CONTAINMENT, POLICYMAKERS, AND WORLD FINANCIAL MARKETS

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Summary and Major Conclusions:

- There are two central themes governing global financial markets: Investor panic and market illiquidity. All asset classes are under intense selling pressure as investors in all markets engage in a frantic scramble for liquidity.

- The general feeling among investors is that "cash is king." There are even instances of sales of US Treasury ***bonds*** to buy Treasury ***bills***, the quintessential risk-free asset. Currently at zero, the yield on three-month Treasury bills fell briefly to a ***negative 0.15%*** last Thursday afternoon.

- Circumstances on the ground are changing on a daily basis. In the negative column, the number of new cases in Europe and North America are in accelerating at an exponential pace; economic trends continue to worsen; unemployment is rising; and company earnings and cash flows are hemorrhaging.

- In the plus column, policymakers have responded aggressively with commitments of trillions of dollars to support the economy and credit markets. Public health officials have also begun to exhibit a greater sense of urgency in dealing with the pandemic.

- The US economy entered a recession this month, one that could persist throughout the second quarter. The depth and duration of the recession is impossible to predict, but will depend upon the success of containment measures designed to flatten the curve of new infections.

- As a reminder, the US economy was gathering considerable momentum in January and February, just prior to the epidemic. Employment and consumer spending were strong, airline bookings were in a steep uptrend, and housing sales rose to the highest level since 2006.

- My forecast assumes a brief but deep recession, with US GDP declines in the first and second quarters. The expected contraction in second quarter GDP could surpass the record quarterly decline of 10% that occurred in the first quarter of 1958.

- Corporate earnings in both the first and second quarters will also suffer severe declines. Assuming the number of cases peaks later this spring, Q3 earnings could stabilize on a sequential quarter-to-quarter basis, followed by a sharp increase in Q4.

- Many analysts have made comparisons between the current economic crisis and the financial crisis in 2008. I disagree with this analysis and believe that these two episodes are fundamentally very different, in two important respects.

Although there remains enormous uncertainty regarding the immediate future, it is important to remember that financial markets are forward looking and will anticipate an improvement in economic trends well in advance of the media. Long-term investors should adjust asset allocation strategies to reflect an overvalued bond market and undervaluation in common stocks. The most important indicator of an expected shift in market psychology will be concrete evidence of a peak in the number of new COVID-19 cases.

- Whereas 2008 involved a vicious solvency crisis, the current episode is primarily a liquidity crisis. Households and businesses are fundamentally sound, but each is at risk of an abrupt shortfall in cash flow necessary to meet obligations. The banking system is extremely well capitalized today, but dangerously leveraged in 2008.

- The period leading up to the world financial crisis in 2008 was characterized by unprecedented cyclical imbalances and excesses. The most glaring of these were a massive credit bubble and an immense overhang of unsold homes.

- The result was a multi-year deleveraging cycle to restore balance sheets to normal, along with a crash in new construction, both of which created daunting headwinds for economic growth. The odds of a comparable deleveraging cycle following the current recession are low.

- Economic conditions are the direct opposite of those in 2008: Household balance sheets are in excellent shape; capital ratios in the banking system are at a 35-year high; and the supply of unsold homes is at an all-time low. Business inventories are depleted and capital formation has been depressed.

- Policymakers have announced very aggressive stimulus initiatives to address rapidly growing economic and credit risks. The Federal Reserve announced that it would inject trillions of dollars into the financial system and resume quantitative easing (QE4), beginning with $700 billion in asset purchases.

- The federal government also announced more than $1 trillion in fiscal policy stimulus. The relief package includes $500 billion in direct payouts to families, another $300 billion for the small business sector, and $200 billion for secured lending targeted for critical industries, such as airlines.

- Although there remains enormous uncertainty regarding the immediate future, it is important to remember that financial markets are forward looking and will anticipate an improvement in trends well in advance of the media. The most important signal for a shift from risk-off to risk-on will be concrete evidence of a peak in the number of new COVID-19 cases.

- Investors should also pay close attention to the other indicators, including continued policy support from central banks and fiscal authorities and the day-to-day functioning of money and credit markets.

- Other trends to monitor include the speed at which businesses are able to restart the economy. This includes routine data regarding airline bookings, office and retail store openings, and new hiring intentions. Finally, a close monitoring of economic recoveries in the early-infection countries — most notably China and South Korea — can provide relevant insights regarding the eventual US recovery.

