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The First Quarter Was a Disaster. What Comes Next?

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It would be the height of understatement to say that investors did poorly in the first quarter of 2020. Although many were optimistic as the year began, the March market crash which followed the onset of the COVID-19 pandemic and its related global-quarantine measures altered that outlook dramatically. Fortunately, the U.S. governmental response to the crisis was swift and unprecedented, with massive amounts of new monetary and fiscal stimulus. Congress and the President quickly passed new laws, including The Families First Coronavirus Response Act, The CARES Act, and The Paycheck Protection Program and Healthcare Enhancement Act. Moreover, Chairman Powell recently assured markets that the Fed still has plenty of ammunition available in order to provide additional monetary relief if necessary.

And while early indications are that the global governmental stimulus response to the pandemic was effective, still unanswered are the questions I've posed before: "Who will pay for all this?" and "How will it impact the future value of the dollar?"

We can probably take some comfort in the fact that similar measures have been enacted by many other governments around the world. Even so, it makes good sense to hedge portfolio inflation risk, given the many trillions of dollars that have just been printed. Although we are still in the eye of the storm, and it may take some time for all of these new dollars to create inflation, future inflation is inevitable over the long term.

But before we consider what might come next, it would be helpful to look at where we are right now. The latest U.S. macroeconomic statistics show real GDP growth down dramatically, currently at -5%. According to Bloomberg, the Q2 forecast for GDP is -34%, with unemployment rising to ~16%. On the positive side, CPI inflation is almost nonexistent, at just 0.3%, but a rise in grocery store prices could change that soon. Finally, the Fed funds rate is down to just 0.3%, as the U.S. government aggressively pursues expansionary monetary and fiscal policies.

Just last quarter, U.S. GDP had registered its longest phase of economic growth in history, with unemployment at a 50-year low. Like many other professional investors, the dramatic macroeconomic changes listed above caught me by surprise.

Sure, there were some obvious major market risks (coronavirus, an inverted yield curve, etc.), but no one could have predicted that most major economies would suddenly be forced to shut down entirely due to the rapidly expanding pandemic. The ensuing drop in economic growth, which started in the last few weeks of the first quarter, haven't been fully factored in yet. As such, it's inevitable that alarmingly negative economic statistics will continue for at least another quarter or two. From there, some type of recovery is guaranteed as businesses re-open and Americans start coming back to work.

However, some firms and industries are much more poorly positioned now than they were before. As always, overleveraged companies with bloated balance sheets face a higher likelihood of failure, and the coronavirus crisis amplifies this risk. These firms will continue to struggle to meet expenses, despite excruciatingly low interest rates, while more moderately-leveraged competitors fight to take their market share. Similarly, firms which were already operating in industries with massive secular change (such as telecommunications and oil production) face elevated risk of future distress. In the retail space during May alone, we've seen Chapter 11 filings by time-honored companies such as J. Crew, JCPenney, and Neiman Marcus.

Finally, industries which rely on close human interaction (such as airlines, cruise ships, and theatre chains) will take longer to recover, if they will recover at all, and will therefore also face elevated bankruptcy risk. These overall trends have caused total distressed debt outstanding to rapidly spike above $1 trillion.

With this forecast, we recommend that investors diversify some passive long equity holdings with selective ownership of value stocks which exhibit event-driven return potential. Although value stocks have underperformed growth for some time, many still have built-in catalysts – such as special dividends or M&A transactions – which can help increase the likelihood of good market-uncorrelated returns. We also recommend that investors hedge some market and inflation risk in their portfolios (with short market hedges and long precious-metal positions), as noted above. Given the overwhelming new supply of distressed debt, we would advise investors to also increase portfolio allocations to this asset class. Finally, there is an increasing number of firms teetering on the verge of default, and many of these represent outstanding new short-sale opportunities.

There are still a wealth of unanswered questions about what comes next, but the global economy appears to be cautiously reopening as of this writing. Hopefully, the rapid and unprecedented governmental response will help alleviate the severity of the crisis, which many had predicted would be worse than the Great Depression. Having said that, the longer-term risk of inflation as a result of so much money printing seems inevitable.

Going forward, the COVID-19 crisis has produced it a vast new supply of distressed debt for future potential investment. This should help experienced distressed debt investors find more "good companies with bad balance sheets" as they dig through the new inventory. In addition, the opportunity set for short selling overleveraged firms with broken business plans has grown as well.

The next few months are likely to be a bumpy ride for investors, and that will require patience and fortitude. That said, history has shown that markets inevitably recover. In the meantime, investors would be wise to conduct their own research, or sign up to partner with investment managers they respect, while deciding how to proceed.