MARKET COMMENTARY

Cause For Hope or Doubt?

May 2020 Commentary

- **As the economic, political, and social costs of lockdowns increased, segments of the U.S. economy gradually reopened in May.**
- **By contrast, the rebound in markets has been anything but gradual: from its low in March, the S&P 500 Index has rallied over 40%, bringing it to within less than 6% of its all-time high.**
- **The growing disconnect between markets and the economy can be largely explained by excitement over the reopening, the relative unattractiveness of cash and bonds as long-term alternatives to stocks, and a tidal wave of liquidity from central banks. A surge of speculative mania is a final factor.**
- **Collectively, these forces have the potential to drive markets higher in the short term, but high valuations and a host of risks—including a second wave of COVID-19 infections in the fall—should not be overlooked.**

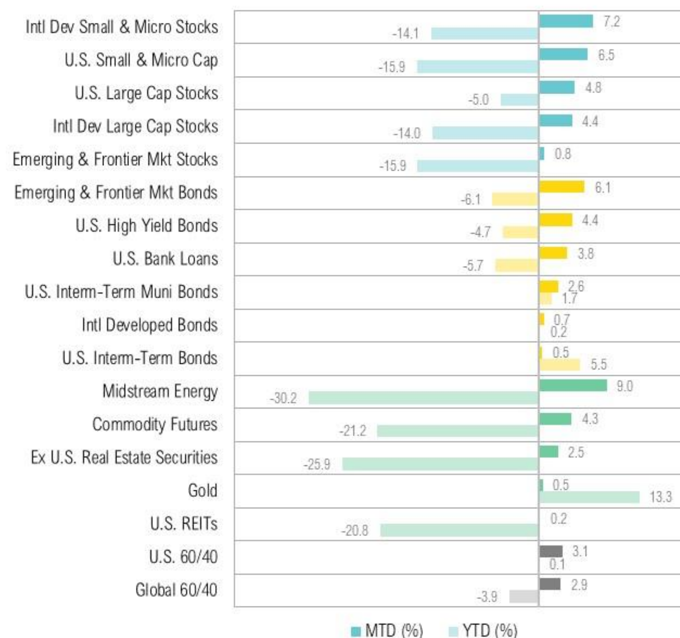
The Reopening

Even as the American economy is reopening tentatively and gradually, the markets have come back with a fast and furious rush. From its low in March, the S&P 500 Index has rallied over 40%, bringing it to within less than 6% of its all-time high. The technology-heavy NASDAQ 100 Index hit an all-time high on June 4. High yield bonds are down just 4.7% for the year. All other risky assets rallied for the month, paring their losses for the year substantially. This impressive rebound has occurred during one of the most widespread global pandemics in 100 years, the worst economic collapse since the Great Depression, and a rising wave of social unrest, leaving investors to question the rally's sustainability. But there is even more to this disconnect than meets the eye. We are in the midst of one of the most heated bull versus bear debates in our lifetimes. In this commentary we delve into the two sides of the debate in order to understand the sources of hope as well as the reasons for doubt.

The Bull Case

According to MarketWatch, the 40% rally over the past 50 days has been the sharpest ever for the S&P 500 during that amount of time, and its year-to-date losses have been trimmed to just 5%.[1] What began as a welcome rebound from a bear market has morphed into a relentless run that seems so disconnected from what is happening in the rest of the economy as to be baffling, if not concerning. But there are several powerful drivers of the market recovery.

May 2020 Key Market Total Returns



Source: Bloomberg

The first is that the stock market is forward-looking. As the economy reopens—if we assume a second wave of COVID-19 either does not materialize or if a viable vaccine or treatment is discovered—life will normalize, people will return to work, and corporate earnings will rebound. In 13 of the past 14 recessions, the stock market hit its low point more than three full months before the recession officially ended, showing that market returns often telegraph economic conditions.[2] The strong May jobs report is a good example of this point. Notwithstanding data collection errors that may have overstated the improvements in employment rates, the report gave analysts hope that the economy is on the right track. History has shown us that, especially during severe downturns, disconnects between stock indices and the economy are common, and market rallies often presage economic recovery.

A second reason for the market surge is the relative attractiveness of stocks compared to bonds, at least on the surface. So slim have been the pickings in bond land that investors adopted the Thatcherism "TINA" ("there is no alternative") to refer to the idea that stocks may be the only asset class capable of generating long-term gains. It's worth noting that "TINA" was first adopted by investment professionals in 2013—when rates were significantly more attractive than they are today.[3] In that year, short-term rates were near zero, but longer-term yields, as measured by the U.S. 10-year Treasury note, averaged a relatively juicy 2.4%. Compare that to May 2020: short-term rates are again near zero, but the 10-year Treasury note yield is down to a paltry 0.65%. TINA may be more relevant today than ever!

