updated in the second half of March and found the most negative forecast from Nomura Securities at -9% (dated 27 March) for full-year 2020 GDP. The most optimistic was +0.9% from Unicredit (dated 20 March). The key differentiator among the 20 forecasts we reviewed was the length of the downturn. Some forecasters expect the second quarter of 2020 to be the worst since the Great Depression, but almost every one of them assumes a sharp rebound in the third quarter, which is the bull case in our view. We have no reason to believe a therapy for COVID-19 will be widely available before the end of the second quarter, and we have no epidemiological basis for assuming that warm weather will mitigate the spread and severity of the coronavirus.

We believe a reasonable base case is to expect two-to-three months of social distancing. Perhaps late in the second quarter of 2020, some states and localities could begin to eliminate restrictions and start revitalizing their economies. By this time, we assume another fiscal stimulus package passes and total supplementary spending by the fed-

Every 1.65 million increase in unemployed people is equivalent to a 1% increase in the unemployment rate. In our bullish case then, the social consumption sectors alone could shed 7.3 million jobs, taking the unemployment rate to almost 8% by June of 2020. In the more bearish case, unemployment would increase by 11.8 million jobs taking the unemployment rate to almost 11%.

These scenarios do not account for the additional job losses likely in other sectors, given the feedback loop from reduced consumption. (Keep in mind that the projections estimate peak unemployment, not a sustained level of unemployment through several quarters. That type of projection is impossible to make at this point with any level of confidence.)

Sentiment indicators have fallen sharply. In fact, sentiment regarding current conditions fell more than any time since 2008, while expectations fell to the lowest level in three years. The US Services Purchasing Manufacturers’ Index (PMI), released on 24 March, dropped to 39.1 from 49.4, while the manufacturing PMI fell to 49.2 from 50.7. (A reading above 50 suggests expansion while below 50 indicates contraction.) On 27 March, the University of Michigan Consumer Sentiment Index declined to 89.1 from a reading of 101.0 in the prior month. Yet while consumers are clearly shaken by COVID-19, it is not clear if their expectations have fully aligned with the likely economic damage from the crisis.

The last category of high-frequency data we would highlight comes from hotels and restaurants. In the hotel sector, monthly data for February showed a decline in occupancy rates of 29.4% and a decline in room rates of 10%, taking revenue per available room (RevPAR) down 36.5%. This decline was the largest on record and compares to...
eral government approaches $3 trillion – $4 trillion, with the bulk of incremental funding going forward targeted at small business, households, healthcare systems, and state and local governments.

We agree with consensus that after the crisis ends the recovery is likely to be sharp. The key question is how much long-term damage will have been done before then. Small businesses that close are unlikely to reopen quickly, if at all. People who are unemployed for extended periods are unlikely to find employment readily, especially if they are older workers. Older workers may also find their nest eggs badly damaged, causing them to reassess their spending and retirement plans.

Yet on the bright side, the escape path from this crisis may also lead us out of secular stagnation. For too long, the US government has grappled with a philosophical divide over whether and how to stimulate growth through fiscal policy, in our view. This crisis—and the trillions of dollars the government injects to save the US from a depression—is likely to end the stalemate. We hope that in the aftermath of the crisis the US will continue to invest in growth with a multi-trillion-dollar infrastructure program over the coming decade. With interest rates at all-time lows, the productivity increases that result from such infrastructure spending should far exceed the costs. If this philosophical shift can take hold, it could spell a new chapter for growth in developed economies.

Against this backdrop, we believe the Fed will be extremely cautious about normalizing monetary policy. In 2018, the Fed tightened in anticipation of inflation and had to reverse course in 2019. We do not believe the Fed will make the same mistake again. We expect zero interest rates to remain a fixture of monetary policy for several years. We also believe the Fed is unlikely to shrink its balance sheet as quickly as it did in the aftermath of the global financial crisis.

In light of even lower interest rates for even longer, we think equities can regain their prior peaks, but only over a two-to-three-year period. Given our less optimistic view of the next few months and the unavailability of a therapy to mitigate the contagiousness and severity of COVID-19, we are focusing on compouders, companies with high sustainable returns on capital trading at attractive valuations. We also are prioritizing corporate liquidity and balance sheet strength as companies without access to funding are likely to remain extremely challenged until this crisis has passed, if they can survive that long. We are avoiding non-investment grade companies and those that we believe are at risk of falling into non-investment grade ratings as access to funding is severely impaired for such companies, and the Fed’s programs do not extend to them at this point.

As always, we continue analyzing a range of scenarios for each company and for COVID-19. The market dislocation has created opportunities to buy great companies at significantly discounted prices, and we are taking advantage of these situations to position clients for long-term capital appreciation with limited downside exposure. In sum, we believe this is precisely the type of environment that creates the basis for active management to deliver alpha relative to markets for several years to come.
US Fixed Income

The preceding Outlook reflects the views and analysis of Lazard’s US Equity teams. The following Outlook reflects the views and analysis of Lazard’s US Fixed Income team.

The global markets had a decidedly risk-on tone as 2020 opened. US high yield issuance chalked up its second-busiest January on record, and yields on 10-year government bonds from Europe’s one-time weakest link, Greece, went below one percent. Investment-grade corporates continued to be well bid, as evidenced by the ability of French luxury conglomerate LVMH to finance its takeover of legendary jeweler Tiffany with negative-yielding debt. By late February, however, the tone of the markets had changed completely as markets began digesting the economic fallout of the pandemic spread of the SARS-CoV-2 virus and the resulting disease, called COVID-19. What started as a supply shock became a demand shock as well as governments ordered workers to stay home and businesses shut down. The demand shock manifested itself in the markets through decreasing inflation expectations (Exhibit 4).

