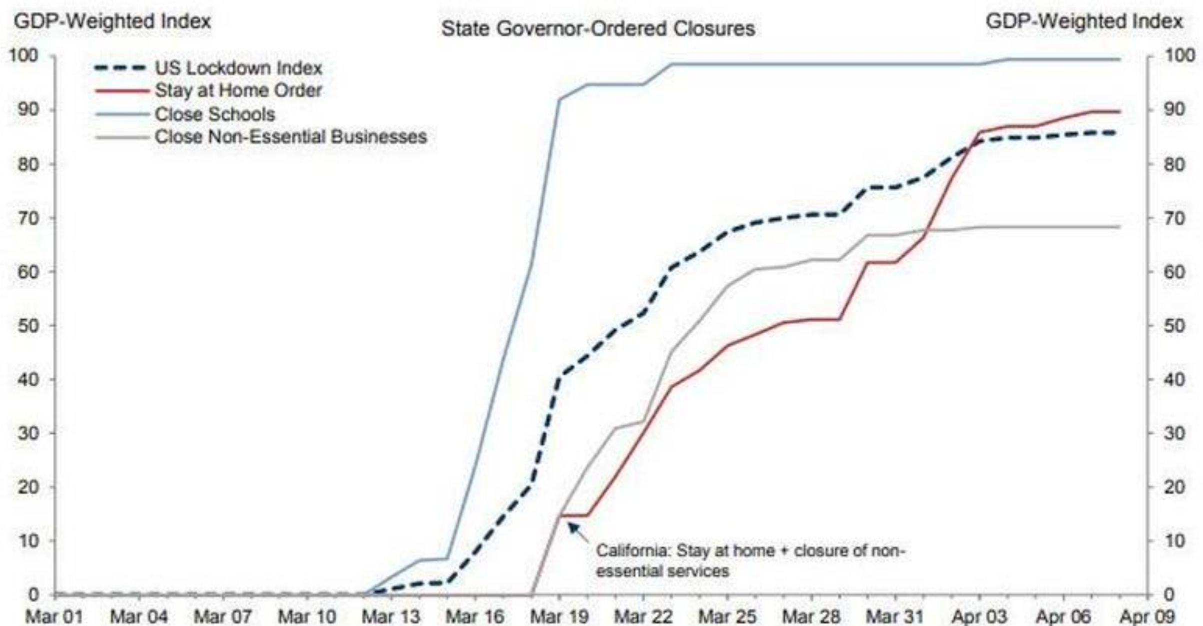
SPECIAL MARKET UPDATE: WHY ISN'T THE MARKET MORE WORRIED ABOUT THE SOCIAL DISTANCING RECESSION?
April 20, 2020

In just one month, US Large Cap (S&P 500), International Developed (MSCI EAFE), and Emerging Market (MSCI Emerging Markets) stocks have managed to rally 30%, 23%, and 20% respectively off of their coronavirus driven March 52-week lows, following federal government and central bank-led stimulus measures, flattening coronavirus incidence rates across the globe, and a first look at the impact of foreign nations beginning to reopen their manufacturing and service economies. At the same time the economic data is just starting to violently demonstrate the impact of shutdowns. And with 86% of the US economy subject to a lock-down in the month of April, this negative data is likely to accelerate.



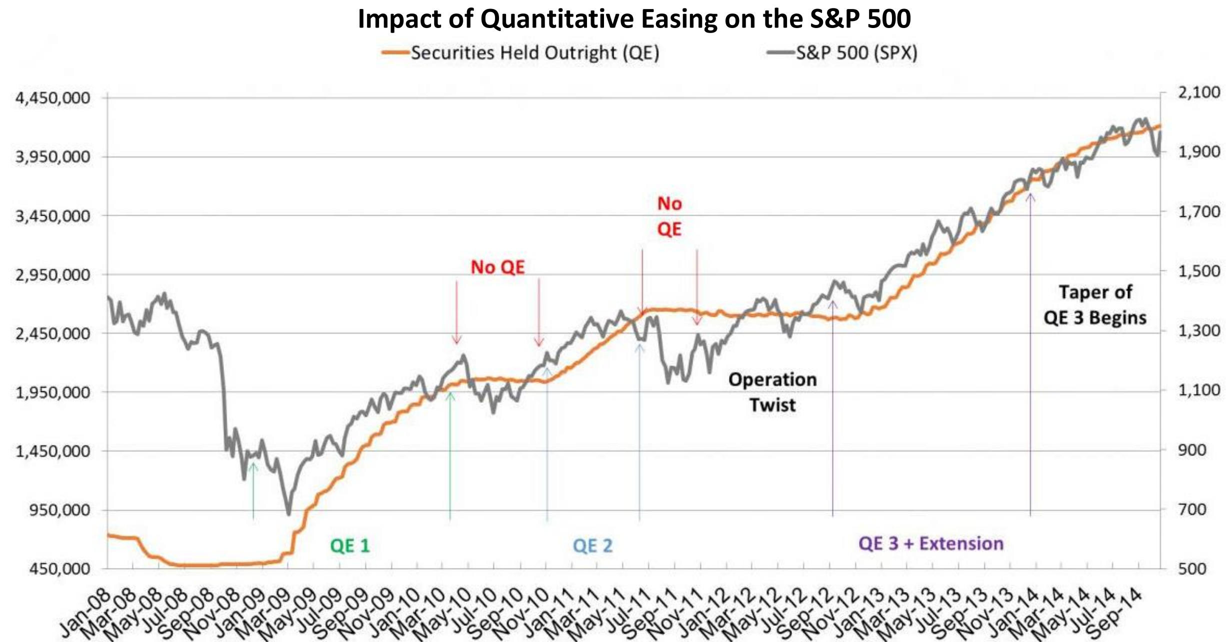
Source: National Governors Association, University of Washington IMHE, Goldman Sachs Global Investment Research