A third reason for the market rally is the unprecedented intervention in the markets by central banks. The Fed's balance sheet was already elevated before the pandemic, but its total balance sheet assets have since rocketed by more than $2.9 trillion or 13.6% of 2019 U.S. gross domestic product (GDP).[4] These asset purchases have allowed the U.S. Treasury to issue a record amount of debt—funding a record $3.7 trillion expected deficit—without the bother of having to find a buyer.[5]

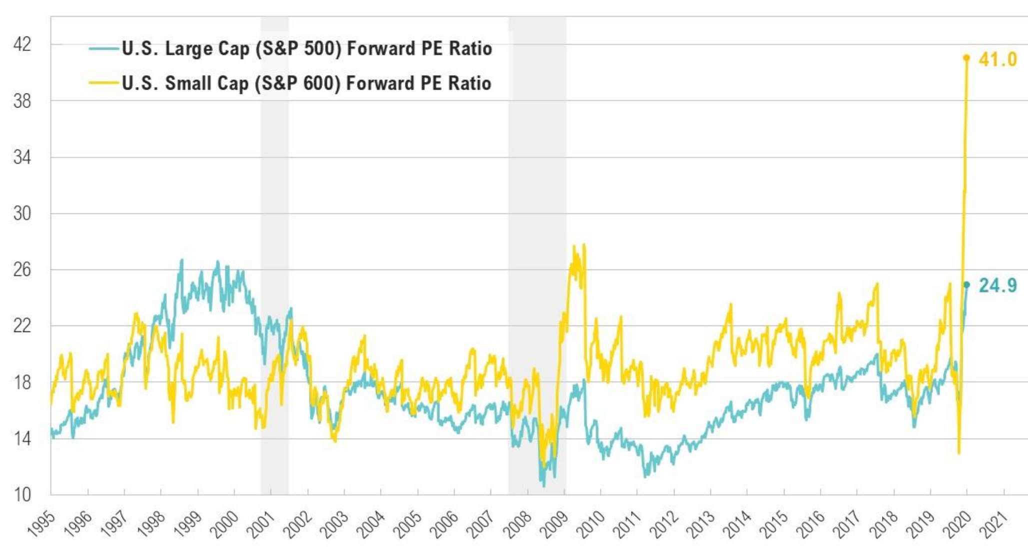
These newly created dollars are fungible; they flow through markets and support asset prices, as they were designed to do. This works hand in hand with the massive amounts of fiscal stimulus that have also been pumped into the economy (currently totaling 11% of GDP).[6]

The Fed-subsidized borrowing and spending doesn't stop at the government level. Corporate bond issuance exploded in April and May in anticipation of the Fed's imminent support.[7] That support arrived late in the month of May as the Fed's *Secondary Market Corporate Credit Facility* (SMCCF) kicked into gear, buying U.S.-listed corporate bond ETFs, a first for the Fed. According to Credit Suisse, net issuance in the second quarter through May 14th for both investment grade and high yield bonds was higher than the previous five quarters combined. Boeing's $25 billion debt sale, the sixth-largest investment-grade bond offering ever, was a perfect example of this. These bond offerings have allowed companies to shore up their balance sheets and decrease their solvency risk. They have also signaled to the rest of the capital markets that the worst-case scenario for many companies is off the table.

The Bear Case

Despite the compelling reasons for the market rebound, there is another side to the story, even if it has so far taken a back seat. Yes, stocks are forward-looking, but what are they looking forward to? Not a rebound in earnings, apparently. According to Refinitiv, consensus estimates for S&P 500 operating earnings per share (EPS) for 2020 were cut by over 30% from $180 on January 1 to $125 at the end of May.[8] Forecasts for 2021 and 2022 EPS have also been cut—by 17.3% and 13.7%, respectively. Those estimates are yet to turn higher. Although the future is always uncertain, several market-disrupting issues are lurking: the prospects of renewed trade war with China, a no-deal Brexit, a contentious presidential election, and potentially higher taxes to fund off-the-charts deficits (or inflation if those deficits continue to be funded by "printing" money). Another factor, which does not seem to be getting much attention recently, is the potential for a second COVID-19 wave. By global measures, the pandemic is not slowing down. On June 3, more than 100,000 new cases of COVID-19 were reported in the world ex-U.S., a new high. The worst growth rates are occurring in parts of Africa, India, and Central and South America. In the U.S., the seven-day moving average of cases (excluding New York and New Jersey) has been rising steadily since May 29.[9]

