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ON OUR MINDS

Take Me Out to the Ballgame

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The stock market has been tumbling lately, bringing out all sorts of Cassandras. The reasons for the market's wobble are easy to identify, too:

- We are on the precipice of a constitutional crisis because President Trump may try to steal his reelection.
    - No, the crisis will only come if a possible President Biden might try to pack the Supreme Court with left-wing radicals.

- The country is re-opening too fast, which will lead to a new wave of the pandemic.
    - No, the country is re-opening too slowly, which will lead to another recession.

- Congress has abandoned hope of passing another stimulus bill, dooming us to stagnation.
    - No, Congress has already done enough; people would have no incentive to go back to work if Congress were to enact more stimulus.

- The Fed has thrown so much money at the economy that insidious inflation is inevitable.
    - No, inflation is the least of our worries when the recovery is running out of gas.

- Market valuations had gotten too rich, with P/E multiples approaching the bull-market tops of the dot-com era.
    - No, these valuations are warranted when interest rates are near zero, increasing the present value of future earnings.

It almost doesn't matter whether the pundits are coming from the left or from the right, whether they are inflation hawks or doves, bulls or bears: Everyone has an explanation for the stock market's September swoon that happens to fit their broader worldview.

It's also possible that the market is simply responding to factors that have little to do with any of these concerns. Softbank was reported to have deployed a massive options-trading strategy on technology stocks that may have pushed the entire market to its best August in 34 years; as those contracts unwound in September, they may have correspondingly deflated the market. Similarly, the rapid rise of trading platforms like Robinhood may have drawn retail investors into the market – perhaps especially those who lost their jobs during the pandemic; when the markets stumbled, these newbies may have rushed to the exits, exacerbating the decline.[1]

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[1] It's one thing for retail investors to jump into common stocks through venues like Robinhood; they can't hurt themselves too badly. But retail trading volumes in options contracts have also jumped sharply, which suggests that many individual investors could be exposing themselves to much more dangerous financial risks.

In my last *On Our Minds* commentary[2], I highlighted a slate of "high-frequency" metrics that show the economy holding to its upward trajectory. But it's still fair to note that many of these metrics also show some deceleration, and this makes sense: The easiest steps to recovery were taken first, and the hard work is still in front of us.

Major League Baseball is an apt microcosm of the broader economy. Six months ago, baseball fans feared that the Covid-19 pandemic would force the complete cancellation of the 2020 season. When the abbreviated season did begin in July, it was unclear whether it could be completed or would be aborted by an outbreak among one or more teams. To be sure, the game itself implemented some rather goofy adaptations alongside some wise precautions: Seven-inning doubleheader games and free runners in extra innings offended the purists but shortened the time players are in contact with one another; the cardboard cutouts in the stands offered a lighthearted reminder that the game is played for the fans, even when we couldn't be in the ballpark. Television ratings have been strong, however, supporting MLB's decision to play.

But here's the important point: MLB *did* complete its regular season, albeit with some weird moments along the way that fans like me will be debating for years to come.[3] As the playoffs begin tonight, we can celebrate the accomplishment, miss what might have been, and look forward to next season with hope.[4] So too with the U.S. economy as a whole.

Major League Baseball completed a 60-game regular season – not nearly a full 162 game slate, but infinitely better than no season at all; and better too than having to call it off partway through because of a Covid-19 outbreak. The economy too came partway back through the summer; again, it wasn't nearly as robust as it could have been without the pandemic, but it was still far better than many of us feared last March. Indeed, GDP growth for the September quarter will likely be the highest ever reported in the U.S., compared to the depressed June-quarter base.

An important element in the recovery was the gradual recognition that *shutdown* and *reopening* were not bipolar opposites governed by an on-off switch. As early as mid-April, California governor Gavin Newsom began using the analogy of a dimmer switch, and in retrospect he was correct. MLB (and the economy) could reopen gradually, taking appropriate steps to limit the spread of the virus while still offering some semblance of normal activity.

Newsom's key insight wasn't just that a dimmer switch can slide gradually toward *more* light, or that the economy could move gradually to be *more* open; it was also that the switch could go the other way, too. When the Miami Marlins suffered a large outbreak at the outset of the season, more than half of the team's roster was stricken with the virus, and the team was forced to postpone almost a dozen games.

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[2] "Reasons to be Cheerful," published August 26, 2020.

