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COVID-19 Vaccine and Market Medicine

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June 1, 2020

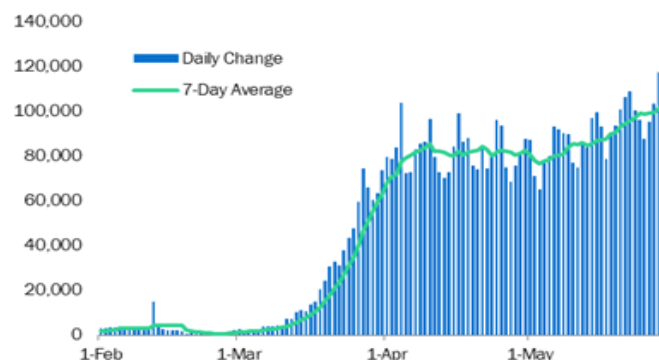
At the same time that the world is searching for a vaccine for Covid-19, the Federal Reserve, Treasury, Congress and the White House have pumped the U.S. full of medicine to protect households and businesses and avoid a financial crisis. When financial markets nearly came to a halt in mid-March, as investors and the world realized that the global response to the coronavirus pandemic would lead to tremendous strains on businesses and consumers, governments around the world responded with a heavy dose of aggressive actions to relieve some of the pain. For investors, this medicine has worked well as stock and bond prices rose quickly in April and May and credit market functioning improved.

As governments are addressing financial hardships, doctors and scientists are searching for a Covid-19 vaccine and treatments. More than 120 drug and vaccine research programs aimed at the coronavirus are under way according to the Wall Street Journal. Progress on vaccine testing has grabbed headlines in recent weeks as several potential coronavirus vaccines have entered human testing. The U.S. government is funding a large study this summer and supporting the expansion of manufacturing capacity to make at least 300 million doses. With respect to potential treatments, a study published in the New England Journal of Medicine

revealed that Gilead's antiviral drug Remdesivir showed some early signs of promise in treating coronavirus patients. White House health advisor Dr. Anthony Fauci said the data was "highly significant" and showed "quite good news."

Developments regarding a possible vaccine also supported improving market trends in April and May. Markets were also buoyed by signs that social distancing and other initiatives aimed at containing the virus have succeeded in flattening the curve in the U.S. and much of Europe. However, spiking cases in countries such as Brazil and India are bending the curve back up globally.

Daily Change in Globally Confirmed COVID-19 Cases



The reopening of nearly every U.S. state, to varying degrees, provided further support to markets in May. Related to these easing restrictions, some high frequency economic data such as unemployment claims, restaurant bookings and mortgage applications have spurred optimism. First quarter corporate earnings season also provided good news for industries such as technology and pharmaceuticals.

While markets seem focused on these positive developments, a steady stream of deeply troubling economic news continues. Most significantly, more than 40 million Americans have lost their jobs as “non-essential” businesses were closed. Despite this moniker, we know that every job is essential to provide families with food and other necessities. The unprecedented speed and breadth of the job losses has already resulted in late mortgage, credit card and other loan payments. Consumer spending dropped by a record amount in April despite a 10.5% monthly increase in income driven by government stimulus.

Businesses are also struggling to survive and every industry has been impacted. With revenues down, large, investment grade companies have been issuing debt at record levels to boost cash reserves. New debt issued by investment grade corporations surged to over \$200 billion each month in March through May to support liquidity. Companies have also been drawing on bank lines of credit, but many businesses are falling behind on loan payments such as commercial mortgages.

The most directly impacted industries such as airlines, cruise companies and hotels have received support from the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) as well as Federal Reserve initiatives. Small businesses and service industry companies may have suffered the deepest wounds and are now scrambling for cash to pay their bills. The CARES Act and a subsequent stimulus package provided \$660 billion to support small businesses through the Paycheck Protection Program (PPP). Despite the immense relief already delivered, Congress is considering additional rescue efforts as it becomes apparent that support will be needed over a longer period of time. Any new aid packages have become more politically contentious as states and local governments are seeking aid to help manage higher costs and lower and delayed revenues.

The economic impact of the coronavirus can be summarized by U.S. Gross Domestic Product (GDP). Though the U.S. responses to the pandemic only started in the final weeks of the first quarter, GDP shrank 5.0%.

Personal consumption, the primary driver of U.S. growth, fell at a 6.8% rate, the steepest quarterly drop since 1980. The impact to services was higher as growth in this sector fell 9.7%, the largest decline since the agency began compiling quarterly statistics in 1947. Economists project 2nd quarter GDP may approach -30%.

S&P 500 Index



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The response to the pandemic has been enormous and has helped financial markets recover and grow; it is additionally clear that the economic and human toll has been massive. The result is a giant gap between economic conditions and stock prices, which appear to be pricing in a strong and swift recovery. The S&P 500 posted its biggest monthly gain in April since January 1987. As of May 29, the index was up about 36% since its March 23rd low, cutting the coronavirus-driven losses on the S&P 500 this year to less than 6%. Our belief is the stock rally is not driven by fundamentals, but rather by inflated optimism created by government support.

We remain skeptical that the economy will be able to rebound as quickly as market valuations suggest. One concern is that reopening the economy too soon might lead to another wave of infections. This could result in a start-stop cycle and a future drop in stock prices. We also worry that behavioral changes may result in even lower growth rates than the modest levels we have experienced since the Great Recession. Consumers, businesses and regulators could all make changes and we have many questions about the repercussions:

- How long will fears over the coronavirus or other diseases slow travel?

- Will employees in certain sectors demand higher pay, thereby reducing corporate profits?
- How might profit margins be impacted by potential changes to global supply chains?
- Will companies pay down debt with revenues or raising equity, or maintain higher leverage?
- What impact will higher government debt and growing central bank balance sheets have on markets?
- Will regulators impose new rules on the healthcare or financial sectors?

To us, all of the market medicine is hiding the symptoms. No doubt, both the body and the markets need medicine from time to time and we hope that scientists will find a safe and effective vaccine for the coronavirus very soon. We also recognize that medicine can suppress or even hide the symptoms. The Federal Reserve and central banks globally have been pumping liquidity into the financial system since the Financial Crisis of 2008-2009. This has distorted markets and made it more difficult to determine appropriate security prices. Based on the economic and virus-related risks we see, we expect market volatility to remain elevated in the months ahead. Our recommendation to investors is to remain high quality and to focus on research and security selection as we navigate these uncertain times.



Sources: Bloomberg, FactSet, Wall Street Journal, www.nbcnews.com, www.bea.gov, www.sifma.org

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