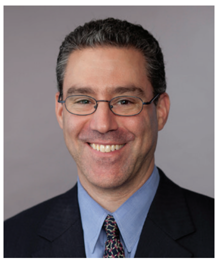
April 2020
Market Insights

Breaking a Glass Is Easy; Putting It Back Together Is Hard



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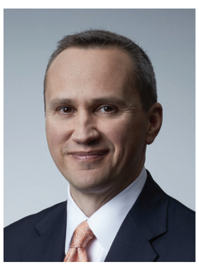

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In brief:

- In our view, the process of reopening the US economy in the wake of the coronavirus pandemic will be a complex matching game.
- The postcrisis economy won't resemble the precrisis one.
- In the period ahead, we believe that returns will be lower, growth slower and risks higher, resulting in a challenging environment for risky assets.

At some point, hopefully in the not-too-distant future, the US economy will open back up as the threat from the coronavirus moderates, but that process will present challenges. Here are some that we think will have to be faced first:

- Some, perhaps many, companies won't survive whatever lockdown period they're facing or may be late to reopen. Thus some workers will have no job to return to.
- Some workers may not return to work until their relatively generous unemployment insurance benefits run out. Consequently, some companies may have to find new and potentially inexperienced (*i.e.*, lower-productivity) workers.
- When companies that produce intermediate goods fail, companies that rely on those goods for their own production will either be out of luck (perhaps resulting in their demise) or have to find new suppliers (a potentially long and costly process).

The reopening process will become a complex matching game: sequentially matching capital and employers with labor — and let's not forget financing — within complex global supply chains, all amid a very low-visibility environment.

Indeed, we don't know how robustly final demand will rebound, what the likelihood of a second wave of infections is, when we might see viable treatments or vaccines, which export and import markets are reopening when and so on.

Maybe an analogy is in order. Imagine for a moment that you have the ability to repeatedly go back in time and break the same wine glass again and again. As there is an infinite number of ways to break a wine glass, it would break differently each time. But there would always be only one way to put it back together: piece by piece.

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If we wanted to recreate the global economy exactly as it was before COVID-19 broke it, we would need to put all the pieces (capital, employers, labor, financing and supply chains) back together exactly as they were before. In our view, that just isn't going to happen. The matching game is too complex, and some of the pieces weren't there to begin with. Moreover, recreating that precoronavirus world would simply bring back an economy broken in a different way. The just-ended business cycle was one of excessive leverage, underinvestment in productive resources and an overreliance on returning capital to shareholders. It was unsustainable. So against that backdrop how should we think about risky asset valuations going forward as we try to put the broken economy back together in some new form?

In our view, equity valuations are derived from three things: profits, growth expectations and the risks a business faces. As we recently noted in "Market Knowns and Unknowns", companies today are prioritizing liquidity and survival over two of the three key pillars of valuation: growth and profits. In the period ahead, we believe that returns will be lower, growth slower and risks higher, resulting in a challenging environment for risky assets.

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