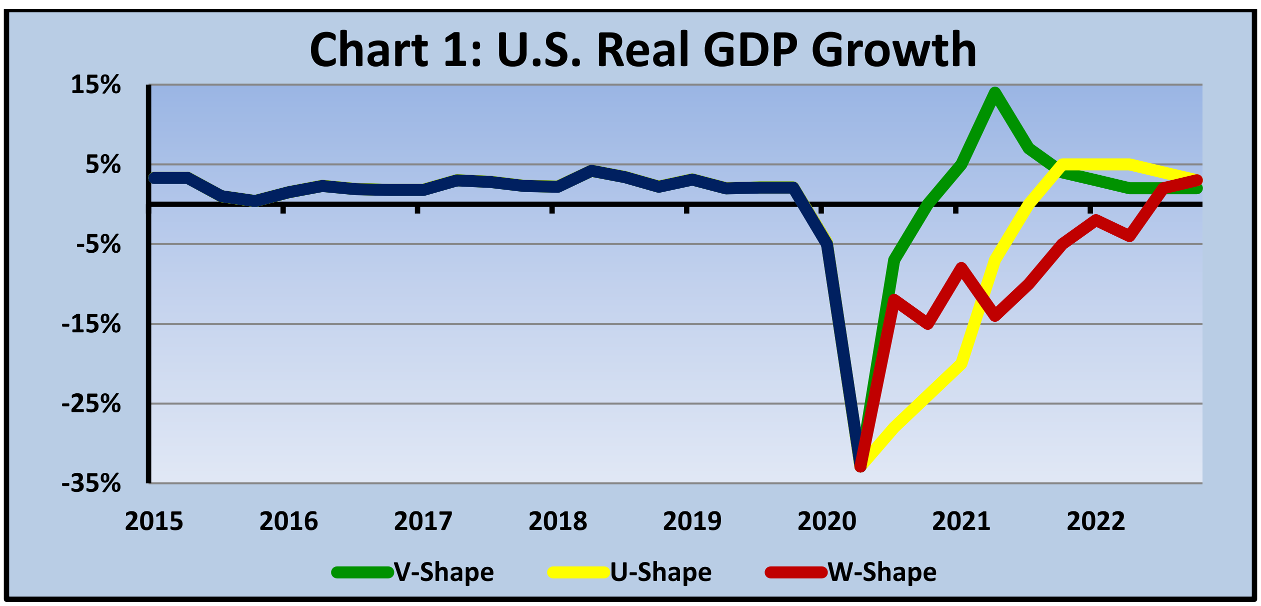
[3] The oddest moment, to me, was when Mets infielder Amed Rosario hit a walk-off home run *as a member of the visiting team*. That hadn't happened in more than a century. Even more bizarre, it also was possible this season for a pitcher to throw *and lose* a perfect game; thankfully, that headscratcher didn't come to pass.

[4] Even Red Sox fans have reasons to look ahead with hope, as Tanner Houck and other late-season call-ups showed promise for 2021.

Yet MLB didn't buckle; it turned down the dimmer switch but didn't turn off the light. Rather than cancel the games (or the season), MLB found ways to reschedule and make other accommodations.[5] The Marlins, it must be noted, overcame the Covid outbreak and found a way to cram a full slate of games into the remaining dates on their schedule. They even clinched their first playoff spot since 2003; that was sweet to see, even for non-fans.

The same dimmer-switch approach has worked equally well for the U.S. economy. As the various states and municipalities gradually reopened their economies, some of them were hit with sudden Covid outbreaks – especially on some college campuses. But the nation has collectively learned from early experience: We found ways to target these outbreaks more surgically. Colleges have allowed only some students back on campus while still providing online classes; cities have closed streets to automotive traffic so that restaurants can serve more patrons at outdoor tables on the sidewalks and streets; businesses (including Eastern Bank) are using technology in new ways to accomplish tasks that previously required in-person transactions. Because these responses have been marked by creative use of the dimmer switch, jobs are returning and the economy is mending itself. It wasn't a normal summer and it won't be a normal fall, but it seems extremely unlikely that new outbreaks would cause the economy to shut down as tightly as it did in March.

