Market Review & Outlook

April 2020

Coming into 2020, expectations for growth and the markets were somewhat muted given the 31.5% rally in the S&P 500 in 2019 and the fact that leading economic indicators had been slowing for many months. Not to mention the US had already experienced a record long economic expansion and bull market since the Great Financial Crisis ended in the first half of 2009. It is true that a yield curve inversion last year foreshadowed a downturn on the horizon, but marginally improving US economic data towards year-end led many economists to push their recession forecasts out to 2021. Moreover, while declining interest rates in the bond market had been signaling economic weakness since the second half of 2018, stocks had powered back to new all-time highs after a 20% plunge during the 4th quarter of that year. Indeed, the headline stock indices in the US last made new all-time highs on Wednesday, February 19, a mere six weeks ago.

Index	March 2020	1st Qtr. Perfomance	One Year Performance	Description (what the index is comprised of)
S&P 500	-12.35%	-19.60%	-6.98%	Large cap stocks
DJ Industrial Average	-13.62%	-22.73%	-13.38%	Large cap stocks
NASDAQ Composite	-10.03%	-13.95%	0.70%	Large & mid cap tech stocks
Russell 1000 Growth	-9.84%	-14.10%	0.91%	Large cap growth stocks
Russell 1000 Value	-17.09%	-26.73%	-17.17%	Large cap value stocks
Russell 2000 Growth	-19.10%	-25.76%	-18.58%	Small cap growth stocks
Russell 2000 Value	-24.76%	-35.66%	-29.64%	Small cap value stocks
MSCI EAFE	-13.35%	-22.83%	-14.38%	International stocks
MSCI EM	-15.40%	-23.60%	-17.69%	Emerging markets stocks
S&P US Corp HY Bond	-12.54%	-13.39%	-7.40%	High Yield Bonds
Barclays US Aggregate Bond Index	-0.59%	3.15%	8.93%	Primarily U.S. Government Bonds

However, that was before the coronavirus was on the radar, at least here in the West. Yes, news reports started to trickle out of China in early January about authorities there battling a new virus in the Hunan province, but the potential scope and threat of the outbreak to China and the rest of the world was not well understood at the time. Over the ensuing weeks, reports of new cases began to surface in dozens of other countries, including the United States. Entering the final week of February, major outbreaks in Iran and Italy confirmed that a serious global pandemic was at hand, and financial markets took notice.

Starting on Monday, February 24, stock markets around the world began to correct sharply. The major US indices dropped every day that week, with the S&P 500 sinking 11.5% by the time the market closed that Friday. From February 19 through March 23, US stocks had declined nearly 34%, a breathtaking drop the speed of which surpassed the initial leg down in the historic market crash that kicked off The Great Depression. That stretch of panic selling included Monday, March 16 when stocks fell 12%, making it the second worst day market history. For a closer look at how various asset classes performed in recent periods, please refer to the table.

To compound the pain, oil prices have also been in free fall, initially because of the rapidly declining demand outlook, but also because of a price war initiated by Saudi Arabia and Russia. The worsening economic crisis provides an opportunity to drive less profitable producers, namely those in the US fracking industry, out of business. Vladimir Putin knows the fragile US shale industry is built on a mountain of cheap debt. Oil prices sit around $21/barrel (as of April 1), down from $61 at the end of last year. Considering the breakeven oil price for US shale producers ranges from $48-$54/barrel, many of these companies will be unable to service their debt if oil remains at these depressed prices. While the initial result would be defaults and job losses in the energy sector, it is unclear how serious the impact would be for the financial markets and broader economy.

Only a few weeks ago, more optimistic commentators questioned whether the coronavirus pandemic would even cause a recession. As risky assets have declined in value and more recent economic data has come out, that question has evolved more into how bad the recession will be. Recessions are generally caused by the interplay between severe economic and/or financial imbalances building up during the expansion and a typical late-cycle tightening of monetary policy. This time really is different in the sense that the spark for the current downturn is an exogenous shock that originated outside the economic or financial sphere: a highly contagious novel coronavirus that has spread rapidly throughout the globalized, developed world since the start of the year. Most governments have responded to the pandemic by severely curtailing the economic and social activity that drives much of daily life in the developed parts of the world. Billions of people around the world are in various states of lockdown mandates that vary depending on how affected a region may be. At the time of this writing, many clients in California are on their third week of shelter in place directives, with residents advised to leave home only to obtain necessities like food or medicine.

