PFM's Current Thinking on the Pandemic

and a Range of Topical Economic Issues

Q&A | Summer 2020

COVID-19 has had an enormous and unprecedented impact on both the global economy and the capital markets. In order to provide a better understanding of the firm's current thinking on a range of topical economic issues and the potentially long-lasting effects of the ongoing pandemic, we conducted the following Q&A session with Biagio Manieri, Ph.D., CFA. Biagio is PFM's Global Chief Investment Strategist.

The Federal Reserve (Fed) has been adamant that it will not pursue negative interest rates. What are your thoughts on this issue?

Manieri: The Fed has indeed suggested on numerous occasions that it will not embrace negative rates as some other countries have, including Japan. We think that the monetary policy body will instead continue to use other tools at its disposal, including bond-buying, forward guidance and maintaining low-interest rates for an extended period of time. The Fed may also pursue other policies such as yield curve control.

To be clear, the Fed is aware of the adverse effects of negative rates and would rather not go down this path. But at the same time, we do need to acknowledge that we are in uncharted territory, and one should "never say never" in this environment. For example, few would have predicted six months to a year ago that the Fed would be buying securities such as high-yield bonds and exchange-traded funds. Again, while we do not expect the Fed to "go negative," anything is possible in this environment.

Given the unprecedented economic shutdown and historic rates of unemployment, will additional stimulus be needed to help the U.S. economy fully recover?

Manieri: Additional stimulus (in some form) will likely be needed. In fact, both political parties are discussing the next package. Not surprisingly there are disagreements between the Democrats and the Republicans on what exactly should be included in the stimulus.

For example, Democrats favor extending the $600 per week additional unemployment benefit, while Republicans favor a return to work bonus as a way to incentivize those on unemployment.

Another area of disagreement between the two parties revolves around whether to provide aid to state and local governments and, if so, whether that relief should come with strings attached. On a positive note, there seems to be some agreement on the need for infrastructure spending.

One final potential sticking point that must not be overlooked because it could still adversely impact a stimulus bill is that Republicans are reluctant to continue to spend large amounts of money given that the annual deficit and the overall national debt are already so high. All of that said, while we think that another stimulus package is likely, any additional packages after that are less likely.

States are beginning to re-open. Is the worst behind us?

Manieri: I wish that were true. Some states that have re-opened or have begun to re-open are seeing an increase in the number of new COVID-19 cases. Therefore, these states are now slowing down or reversing their re-opening plans, which is impacting both large and small businesses.

We are also beginning to see that people who had gone back to work are getting laid off or furloughed once again. Furthermore, we have seen announcements

from large companies indicating that sizable layoffs later in the year are a possibility. While many of these companies had resisted laying off employees, the sluggish pace of the economic recovery has forced even large and fundamentally strong businesses to consider "right-sizing" their organizations, given current economic conditions. Finally, we also see an increasing number of bankruptcies. Therefore, the worst may not be behind us. Incidentally, as a result, and tying back to the previous question, the federal government may be forced to do more in terms of stimulus.

Are there any particular regions/countries, and at a more granular level, any sectors that look attractive or unattractive in this environment?

Manieri: Based on valuations, one might argue that developed international markets are a very attractive place to be. However, there are structural issues that are concerning and worth mentioning, which will impact these markets. Specifically, non-U.S. equity markets have higher exposure to sectors that face headwinds, including Financials, Commodities, Industrials and Consumer Staples, while having lower weightings in growth sectors such as Technology.

That being said, given the recent European stimulus effort which is underway, there is a possibility that it will help to enhance liquidity and could also increase the appetite for risk assets such as equities, much like it has done in the U.S. In addition, a declining U.S. dollar is likely to be a tailwind for companies that sell heavily into the U.S. markets. Also, there are individual companies outside of the U.S. in the Consumer Discretionary, Healthcare and Technology sectors that are worth considering.

In Emerging Markets (EM), while China seems to have somewhat contained the COVID-19 outbreak, other major EM countries are seeing new cases continue to rise. Therefore, the recent equity rally in EM equities when coupled with weak trade data is concerning. That is not to say, however, that opportunities won't materialize down the road. But the key is to pay attention to how companies are adapting in this tenuous environment.

What data points or events are you looking at to determine when might be a good time to increase equity exposure?

Manieri: We are paying extremely close attention to the spread of the virus (both domestically and internationally) as well as the prospect of a viable vaccine. As we get closer to having a vaccine, we will have more confidence that the worst is behind us. If equity valuations are attractive at that time, we would consider once again being overweight equities. In the interim, we are looking at investments that we expect will provide reasonable returns while controlling risk.

What is PFM doing to mitigate risk and to protect client assets during these turbulent times?

Manieri: Our priority has been to manage downside risk and to preserve client capital. To that end, in late February, we reduced our positioning in equities by a significant amount and increased our cash and fixed income holdings.

Given the recent surge in equities prices, we have been hesitant to increase our exposure to the asset class given the lackluster earnings outlook, broader economic backdrop and our belief that the recovery period will likely not resemble the "V" shape pattern that many investors are anticipating.

As some market segments became attractive and the Fed launched its many new programs, we added new positions in municipals and convertibles. We expect these segments to provide a reasonable return while controlling risk. We also shifted some assets to sub-advisors who invest in high-quality businesses that are fundamentally strong and can weather the current environment.

Beyond this, we are actively monitoring risk within the portfolio on a consistent basis. We are conducting remote meetings (due to social distancing requirements) to discuss the markets and positioning within the portfolio. We acknowledge that this is a turbulent time, yet we remain focused on doing what is best for our clients and helping them navigate through these unprecedented times.

What are your thoughts on the current state of relations between the U.S. and China, and how important is it for these two parties to resolve their differences and engage in further trade talks?

Manieri: Obviously, we are concerned with the current state of the relationship between the U.S. and China. Phase I of the trade deal is in danger of unraveling and more fundamental trade agreements that deal with intellectual property protection, state subsidies, etc. are unlikely in the near term. In addition to trade, there are political and military issues straining the U.S. and China relationship, including:

- International boundaries in the South China Sea and the militarization of certain disputed islands
- The issue of North Korea (a close ally of China) developing nuclear weapons and providing support for international terrorism
- 5G technology and the concern that equipment provided by Chinese companies may be able to be used by the (Chinese) government to spy and/or disrupt western economies
- The alleged theft of intellectual property and attempted hacking of several U.S. pharmaceutical companies for COVID-19 vaccine secrets

In addition to those, the issues and tensions around both Hong Kong and Taiwan remain. Again, these are just a few of the issues straining relations between the U.S. and China. In short, this strained relationship needs to be watched closely as the economic ties between the U.S. and China are deep and can have a material impact on asset prices. We are hopeful that while the relationship is likely to be less friendly going forward, it can be managed so that it does not deteriorate into a new cold war.

For more information, please reach out to your PFM representative.

To learn more or discuss in greater detail, please contact us:

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