COVID-19: WHAT WE SEE IN THE FUTURE

The impact of COVID-19 is unprecedented. Your life has been affected in many ways, and the pandemic will change the way we conduct our lives in the future. This is not news to you. The question is how will your life be effected in the future? Many Americans are focused on the daily headlines and are not considering how life will be changed as a result of this pandemic.

While the crystal ball is not always clear, I want to take an opportunity to lay out some of the things we see, and how it will affect the way we invest your portfolios. In the following pages, I'll try to lay out where we currently are, and where we think we are going.

As the second half of the year progresses, we first want to say **thank you**. We are honored and privileged to have your trust and confidence.

The Pinnacle Financial Group

The Economic Scorecard

So, what has occurred in the last few months to get us to where we are?

Growth	👎	The economy entered a recession in 1Q20, ending the 11-year record long expansion. While there has been a snap-back due to monetary and fiscal policy, we expect the recovery to be long and slow. However, the development and distribution of a vaccine could be followed by a surge of pent-up demand.
Jobs	👎	The damage to the labor market has been sharp and rapid. Nonfarm payrolls fell by 22 million in March and April — erasing 10 years' worth of gains. The unemployment rate peaked at 14.7% and has come down to 11.1% in June. While the recent employment gains have been impressive, the pace of the recovery going forward is likely to be much slower, particularly in light of rising cases of COVID-19.
Profits	😐	1Q20 operating earnings growth declined 49% y/y — namely from the shutdown of the economy. Earnings for 2Q20 are expected to be much lower..which would warrant a thumbs down. However, we think that expectations will be so low that many companies will beat those expectations, and the market will like that. Thus, the "meh" face.
Inflation	😐	Disinflationary pressures increased in 2Q due to the shutdown. While rising budget deficits, a soaring national debt, and monetary easing may spur inflation in the medium-term, inflation is likely to remain low in the short-term.
Rates	😐	The Fed maintained the federal funds rate at a range of 0% to 0.25% with projections showing no rate hikes through 2022. The Fed has expanded its balance sheet by about $3 trillion since March and will continue with unlimited asset purchases to support market and financial conditions. It has even begun purchasing ETFs and individual corporate bonds. Unwinding this all will not be easy.
Risks	👎	1. The US recession and recovery could be at a slower pace than markets have anticipated. 2. Political headlines could cause market volatility. 3. Government stimulus can only prop things up for so long.
Investment Opportunities	👍	1. Keeping diversified and high quality at the base of the triangle is wise. 2. Increasing non-correlated assets, particularly those that focus on the post-COVID world.

The US recession and recovery could be at a slower pace than markets have anticipated.

Let's Review:

The COVID pandemic and subsequent shutdown caused US markets to drop suddenly and swiftly. The Fed used monetary policy and Congress used fiscal policy to prop things up. The market loved both of these items and bet on a quick vaccine and a smooth re-opening of our economy. This scenario would cause a "V" recovery. However, the reopening has issues, and the vaccine will likely not be here until 2021. The "V" does not look like a longer-term reality…and there are many hurdles to overcome.

Challenges we see:

1. Unemployment:

- Roughly 90% of the population was forced to stay home during the lockdown. This created a sudden loss of customers for many businesses, and those businesses laid off or furloughed employees. The Economic Policy Institute (EPI) says the actual number of people who lost their job is close to 55 million — 39 million counted by the Department of Labor (DOL) who applied for unemployment benefits, and close to 16 million more counted by the EPI who did not file for various reasons.

- While many employees have been hired back, the DOL 4-week moving average of weekly unemployment claims shows weekly claims of 1,375,000 for the week ending July 11th. This number is still about 550% what we are used to seeing. So, even though companies are hiring back those furloughed employees, they are still laying off a large number of people. How many will be permanent layoffs?

- While the $600 federal unemployment subsidy has helped keep consumer spending high, that subsidy will end on July 31st. Yes, Congress may extend this subsidy…and may pay it retroactively to July 31st…but we do expect a gap.

- Per Fed Chair Jay Powell: "A prolonged recession and weak recovery could also discourage business investment and expansion, further limiting the resurgence of jobs as well as the growth of capital stock and the pace of technological advancement. The result could be an extended period of low productivity growth and stagnant incomes."

