WILL THE V BECOME A W?

THE CURRENT V-SHAPED RECOVERY IS LIKELY TO SLOW

June 29, 2020

Northern Trust
Global Asset Allocation

James D. McDonald
Chief Investment Strategist
jxm8@ntrs.com

Daniel J. Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

Erick Noensie, Ph.D.
Senior Health Care Equity Analyst
en35@ntrs.com

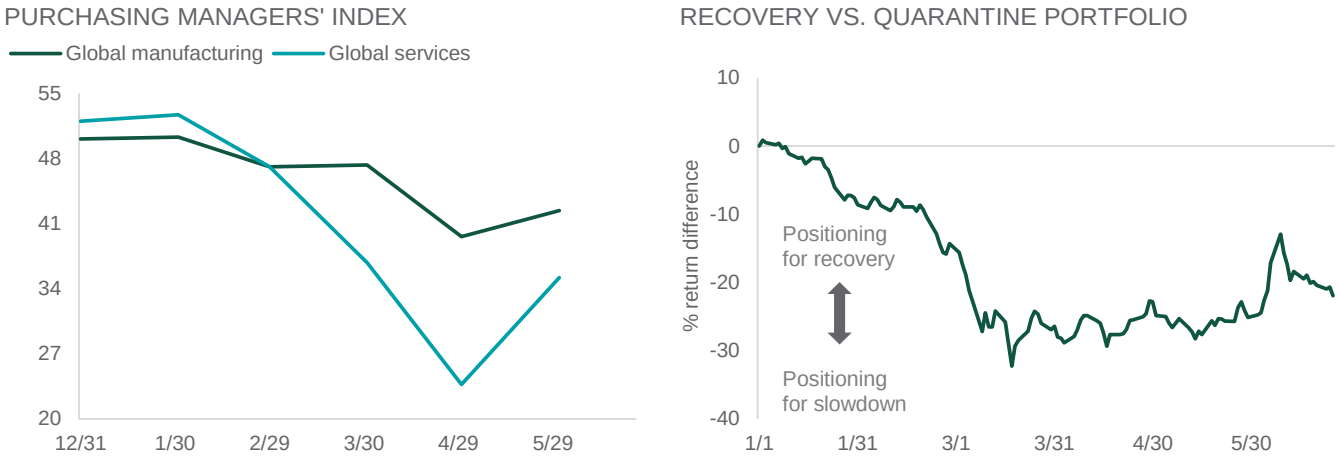
Wouter Sturkenboom
Chief Investment Strategist, EMEA & APAC
ws61@ntrs.com

The upward march in financial markets and economic activity has been quite rapid in recent months, resembling a V-shaped recovery. Risks to a continuation of that unabated recovery have emerged recently in the U.S., as COVID-19 case counts are now rising in more than half of U.S. states. We think tighter social distancing measures will be required to contain the rise, with governments, companies and individuals all restricting activity. This is likely to slow the pace of the economic recovery over the next year.

The path of the COVID-19 virus remains the most important driver of economic growth over the next year. While Europe and parts of Asia are controlling overall case levels, case counts in the U.S. and various emerging markets countries continue to rise. Increasing cases in states like Arizona, California, Florida and Texas are leading to delayed openings (such as Disneyland) and shutdowns of current activity (such as Texas shutting taverns). The global economy has enjoyed a V-shaped bounce off the bottom (as shown in the purchasing managers' indices in Exhibit 1), and that was reflected in outperformance of "recovery" oriented stocks in May. In recent weeks, however, more defensive "quarantine" stocks have started outperforming (as shown on the right side of Exhibit 1) as investors have started to position more cautiously. With broad availability of a vaccine unlikely before mid-2021 at the earliest, the global economy faces another year of constraint from social distancing (both voluntary and prescribed). It is this constraint that has led us to our more conservative view on the markets over the last six weeks.

EXHIBIT 1: V-SHAPED ECONOMIC BOUNCE

However more defensive stocks have again been outperforming.



Source: Northern Trust Asset Management, Bloomberg, JPMorgan, Evercore ISI. Purchasing Managers' Index data through 5/31/2020. Quarantine and recovery portfolios are equal-weighted baskets of stocks expected to outperform from quarantine and eased quarantine restrictions, respectively; year-to-date cumulative performance through 6/24/2020.

