



THE OTHER VIRUS

As the country's death toll surpasses 92,000, all 50 U.S. states have now partially reopened after a two-month shutdown. Our leaders believe that we are past the worst of the coronavirus, and so we begin the work of our return. The last crisis left behind a changed financial system, a pile of government debt, a long road to full employment and a cycle in which the new normal for interest rates was much lower. What will the coronavirus recession have wrought when we look back on it years from now?

Hope for a quick return to where we would have ended up pre-virus ignores what we're hearing from epidemiologists and the lessons of past shocks. Experts suggest that until a vaccine or cure is available, some base line level of infection will still circulate in the population, and our exit strategy will be to move from a mass lockdown to aggressive testing, contact tracing, and localized bouts of enforced isolation and workplace shutdowns. During that period, which could extend through 2021, cross-border travel will be at least partially restricted or subject to strict quarantine rules until all countries are on the same page. Large conventions and other mass gatherings are inconceivable. Sectors like cruise lines and retirement homes could face lingering reputational issues. Sectors like airlines and oil and gas have lost so much demand that even a respectable climb back will be a long road.

And yet we all heard Fed President Jerome Powell exhort this week on CBS' News '60 Minutes' not to bet against the American economy. Judging from history, that has indeed never been a good idea. But it is difficult to reconcile the dissonant reopening plans and the dismal picture painted by the current and forthcoming economic data with the seeming ebullience of the markets. Clearly, the market views the shock-and-awe level of fiscal and monetary stimulus as enough to overcome the short-term economic challenges created by the virus, and we suspect that may be true. But perhaps more critical is the "risk of permanent economic damage" referenced by Treasury Secretary Steven Mnuchin in his Congressional testimony this week as he argued with lawmakers about reopening plans. For while we focus on COVID-19, Mnuchin and Powell know that the virus of hysteresis could already be circulating.

In economics, hysteresis refers to an event in the economy that persists into the future, even after the factors that led to that event have been removed. Even after more typical shocks, economies often struggle to return to their prior level of GDP. We certainly can bear witness to this dynamic when we consider our most recent period of tepid GDP growth following the global financial crisis. Some attribute this 'failure to launch' effect to psychology, and we discussed at length last week why the consumer may be challenged in the coming period. Labor markets also suffer from hysteresis, as those who are dislodged from jobs lose skills, opt to retire early, go on disability benefits, or are forced to take a position that makes lesser use of their strengths and entails lower output per hour. Likewise, a tumble in capacity use rates that obviates the need for a quick upturn in new plants and equipment entails less upgrading to the newest technologies, reinforcing a drought in capital spending.

We face the risk of hysteresis anytime there is a shock to the system, but we suspect the current health crisis has the makings for some gnarly aftershocks that complicate bold views about the path of economic recovery and thus the sustainability of the stock market recovery. Investors have to think about these longer-term issues because stock prices trade based on the discounted value of the earnings stream ahead. The lessons of large major shocks in the past, and likely this one, is that a bear market that is tied to a downturn does not reverse in a hurry, as that's also the case for earnings. Not only will huge haircuts and higher insolvency risks have to be priced in for 2020, but markets must also reassess how much of that will be recouped in 2021. For all of these reasons, we are increasingly wary of current market conditions. We remain as ever focused on the individual securities we select or pools of securities we own via the funds we recommend to be financially strong, enduring business models run by experienced management teams. This is a marathon, not a sprint, and our task is to manage through both the short-term and the long-term challenges and euphoria with a careful eye to our mandate—preservation and growth.

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RESPONSIBLE INVESTING RISES UP

While many investment strategies saw outflows during the volatile first quarter of 2020, one particular area of the market, described as ESG investments, actually saw inflows and experienced downside protection throughout that time period. ESG refers to investments that consider Environmental, Social, and Governance criteria, but what does that really mean?

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