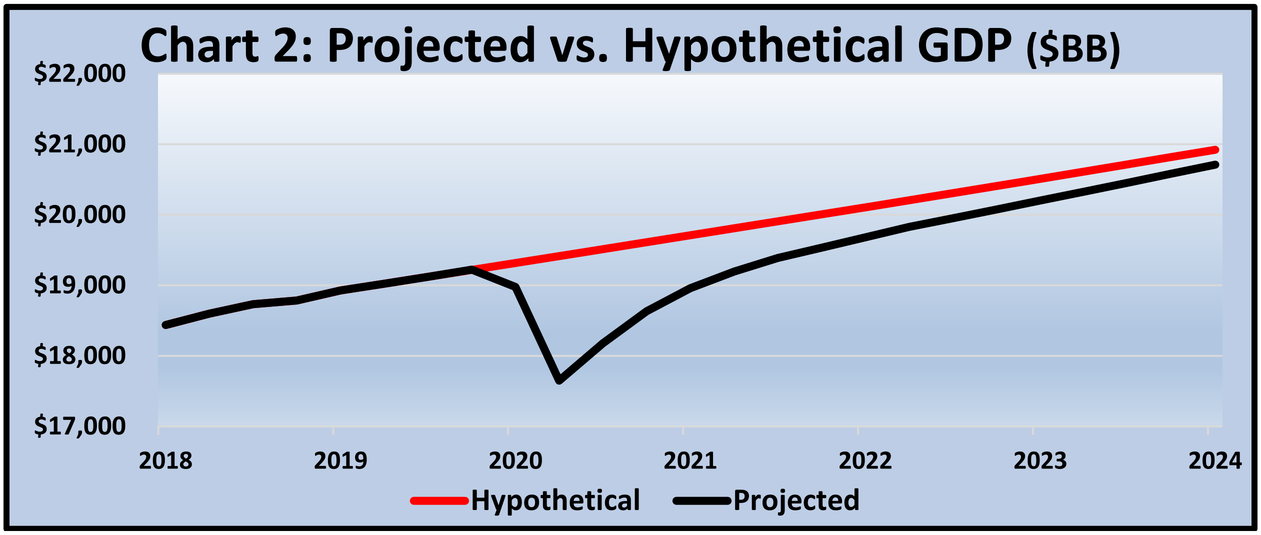
So as the playoffs begin, we can acknowledge that we still don't know how the contours of the recovery will play out. Chart 1 shows three hypothetical trajectories – a V-shaped bounce in which we steadily open more and more of our economy, without any meaningful backsliding; a W-shaped slog in which we have a few setbacks in the course of a broader re-opening; or (least likely) a U-shaped pattern in which we don't make much progress for a long time.



Source: Commerce Department (historical); Eastern Bank Wealth Management (future possibilities)

[5] It was a similar Covid-related rescheduling that made Rosario's unique feat possible, as the Mets were playing a make-up "home" game in the visiting team's ballpark in order to minimize team travel. (Never mind that the other team was also in New York, a short subway ride away.)

Much depends on the persistence of the virus and on how we respond. Despite the uncertainty, however, it seems reasonably certain that the overall trajectory will continue to be more or less upward. Still, as Chart 2 suggests, it will likely take a long time before the actual *level* of U.S. economic activity matches where we could have been, absent Covid-19. In this chart, the red line shows how the U.S. economy hypothetically could have grown if the virus hadn't emerged; the black line shows that even a V-shaped (best case) recovery will still result in a weaker economy for several years to come.



Source: Commerce Department (historical); Eastern Bank Wealth Management (projected and hypothetical)

These charts look at the entirety of our national economy, and as such they obscure variations among different sectors of the economy and among different demographics of our population. Technology and some consumer discretionary sector companies, for example, have thrived recently while hospitality and energy and many other sectors have suffered. Larger corporations have taken market share from small businesses. The CARES Act was not helpful to sole proprietorships, many of which won't survive until the economy has fully reopened.

Demographically, the embedded tendencies of the economy (favoring college-educated, affluent, and white people to the detriment of everyone else) were accelerated by the pandemic and show no signs of changing. Hence we may have what some analysts have called a K-shaped recovery, in which the rich get richer while the bottom 80% lose ground. There is substantial merit to this hypothesis, though it is beyond the scope of my ambit today; suffice for the moment to note that it is yet one more reason that the hardest work remains in front of us.

So to return to the stock market's weakness over the past few weeks: It turns out that there is some truth to *all* of those explanations, even those that contradict one another. The market *did* run up too fast and *did* get too expensive, but low interest rates also mean that higher P/Es are likely to persist for a long time: the debate is over what the "new normal" will be. Similarly, the Fed and Congress have both flooded the economy with money in various ways, but more may be needed today even if that raises the risk of inflation tomorrow. We may benefit from pushing the dimmer switch all the way to its limit and fully reopening the economy (as Florida has done), but that may come at the cost of a severe new wave of infections.

The hardest work of reopening is still in front of us: Even when the government removes restrictions, how we respond will be critical: You can give me lots of money but I won't spend it if I'm scared; you can open the barber shop but I won't get my haircut if I think I'll get a virus too; and if we're not getting on the airplane, then the airlines will still be laying off thousands of employees. The political climate may also hamper our ability to rise to the occasion.

Two questions hover over everything: How will the Presidential and Senate elections be decided? And will any of the phase 3 Covid-19 vaccine trials prove successful? The next three months may be among the most extraordinary in our lives as we watch these storylines unfold, and markets may be highly volatile. But look ahead: By January 21, we will know who has been elected and inaugurated as President, and which party controls the Senate; by then, we will also likely know whether a vaccine will be rolled out over the course of 2021. Markets are forward-looking: Today, they anticipate a volatile end of 2020, but they are also considering the prospect of a more stable 2021.

Will we avert a political meltdown and a contested election? Will we avert micro-shutdowns? Will the vaccine(s) arrive quickly? Or, to return to the leitmotif of the day, will Major League Baseball open next season with fans in the stands? Time will tell; personally, I'm still expecting to be sitting in Section 317 at Fenway Park on Patriots Day next April. If you find me there, I'll buy you some peanuts and Cracker Jack – I won't care if I ever get back.