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Economic Perspective

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EQUITY MARKET VOLATILITY TO CONTINUE

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Summary and Major Conclusions:

The central focus of investors will remain on the rate of new infections as many states begin to reopen their economies. It seems reasonable to assume that the number of new cases will begin to show a rising trend as social distancing guidelines are relaxed. In this event, the critical issue will be the magnitude of increases in confirmed cases, hospitalizations, and fatalities. I expect a moderate rise in new cases in the summer but a more significant wave of new outbreaks on a regional basis beginning in the fall.

Financial markets continue to be buffeted by rapidly changing news involving the impact of the coronavirus pandemic on the outlook for economic growth. Following a 33% surge in the S&P 500 off its March 23 bottom — retracing nearly 60% of its cumulative bear market losses — the equity market has consolidated during the past two weeks. This Special Report provides an update on current conditions affecting financial markets.

- Financial markets continue to be dominated by news pertaining to the COVID-19 pandemic. Developments on the public health front have been mixed: The number of new cases nationwide appears to have peaked over the past month within a range of 25 to 30 thousand per day; however, rather than declining as in most of Europe and Asia, the number of cases, hospitalizations, and fatalities have remained stubbornly high.

- Data trends reveal vast differences across regions and states. New cases in New York, California, and the Pacific Northwest are in steady decline, while cases in 20 states remain in steady uptrends. The number of deaths nationwide has also plateaued — but not declined — in the vicinity of 2,000 per day. Conversely, both new cases and fatalities remain in a downtrend in Germany, France, and Italy.

- The availability of testing equipment continues to expand but remains inadequate, and will not reach desired levels until June. However, news pertaining to medical research has improved significantly, with Gilead's anti-viral drug Remdesivir receiving FDA approval for emergency use.

- Remdesivir is not a home run and does not prevent the spread of COVID-19, but it has shown success in alleviating symptoms, shortening the duration of the illness, and reducing the risk of death. Progress on other therapeutics is also encouraging.

- Although an effective vaccine will not be available in mass quantities until 2021, the pharmaceutical industry has dedicated unprecedented resources to the discovery of a drug. A basic theme in the outlook is that a genuine ***inflection point*** in the economic crisis will not be reached without major technological innovation.

- It is possible that one or more vaccines scheduled for clinical trials in the fall could be approved for controlled emergency use later this year in response to a major outbreak in one or more major cities. However, doses of 100 million or more are unlikely to be available until the second half of next year.

- At the same time, the Swiss biotech company Roche Pharmaceutical won approval from the FDA for an advanced diagnostic test. The company plans to begin production of millions of tests this month, with the potential to produce 100 million per month later this year.

- The central focus of investors will remain on the rate of new infections as many states begin to reopen their economies. It seems reasonable to assume that the number of new cases will begin to show a rising trend as social distancing guidelines are relaxed.

- In this event, the critical issue will be the ***magnitude*** of increases in confirmed cases, hospitalizations, and fatalities. I expect a moderate rise in new cases in the summer but a more significant wave of new outbreaks on a regional basis beginning in the fall.

- This scenario is based upon the assumption that state-by-state reopenings will be accompanied by an increase in new cases — but ***partially offset*** by the possibility of a moderation in new infections in response to rising temperatures and humidity during the summer months.

- Another offsetting factor could be the benefits of increased availability of testing equipment, which should also assist policymakers in implementing quarantine measures to contain the pandemic during the summer months. Selective shifting of commercial activities from indoor to outdoor settings could be another offset.

- The biggest unknown involves the magnitude of a second wave of the pandemic in the fall and winter months. The primary risk is that a surge in new cases leads to a resumption of lockdown measures, causing a major setback to the economy. Under this worst-case scenario, a double-dip recession could occur later this year.

- Another unknown is the extent to which public health officials will be equipped to cope with a second wave later this year. The optimal toolbox for the medical community includes an unlimited supply of testing equipment, antibody tests, face shields, masks, and ventilators. Availability of one or more therapeutics would be invaluable in mitigating symptoms for those who become infected.

- A gradual and phased reopening of the economy should result in some undefined recovery in spending, output, and employment during the second half of this year. The strength and pace of the economic recovery is totally dependent upon the path of new infections in response to a relaxation of social distancing practices.

- Incoming monthly government data will likely show that the US economy hit rock bottom in April, with some modest improvement in May and June. An estimated 25% of the nation's GDP is currently off line, down from close to 30% in April. This metric could decline to 10% to 15% in June and 5% to 10% in July. The economy will not fully reopen until a vaccine is available in large quantities, expected during 2021.

- Following the worst decline in second quarter GDP since the 1930s, economic activity should stage a gradual rebound in the third and fourth quarters of this year. Rather than a V-shaped recovery, my forecast assumes a more moderate U-shaped recovery.

- A W-shaped recovery would result from severe outbreaks of infections during the fall and winter. The next several months will be crucial in revealing the sensitivity of infections to a resumption of normal economic and social activities. In any case, the odds of a smooth and orderly economic reopening are low, at least in the early phases, with the likelihood of numerous setbacks along the way.

- Despite widespread warnings by the media, the odds that the current self-induced economic downturn will morph into another 2008 Great Recession and protracted deleveraging cycle are quite low. *I continue to believe that the recession will be the deepest but also the briefest since 1945*.

- Pulling it all together, the US economy should be in a gradual and somewhat uneven recovery during the second half of this year, with output in most sectors remaining well below normal. Manufacturing and construction should be the first industries to return to normalcy, while consumer services and travel-related industries will lag.

- Company earnings tend to follow the trend in real GDP. My forecast assumes that real GDP will not return to its previous 2019 peak of $19.22 trillion until the fourth quarter of next year. My forecast assumes a decline in operating profits of nearly 30% this year, followed by a 25% increase in 2021.

- History reveals that company earnings return to their previous peak within a space of two to three years. It seems plausible to assume that earnings per share (EPS) for the companies in the S&P 500 are unlikely to return to their 2019 peak of $163 until 2022.

- Stock market volatility could intensify in coming weeks, as investors respond to alternating good and bad news pertaining to public health trends. In particular, investors will be closely monitoring new cases on a state-by-state basis in the wake of relaxed social distancing guidelines. Moreover, headlines pertaining to advancements in diagnostic testing, therapeutic medicines, and vaccines could accentuate volatility.

- Equity markets are likely to be range-bound in the short term, fluctuating within the approximate highs and lows of the past month. This volatile sideways pattern could be followed by a steady uptrend in stock prices during the second half of this year and in 2021.

- Assuming that the US economy enters a sustained business recovery cycle in the third quarter, stock prices should be higher in both three months and at yearend. I expect the equity market rally to be led by cyclically sensitive stock groups, such as financials and industrials.

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