SPECIAL REPORT:
A WORRISOME ESCALATION IN INVESTOR PANIC

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With respect to the issue of valuation, it is crucial for investors to understand the ironclad relationship between equity market valuations and the level of interest rates. History reveals a clear and consistent inverse correlation between government bond yields and price-to-earnings (P/E) ratios. The plunge in bond yields, if sustained, should be accompanied by a systematic rise in equity market valuations.

Financial markets continue to react violently to news regarding the coronavirus as the epidemic continues to curtail additional forms of business activity. US Treasury yields have collapsed to unprecedented levels, while measures of equity market volatility rose to the highest level since the 2008 financial crisis.

- The number of cases of COVID-19 continues to rise and surpassed the 100,000 mark on Friday, with continued rapid increases in Italy, South Korea, and Iran. The virus has spread to more than 85 countries.

- The US economy faces a progressive slowdown in coming months as containment measures become increasingly disruptive to spending, output, and travel. GDP growth in both the first and second quarters is likely to fall to 1% or less, followed by an economic recovery during the second half and throughout 2021.

- Economic data for both January and February were surprisingly strong. Nonfarm payrolls increased by a robust 273,000 in each month, while both the housing market and service sector were in a distinct strengthening trend. The key point is that the US economy was in an improving trend just prior to the epidemic.

- The economic effects of increasing containment measures should begin to appear in the March data, persisting for several months until COVID-19 runs its course. My forecast assumes that the epidemic will have only a transitory effect on GDP growth.

- Because underlying economic and financial fundamentals are healthy, US GDP growth should improve markedly during the third and fourth quarters. GDP growth in 2021 could also be significantly faster than previous forecasts.

- US corporate earnings are vulnerable to downward revisions in the first half of this year, as revenues decline at a faster rate than businesses are able to cut costs. A rebound in GDP growth in the second half of this year and throughout 2021 should be accompanied by solid growth in company earnings and dividends.

- The 50-basis point cut in policy rates last week confirmed the Fed's commitment to support financial conditions and ensure ample credit availability. However, monetary policy is powerless in supporting the real economy in the short term. Nonetheless, further Fed rate cuts will likely be announced in coming months.

- The bond market has entered uncharted waters, with interest rates at the lowest levels in US history. Global investors can lend money to the US Treasury at 0.55% for ten years and 1% for 30 years. I am skeptical that these record-low market yields can be sustained, as the market seems to be anticipating.

- The domestic equity market has experienced extraordinary volatility over the past two weeks, with alternating days of massive gains and losses. The Chicago Board Options Exchange (CBOE) Volatility Index, or VIX — often referred to as the "fear index" — exceeds 50, the highest level since the 2008 financial crisis.

- Financial markets are clearly in panic mode. Taken literally, the stock and bond markets are discounting a deep and protracted recession, which is highly unlikely. The stock and bond markets are also discounting permanent long-term structural damage to the US economy, which is currently not apparent.

- The most compelling evidence of an emotional panic is the plunge in long-term bond yields to 0.55% and the total collapse of many stocks in key economically sensitive sectors, such as industrials, materials, and financials.

- The collapse in world oil prices has both positive and negative implications. Household spending should benefit from a rise in consumer purchasing power, as inflationary pressures subside. In the negative column are increased risks to credit markets and cancellations of energy-related capital investment projects.

- A continuation of disorderly markets and growing risks to the financial system should elicit a strong response from policymakers around the world. More important than further monetary easing would be bold fiscal policy measures to support the broad economy, as well as targeted assistance to highly vulnerable industries.

- It is crucial for investors to understand that the current equity market is comprised of two extremely divergent segments: Defensive stock groups and economically sensitive stocks. The latter is extremely oversold and undervalued, while the former is heavily overbought and overvalued.

- The combination of these two extremes has resulted in an equity market that is moderately undervalued. The implication is that individual stock selection — rather than market timing — will be the key to future investment returns. Widespread indiscriminate selling will create opportunities for patient long-term investors.

- Overvalued sectors include consumer staples, utilities, real estate, telecom, and technology. Undervalued sectors include industrials, financials, energy, materials, and transports. These cyclical sectors should significantly outperform the former sectors over the next one, two, and three years.

- With respect to the issue of valuation, it is crucial for investors to understand the ironclad relationship between equity market valuations and the level of interest rates. History reveals a clear and consistent *inverse correlation* between government bond yields and equity price-to-earnings (P/E) ratios.

- Over the past 50 years, the average P/E ratio for the S&P 500 was 16x, consistent with an average yield of 6.25% on ten-year Treasury securities since 1969. Looking at two historical extremes, the P/E ratio fell to a low of 8.5x in the early 1980s when bond yields spiked to 15%. The P/E ratio climbed to 20x in the early 1960s in an environment in which government bond yields were less than 4%.

- On the basis of finance theory, a yield of 1% on ten-year government bonds would be compatible with a P/E ratio in the mid-20s or higher, well above the current 16.5x P/E ratio on the S&P 500.

- One cannot be dogmatic regarding the subject of equity market valuations because of the numerous subtleties involved. One can only conclude broadly that higher P/E ratios are warranted when bond yields are sustained at less than 1% than when yields are above 2%, all else equal.

- In the end, the outlook for stocks is predicated upon whether the US economy experiences a sharp slowdown in growth or an outright recession. In a slowdown scenario, the losses might be limited to 20%; a full-blown recession would trigger a much larger decline. I continue to believe that containment measures will cause a steep but brief slowdown, but will not derail the 11-year old economic expansion.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.