- Financial markets could remain in disarray for another several weeks before massive selling pressures reach a state of exhaustion. Equities are massively oversold and undervalued; at current depressed stock valuations, long-term investors should emphasize potential long-term gain over short-term pain.

- At current valuations, equity markets offer an exceptional buying opportunity for long-term investors. Annualized total returns for the S&P 500 could easily exceed 10% over a three-year time horizon. Expected annual returns for a diversified bond portfolio are unlikely to exceed 2.5%.

"The biggest insight gleaned from economics is that asset prices are set at the margin. The stock price on the screen is the one at which the most desperate seller and the bravest buyer are willing to do business. When the ranks of the first group overwhelm those of the second, the result is a market rout, or capitulation, in market-speak."

The Economist
Buttonwood, Page 62
March 21, 2020

"Italy has now surpassed China with the highest death toll, becoming the epicenter of a shifting pandemic. If Italy's experience reveals anything, it is that measures to isolate affected areas and limit the movement of the broader population need to be taken early, put in place with absolute clarity, and then strictly enforced."

The New York Times
Page one
March 22, 2020

THE US ECONOMY

The US economy entered a recession this month that could persist throughout the second quarter. The duration of the recession is impossible to predict, but will depend upon the success of containment measures to flatten the curve of new infections in Europe and North America. The more aggressive the containment measures, the more severe the decline in GDP — but also the sooner the inevitable rebound in growth.

Pluses and Minuses: Circumstances are changing on a daily basis. In the negative column, the number of new cases in Europe and North America are increasing at an accelerating pace; economic trends continue to worsen; unemployment is rising; and company earnings are on a path toward very large declines in the first half. In the plus column, policymakers have responded aggressively with commitments of trillions of dollars to support the economy and credit markets. Public health officials have also begun to exhibit a greater sense of urgency in dealing with the pandemic.

GDP Forecast: My forecast assumes a brief but steep recession, with US GDP declines in the next two quarters among the worst in modern history. In particular, the contraction in second quarter GDP could surpass the record quarterly decline of 10% that occurred in the first quarter of 1958. Real GDP should stabilize in the third quarter but experience a very large rebound in the fourth quarter and in the first half of next year.

Company Earnings: Corporate earnings in both the first and second quarters will also suffer severe declines. Assuming the number of cases peak within several months, third quarter earnings could increase on a sequential quarter-to-quarter basis. Companies should register very large gains in the fourth quarter and during 2021.

COMPARISONS TO THE 2008 FINANCIAL CRISIS

Many analysts have made comparisons between the current economic crisis and the financial crisis in 2008. I disagree with this analysis and believe that these two episodes are fundamentally very different, in two important respects.

- **Solvency Issues**: Whereas 2008 was mainly a widespread ***solvency crisis***, the current episode is primarily a ***liquidity crisis***. Households and businesses are fundamentally sound, but are simply at risk of a shortfall in cash flow to make payments. The banking system is extremely well capitalized today, but was highly leveraged in 2008.

- **Economic Imbalances**: Another major difference were the enormous imbalances in 2008, requiring a lengthy rehabilitation period for the domestic economy. The most glaring of these imbalances was a massive credit bubble and an immense overhang of unsold homes. The result was a *multi-year deleveraging cycle* to restore balance sheets to normal, along with a depression in housing.

- **Pent-Up Demand**: Another deleveraging cycle following the current recession is not warranted, with the possible exception of select industries within the nonfinancial business sector. Importantly, instead of excesses in investment and consumption, the US economy is characterized by a significant pent-up demand for goods and services.

POLICYMAKERS RESPOND

Policymakers have responded aggressively to the economic and financial crisis, although somewhat belatedly.

- **Monetary Policy**: The response of the Federal Reserve has been impressive. After slashing its policy rate to zero, the Fed announced that it would inject trillions of dollars into the financial system, using various lending facilities that were initially employed during the 2008 financial crisis. The Fed also announced a resumption of quantitative easing (QE4), pledging $700 billion in asset purchases.

- **Fiscal Policy**: The Trump administration is finally working in concert with Congress to enact legislation to provide direct assistance to businesses and workers during the current shutdown of the economy. An initial fiscal package of $1 trillion could be forthcoming as early as this week.