As a result, we have not yet reached peak unemployment, experienced the impact on second quarter GDP growth, nor begun to understand the magnitude of this recession on bond defaults, corporate bankruptcies, and the credit rating downgrades likely to occur in the coming months. This leads us to explore, why isn't the market more worried about the social distancing recession? Let's review seven possible reasons why the market is so optimistic.

Remembering an Important Lesson from Recent History

There is often confusion between the Federal Reserve's liquidity measures meant to keep markets orderly – such as the Federal Reserve Bank of New York's repurchase operations that began in Sept 2019

- and the Federal Reserve's asset purchases meant to stimulate the economy, such as the Quantitative Easing announced in March 2020. The former has little impact on the stock market, while the latter has proven to have a very significant impact of stock prices. This can best be understood through the Quantitative Easing (QE) cycles that occurred during the aftermath of the 2008 financial crisis, known more colloquially as QE1 (12/2008-6/2010), QE2 (11/2010-6/2011), Operation Twist (9/2011-12/2012), QE3 (9/2012-12/2012) and QE4 (1/2013-10/2014).

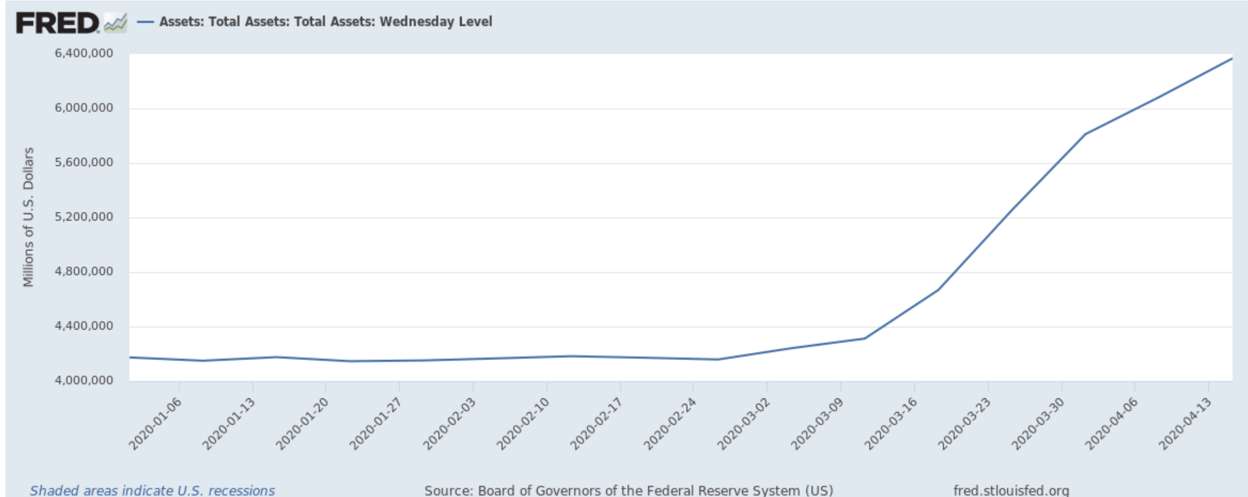


As you can see from the chart above, which compares the performance of the S&P 500 to the size of the Federal Reserve's Balance sheet, as the Fed purchased bank debt, treasury bonds and mortgage backed securities, the stock market rallied in tandem. In fact, there was a near perfect correlation between the two (for those statisticians out there, the R-squared was 96.47%).

Throughout this period the Federal Reserve's balance sheet had increased from $700 Billion to a peak of $2.1 Trillion, an increase of 300%. The S&P 500 appreciated by nearly the same amount.

