Rockefeller Insights

Around the Markets

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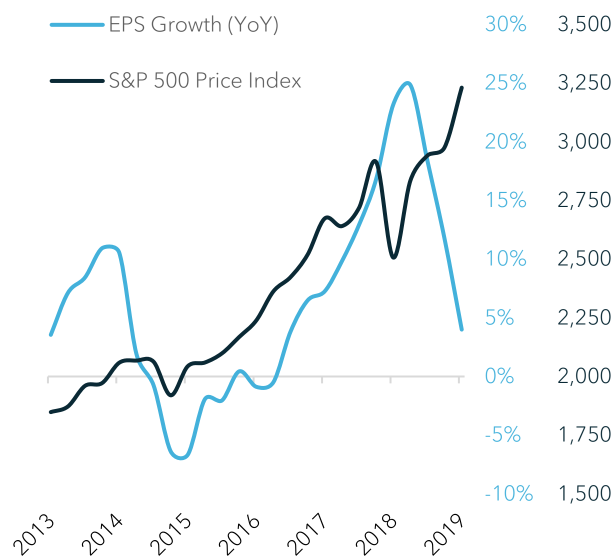
There Is No Such Thing as The Real World

In the past week life as we know it has been rudely interrupted. News of emergency procedures to combat the spread of the COVID-19 virus have caused panic selling in the financial markets and panic buying in the grocery markets. This new, hopefully temporary, paradigm of stay-at-home is likely to test the limits of the American educational system, Wi-Fi bandwidth and television content. Amidst the confusion and anxiety, beneficiaries are sure to emerge. Grocers are hiring aggressively to meet increased demand; Amazon recently announced plans to hire an additional 100,000 distribution warehouse and delivery workers[1]. It is logical to assume that online communications companies and food delivery businesses will get a revenue boost, as well. As families rediscover simpler pleasures of books and bike riding, it will be interesting to see if this crisis leads to more permanent societal changes.

Stocks' Weak Immune System Even Before the Virus

Global spread of the coronavirus and a collapse in oil prices are blamed for the resulting bear market; through March 18, the S&P 500 Index is down 29% from its peak reached on February 19. But US stocks faced significant challenges prior to the virus outbreak. Quantitative Easing that pumped liquidity into the financial markets after the 2008-2009 financial crisis led to massive growth in corporate earnings and stock prices. Fed tightening was ineffective in derailing stocks that were propelled even higher by corporate tax rate cuts in 2018. In 2019, the market continued to rise, helped along by Fed easing, despite a significant slowdown in EPS growth, global trade wars and expanded tariffs.

S&P 500 Index YoY EPS Growth vs. Price[2]



This decoupling of stock prices from underlying fundamentals resulted in a market that was expensive by several measures. Either earnings needed to catch up to stock prices or stock prices needed to "catch down" to earnings. The spread of COVID-19 and collapse in oil prices were the precipitants that pushed stocks over the edge. Now, of course, stocks have corrected to the point where they are much less expensive, but we do not know the extent to which earnings will be revised downward.

Say It Ain't So

We have been asked if this market decline is reminiscent of the last bear market of 2008-2009. In some ways, yes. Then, as now, Federal Reserve tightening prior to the crisis was ineffective; in that case, it did not cool the housing market bubble. The Fed then lowered the Fed funds rate aggressively to near zero by late 2008 accompanied by emergency lending facilities, but that did not stop

[1] Dow Jones, 3/16/2020

[2] Bloomberg, reported earnings from Q4 2013 to Q4 2019

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daily stock market turbulence. Every asset class was sold down, including Treasury bonds and gold. For investors, these parallels may seem worrisome.

But the current environment is vastly different from the financial crisis in many ways. Importantly, the economy today is much improved; years of lower interest rates have resulted in healthy household and corporate balance sheets. The labor market is much better—the unemployment rate averaged over 7% in 2008 vs. 3.5% pre-crisis in February.[3] Even though we expect more job losses in 2020, they will be rising from a very low base.

Perhaps the most compelling argument for "this time is different" is in the root cause of the market breakdown. In 2008, years of housing market leverage created systemic stress on the banking sector until the bubble burst; the workout took several years of emergency bailouts and consolidation to unwind the excesses that had been created. In the present crisis, the banking system and most of the corporate sector is relatively healthy and balance sheets are in good shape. We do not see material excesses or bubbles in any asset classes today. So, the stage is set for a less painful path to stock price recovery this time around once the market can stabilize.

