The Merrill Perspectives Podcast

"The Road to Recovery”

With

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Candace Browning: The coronavirus has altered almost every aspect of our lives. Parents are homeschooling their children, social distancing has become the norm, and how we work and engage with other people has fundamentally changed.

It's no surprise that all of these changes have affected the markets and the economy, too. So what needs to happen for things to begin to recover and how long might it take?

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Hello and welcome to this market edition of the *Merrill Perspectives* podcast. I'm Candace Browning, Head of BofA Global Research.

On this episode, were going to explore the road to recovery for the rest of this year and into 2021. We'll look at what shape that recovery could take and how people, businesses, and industries are adapting to the strange new normal we find ourselves in. We'll also offer guidance for investors as they continue to navigate the emerging risks and opportunities ahead.

Joining me for today's discussion are Chris Hyzy, Chief Investment Officer for Merrill and Bank of America Private Bank.

Chris Hyzy: Hi, Candace.

Candace Browning: And Jared Woodard, Head of the Research Investment Committee and Director for Global Investment Strategy at BofA Global Research.

Jared Woodard: Hello, Candace.

Candace Browning: Chris and Jared, let's start with a look at the trillions of dollars of stimulus money that's going to help American families, workers and businesses get to the other side of this pandemic. It's a massive amount, more than $7 trillion and still counting, but how is it working and will we need to see even more government measures down the road?

Chris Hyzy: Yes, so when you start talking about using the T or trillions, this is serious. And in fact, if you add to this the fiscal spend and some of the balance sheet expansion, it could approach 50% of GDP in the United States.

And how is it working? Well, first and foremost, it has re-liquefied, if you will, the financial markets, because of the backstop and the massive amount of stimulus first by the Fed. And then ultimately as it relates to fiscal spend from the federal government, deposits have been put in place directly, direct paychecks to the actual household, and then ultimately lending programs into the small businesses.

So it's early days but what we're finding is, is this is providing that backstop support to the consumer, and as we all know, the consumer is most important to the U.S. economy.

Jared Woodard: Yeah, I would add that it's worth thinking about just how far we've come already. In 2020, we endured the fastest start to a bear market in history but we also witnessed the fastest and largest government response in U.S. history in peacetime. In the United States, just the fiscal support alone has made all the difference to households and businesses who otherwise had no source of revenue, no source of income.

But more will be needed. Even after the economy is fully open, we think that that debt forbearance, income support, and needs measures can help a lot, but we will also need to replace things like lost tax revenue for state and local governments so that essential services won't be cut. We've made a lot of progress but we think there will be a lot more work to be done.

Chris Hyzy: And in times like this today, we talk about science; we talk about technology. That gets us back and that gets us through, and we're already starting to see two very important items.

The claims numbers, unemployment claims numbers on a weekly basis are slowing down. And taking a look further, the continuing claims numbers are flatlining. All that basically means is, as jobs leave the broader economy, the number of jobs going back already is matching it, which means the economy is getting up off the ground again.

Candace Browning: The other thing that we're all very closely watching is consumer spending, which we all know makes up a very significant part of the U.S. economy; in fact, it's about 70%. So it could take months for the actual physical economy to fully reopen in all 50 states, and months before we're all comfortable heading back to the stores and eating out in restaurants.

So Chris, I'm particularly interested in what your perspective is on this and what it will take to restore consumer and business confidence?

Chris Hyzy: Yes, it's important to kind of put this in stages. The actual first phase of what took the economy down after the pandemic hit was the shutdown. And then from a shutdown, you go into a transitional period where you begin to see some states reopen, and then ultimately all 50 states reopen. So you have this wavy move that happens over the course of the late spring into the summer in our estimation. And then as that gets through, you start to see more of a robust recovery take hold.

Ultimately, temporary workers first get hired back in other aspects of it, like tracers or trackers or sanitizers or temporary workers that reconfigure buildings. All of these things are at the beginning stages of that right now.

Once that begins to gather momentum, confidence starts to go up, you spend a little bit more. But the real recovery gathers more momentum in the fourth quarter and heading into what we call the pent-up demand stage which is 2021.

Candace Browning: Okay, so those are some of the stages. But in terms of the actual numbers, Jared, what indicators are you watching for that the economy is actually healing and moving forward?

Jared Woodard: Well, I would group all the different indicators that we're watching into three categories.

Number one, health. Obviously, we're all monitoring new cases and changes in the pandemic on a daily basis now across the country and the world. In addition to those figures, it's important to watch progress on treatments and vaccines and so on.

Number two, the macro, the economic data. Chris mentioned initial jobless claims, continuing claims, I think those are going to be incredibly important.