Fast forward to the current coronavirus crisis, where the Federal Reserve has committed to purchasing unlimited amounts of Treasury bonds and mortgage-backed securities and has already increased their balance sheet by $2.2 Trillion in the month of March alone. It is no wonder the market has rallied so quickly from its March lows.

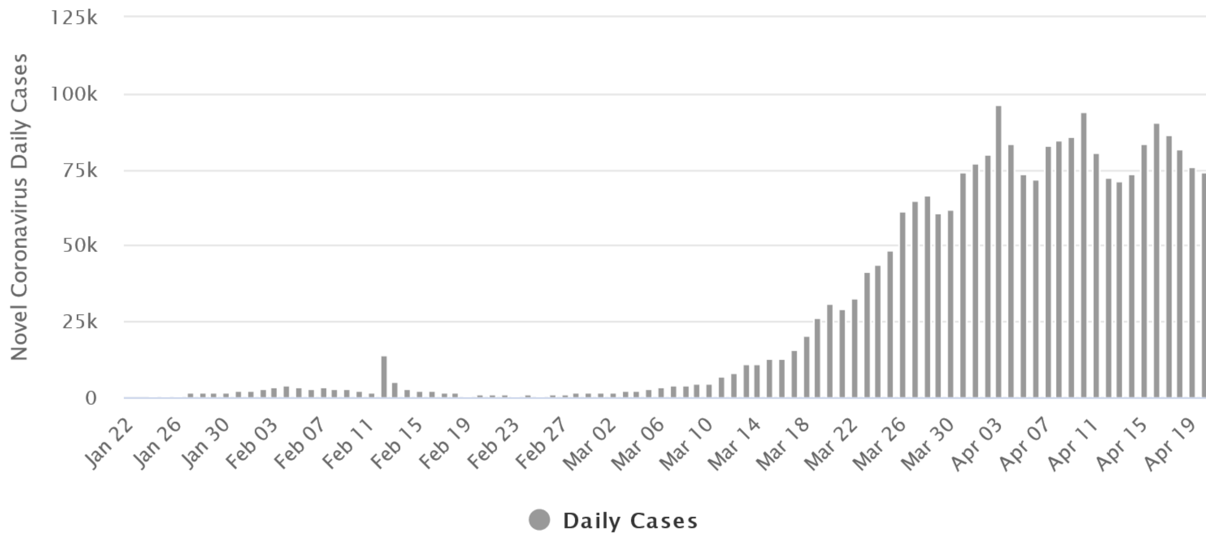
Federal Reserve Balance Sheet (January 1, 2020 through April 20, 2020)



Global COVID-19 Incidence Rates are Stabilizing

Perhaps the most important indicator as to when economic activity will begin to resume (absent a vaccine or treatment) is the plateauing of daily new COVID-19 cases. Just as the Fed's Balance Sheet began to expand, so too did daily new cases accelerate. Yet, April saw a global flattening in this incidence rate. And even "emerging hotspots" in the US, such as Florida, Louisiana, and Massachusetts began to see either a flattening or a decline in daily new cases throughout the month.

COVID-19 Worldwide Daily New Cases



The Economy Isn't A Democracy

The economy isn't a democracy – it doesn't count by heads; it counts by dollars. Fifty-two percent of income comes from the top twenty percent of Americans[1]. The 74% of Americans that we all read about who live paycheck to paycheck, just don't impact the economy all that much[2]. Unfortunately, it is these

[1] https://www.pewresearch.org/fact-tank/2020/02/07/6-facts-about-economic-inequality-in-the-u-s/

[2] https://www.marketwatch.com/press-release/survey-finds-majority-of-americans-live-paycheck-to-paycheck-2019-09-10?mod=article_inline

American's whose livelihood has been most impacted by mandatory business closures due to social distancing.

If we are going to be analytical and not emotional about this, we must embrace these realities. When consumer spending returns, it will be upper income families that will drive the economy back up strongly. There may be long-term consequences about how inequality affects people, and there are likely to be long-term political changes that take place, but they won't impact the economic recovery. Upper income Americans have been asymmetrically less impacted by this crisis, compared to the lowest wage workers that comprise the hospitality, leisure and travel sectors.

Perhaps more importantly, the sectors most directly impacted by the social distancing recession - consumer discretionary (excluding online retail), industrials, materials, real estate and energy - account for only 22% of the value of the S&P 500 by market capitalization. The other 78% of sectors are comprised of technology, financials, healthcare, utilities, communications, consumer staples and internet retail, all of which will be less impacted by the downturn.