UPDATED REVIEW OF COVID-19 SPREAD

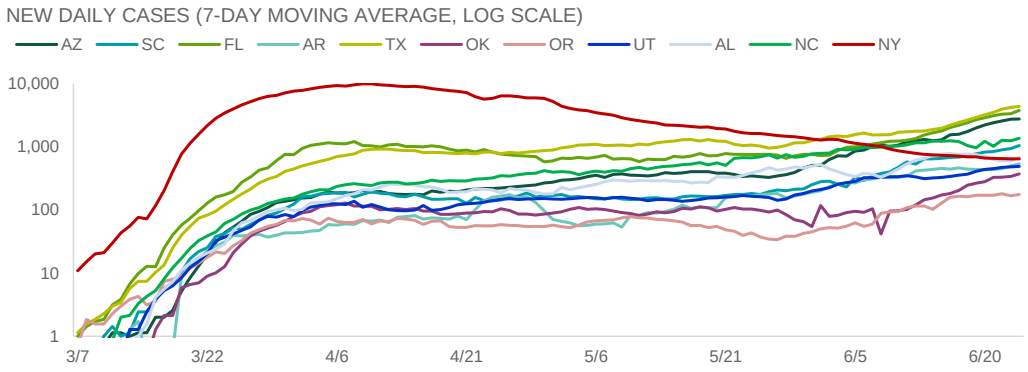
COVID-19 trends across the major developed European and Asian economies have been holding relatively steady in recent weeks, while the data has begun deteriorating in the U.S. To understand the drivers of this deterioration, we analyzed data across U.S. states to identify public health trends of the pandemic and its potential impact on the U.S. economy.

FIRST WAVE INTENSIFYING IN KEY STATES

The reporting of new cases has been partially skewed by increased availability of testing over the past few months; however, we believe the recent rise in case numbers is real, and likely continues to undercount actual infected individuals. Robert Redfield, director of the Centers for Disease Control and Prevention (CDC), recently said that the number of infections nationally could be 10 times higher than the confirmed cases. The good news is that means a lot of people had the virus in a very mild form. The bad news is this still means less than 10% of the population may have developed immunity, well below the level needed for herd immunity. In Exhibit 2, data from the 10 states with the highest case growth suggests that these states only partially flattened the curve through lower mobility and are now experiencing an intensification of the first wave of the pandemic. Conversely, states such as New York, New Jersey and Massachusetts, which had mandated face coverings and lower mobility, are seeing declines in new daily cases. More than half of the states are currently showing a weekly increase in new cases, highlighting the breadth of the continuing pandemic in the U.S. We now have New York, New Jersey and Connecticut requiring people from high case count states to quarantine for 14 days — the reverse of the situation just a month or so ago.

EXHIBIT 2: IT'S NOT OVER YET

New COVID-19 cases are rising in large states like Florida and Texas.

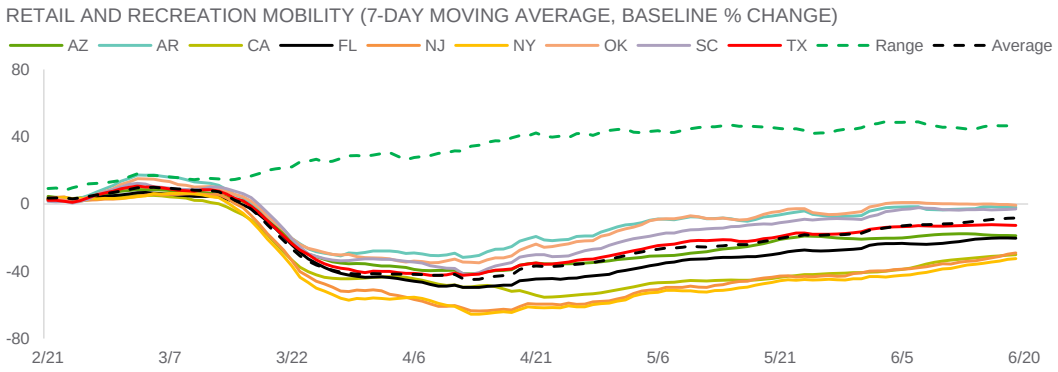


Source: Northern Trust Asset Management, Bloomberg. New daily cases shown for states with highest increase in new cases over past week plus New York. Data through 6/24/2020.