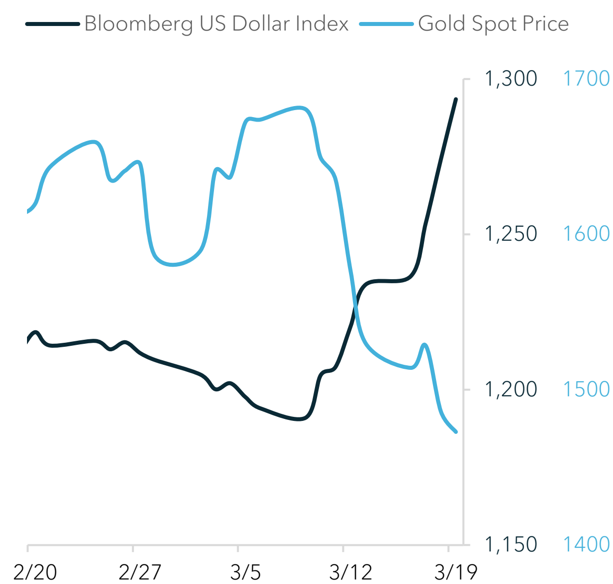
All Hail the Mighty Greenback

Psychologists explain the behavior of panic buying in times of uncertainty as a sign of stress and an attempt to regain control of the situation.

We suspect not all investors are stockpiling toilet paper. They are, however, certainly hoarding cash; that is, if they can manage it.

Over the past week, soaring demand for liquidity has exacerbated dislocations across all financial markets. Leveraged investors and asset managers have been scrambling to raise cash to meet margin calls and/or redemption requests. Even safe haven assets such as US Treasury notes and gold have not been immune to the selloff, as desperate investors looked to raise liquidity from positions that still managed to attract reasonable bids.

US Dollar versus Gold[4]



In our previous *Around the Markets*[5], we discussed the potential monetary stimulus measures that investors might expect. Last week, the Fed unleashed most of its arsenal in an effort to stabilize the financial system and restore liquidity to the Treasury market. After offering $1.5 trillion in short-term loans in the repo market last Thursday, the Fed announced on Sunday that it would cut the Fed Funds rate to near zero and buy $700 billion in Treasuries and mortgage-backed securities. The S&P 500 Index fell sharply following the announcement, posting the biggest one-day percentage drop of 12% since the "Black Friday" crash in 1987. This is a clear sign that investors have

[3] Bureau of Labor Statistics
[4] Bloomberg, 3/19/2020
[5] As of 3/11/2020

recognized that traditional monetary stimulus is not going to save the economy from a pandemic-induced recession. Investor confidence now depends on the Federal government's ability and willingness to deliver aggressive fiscal stimulus.

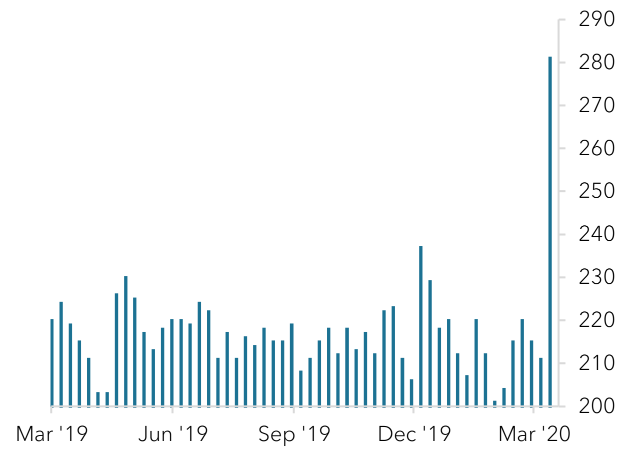
The Dual Challenges of Surviving the Pandemic

A study by the Imperial College COVID-19 Response Team projects that – in the absence of actions to control the pandemic spread – the COVID-19 virus may directly cause over two million deaths in the US.[6] This study was published on March 16th; however, the fatality estimates were shared with the White House a few days prior to the official release. Almost overnight, US policy makers woke up to the seriousness of the pandemic. Across the country, governments on the Federal, state, and city levels have taken fresh steps in an effort to suppress and contain the spread of the coronavirus. Social distancing is promoted. People are encouraged to stay home. Classes are switched to being taught online. Events are canceled. Many restaurants and bars are closed. While such aggressive measures have inspired panic among some Americans, we believe that they are also a cause for optimism: we are now on a path to curbing the magnitude of the pandemic, reducing the potential number of infected cases, and eventually reaching the end of the current crisis.

The economic costs of such aggressive interventions, however, create another severe challenge. Production and spending will inevitably decline for a while. The much greater economic risk, in our opinion, is that as entire sectors of the US economy are shutting down, the eventual recovery may take a long time if critical economic relationships are disrupted by months of low activity. Otherwise healthy businesses may be forced to declare bankruptcy due to many months of low revenue. Firms, in an effort to reduce expenses, may lay off experienced workers who are difficult to replace. Workers without income may default on their mortgages and lose their homes. US jobless claims jumped 70,000 to a seasonally adjusted 281,000 in March. We expect claims to rise much further in the weeks ahead.

US Initial Jobless Claims[7]

(seasonally adjusted, unit in thousands)



The equity market is anticipatory. A V-shaped recovery of the equity market is unlikely, unless investors believe that the economic damage from the pandemic will not be long lasting and society will return to normal once the outbreak starts to wind down. This scenario requires policymakers to act quickly and aggressively.

"Whatever It Takes!"

