Federated Hermes

Coronavirus double whammy

Might the virus slow the U.S. economy enough to boost Bernie's chances?

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BOTTOM LINE

For the second time this week amid an equity market under extreme duress, Federated's PRISM© asset allocation committee today added 1% to its equity overweight, taking stocks up to a 7% overweight (70% of max) at a 61% allocation. Specifically, we increased allocation to domestic large-cap growth by 1% to a 2% overweight at a 15% allocation. We funded that move by reducing Treasury Inflation-Protected Securities (TIPS) by 1%, back down to a neutral allocation of 3%.

Massive flight to safety Due to rampant fears that the coronavirus pandemic will have a hugely negative impact on both the U.S. economy and our upcoming presidential election, the S&P 500 has plunged by nearly 16% over the last seven trading days. That's the fastest such decline from a record high (set on Feb. 19). This smells like capitulation to us.

Buy when there's blood in the streets To be sure, the coronavirus situation is fluid and highly uncertain. But rather than try to catch a falling knife, we believe that given strong technical support, the correct approach is to scale into stocks at better prices over time, patiently awaiting for what we believe will be a snapback when pandemic fears eventually recede. If we wait until we get the all-clear sign, the algos will have already bid stocks sharply higher, and we will have missed our opportunity to profit from the market's current dislocation. No one rings the proverbial bell at the bottom.

Christmas Eve all over again Think back to Christmas Eve 2018, when stocks had plunged 20% over the previous quarter. The market was pricing in the absolute certainty of recession, due to the government shutdown, Federal Reserve aggressive interest-rate hikes and a nascent trade war. Once investors realized they were wrong in their recession calculus, stocks surged 44% over the next 14 months. We see parallels here and now.

Technical support Three of our key tools in combination are pointing to a coming inflection point for stocks:

- Volatility index (VIX) more than quadrupled from 12 months ago to nearly 50 today, which is dramatically overbought.
- Benchmark 10-year Treasury yields plunged from 1.95% at the beginning of the year and from 1.65% earlier this month to an all-time low of almost 1.14% earlier today in a massive flight-to-safety trade. This also is sharply overbought.
- S&P plummeted nearly 16% over the past seven trading days in a significant risk-off trade, putting stocks in a deeply oversold condition. Stocks pierced their 200-day moving average of about 3,050 yesterday like a hot knife through butter, hitting 2,855 earlier today.

What's the latest out of China? The coronavirus may be plateauing there. Through Thursday, 82,459 people have been confirmed sick and 2,810 have died, shrinking the mortality rate to 3.4% on Feb. 27. On Jan. 26, their mortality rate peaked at 5.34%. (Contrast that with the SARS coronavirus from November 2002 to July 2003, when 8,098 were confirmed sick and 774 were killed, but the mortality rate was a much higher 9.56%). For the rest of the world outside of mainland China, there are 4,052 confirmed cases, 66 deaths and a mortality rate of only 1.6%.

Calvary on the way? Gilead is currently testing an antiviral drug called Remdesivir and Moderna is testing an experimental vaccine. Optimistically speaking, if human clinical trials appear efficacious in coming months with reduced levels of mortality, the WHO, CDC and FDA may fast-track those drugs into action.

Inverted yield curve flags recession risk With 10-year Treasury yields now at 1.14% and the upper band of the fed funds rate sitting at 1.75%, the yield curve has once again inverted with a negative spread of 60 basis points, potentially signaling recession. Certainly, abruptly reduced economic growth out of China, which accounts for 18% of global GDP, will filter through the U.S. and the world for at least the first half of 2020. But given the media frenzy surrounding the virus, recession could become a self-fulfilling prophesy as people hunker down to protect themselves.

Fed to the rescue? To that end, it is not unreasonable to think the Fed could cut interest rates by 50 basis points at its upcoming policy-setting meeting on March 17-18, as a means of boosting business and consumer confidence that the central bank has our back. That would effectively flatten the yield curve and reduce the risk of recession.

Political double whammy? Part of the equity market's sizable correction over the past seven days is due to political concerns. Much of the narrative to re-elect President Trump is to ignore his boorish behavior but focus on the good job he's done with the economy, the labor market and the stock market. But if the economy's in recession, people are losing their jobs and the stock market is in free fall, then the leading Democrat at present in the primaries, uber-progressive Sen. Bernie Sanders, likely will benefit.

Sanders' key fiscal policy planks are free health care, free college education, absolving all student loan debt, doubling the minimum wage and increasing Social Security benefits. That total spending package is estimated to approximate $90 trillion in additional federal debt over a decade. How will he fund it? By sharply raising taxes on corporations and the top 10% of taxpayers, likely resulting in a deep recession and a 20- 40% decline in share prices over a 2-year period.

So aside from coronavirus concerns, part of the market's current correction may additionally be to price in a potential Sanders victory. The primary tomorrow in South Carolina and next Super Tuesday will be critically important to assuage investors' bruised psyches. The likelihood of a contentious, brokered Democratic convention in Milwaukee in mid-July is critically important. Do the super delegates snatch the nomination from Sanders for the second consecutive cycle and anoint a moderate ticket?

Scale in on weakness We have been expecting a 5-10% equity-market air pocket before midyear, and we got it in spades. While the near-term picture is opaque and uncertain, we continue to believe coronavirus outbreak will fade, the U.S. economy will skirt a recession and we will get economic- and market-friendly election results. Consequently, we would take a longer-term point of view and use the current market hysteria as an attractive buying opportunity.

Historically, comparable pandemics such as SARS, Bird Flu, Swine Flu and MERS resulted in a 23% rebound in stock prices a year after the pandemic was arrested. If that holds for the coronavirus, we could enjoy a solid second-half economic rebound and stock-market rally that could lift the S&P to our 3,500 full-year target.

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DISCLOSURES

Views are as of the date above and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

The Conference Board's Consumer Confidence Index measures how optimistic or pessimistic consumers are about the economy.

Consumer Price Index (CPI): A measure of inflation at the retail level.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

The Institute of Supply Management (ISM) nonmanufacturing index is a composite, forward-looking index derived from a monthly survey of U.S. businesses.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation and their plans.

Personal Consumption Expenditure (PCE) Index: A measure of inflation at the consumer level.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The University of Michigan Consumer Sentiment Index is a measure of consumer confidence based on a monthly telephone survey by the University of Michigan that gathers information on consumer expectations regarding the overall economy.

VIX: The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

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