In Exhibit 3, data from Google's Community Mobility Reports, which tracks individual localized movements, shows that activity in retail and recreation settings sharply declined in March. The data shows a narrow band of activity levels at the trough in April but a wide dispersion of activity levels as states reopened at different paces. Some states with rising case numbers (e.g. Texas and Arizona) show a recent slowing in mobility, possibly reflecting individual behavior reacting to local spread of the virus. In fact, restaurant reservations have turned back down in rising case number areas reflecting caution by individuals.

EXHIBIT 3: MOBILITY WIDE RANGING ACROSS STATES

Those states with greater mobility are now starting to see rising cases.



Source: Northern Trust Asset Management, Google. Change in mobility from baseline (median value from 5-week period 1/3/2020 through 2/6/2020). Data through 6/20/2020.

WIDESPREAD MASK USAGE MAY BE NEEDED TO SUPPRESS THE PANDEMIC

Although we cannot track facemask usage, a group of states had mandated the use of face coverings in public settings by early May. Looking across states, we believe COVID-19 case growth is correlated to the use of facemasks and mobility in the retail and recreational settings, as shown in Exhibit 4. Although there are likely many other factors that contribute to the viral spread, suppression of the pandemic may not occur without widespread facemask usage.

EXHIBIT 4: WEAR YOUR FACEMASKS!

Broad facemask usage may be needed to contain the national case count.

U.S. CUMULATIVE CASE GROWTH							
Highest change in cases				Lowest change in cases			
State	Weekly change	High mobility?	Early facemasks?	State	Weekly change	High mobility?	Early facemasks?
Arizona	44%			New York	1%		Yes
South Carolina	32%	Yes		New Jersey	1%		Yes
Florida	27%			Massachusetts	2%		Yes
Arkansas	27%	Yes		Connecticut	2%		Yes
Texas	26%			Michigan	2%		
Oklahoma	25%	Yes		Rhode Island	2%		
Oregon	22%			Vermont	3%		
Utah	21%			Illinois	3%		Yes
Alabama	20%			Pennsylvania	3%		Yes
North Carolina	19%			New Hampshire	4%		

Source: Northern Trust Asset Management, Bloomberg, Google. States with top 10 highest mobility have high mobility. Early facemasks indicate first 10 states to impose facemask mandates. Data through 6/24/2020.

INCREASING HOSPITALIZATION RATES TIED TO INCREASED COVID-19 CASES

Looking at COVID-19 hospitalization data across states in Exhibit 5, we find that the 10 states with the highest hospitalization growth clearly overlap with the states with high case growth. This correlation suggests not only that the higher diagnosis rates are real, but that they are also leading to higher hospitalizations and will likely lead to higher mortality over the coming weeks. Regional leaders are starting to manage hospital capacity to reduce the risk of overload. As an example, the governor of Texas has halted elective surgeries in Houston, Dallas, San Antonio and Austin.

EXHIBIT 5: THE UNSURPRISING LINK BETWEEN CASES AND HOSPITALIZATIONS

Rising cases mean more hospitalizations, which could increase mortality rates.

U.S. HOSPITALIZATION DATA					
Highest change in hospitalizations			Lowest change in hospitalizations		
State	Weekly change	High new cases?	State	Weekly change	High new cases?
Montana	57%	Yes	Vermont	-32%	
Texas	49%	Yes	New York	-31%	
Arizona	35%	Yes	Connecticut	-31%	
Wyoming	34%	Yes	Puerto Rico	-25%	
Oklahoma	34%	Yes	New Hampshire	-23%	
South Carolina	31%	Yes	Maryland	-23%	
Oregon	16%	Yes	West Virginia	-21%	
Arkansas	16%	Yes	New Jersey	-19%	
Georgia	14%	Yes	Illinois	-18%	
Utah	12%	Yes	Wisconsin	-18%	

