ECONOMIC FORECAST: A TECHNICAL RATHER THAN A TEXTBOOK RECESSION

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Although further market declines are likely, the indiscriminate dumping of stocks has created a unique buying opportunity for patient long-term investors. Shares of high-quality stocks in the industrial, financial, energy, and transportation sectors have collapsed and offer exceptional values at current depressed prices. For the first time in several years, my valuation model indicates that long-term expected returns on the S&P 500 are now attractive at current depressed levels, estimating a 10% return over a three-year time horizon. In sharp contrast to the bond market, the risk/reward ratio on common stock investing is favorable.

Developments in world financial market over the past three weeks has been unprecedented. The 27% peak-to-trough decline in the S&P 500 officially ended the cyclical bull market that began in 2009. The yield on ten-year US Treasury bonds plunged to less than 0.35%, while high-yield corporate bond prices tumbled by 10% in less than two weeks. Stocks ended the week with a nearly 10% gain, the biggest single-day bounce since 2008. This special report provides an update of most recent developments and implications for financial markets.

- Despite Friday's massive equity market rally, world financial markets remain in panic mode as the coronavirus has been declared a global pandemic. US financial markets are discounting a severe and protracted economic and profit recession — as reflected in the 40% decline in cyclical stocks and crash in US Treasury bond yields.

- I believe that investors have overreacted: While a technical recession seems inevitable, the contraction in aggregate output is likely to be very brief and could fade beyond the next several months. A strong rebound in GDP and company earnings is likely in the second half of this year, continuing into 2021.

- Investor sentiment has plunged to record lows. The market detests uncertainty above all else; in the absence of a predictable outcome, investors almost always assume the worst-case scenario and shift into panic mode.

- While the Federal Reserve has acted boldly, investor hysteria was accentuated last week by the conspicuously weak response from the Trump administration, along with the appearance of typical partisan politics within Congress — until late last week.

- The ostensible catalyst for the nearly 10% jump in equity markets on Friday was the declaration of a national emergency by the Trump administration, accompanied by specific fiscal policy initiatives to deal with the crisis.

- Congress also responded with a nonpartisan multi-billion-dollar spending package to combat the impact of COVID-19 on the domestic economy. The package includes provisions to provide two weeks of paid sick leave for afflicted workers, three months pf paid family and medical leave, and federal funding for Medicaid.

- Tax cuts along with additional spending programs are expected in coming days and weeks. The administration also announced plans to suspend interest on student loans and to buy large amounts of crude oil for the Strategic Petroleum Reserve.

- The Federal Reserve announced last Thursday that it would pump trillions of dollars into the financial system to ensure that credit markets remain open. The Fed has essentially promised to act as lender of last resort in the event of a cash flow crunch.

- The Fed followed up on Sunday with another emergency rate cut, pushing the federal funds rate to zero. The Fed also announced further actions to support the financial system, including an additional $700 billion in asset purchases, expanded repurchase operations, dollar swap lines with foreign banks, and a credit facility for commercial banks to ease household and business lending.

- The private sector has moved aggressively on the containment front by suspending events involving mass gatherings, announcing cutbacks in business operations, and initiating widespread office closures. Continuation of these containment measures is crucial in flattening the curve of new COVID-19 infections.

- It should be obvious that strict containment measures will have a significant dampening effect on economic activity, mainly in the service sector, travel and tourism industries, manufacturing, retail, and delivery services.

- The plunge in spending and output nationwide appears likely to result in a deep contraction in GDP, thereby qualifying as a technical recession. However, aggressive containment measures are an evil necessity in mitigating the ultimate spread and magnitude of the contagion. In short, a world recession is an important component of a cure for a global pandemic.

- My new economic forecast assumes that US GDP will decline at an annual rate of 1.5% in the current quarter, followed by a 2.5% decline in Q2. Key economic data for January and February were remarkably strong, but government data for March, April, and May are expected to show profound weakness.

- My forecast also assumes that GDP growth could strengthen considerably during the second half, consistent with other health crises and natural disasters in the past. My new forecast assumes GDP growth of 3.5% in the second half of this year.

- US GDP growth for all of 2020 would average roughly 1%, down from my previous estimate of 2.5%. GDP growth could rebound to 3% or greater in 2021 as the expansion broadens. A classic V-shaped recovery is possible, although not assured.

- It is important to understand that the current economic downturn does not fit the description of conventional or textbook recessions, which systematically come about because of deep-seated fundamental imbalances and excesses within the economy and financial system that have accumulated over a period of several years.

- There have been 12 recessions since World War II, virtually all of which resulted from unacceptably high inflation, forcing the Federal Reserve to implement an aggressive tightening of monetary conditions. Tighter credit conditions led to a slump in residential construction, along with cutbacks in business and household spending.

- Moreover, conventional recessions have generally occurred in the context of an overheating economy. Typical catalysts for cutbacks in spending and output included surging oil prices; excess accumulation of business inventories; and overinvestment in plant and equipment, housing, and commercial construction.

- The technical definition of recession is two quarters of contraction in GDP, which appears likely in Q1 and Q2. The need for recessions within the classic business cycle emanates from adjustments to aggregate spending and output following excesses and imbalances that emerged during the previous expansion.

- Most recessions are also accompanied by a financial crisis reinforced by profound structural weakness in the financial system. Currently, none of these conditions are evident. The expected decline in GDP will result from containment measures that remove consumers and workers from society, rather than an adjustment in cyclical behavior by households and businesses.

- The crucial assumption for long-term equity investors is that the pandemic does not inflict permanent structural damage on the US economy nor on the ability of companies to generate annual growth in earnings and dividends.

- Investors should also differentiate between a liquidity crisis and a solvency crisis. Many companies will experience short-term cash flow and funding difficulties, despite strong balance sheets and low solvency risk. The Fed indicated that it will act as the lender of last resort to assist businesses facing a short-term liquidity crunch.

- The cumulative decline in the S&P 500 through last Thursday was 27%, which could mark an important market bottom, but probably not the ultimate bear market bottom. History reveals that investors should expect a volatile consolidation phase before a healthy and sustained uptrend can be reestablished.

- Although further market losses are likely, the indiscriminate dumping of stocks has created a unique buying opportunity for patient long-term investors. Shares of high-quality stocks in the industrial, financial, energy, and transportation sectors have collapsed, and are currently priced at deep discounts to intrinsic value.

- For the first time in several years, my equity valuation model estimates that prospective long-term returns on common stocks are attractive. The model indicates that the expected annualized total return for the S&P 500 is currently close to 10% over a three-year time horizon. In most recent years, the implied long-term expected return had been within the range of 3% to 5%.

- Market yields in virtually all fixed-income sectors appear to have bottomed for the cycle, including US Treasury bonds (0.35%), investment-grade corporate bonds (2.15%), high-yield corporate bonds (5.1%), mortgage rates (3.25%), and German sovereign debt (-0.85%). The general direction of interest rates is likely to be upward over the next one to two years, implying sustained losses in bond portfolios.

- The implications for disciplined long-term strategic investors are clear: With an expected return in excess of 10% on common stocks versus only 2% on bonds over a three-year time horizon, a shift from bonds to stocks in balanced portfolios appears warranted. The risk/reward ratio for equity investing is now quite favorable, while the opposite is true for bonds.

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