- **Targeting Households and Businesses**: The program provides $500 billion in direct payouts to families, in the amount of $3,000 for a family of four. Another $300 billion is directed toward the small business sector to prevent mass layoffs. Another $200 billion is targeted for secured lending to critical industries, such as airlines and domestic energy producers.

- **The Eurozone**: It is encouraging that other countries are following the lead of America. The European Central Bank (ECB) has announced a very large increase in its asset purchase program. At the same time, Germany has announced that it will use its untapped financial prowess to provide fiscal stimulus.

KEY INDEPENDENT VARIABLES

Although there remains enormous uncertainty regarding the immediate future, it is important to remember that financial markets are ***forward looking*** and will anticipate an improvement in trends well in advance. <u>The following are critical independent variables that investors should closely monitor in coming days and weeks</u>:

1. The timing of a peak in new COVID-19 cases in the US, Canada, and Europe, especially Italy. Trends in China, South Korea, and Singapore should also be monitored to ensure that a second wave of infections does not occur

2. Announcements of public health countermeasures, including availability of test kits and respirators and the ability of hospitals to manage the surge in new cases expected over the next several weeks

3. Medical innovation in terms of new therapeutic treatments to mitigate the illness, along with state-of-the-art medical testing equipment. Regrettably, approval of an effective vaccine is at least one year away.

4. The policy response from the Federal Reserve and the Treasury in providing open-ended relief for businesses, workers, and ailing credit markets

5. The effective functioning of money and credit markets and continued availability of credit for businesses and consumers

6. When new cases reach a peak, the focus should return to commercial activity in order to gauge the speed at which businesses are able to restart the economy

7. The focus should be on timely data regarding initial jobless claims, hiring intentions, airline bookings, retail store openings, and the pace of office openings — all leading indicators of a rebounding economy

8. Economic trends in the early-infection countries — especially China and South Korea — as a possible guide as to how quickly and effectively the US economy might restart once the coronavirus is contained

INVESTMENT CONCLUSIONS

Both stocks and bonds are in a bear market, which could persist for a while longer. The peak-to-trough decline in the S&P 500 through last Friday was 31.5%. Fixed-income markets have also suffered steep declines, including both investment-grade corporate bonds (-15%) and long-term speculative-grade corporate bonds (-23%).

There are clear signs of a market panic. Correlations on all asset classes — stocks, bonds, commodities, crude oil, gold — have converged on 1.0. This is unprecedented and means that all asset prices are moving in lockstep, an obvious sign of ***forced liquidation*** in highly leveraged financial firms — hedge funds, mutual funds, and traders — faced with severe liquidity pressures, which are compelled to sell all assets simultaneously. The obsession over cash is so great that firms are selling Treasury bonds to buy Treasury bills. *The three-month US Treasury bill fell briefly to a negative 0.15% late last week*.

Evidence of forced liquidation and a mad scramble for cash is ubiquitous. Outflows from bond funds exceeded $100 billion last week, while stock funds continue to experience the largest redemptions on record. US Treasury bills have been in such high demand that the yield fell briefly into ***negative territory*** on Thursday. The closely watched Volatility Index (VIX) also rose to an all-time high last week.

How should long-term investors react to the hysteria in the market? The first thing to recognize is that irrational behavior and forced selling of troubled investment firms are driving the pricing of financial assets. It is also true that algorithmic computer trading and the proliferation of exchange-traded funds (ETFs) have accentuated the indiscriminate selling of all assets.

It is useful to examine market history to understand the pattern of similar market panics in the past. Once economic stability is restored, the normal negative correlation between common stocks and government bonds will be reestablished, which should mean rising stock prices and bond yields and falling bond prices. In an improving economy, corporate bonds should also significantly outperform government bonds.

The performance of the equity market in the aftermath of all post-World War II recessions is uniform: Stocks rebound strongly and are ***always*** higher in three, six, and 12 months. *The subsequent three-year returns have always exceeded the long-term average of 10%, while returns in 12 months have always exceeded 50%*. ***Value managers*** have almost always outperformed growth/momentum managers.

Investors in balanced portfolios should ensure that allocations among asset classes are at desired levels. Based upon relative valuations, this would typically involve a shift from fixed-income assets to common stocks. My proprietary valuation model indicates that annualized total returns for the S&P 500 could easily exceed 12% over a three-year time horizon, whereas expected annualized total returns for a diversified bond portfolio are unlikely to exceed 2.5%.

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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.

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