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The uptrend in global stock markets since the end of the first quarter reflects the impact of massive liquidity pumped into the financial system, as well as investors' expectations of a gradual return to more normal levels of economic activity. The timeline to the end of the pandemic remains uncertain, while the economic and social risks have not yet diminished. Nevertheless, we see green shoots developing on the global economic and healthcare fronts. We remain mindful of the uncertainties in the short-term and are therefore investing surplus cash progressively.

Economic green shoots are developing …

As the current pandemic took hold, demand for goods and services declined at historic rates worldwide. The airline industry saw passenger traffic collapse by more than 90% in just a few weeks. U.S. auto sales dropped by 47% in April when compared to 2019. World oil demand plunged by around 30% in the same month. U.S. employment fell by 16% in April as 25 million people lost their jobs, while retail sales were down 22% year-on-year. U.S. real GDP contracted by 1.3% in the first quarter, as the lockdown was just beginning, and is forecasted to decline by a further 10% in the second quarter.

There are, however, tentative signs that the global economy is starting to reopen and recover. Oil demand has begun to improve but remains 15%-20% below normal levels. China's annualized car sales rebounded from 4 million in February to 17 million in April. In the U.S., disposable personal incomes are rising. The savings rate is estimated to have reached 33%, leaving considerable room for consumption growth. Manufacturing facilities are restarting in June. North American car production is expected to rise to up to 14 million vehicles (at an annual rate) in the third quarter, up from 4 million in the second quarter.

… which partly explains the stock market's recovery

Equity markets have begun to discount the end of the pandemic and a return to more normal levels of economic activity. However, normal economic activity will only occur when the pandemic is over and the end of the pandemic will only occur when we achieve herd immunity, which can come about through cross infection of the population or vaccination. In either case, this seems to be at least a year away.

The stock market is also reacting to massive monetary and fiscal stimulus. The U.S. Federal Reserve's balance sheet is expected to grow to $9 trillion, double its level at the beginning of 2020. The increase in the Fed's balance sheet is equivalent to nearly 25% of U.S. GDP. The federal deficit for 2020 is expected to be close to 20% of GDP. Similar, but slightly more measured responses have occurred worldwide.

Short and long interest rates have declined to multi-century lows, pushing bond prices even higher and offering little prospect of a nominal return let alone a return after inflation. Nonetheless, investors are buying the massive amounts of debt being issued.

Positive developments on the vaccine front

The virus has not changed much since it first appeared. There are different strains with slightly different characteristics, but its infectiousness, its overall lethality and its effect on older people are still all in line with early estimates. While no cure or vaccine has yet been developed, the global effort to curb the virus is encouraging. Nonetheless, the significant difficulties involved should not be underestimated.

There are more than 90 vaccines for the coronavirus under study. Two vaccines have made progress in Phase I safety clinical trials, one from Moderna and the other from AstraZeneca (the Oxford vaccine). Early data shows promise. Both are moving into Phase II and are preparing large Phase III trials. The U.K. has started enrolling 10,000 volunteers in a trial of the Oxford vaccine and the U.S. is planning to launch multiple trials in July, with over

20,000 people per vaccine candidate. Without knowing if the vaccine will be proven to be safe, efficacious, and ultimately approved, AstraZeneca has committed to produce enough doses for 30 million British citizens by September and 300 million Americans by October. The Moderna vaccine could have enough data to support Emergency Use Authorization by year end. Bill Gates has indicated that his foundation is financing production facilities for five vaccine candidates.

The race for a vaccine is impressive. A year-end timeline is theoretically feasible but would be truly remarkable. Many experts have a more cautious view and do not see this as a base case. Vaccination programs will still take several months to carry out. Popular acceptance of a vaccine based on new technology, new mechanisms of action, little track record and a shortened development timeline is possible, but uncertain.

Our understanding of how the virus spreads also continues to improve. Masks, even the most rudimentary kind, are estimated to reduce the infection rate by 50%. If both persons in an encounter wear a mask, the reduction is 75%, enough to bring the R_0 (the reproductive ratio) below 1, which stops the spread of the disease. The role of super-spreader events is also being highlighted. Eliminating large gatherings in bars, churches, choirs, sports events, or factories, could also have significant impact on R_0.

Testing has dramatically improved over the last few months and should continue to advance. Countries are also setting up contact tracing infrastructures. This might not avoid a second wave but should allow health authorities to identify and contain outbreaks much more rapidly and effectively.

Given what is known of the virus to date, 70% or more of the population needs to be infected to achieve herd immunity. Currently, it is estimated that approximately 5% of the U.S. population has been infected, 15 times less than required. But there are small studies indicating that there may be a significant portion of the population that is less susceptible to infection due to cross immunity from other coronaviruses. If that is the case, then herd immunity could be achieved at lower infection levels.

But uncertainty remains regarding our reaction to the virus

If we look at the measures to contain the virus taken by different countries, we can see that not all are taking the same course. Even within the U.S., different states have encouraged different behaviours. Emerging economies with fewer resources and denser populations may also find it difficult to deal with the pandemic.

As economies reopen, if there is a lack of discipline, a lack of mitigation and containment, if the virus proves more difficult to deal with, or a vaccine remains elusive despite early promises, companies may have a more difficult time. There will be a lot of debt taken on in this period and there may be bankruptcies, particularly of small and medium-sized businesses. But how much debt is still unknown because it depends on whether the economy can operate more or less normally until a vaccine is found. What will be the lasting effects of this debt on corporate cash flows, on their ability to invest, on their need to raise prices, on government’s need to tax or ability to spend?

The damage done by the virus is not just to human health, but also to social and political cohesion. The consequences of these stresses are also unknown. We are optimistic that every effort will be made to deal with potential social problems, just as the fiscal and monetary interventions have tried to deal with the economic problems.

Positioning the portfolios for a post-pandemic recovery

Despite these uncertainties, we expect that a year from now, the virus will have run its course. We know that, unlike natural disasters, physical facilities will have been spared and the working age population, even in the most pessimistic scenarios for the pandemic, should not decline. We also know that massive fiscal and monetary stimulus will have been deployed and that these measures typically take between 6 to 18 months to work through an economy. As a result, 2021, particularly the second half, could be a very dynamic year. Stock markets normally react in anticipation of events.

We know there is a way forward which enables the economy to restart and to deal with the liquidity issues posed by the pandemic. We think this is the road that will be taken but not without hesitation. Many companies are trading at reasonable valuations and once the uncertainty of the current period is removed, the economy will recover.

Demand for goods and services will return to previous levels, even for the most hard-hit sectors like oil and other commodities, travel, restaurants, and retail.

We are navigating through extraordinary and unprecedented events. We think that the companies in our portfolios will prosper and continue to play a constructive and essential role in their industries. We also see opportunities, but it would not be wise to ignore the risks in the shorter-term. In retrospect, some of our actions will possibly have been premature and some too hesitant. Nevertheless, we believe the prudent course is to invest surplus cash in a progressive, measured way.