Earnings Drive Valuations

A stock is worth the sum of its future earnings, discounted back to the present value. This means that as earnings rise, or as interest rates fall, all things being equal, stocks become more valuable. At the moment, the S&P 500 trades at a Price/Earnings ratio of ~17X 2020 expected operating earnings. As such, 2020 earnings represent 1/17 of its value. 2021 earnings account for an additional 1/17 of its value. Thus, earnings for the next 2 years represent 2/17, or 12% of the value of the S&P500. All future years represent the remaining 88% of its value.

Therefore, if the current recession were to eliminate all earnings of the S&P500 in both 2020 and 2021, yet leave earnings beyond that unharmed, it would justify a 12% decline in the value of the index. Year to date the S&P 500 is now down ~12%. Many believe that earnings will have returned to their year-end 2019 levels by the end of 2021. This implies that the market is pricing in a 2-year earnings recession. We continue to expect a steep earnings recovery by the end of 2021.

Investors Are Again Being Pushed Up the Risk Spectrum

Both short and long-term interest rates are now at historically low levels, making bonds relatively unattractive long-term investments to many investors. Consider that the 10-year US Treasury bond pays a 0.6% annual return to an investor today, which is a negative real return when accounting for the fact that the Federal Reserve is targeting a 2% long-term rate of inflation. Alternatively, the S&P 500 is down 12% for the year and pays a 2.3% dividend yield. Even if it took 10 years for the S&P 500 to reach its February highs, a long-term buy and hold investor would have received a 3.5% annual return from dividends and appreciation in stocks compared to a 0.65% return from bonds, more than 5X the annual return of the Treasury bond. Clearly investors are being pushed up the proverbially risk spectrum, enticed to sell bonds and buy stocks at current prices.

The Expectations for a Reopening of the Economy Are Accelerating

On Thursday April 16 President Trump unveiled his plans for Opening America Again, a three phased plan to restart the US economy. While State's will have the autonomy to implement their own timeline, the markets are watching what is happening in Europe as Germany, Italy, Spain, Netherlands, Austria, Denmark, and Sweden have begun to loosen restrictions. Two weeks of deceleration in the incidence rate of cases in Germany, Italy, France and Spain is certainly encouraging, and the flattening of the curve in the US is helping excite many regional leaders. Parts of Asia, such as China, South Korea, and Taiwan

have been in various reopening phases for over a month, while other nations such as Japan, India, Singapore, the UK, eastern Europe, the Middle East, Africa and Latin America are continuing to see a growth in cases. Of course, the risk remains that a reopening of the economy prior to the creation and distribution of a vaccine or the development of herd immunity (60%+ of US population) can lead to a reacceleration of the virus, and a retesting of market lows. But at current prices, the market seems to believe a reopening will be underway shortly.

Markets Bottom Well in Advance of the End of a Recession

On average, the stock market bottoms around 1.5 months before the peak in jobless claims and 4.5 months before the end of the recession. The question facing investors is whether fiscal stimulus is enough to keep businesses solvent and Americans out of poverty, despite rapid increases in unemployment. The markets will recover, it’s just a matter of how long it will take. Since 1928, the U.S. has experienced 14 recessions and 21 bear markets, yet the market has never failed to recover and pass its previous peak. If states reopen economic activity in the second quarter, as many pundits assume, peak unemployment in early May is reasonable (1.5 months from March lows), although a positive August GDP print is less likely (4.5 months from March lows).

Conclusion

Unprecedented fiscal stimulus and Quantitative Easing, stabilizing incidence rates of daily new COVID-19 cases, economic weakness concentrated in segments of the population and sectors least impactful to the broad economy, relative valuations of stocks to bonds, expectations of a near-term reopening of the economy, and forward looking markets have caused equities to rebound from their March lows, despite the uncertainty of the impact of the virus on earnings, GDP, employment, and bankruptcies.

Many of the conditions we described last month under which the market can begin to price in a recovery are being addressed. A stabilization of the infection rate curve in the US and Europe has begun to occur. Coordinated global stimulus has stabilized credit markets and mitigated liquidity stresses. A deep undervaluation of equities has been realized, although the recent market rally has caused equity prices to be closer in-line to historic average valuations.

While we do not yet have full visibility on the depth and duration of disruptions on the economy, economists are watching Industrial Production and Consumer Spending trends in China as a sign for what is likely to come in Europe and the US, and the data has so far been hopeful. Before calling a bottom however, it is prudent to understand the risks of the inevitable negative adjustments coming to earnings estimates in the coming weeks, as well as the likelihood that an early reopening of the economy will lead to a resurgence in cases, causing the markets to potentially retest their bottom. We continue to recommend investors resist the urge to actively trade in this environment, and instead maintain a bias towards quality, and maintain a disciplined process of rebalancing and repositioning in-line with long-term target weightings across portfolios.

As always, feel free to call if you have any questions, or would like to discuss further.

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