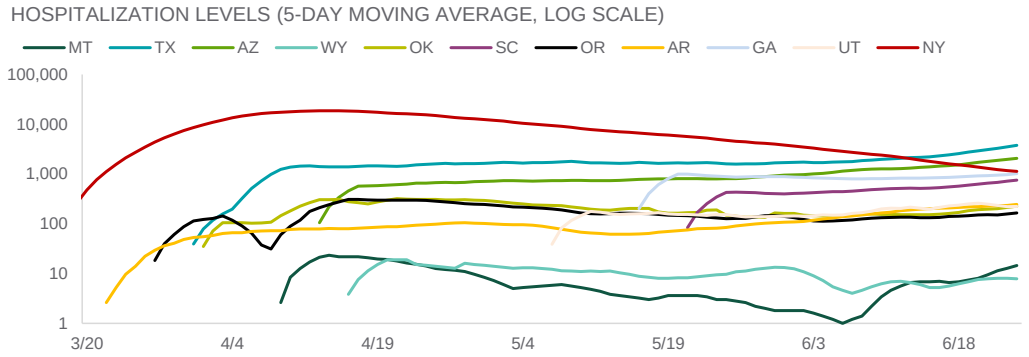
Source: Northern Trust Asset Management, Bloomberg. States with top 20 highest weekly increase in new cases have high new cases. Data through 6/24/2020.

RISING HOSPITALIZATION RATES LIKELY TO LEAD TO SLOWER REOPENINGS

Exhibit 6 shows the 10 states with the highest increasing rates of hospitalization, compared to New York where hospitalization rates continue to decline. This data is in line with our prior view that we should expect variation in the path of the pandemic between states, with flare-ups in various states. It is doubtful that state officials will reverse course and mandate shutdowns, but the risk of exceeding hospital capacity may lead to slower re-openings and stronger directives for face coverings and social distancing. Furthermore, individuals and businesses may independently reduce mobility in these at-risk states in order to avoid contracting the virus. We believe it will take at least two to three weeks for changes in policy and personal behavior to take effect in the currently resurging states. With mortality a lagging indicator, we should expect to see rising COVID-19-related deaths in these states. Current indications are that a much larger percentage of people currently being infected are younger and healthier — but the fact that they are still being hospitalized indicates the severity of the illness. We expect this to constrain consumer behavior as a result.

EXHIBIT 6: ANOTHER LOOK AT HOSPITALIZATION RATES

Rising hospitalizations may lead to less reopening and stricter social distancing guidelines.



Source: Northern Trust Asset Management, Bloomberg. Hospitalization levels shown for states with highest increase in current levels over past week, in addition to New York. Data through 6/24/2020.

The resurgence of the pandemic across many states suggests a delay to our previous framework for reopening. For example, it will be nearly impossible to arrive at less than 10,000 active cases in the U.S. by the end of August, per our prior framework. Actual live cases could still be well above one million at that time, though with most remaining undiagnosed. Among the many implications of a slower reopening is the possibility of large venue activities in the fall coming into doubt, at least in some states. Furthermore, assuming some schools do reopen, it will have to be done with a well-planned strategy to reduce transmission. The near-term U.S. outlook for the pandemic remains cloudy, and there is still no consensus among epidemiologists to forecast a second wave this winter. However, we remain optimistic that strong public health measures can suppress the viral spread, and we believe private and government preparedness will be a key variable moving into the fall. The cost, however, will be a slower return of the economy towards normal levels of activity.

THE RISK OF THE PARADOX OF THRIFT

Fiscal support has been very important in bridging the income gap for consumers in the U.S. facing unemployment or reduced income. In February, U.S. consumers spent $15.5 trillion and saved $1.4 trillion out of disposable income of $16.9 trillion (annualized) — a savings rate of roughly 8%.

EXHIBIT 7: SAVING FOR MORE RAINY DAYS

Increased consumer saving may further weigh on the pace and magnitude of the recovery.

U.S. PERSONAL INCOME AND SPENDING (trillions of $)					
Personal Income and Spending	**January**	**April**	**May**	**One month % change**	**Year-to-date % change**
Personal income	**19**	**21**	**20**	**11%**	**14%**
Compensation of employees	12	10	11	-7%	-5%
Wage and salary	10	8	9	-8%	-6%
Proprietors' income	2	1	1	-13%	-14%
Rental income	1	1	1	0%	5%
Personal income on assets	3	3	3	-2%	-4%
Personal transfer receipts	3	6	5	90%	112%
Less: Contributions for social insurance	1	1	1	-6%	-3%
Less: Personal current taxes	2	2	2	-7%	-3%
Disposable personal income	**17**	**19**	**18**	**13%**	**16%**
Less: Personal spending	15	13	14	-12%	-14%
Personal saving	**1**	**6**	**4**	**190%**	**323%**
Personal saving as % of disposable income	***8***	***33***	***23***	***20%***	***23%***

Source: Northern Trust Asset Management, U.S. Bureau of Economic Analysis.