Shelter in place and other social distancing measures have understandably been implemented to try to "flatten the curve" as the number of cases threatens to overwhelm healthcare systems in many countries around the globe. At the same time, these policies are causing immense short-term economic pain, as most companies in the travel, entertainment, restaurant, and retail (ex-food & beverage) industries are operating at a sharply diminished capacity. Even in states where authorities have not ordered "non-essential" businesses to close, many smaller businesses have temporarily shuttered and laid off workers because of the lack of customers. A major concern is that many smaller businesses, which employ ~47% of the American workforce, will not be able to survive a prolonged forced shutdown. One study estimates that 55% of small business, defined as those that employ 500 employees or less, would not be able to survive a 3-month shutdown. The same study found that 53% of American households have no emergency savings.

In response to this economic shock, governments and central banks around the world have been working overtime to try to contain the damage. In the US, the Federal Reserve has essentially dropped short-term interest rates back to zero and implemented a package of other measures aimed at providing liquidity to the financial markets. Congress has passed stimulus packages to help affected workers and industries, though there are valid questions about how effective all these policies will be. As many commentators have pointed out, the American economy is about 70% consumption driven, and lower interest rates will not lead people to go out and spend when they are unable because of shelter in place policies or otherwise risking their health.

The extent of the economic damage will be determined by how long it takes to get the virus under control and life back to normal. Given how much we still don't know about the coronavirus, this is impossible to forecast, and most estimates for how long it will take to develop an effective vaccine range from 12-18 months. When the virus first began to spread in the US, many economists were predicting a "V-shaped" recovery, which assumes the economy will snap back quickly once the peak of the virus outbreak passes and normality returns. This scenario seems optimistic now that more data is coming in. For example, last week Goldman Sachs' chief US economist predicted a 34% annualized decline in GDP for the 2nd quarter. Over the past week, economists seem to be leaning more towards a "U shaped" or even a "W shaped" recovery, where the recovery is more prolonged in the first case. The W shaped economy considers the reality that the economy might come back on line in fits and starts and the possibility that a second outbreak of the virus may spread when the weather cools down towards the end of the year.

On the labor front, over 10 million jobless claims have been filed in just the past two weeks, multiples of anything we have ever seen in this country even during our most challenging economic episodes. There are estimates that unemployment could rise to levels not seen since The Great Depression. Since then, the highest unemployment rate seen in the US was 10.8% in 1982, and nearly all forecasts believe it will soon be higher than that, potentially much higher. A real risk is that the longer the shutdown goes on, the more likely it is that the economic damage will be permanent, as companies are no longer solvent and workers have no jobs to return to once the crisis passes.

Another big question is whether we have seen "the bottom" in the stock market. We feel it is highly likely that markets will remain volatile over the coming weeks and months, including the possibility that stocks will re-test their lows or even make new lows. Already, many publicly traded companies are slashing dividends and declining to provide earnings guidance. With so little visibility in the economic and earnings outlook, there is a strong desire to look at what the economic situation was just prior to the virus and extrapolate that forward to when the virus passes. However, that outlook makes some heroic assumptions. Finally, bear markets in the post-WWII era have lasted on average about 14 months, so the desire on the part of investors to believe the end of the current episode is right around the corner seems overly optimistic.

As previously stated, economic indicators (aside from a generally strong labor market) had been trending negatively for months prior to the virus outbreak. Looking back, the peak of this business cycle was in January 2018 on a sentiment, momentum, and earnings basis, at least when looking at the global economy in aggregate. Perhaps this extended out to September 2018 when looking strictly at the US. It was the Fed's policy pivot back to loose monetary policy at the beginning of 2019 that was primarily responsible for the rise in the market last year, as corporate profits were basically flat and even negative if you remove the contributions of just a few technology companies. Throw in positive sentiment as another reason stocks rallied. However, if one looks back to 2015, corporate earnings barely grew in the 5 years ended 2019, but stocks rose more than 60%, so arguably they have been overvalued for years. Many old school, value-oriented analysts will say the coronavirus pandemic is simply the pin that pricked the stock market bubble that had been inflated through a decade plus of easy monetary policy on the part of the Fed and other central banks.

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