- About 67.7% of the US economy is driven by consumer consumption. With high unemployment and stagnant wages, this will cause downward pressure and potential future drops on the US stock market.

2. Reopening Schools and Universities

- As a segue from the unemployment conversation, whether schools and universities actually reopen will also play a large role in unemployment. How do parents work if their children are home every day or every other day?

- The problem is going to be worse if a May *USA Today* poll becomes reality. It stated that 20% of schoolteachers say they will not return to work in the fall, and 30% of parents are "very likely" to home-school their children instead of exposing them to infection risk. This is likely to further slow the drop in the unemployment rate.

- Higher education will not be immune. Between 2008 and 2017, state funding for higher education fell by $9 billion, or 16%. During the same time, inflation rose 17%. This helps explain why college tuition rose 37% — or more than twice as much as inflation — during the last decade. Now, due to COVID, states will have no choice but to further cut funding to public universities (more on this later). Private universities will also be effected. More than 33% of private colleges are in "low" financial shape per *Edmit* — meaning they will run out of money within 6 years.

- Two areas of concern are foreign students and football. Universities love foreign students because they usually pay full price and are very lucrative. If these students are unable to travel to the US, this will affect schools for the long-term. Remember, this is likely not a one semester situation. If a foreign student begins their college education in their home country, it is unlikely they will transfer to the US for their sophomore year. Therefore, US colleges may be out of this revenue for four years. How big a hit can this be? *The Chronicle of Higher Learning* states that 6% of all college students are from foreign countries, but the figure is much higher at some schools. Take Yale for instance. About 20% of their student body comes from overseas. Losing 20% of your student body…the ones that pay full fare…can have a significant effect on things. Yes, these student could be replaced by US students…but at a lower cost. And then there is football — a major revenue driver for schools. Football and a college's sports program account for about 60% of the school's budget. If there is no football season, what will that do to the budgets?

- Fewer students means less revenues, adding to the budget pressure for colleges and universities. While the college experience will be different, and many argue inferior due to remote learning, we do not see many colleges reducing their tuition costs. They likely feel as if they don't have a choice (though one could argue now is a great time to use endowment money). This is causing 17% of high school seniors (per bestcolleges.com) to take a year off

to see if things improve next year. And, 41% of students worry about their ability to enroll or stay enrolled due to the current financial situation of the family.

- Even if they do survive, look for increased unemployment not only on the college campus itself, but also in the surrounding community. I have a daughter that will be a Freshman at Virginia Tech this fall. Yes, all of her classes will be online. Per *Emsi*, Virginia Tech generates $1.2 billion annually for the town of Blacksburg, VA. Fifty percent (50%) of the town's jobs are supported by the university, its students and visitors. This is a true "college town." If schools are forced to hold classes online and their students are not on campus, entire communities face severe financial damage.

3. State and Local Governments:

- I mentioned that funding is likely to decrease for public schools and universities. Let me expound on that a little further.

- The shutdown of the economy has also hurt federal and state tax revenue. During the lockdown, I am guessing that you did not travel as much as usual. With few drivers on the road, much of the tax revenue is gone. The federal government raises $36 billion in auto fuel excise taxes. North Carolina gets 64% of its revenue from transportation taxes — the highest percentage of any state. You read that correctly — 64%! Now does it make sense why the highway medians have not been mowed? The funds aren't there.

- Moody's Analytics projects a national average 20% cut in state tax revenue for next year and says that nearly 50% of the states are "significantly unprepared" for even a mild recession.

- Don't forget that many state constitutions require legislatures to produce a balanced budget. So, a drop in tax revenue must be matched by a dollar-for-dollar reduction in spending. Therefore, we predict critical social services including hospitals and schools (mentioned above) as well as police and fire departments (and this has nothing to do with any "Defund" push). We also predict potential funding cuts to pensions and for the poor, elderly, homeless, disabled, etc.

The Bottom Line:

We are a resilient nation and always seem to find ways to overcome our challenges. However, it is not always in a straight line. The "V" recovery we have seen is largely built on a straight line. We do not think this is reality and we believe the market will experience volatility as it overcomes the challenges mentioned above. The positive is that we believe this also provides opportunities which we discuss below.