Looking ahead, the impact of demand destruction through a higher savings rate has a direct and indirect impact. The direct impact is the dollar number of spending extracted. If the savings rate due to COVID-19 settles at something in the ballpark of 12%, even if just for a year, it would take $640 billion (roughly 3% of U.S. gross domestic product) of demand away (using February savings numbers). Assuming a linear relationship, a rise to a 10% savings rate would take away roughly 1.5% of U.S. gross domestic product. However, there is also an indirect effect. All else equal, a higher savings rate will depress disposable income. One person's spending is another person's income and vice versa. This would amplify the impact of an increase in the savings rate suggested by the direct impact by itself. Fiscal stimulus can cover a lot of this shortfall, as we see in the April data. In April, the rise in disposable income was more than offset by a surge in savings. May showed some improvement in spending, while transfer payments fell. This led to an overall savings rate at a still-elevated level of 23%. Overall, the paradox of thrift may mean that more conservative behavior manifesting itself through an elevated savings rate will be a headwind to the economic recovery.

CONCLUSION: WE EXPECT THE GROWTH OUTLOOK TO DISAPPOINT

In this report, we have identified our concerns about the rising case counts across the U.S. and the likely constraint on growth that will result. We also highlighted the paradox of thrift, where solid income growth is saved by cautious consumers, blunting the pace of the recovery. We have seen lots of evidence of the strength in the global economy off of the March/April lows in addition to some positive news on the COVID-19 front, including falling mortality rates and some modest progress on the treatment front. However, the vaccine timetable remains bound to the required duration of trials to both discover and ensure safety of any vaccine that could be administered to billions of people globally. Hence, we expect to be wrestling with social distancing constraints on the global economy for at least the next year. Monetary policy will continue to be supportive, while fiscal policy will likely be incrementally less stimulative over the next year — one of our key risk cases. We also, however, have an upside risk case that "the market has it right" and the nearly unabated rally in risk assets is a positive signal for the global economic outlook. On balance, we have moved to a moderately underweight risk position tactically in our global policy model over the last six weeks. We feel the market is overestimating the growth rebound and rising equity prices have uncomfortably reduced the margin of safety in stocks.

Special thanks to Tom O'Shea, Investment Strategist, and Colin Cheesman, Investment Analyst, for data research.

What do you think of this commentary? **Click one:** ***Like it*** **—** ***Just okay*** **—** ***Don't like it***

IMPORTANT INFORMATION. **For Asia-Pacific markets, this information is directed to institutional, professional and wholesale clients or investors only and should not be relied upon by retail clients or investors.** The information is not intended for distribution or use by any person in any jurisdiction where such distribution would be contrary to local law or regulation. Northern Trust and its affiliates may have positions in and may effect transactions in the markets, contracts and related investments different than described in this information. This information is obtained from sources believed to be reliable, and its accuracy and completeness are not guaranteed. Information does not constitute a recommendation of any investment strategy, is not intended as investment advice and does not take into account all the circumstances of each investor. Opinions and forecasts discussed are those of the author, do not necessarily reflect the views of Northern Trust and are subject to change without notice.

This report is provided for informational purposes only and is not intended to be, and should not be construed as, an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Recipients should not rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Information is subject to change based on market or other conditions.

Past performance is no guarantee of future results. Performance returns and the principal value of an investment will fluctuate. Performance returns contained herein are subject to revision by Northern Trust. Comparative indices shown are provided as an indication of the performance of a particular segment of the capital markets and/or alternative strategies in general. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Gross performance returns contained herein include reinvestment of dividends and other earnings, transaction costs, and all fees and expenses other than investment management fees, unless indicated otherwise.

Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, Northern Trust Fund Managers (Ireland) Limited, Northern Trust Global Investments Japan, K.K, NT Global Advisors Inc., 50 South Capital Advisors, LLC and investment personnel of The Northern Trust Company of Hong Kong Limited, and The Northern Trust Company.