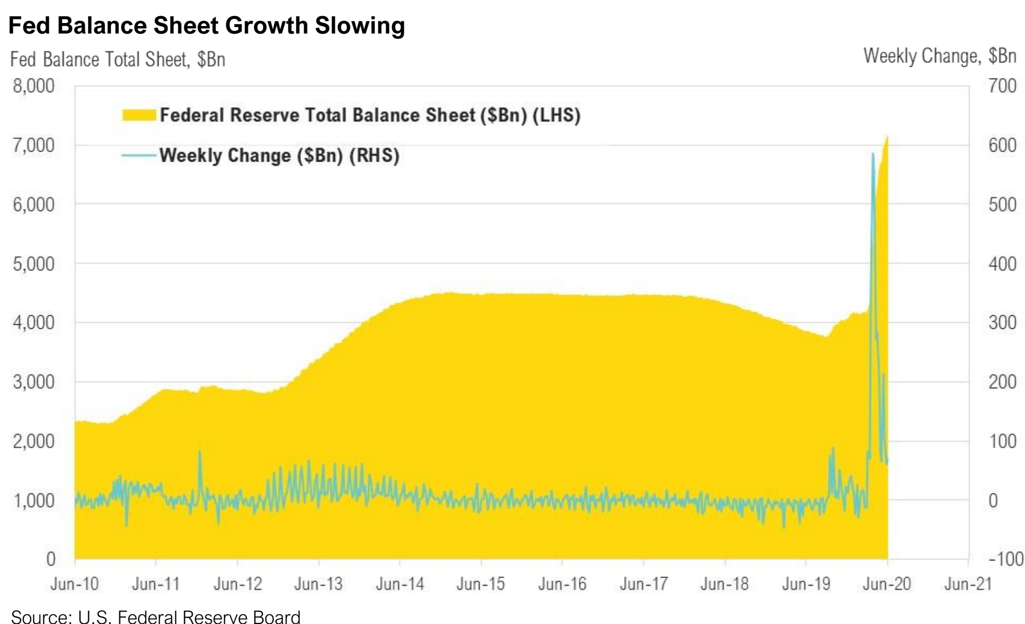
Stock Market Valuations, *1995-2020*



Source: Bloomberg

What about the TINA appeal of stocks? Through the lens of current yield, the roughly 2% dividend yield on the S&P 500 is attractive relative to government bonds. But this yield is not set in stone: some estimates anticipate that dividends could fall anywhere from 15% to 35% for companies around the world in 2020.[10] Further, relative to their earnings expectations for the next 12 months, large cap companies are valued near the upper end of their long-term ranges while small caps are pricier than they have ever been.[11] Forecasts can change, of course, but the point remains that stocks may not be as much of a bargain when examined from other perspectives than just a simple comparison to bonds.

In terms of central banks propping up economies, there seems to be no end in sight, especially given the political pressure on the Fed during an election year, but the tide of easy liquidity is already slowing. At its peak in late March, the Fed was buying over half a trillion dollars in bonds every week. For the two weeks leading up to June 3, that number declined to $68 and $60 billion, respectively.[12] These are still enormous numbers, but they should be viewed in the context of the $3.7 trillion deficit estimated by the Congressional Budget Office, which implies a weekly borrowing need of just over $70 billion by Treasury.[5] Further, as the economy reopens and activity ramps up, the chances that the Fed will fall behind the curve, relative to an improving labor market and rising inflation, increases. While core inflation (which excludes the volatile food and energy components) came in at only 1.4% year-over-year in April, expectations for future inflation are already increasing.[13] According to the Conference Board, consumer expectations for inflation one year from now jumped to 6.2% in May, one of the highest readings of the past 25 years.



Source: U.S. Federal Reserve Board

A final reason for the rally that is concerning—though extremely bullish while it persists—is the budding speculative mania that has gripped retail investors. Stuck at home, with no sports to watch and seemingly lots of time on their hands, hordes of small, often first-time, investors are speculating on the stock market in record numbers. New accounts at the major online brokers—Robinhood, Charles Schwab, TD Ameritrade, and E*Trade—jumped 170% for the second quarter through mid-May.[14] The trade *du jour* involves buying call options (contracts that represent a one-sided, leveraged bet on higher stock prices). According to SentimenTrader, at the peak of the market in February 2020, retail investors purchased 7.5 million call option contracts in one week—a record high. In the first week of June, retail investors purchased 12.1 million calls—61% higher than the previous record![15] On the other side of the coin, demand for single-stock hedges, called put options, has

plummeted. According to the CBOE, the number of put options traded for every call option has dropped to the lowest in six years.

Looking Ahead

The growing disconnect between markets and the economy can be explained largely by excitement over reopening the economy, the relative attractiveness of stocks compared to bonds, a tidal wave of liquidity from central banks, and a surge of speculative mania. Although these factors have pushed markets to dizzying levels in recent weeks, high valuations and a host of risks, especially the potential for a second wave of infections in the fall, should not be ignored. If we have learned anything from recent events, it is that conditions can change quickly and unexpectedly. The rapid evolution of the coronavirus and the possible need for additional interventions by governments necessitate that prudent investors combine discipline with creativity. Discipline will help execute existing strategies, and creativity will enable for quick adjustments to take advantage of emerging opportunities. As always, be cautious of anyone claiming that they can confidently and clearly predict what the immediate future has in store.

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Performance Disclosures
All market pricing and performance data from Bloomberg, unless otherwise cited.

Citations

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