The Future World

As discussed, COVID will have lasting effects on how we live. These changes or developments offer huge investment opportunities, in our opinion. **You will likely see these themes to continue to expand as a focus in your portfolios.**

1. Technological Innovation Breakthrough

- Technology is driving exponential progress in the tech sector and far beyond. We believe Artificial Intelligence (AI) learning systems and robotics will transform not only retail, media and telecom, as it did the internet, but all sectors of the economy including healthcare and financial services.

2. Demographics and Social Change

- Longer lifespans and modern lifestyles will change medicine and consumer habits. Some estimates project a 45% increase worldwide in people aged 60 or older by 2030.

3. Rapid Urbanization

- Mass migration to cities will require new business models and infrastructure. Two-thirds of the word's population is expected to live in cities by 2050 — double the percentage from 1950.

4. Emerging Global Wealth

- Newly affluent consumers will expand in Asia and across emerging markets. Emerging market economies today are predicted to represent six out of seven largest economies by 2050.

5. Energy Storage

- Declining battery costs should cause an explosion in a number of sectors. These innovations should increase the demand for electrical energy, displacing fossil fuels and reducing not only the vulnerability of the electric grid but also operating expenses. Drones, the delivery system of the future for a wide variety of things, will greatly benefit and play a large role in our future.

6. Digital Wallets and Blockchain Technology

- Watch for digital currency to continue to grow. COVID will quicken this pace because fewer people will want to handle actual cash (those that still do). Money is seen to be full of germs…so look for a push to decrease the circulation of cash in order to lessen the spread of disease. China is expected to launch an online version of the yuan, its currency, later this year. Sweden's economy is almost all digital. Every year, we get more comfortable with electronic transactions like bill pay, credit and debit cards, Venmo, PayPal, etc. Digital currency makes these transactions

faster, cheaper and safer. This is why cybersecurity and financial technology will continue to be so important.

7. Health Care and Genomics

- The race is on to find a COVID vaccine, One of the expected benefits of this race is a permanent shortening of the FDA approval process. Next-generation DNA sequencing is the driving force behind the genomic revolution. It will introduce more science into healthcare decision-making, enable personalized medicine, and accelerate drug discovery.

8. The Contrarian Opportunity

- As I mentioned, the COVID pandemic is unprecedented. Certain industries have been more affected than others. Examples include travel (I.e. airlines, cruises) and entertainment. These industries are not going away and while their stock prices have been decimated due to COVID, we believe they will eventually return to their prior levels. In a sense, our goal is to skate to where the puck will be…not where the puck is now (to paraphrase Wayne Gretzgy). Patience is a virtue here.

The Bottom Line:

We are not concerned about the long-term prosperity of the nation or the stock market. We do believe there are significant risks that lie ahead and that major market declines are likely. In addition, there will be fundamental, long-lasting changes to how we live. In many respects, life will be better. You will likely see these themes to continue to expand as a focus in your portfolios.

Make Sure Your House is in Order

The world post-COVID may change other aspects of your life, too. I would be remiss if I did not recommend the following:

1. **Review the beneficiaries of all retirement plans, IRAs, Life Insurance, Annuities, etc.**
2. **Revisit and update, as needed, your wills, Power-of-Attorney, Healthcare Power-of-Attorney, Living Wills, Trusts, and other Estate Planning, Elder Care and Advanced Directive items.**
3. **Get your financial organization in order.**
4. **Let's sit down to make sure you continue to be on the best path and can answer the question, "Am I on track?"**
5. **Review and adjust your budget, as needed.**
6. **Review and insure you have the correct amounts and types of Life Insurance, Disability Insurance, and Long Term Care Insurance.**
7. **Consider multi-generational planning. Make sure the next generation is ready.**

Let us know if you would like to discuss any of these issues. We are here to help.

Again, we thank you for your trust and confidence. It is our commitment to provide you with the insights and advice that will not only help you today, but most importantly, put you on the right path toward your future objectives.

We wish you all the best for the remainder of 2020 and beyond.

Every Best Wish,

Thomas J. Donahue, ChFC, CFP(R)

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