In addition to that, every month the Institute of Supply Management publishes their Purchasing Managers Index. It's probably one of the most important pieces of macroeconomic data every month. And in particular, the new orders component of that series, when we see a surge in new orders, meaning that more people are placing orders for manufactured goods, I think that's going to be an incredibly early and important sign. As well as housing, because we know that housing and real estate are so important to the U.S. economy.

And then finally, number three, markets. If you see continued strength in investment-grade bonds and high-yield corporate bonds indicating that investors are confident that we'll be able to avoid a really catastrophic wave of corporate defaults, I think that's going to be an incredibly powerful sign to watch.

Candace Browning: We hear a lot about the different shapes the recovery could take, from a V to a U to an L, possibly even a W. Chris and Jared, is there a particular letter you're watching for and why is this so important?

Chris Hyzy: Candace, that's a great way to frame this. I think the only letter in the alphabet we haven't heard about is a Q. But nonetheless, we're all talking about shapes. And I think the way to think about it is, is what segment of the economy are we actually talking about? I mean, some segments could be a U for sure, some could be a V, some could be a W and an L.

Certainly, the travel, leisure and entertainment space could exhibit more of a move down and then a flatline for a while until confidence comes back overall, and that's going to depend on science more than anything.

If you're thinking about actual manufacturing data or housing data, some of the indicators that Jared talked about, many of them are Vs simply because of mathematics. You fall that hard, that fast, and ultimately when you begin to produce things again, those numbers turn around and go the other way pretty quickly.

Then ultimately, between now and the end of 2021, which we believe the economy in the U.S. can get back to a similar level it was heading into the virus, that's more of a U overall. But it's hard to describe any one shape basically. It's more of a wavy recovery in the economy in our estimation.

Jared Woodard: Can I add one more letter? [Laughter] I'm thinking about the letter J, just because a J-shaped recovery would mean that we rebound to a higher level of economic growth than where we began.

The reason I'm thinking about – this is a very optimistic scenario, but this pandemic is forcing leaders in government and business to rethink a lot of old assumptions; assumptions about the way we work, about what kind of economy we should have, where our collective priorities should be on things like trade and investment and the allocation of capital.

I think with the right mix of productivity-boosting policy at the government level and resilience-boosting leadership from the private sector, I think economic growth maybe could surprise us, especially in 2021. That doesn't mean we regain all the lost jobs immediately, but I think there is more upside particularly in the United States and other developed economies than people are anticipating right now.

Candace Browning: Jared, I agree with that. It is a very optimistic scenario, but I think that this disruption is forcing massive amounts of innovation, and I think it could also force real physical investments in capital expenditures that we haven't seen in quite some time in this country, where corporations as you know have been more focused on things like share buybacks in order to boost earnings per share. So it is a very optimistic scenario, but it's not out of the realm of possibility as far as I'm concerned.

Another powerful trend that I've been seeing is this shift towards localization or de-globalization or the return of domestic production and manufacturing, and it certainly appears that this pandemic is helping to speed up that process.

So what could that process say about the path of the recovery, obviously both in the United States but also in other countries?

Jared Woodard: Well Candace, our expectation has been that, this pandemic is accelerating I think the widespread rejection of what was orthodoxy around free trade and open capital accounts, open flows of labor, and so on around the world. I think that this shift in thinking will benefit investments in local relationships, in regional alliance, in resilient supply chains, and in shared values, to be honest.

So I think you will see companies start to invest in key ways.

Number one, I think will be healthcare, pharmaceuticals, personal protective equipment, medical equipment. If you look at countries that have retained the strong industrial base, they were able to produce these for themselves. So number one, I think, is health care where you'll see more investment locally.

Number two has to be industrials, particularly things with the national defense focus. Number three, I think, is going to be technology and telecom. That's partly U.S.-China, a story that I think most investors are familiar with, and I think that the pandemic will only accelerate the need to have more security, more focus on cybersecurity, and more domestic investment to make those supply chains more resilient.

Chris Hyzy: I think Jared really hit on one point that is absolutely fascinating and it's the acceleration; more investment in manufacturing back home. Reconfiguration of businesses, changing business models are being accelerated because of the pandemic. We're hitting that second wave of innovation and that's just not in the healthcare space. That's research and development across all industries.

Candace Browning: So let's shift gears and turn to the outlook for markets. Clearly there are some opportunities but we also have to be, I think, wary of volatility. So how can investors think about a resurgence of volatility this year and also into 2021?

Chris Hyzy: Candace, you've heard me say this in many podcasts before and we'll continue to emphasize this. Number one, one of the best ways to protect against volatility in any asset class is diversification. And diversifying within each asset class and across asset classes help protect against spikes in volatility. So, number one, diversification.

