

## Key Questions

# Is This 2008 All Over Again?

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We remain hopeful that our nation's history of medical innovation will again prove its prominence and our economy will again reveal its resilience.

Emergency interest rate cuts, large-scale liquidity interventions by central banks, sharply swinging stock prices, and headlines shouting, "Markets in Turmoil!": These developments and others like them are evoking comparisons to the Global Financial Crisis (GFC) in the fall of 2008. While the global economy is currently confronting its greatest set of challenges in the last 11-plus years, and while there are some similarities to 2008, there are many significant differences that need to be understood as well.

Like 2008, markets are moving very rapidly, oscillating wildly as equity markets take their cues from credit markets that respond in turn to moves in the equity markets. More specifically, stock prices are under pressure as investors grapple with forecasting the earnings impact caused by efforts to contain COVID-19. They know that earnings will decline but have no convenient precedent from which to draw, and companies themselves are also unsure how their businesses will fare in the weeks and months ahead.

Sensing this uncertainty, credit markets are anticipating stress and have begun to reprice risk in the form of wider spreads (the differential between safe-haven assets such as Treasuries and corporate bonds). This is spurring a sell-off of high-yield bonds that in turn is triggering concerns of equity holders. As my colleague Steve Hoedt cautions: "It's never a good thing when equity investors feel the need to be concerned with credit."

Still, while credit spreads (broadly defined) are increasing, they are below their 2016 levels (a time when investors were concerned about China's economic slowdown) and are well below levels reached in 2008. Further, actions already taken by the Federal Reserve (and those anticipated\*) are targeted squarely at ensuring that financial liquidity exists. Nonetheless, we will be monitoring these trends closely.

Worrisome linkages between equity and credit markets notwithstanding, an important distinction today versus 2008 is the fact that the coronavirus shock is a true exogenous event. The GFC, however, was endogenous -- it was a shock from within the economy that was far more corrosive and difficult to address. As a result, its impact was deeper and required a far longer recovery relative to our best guess as to how the current situation will play out.

Stated more clearly, the GFC was what economists term a balance sheet recession. The "house as an ATM dynamic" (as my other associate Justin Tantalo labeled it) spawned an unhealthy binge in credit. Once the housing bubble burst, it adversely impacted many households' balance sheets necessitating years of paying down debt as opposed to spending. Exacerbating this, the fall of the housing market exposed large vulnerabilities in a highly leveraged banking system composed of counterparties that were interlinked, which also required years to unwind and years of prioritizing balance sheet contraction over growth.

Today, the banking sector is far better capitalized and consumer savings in the aggregate have been replenished. To be sure, pockets of risk exist, particularly in the energy and travel/transportation sectors that are now contending with escalating geopolitical risks on top of an already weakened demand outlook.

Furthermore, while debt levels are high, debt service levels (the ability to payoff obligations) are seemingly more manageable. Because more debt outstanding today exists within the corporate and government sectors rather than in households, it should represent a lower systemic risk to the economy. Corporate obligations can be refinanced or restructured through bankruptcy, and government debt can similarly be refinanced or dealt with via higher taxes, reductions in services, or asset sales.

None of these scenarios is particularly pleasant, but they represent a far smaller systemic risk to the economy than households retrenching for a prolonged period. Finally, as my colleague Brett Hillard has noted, billions of dollars raised by private capital investors are waiting on the sidelines for the next distressed cycle; if these funds come into the market, that could be a stabilizing factor.

In sum, we are wrestling with a considerable number of vexing “unknown unknowns.” Moreover, we live in a global environment of instantaneous information, including real-time tracking of coronavirus cases throughout the world at people’s fingertips. When you combine this with the near-frictionless ability to rapidly move large amounts of money from one asset class to another (and computer algorithms programmed to do so based on the slightest inflection in a variety of data or even mere innuendo), we expect that markets will likely remain highly volatile in the weeks ahead.

Still, provided that the virus fades in the next few months (an important caveat), economic activity should rebound comparatively more quickly and the economic hit – though painful – should be less severe than during the GFC of 2008. We must reiterate, however, such an outlook and the legacy of the virus beyond the next 6-12 months is extremely and unusually uncertain. For this reason, we remain relatively defensively positioned and hopeful that our nation’s history of medical innovation will again prove its prominence and our economy will again reveal its resilience.

## Addendum

Shortly after this article was completed, the Federal Reserve took bold measures to inoculate the economy from the impact associated with containment efforts implemented to limit the COVID-19 outbreak. The Federal Funds rate was slashed 100 basis points (1%) to its crisis-era low of 0.0-0.25% and large-scale quantitative easing was commenced. Other actions were also taken, and while some felt more could be done, the Fed is now “all in” and doing (mostly) all that it can to forestall a recession.

As of this writing (11PM EST March 15) equity market index futures are trading at their lowest permitted level (a 5% decline) and further losses in stock prices seem inevitable. Equity participants are concerned the Fed fired a proverbial bazooka and is running dangerously low on ammunition. Investors also need to see a tripartite response: healthcare-policy, fiscal policy and monetary policy should be coordinated, credible and impactful.

We continue to believe that a deep and long-lasting economic decline can be averted but the risks associated with efforts to contain COVID-19 are material and are rising rapidly. The speed and size of the government’s response to the challenge will determine the fate of equity prices in the short/intermediate-term. And the volatility of those assets will play a large role in how aggressively lawmakers respond. Along these lines, we are reminded of the arduous and multi-month process to address the GFC in late 2008/early 2009, a very chaotic time for investors. Today, political divisiveness is far more intense, but the culprit behind the current economic weakness (a lethal virus) is far less controversial.

Our bottom line: investors should continue to expect extreme volatility in the days/weeks ahead. Accordingly, we reiterate the importance of being defensive and disciplined. This suggests maintaining roughly 12 months’ worth of spending commitments in cash equivalents followed by an additional 12-18 months’ worth of obligations invested in high-quality fixed income securities. We further recommend low volatility and high-quality stocks and favor large cap stocks over small cap stocks and high-quality fixed income assets over more speculative issues.

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## Key Private Bank



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