A long-needed correction finds 2 good excuses

Coronavirus and possible Sanders victory are washing out the ″weak hands.″

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Approximately three weeks ago, we mused that, with the market overstretched on a short-term basis following the wholesale capitulation of the bears, "a 5 to 10% pullback could be in the offing in the next few months." Wrong again. "The next few weeks" would have been more accurate. As we noted then, though intermediate and long-term fundamentals to us look remarkably good, the psychology of markets is such that when they rise so far so fast (+17% off the Oct. 2, 2019 lows without more than a 3.5% correction), the un-convicted bears, the "weak hands" if you will, are forced to capitulate and buy, driving markets still higher in the process.

But once the bears are long, watch out. Their conviction is low and they are nervous holders. This is why markets experiencing this kind of sharp advance

almost always have an ensuing correction, averaging about 10% since this secular bull market began in the depths of the 2008-09 financial crisis. With no confidence in the long-term bullish picture, these weak-handed marginal buyers are apt to reverse course and sell in a panic as soon as something, anything, goes wrong. ("I knew it! I knew it! I knew it! I never should have bought stocks in the first place. I was right all along!") It is only by forcing the weak hands out of the market that the stage can be set for next advance. We are in that stage now.

Let's first review the two "excuses for a sell off" currently in focus.

- **Coronavirus scare.** The news this weekend, for sure, has been scary to those who'd hoped that somehow this thing would be contained to the backwater provinces of China. That it's shown up, somewhat mysteriously, in a big way in one of the most affluent, sophisticated cities in the world—Milan—is a scary thought. It means it can't be long before it arrives in the other great financial capitals of the world, including Wall Street itself. As we saw in 2008-09, if you want to see a panic in stocks, get the Wall Street traders not only worried about the revenues and earnings of the anonymous CUSIP numbers they're trading, but also about their own livelihoods and families. We're here. Today's massive sell-off is, we think, very indicative that this fear has now become very real. Let's face it. We are probably only days away, at most weeks, from the virus scare spreading, unfortunately, to cities such as New York and London.

  I don't want to underestimate the human toll of this virus, or even the short-term impact on corporate revenues and earnings. And some companies, to be sure, may face a liquidity crunch if they find themselves over-levered with a disproportionate amount of short-term debt due at just the wrong time. On the other hand, whatever the short-term

economic hit is, we do know that survival rates on this flu are reasonably high, and that the bug is historically unlikely to survive the arrival of spring, just a month away. While some consumption and spending will be permanently lost, most of it will be back-loaded to the second half, reinforcing if anything the second-half reacceleration on forces we believe already are in place. In short, while the near-term news flow on the virus is bad and likely to get worse, by summer this will be behind us and the global economy will be facing a second-half reacceleration driven in part by makeup spending and production arising out of the present slowdown.

- **Bernie scare.** Although the coronavirus is getting all the attention, my guess is there is another scare out there that is bothering investors: Bernie Sanders won politically diverse Nevada and seems to be on the cusp of a Super Tuesday knockout punch of moderate favorite, Joe Biden. Though most political pundits are giving Sen. Sanders little chance of ultimate victory over incumbent President Trump, the markets know that at this time in 2016 the pundits were giving the rising probability of a Trump nomination little chance of beating establishment candidate Hillary Clinton. What if the pundits are wrong? What if Sanders not only wins the nomination, but riding the back of an economic soft patch caused by the global coronavirus, he somehow captures the presidency and implements his socialist agenda? This threat is in some ways complementary to the corona threat in time horizon. Corona is a very short-term threat likely to pass by spring. But Bernie. Bernie could represent a long-term threat to the economy and profits. A Sanders victory could turn even the secular bulls like us into bears.

Like corona, we are respectful of the threat that Sanders represents to the economy and markets. This said, let me offer a little bit of common sense. Assuming we are right and the global economy is robust enough to survive

the current health scare and reaccelerate by mid-summer, a Sanders candidacy seems more likely to result in a sweeping Trump Electoral College victory than a radical reversal of America's economic course after nearly 250 years of democratic capitalism. Too many voters are simply far better off today than they were just four years ago. And the voters that Trump's Republicans lost in the conservative suburbs in the midterms were presumably lost over Trump's social policies and tweets rather than his economic ones. A socialist Sanders' run at the top of the Democratic ticket is probably more likely to put those districts back in Republican hands than result in a change in the White House occupant.

LIKELY SECOND-HALF ACCELERANTS

While considering the risks above, it might also be helpful to just make a short list of the forces that we see driving an economic reacceleration in the back half of the year:

1. **Trade dispute resolution.** Last year's economy was hampered for sure by the confidence-sapping trade war between the U.S. and its three-largest trading partners. With the China, Canada and Mexico deals now inked, managers' worries about the rules of the game and where to put the next factory have passed. Although the likely reboot has been perhaps delayed by the virus scare, if that passes as expected by the spring, the confidence reboot should help global economic activity considerably.

2. **Manufacturing soft patch lapped.** The manufacturing cycle, which we've noted began its global downswing in the fall of 2018, has now largely bottomed out, with inventories back in line. As we enter the back half of the year, a new upcycle is likely as manufacturers globally start to play catch-up. Although the global economy these days is more service than

manufacturing, a reacceleration here can have multiplier effects throughout the economy.

3. **Boeing and GM shutdowns reverse.** The fourth quarter was negatively impacted by as much as 0.5% of GDP by the Boeing 737 MAX shutdown along with the GM strike. GM is already back at work and Boeing will be by summer. This should boost production activity off its artificially low run rates.
4. **Lagged impact of global monetary easing.** The global monetary easing cycle, which began in Q1 2019 and lasted at least through year-end 2019, will begin to impact the economy in its typical 6- to 12-month lag by this spring. More good news.
5. **Presidential election outcome grows more certain.** By summer, the outcome of the election, we expect, will become much more apparent, and the market will begin discounting the positive growth impact of four more years of President Trump's economic policies.
6. **The coronavirus make-up effect.** This will be somewhat artificial, but the make-up orders coming from the restart of global supply chains starved of inventory will certainly result in outsized Q3 and Q4 GDP prints.

THE BOTTOM LINE: ADDING TO STOCKS HERE

While we are respectful as always to the risks out there, the present correction feels to us as more of an overdue consolidation within a very positive long-term picture. With an economy likely to be reaccelerating in the back half of this year, and looking forward to S&P 500 earnings in 2021 in the $200 range, by summer investors should be in a much better frame of mind. And when they consider the alternative, the now very-low yielding 10-year Treasury bond, a P/E multiple of 20 times forward earnings may seem relatively fair. That would

put the market at 4,000 perhaps as early as late 2021, more than 20% above present levels.

Within our PRISM® balanced stock-bond allocation model, we entered 2020 with a 5% overweight to stocks versus bonds, which we view as moderately bullish. We have no idea how deep the present correction will extend, but would note that many of the more cyclical names we like in Technology and Industrials already are down a full 10%. We added one point to equities today and will add further if and when the correction deepens. Although I know it is a little scary at the moment, try to keep your eyes focused on the long term. Markets are likely to be considerably higher further out, and the present worries, like many others we've been through before, will be just specks in the economic landscape.

TAGS

EQUITY | MARKETS/ECONOMY | VOLATILITY

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