Last night, the Senate cleared the second major bill responding to the COVID-19 pandemic. This bill is centered on paid sick leave as well as paid family and medical leave. The package is available specifically for small businesses, which are generally more resource constrained and offer fewer benefits to their employees.

[6] Imperial College COVID-19 Response Team

[7] Bloomberg, 3/19/2020

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The second bill was passed with broad, bipartisan support in the House on Sunday.[8] The COVID-19 pandemic crisis has driven Congress to act at a scale not seen since the 2008-2009 global financial crisis, even more stunning given the backdrop of a bitter election-year struggle between the two parties. Unlike during the global financial crisis however, few lawmakers are expressing concerns about increasing the annual budget deficit. A parallel to World War II has been drawn by many policymakers, including President Trump. Large government spending in the current pressing circumstances appears to have gathered bipartisan support given millions of workers are at risk of losing their jobs and small businesses across the country are at risk of closure by the time the pandemic subsides and economic activity resumes.

Lawmakers in Washington are rushing to follow up with a third bill that is expected to offer additional economic rescue to individuals and small businesses. The White House estimates that the package will cost $1.3 trillion, a staggering jump from the initial $8.3 billion virus response bill approved in early March. The third bill – if approved by Congress – will provide $500 billion (in direct payments) to individuals and $300 billion to small businesses, keeping them afloat during the virus outbreak and keeping workers on payrolls.[9]

The passage of this bill could go a long way toward strengthening investor confidence.

We Hear Opportunity Knocking

Fear-induced panic selling has no regard for fair value and, while fair value may be difficult to identify, it seems to us that opportunity is knocking on the door.

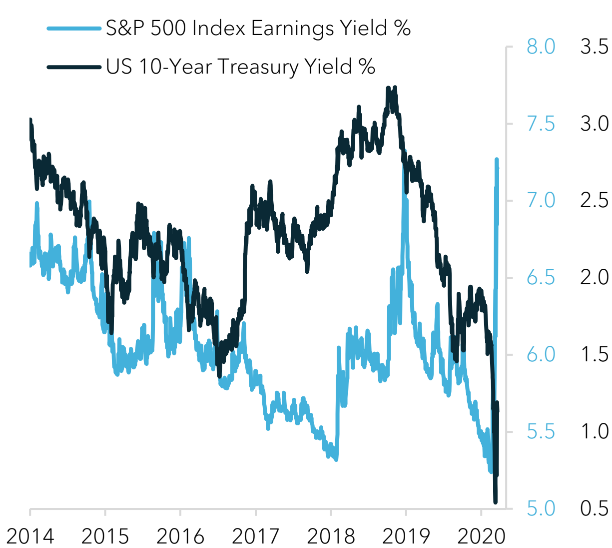
We do not want to gloss over the seriousness of the virus' effect or the longer-term impact of the various shutdowns on the economy and corporate earnings. It may be a challenge for stock prices to return to pre-crisis levels any time soon; it will take time to recover lost revenues and market confidence.

The stock market's bottoming process is a mix of daily ups and downs in prices as confidence is gradually restored. Technical analysis can often be helpful in identifying important market signals that point to a bottom in stock prices. According to technical analysis firm The FRED Report, past similar market declines have had an average peak-to-trough period of around five months.[10] If that holds true today, it suggests that the market troughs around mid-July (the S&P 500 Index peaked on February 19). However, we are increasingly convinced that these dark days are creating opportunities for longer-term investors.

Stocks are more attractively valued relative to bonds than at any time in the last eight years.

S&P 500 NTM Earnings Yield %

versus. 10-Year US Treasury Yield %[11]



[8] Bloomberg, 3/18/2020
[9] Bloomberg, 3/18/2020

[10] www.TheFredReport.com
[11] Bloomberg, 3/19/2020

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With yields on cash close to zero and bond yields not much higher, income-oriented investors are likely to be drawn to dividend paying stocks. According to investment manager Invesco, 93% of dividend paying stocks in the S&P 500 Index had yields higher than the 10-year US Treasury bond yield as of March 13.[12] Even with the recent back-up in yields, the vast majority of dividend payers have relatively attractive yields for those seeking current income.

Patience Is Indeed A Virtue

We encourage investors to avoid panic selling. Selective harvesting of tax losses may make sense, but panic selling is one of the worst detriments to long-term wealth accumulation, according to Richard Bernstein Advisors.[13]

It may be a good time for investors to create a shopping list of assets that can fill gaps in existing portfolios and that look attractive at current price levels. We believe that this period will turn out to be one of the best buying opportunities for financial assets in the past decade.

Our country will eventually return to normal; school buses will re-appear and meat will be back on supermarket shelves. As we recover, there are likely to be heartwarming stories of courage and heroism, as always occur when Americans confront a crisis. And financial markets will be restored to normalcy in the system that has governed them for centuries. Throughout the challenging days ahead, we sincerely hope that you and your families remain healthy and safe.

[12] Invesco, 3/13/2020

[13] Richard Bernstein Advisors, 3/18/2020

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