Number two is think about rebalancing more frequently. Meaning, if you fall below your strategic or tactical weights in equity or in fixed income because of an excessive move in either asset class, consider rebalancing, re-risking upwards in those areas to stay on goal, stay on plan for the long term.

Finally, one of the most important items that any investor can, any client can actually continue to do is to continue to work with their advisor. The advisor working with a particular client sets the blueprint, understands the needs, the risks that clients can or cannot take, understands the full financial picture. And having that framework at hand particularly in times of the highest volatility, both positive and negative, is absolutely important and we expect that importance to rise in the months and perhaps years ahead.

Candace Browning: I know both of you have been talking a lot about growth, quality and yield. In fact, we've been mentioning those attributes and recommending them to clients for years, but they seem to be taking on new importance now. So my question is where can investors find growth, quality and yield in today's environment?

Chris Hyzy: Yeah, I would say first and foremost, it's in the United States. We've long said that the U.S. is breaking away from the rest of the world in a number of different ways. But if you think about the way the U.S. markets are built, the U.S. markets are built more on growth than anywhere in the world and in many cases, that it's even the case in the high growth areas of the emerging markets.

On the yield side, believe it or not, the U.S. on a developed market basis has more yield than most other markets all around the world, not just in fixed income but the equity market has almost a three-time or greater yield in it relative to our own fixed income market and substantially larger than that relative to what Europe is offering.

And then last but not least, quality. It doesn't necessarily just mean safety or conservative industry groups. What quality means is the quality in our opinion of the balance sheet and that puts it squarely again directly in the tech and healthcare segments, which ultimately drive growth and have the greatest free cash flow yield. So it's all converging together, Candace.

Candace Browning: One of the things I'm most interested in is for people who are retired right now, what should they be looking at in terms of investment opportunities and how should they look at the current volatility that's been happening in the markets?

Chris Hyzy: Prior to the pandemic hitting, Candace, the world was undergoing a major change in yield, and that was an anchor that pulled yield down in the U.S.

Those thinking about retirement or those already in retirement had a major plight on their hands, which is how do I replace the income that I had from my job? What we would consider is number one, reassess your plan. As income drops, as yields drop, one of the ways you can take care of that is obviously adjust your spending.

If you need to pick up extra yield, consider increasing the equity side of your portfolio if you have a long enough term investment horizon, because that's where some of the better yield is relative to searching in the traditional areas of yield. And do it on a very diversified basis.

Jared Woodard: I think on a maybe a little more tactical note that investors who have enjoyed the last 30-plus-year bull market in government bonds, might look at this as an opportunity to perhaps realize some of those unrealized gains. If you have a very long-term government bond portfolio, look at the medium term or little bit shorter, so that any increase in inflation or eventual rise in bond yields doesn't become a painful event.

Candace Browning: Well, Jared and Chris, this has been a really helpful conversation on what we could expect as we gradually move along the road to recovery. Are there any final thoughts as you look to the end of this year and into 2021 that you want to share?

Chris Hyzy: I think I'm going to go back to what Jared said on the optimistic tone, Candace. We have some of the greatest minds in the world in healthcare, in science, in technology, all working together globally with massive support working on this pandemic. And with that momentum begets a positive feedback loop both in the economy and the minds of our citizens. But it also spurs new thinking, new innovation, new ways that ultimately gets us to a better horizon.

Jared Woodard: I think that if we do get a J-shaped recovery, it's going to require, collectively, it's going to require all of us to do something that might not be our first instinct. In a time of stress and uncertainty, the natural impulse is to be cautious and to protect what's close at hand.

But if we do see I think the optimistic scenario come through, it will only happen if we find a way to take a breath, to reach out to other people. For folks who have enjoyed stable income through this period to maybe use that flexibility to help the people who haven't. And through our policymakers and elections and so on, to insist that we do more to make the recovery faster in the ways that we can, to invest and to build. If we do those things, I think we can capitalize on some pretty incredible opportunities. But again, it does require I think a conscious decision at the outset to do things a little bit differently.

Candace Browning: Well, on that note, we'll end it. So Chris and Jared, thank you very much for your insights. I know we'll all be watching this situation very closely over the coming weeks and months.

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And thank you all for listening to this market edition of *Merrill Perspectives* podcast.

My co-hosts have been Chris Hyzy, Chief Investment Officer for Merrill and Bank of America Private Bank, and Jared Woodard, Director for Global Investment Strategy at BofA Global Research. I'm Candace Browning, Head of BofA Global Research.

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On our next episode, we'll be taking a longer view into the road ahead, two to five years into the future when much of life, as we know it, could look dramatically different.

Thanks again for listening.

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