Adding to the market volatility was the precipitous drop in global oil prices after Russia rejected OPEC’s demand to cut supply to prop up an already-beleaguered oil price. Saudi Arabia’s countermove, slashing prices and raising output in a market-share war of attrition, drove prices down even further.

The global monetary and fiscal responses to the number and magnitude of these challenges has exceeded those of the 2008 global financial crisis. Although the responses will help mitigate the worst potential market outcomes, we anticipate elevated volatility will persist.

Going into the turmoil the US had been an economic oasis of calm compared to most other developed markets, especially those in Europe. The US headline U-3 unemployment rate had fallen to levels more indicative of a depression than a record-long expansion (Exhibit 5). We believe, as we have mentioned previously, the US yield curve, especially the long end, has been reacting to global rather than domestic conditions. The US 10-Year Treasury note has been investors’ choice for insurance in a world of developed market sovereign rates at or below zero. This dynamic is apparent in the record-low negative term premium we’ve seen for the US 10-year (Exhibit 6). In our view, until rates for German Bunds and/or Japanese Government Bonds rise, giving investors other choices for liquid, flight-to-quality insurance, longer-term US Treasury yields will remain at depressed levels beyond the current pandemic conditions.

The fallout from the COVID-19 outbreak will undoubtedly put an end to the record-long US economic expansion and drive the US into recession, along with the rest of the global economy. And by mid-February, the market was already anticipating Fed intervention. The short end of the US yield curve inverted as fed funds and Treasury bills yielded more than 10-year Treasury notes. Acting to support the

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**Exhibit 4**

**Inflation Expectations Have Collapsed**

Five-Year TIPS Breakevens

![Inflation Expectations Chart](chart1)

As of 31 March 2020
Source: Bloomberg

**Exhibit 5**

**Safe-Haven Demand Has Depressed Yields to Depression-Like Levels**

![Safe-Haven Demand Chart](chart2)

As of 31 March 2020
Source: Bloomberg, NBER

**Exhibit 6**

**10-Year Treasury Term Premium Has Fallen to an All-Time Low**

![10-Year Treasury Term Premium Chart](chart3)

As of 31 March 2020
Source: Bloomberg
economy on 3 March, the US Federal Reserve initiated an inter-meeting 50-bps cut of the fed funds rate to a 1.00% – 1.25% target range. Next, on 15 March the Fed announced a broad set of actions to loosen financial conditions and ensure the Treasury and mortgage-backed securities (MBS) markets continued to function. The Fed package included cutting the benchmark overnight rate down to 0 – 0.25%, committing to buy $500 billion in US Treasuries and $200 billion in MBS, lowering the discount rate to 0.25% and extending loan terms to 90 days, reducing rates on US dollar swap lines for foreign central banks, and cutting reserve requirements for many banks to zero. Although there was initial criticism that the Fed unwisely used precious “dry powder” to stem a supply-side shock, the risk was that the longer the Fed waited to take action, the less effective its actions would likely be in stabilizing markets. We believe delay would have led to an even more acute market dislocation and that the Fed should continue to err on the side of providing more monetary stimulus rather than less to loosen financial conditions and keep markets functioning smoothly.

While we think it was prudent for the Fed to take rates to the zero bound, we think the Fed will resist taking rates negative in view of the deleterious effects a negative-rate policy has had in Europe, especially for the banking system. Instead, we expect that the Fed will expand upon previously announced programs and establish new ones as needed, such as unlimited quantitative easing, programs to increase US dollar availability, issue dovish forward guidance, expand swap lines with other central banks to provide US dollars, and initiate new lending facilities. For example, the Fed announced the re-introduction of its Term Asset-Backed Securities Loan Facility. First used in 2008, the TALF was opened up again on 23 March and will be used by the Fed to support asset-backed securities (ABS) consisting of underlying credits such as student loans, auto loans and leases, and small business loans, with the US Treasury providing equity to the facility through the Exchange Stabilization Fund.

The Fed has also established programs such as the Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility to support the investment-grade corporate bond markets and the Money Market Mutual Fund Liquidity Facility for the money markets, among others, to ensure smooth market functioning. In combination with Congress’ fiscal measures that include loans for businesses, support for the healthcare system, expanded unemployment benefits, funds for state and local stimulus, and direct payment to individuals, the Fed’s actions should go a long way to removing the tail risk of an insolvency crisis affecting corporate and personal balance sheets. Notwithstanding these proactive measures, however, the catalyst, in our view, to return to a semblance of normalcy is more likely to come from positive news in flattening the curve of COVID-19 infections and therapeutic advances to combat the virus.

In such volatile markets, we believe it is paramount that investors look to the stability of their fixed income portfolios. Core fixed income allocations should emphasize preservation of capital, dependable income, and diversification versus risk assets while retaining enough liquidity to meet cash obligations. To achieve these outcomes, investors should make sure each of their holdings can stand on its own merits on the basis of three fundamentals—credit strength, structure, and market sponsorship:

- **Credit Strength**: identify issuers with a demonstrated ability and willingness to pay interest and return principal
- **Structure**: identify securities with a capital structure that favors lenders and that are contractually written, using generally accepted terms and conditions
- **Market Sponsorship**: identify bonds that enjoy robust long-only institutional demand. Operationally, institutions have infinite time horizons, and those that invest without leverage are indifferent to passing market storms. They ultimately give investors a ready, resilient, and liquid market to convert securities into cash when liquidity elsewhere is scarce.
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