Federated Hermes

Sorry for the coughing

The week started just fine in North Carolina...then I came back late Thursday.

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I insisted this week in travel throughout North Carolina—stops in Pinehurst, Raleigh, Greensboro, Winston-Salem and Charlotte—that I was completely recovered from last week's sickness, with just a leftover nagging cough. In advisor and client meetings, coronavirus worries for the market were absent (this was early in the week, mind you!). Baby boomer advisors were joking about the Democratic debates. Regarding billionaires: "He's got a young wife." "Then he must be good looking." "That's not a requirement!" Hahahahaha, the room loved that one! And about millennials and the Sanders movement: "Europeans are perplexed as to why the U.S. would favor a democratic socialist. Don't Americans know that socialism has been tried in numerous countries, and it doesn't work?" I suggested that the millennials like Sanders' promise of student loan debt forgiveness. "Why don't they suck it up like the rest of us did?!" And "Why the (heck) are we targeting the millennials when they have no money?" Sanders' surprisingly large win in the Nevada caucuses was a shock to markets. TrendMacro likened it to the effect of the virus proliferating in Italy—it makes the possibility of a black-swan worst-case scenario suddenly very palpable. The market is struggling to price the uncertainty and risk posed by the election. While head-to-head polls indicate Sanders would be competitive, Wall Street seems to be reflecting an almost certain Trump victory, with Health Care performing surprisingly well despite Sanders' surge.

I was asked if I agreed that virus concerns will shake near record-high consumer confidence. Or a Sanders presidency. With the proviso that our streets don't become ghost towns if the virus proliferates here, I call "hogwash" on global or U.S. election concerns stopping the fully employed American consumer. Witness housing sales (*more below*), construction and packed restaurants everywhere I go. Not one person was wearing a mask in the airports or on my planes during my travels this week. Infection rates outside of China almost certainly will get worse before they get better, and the concern is how badly might supply chains be disrupted? Goldman Sachs sector analysts say the hit to production outside of China has been negligible as companies have enough inventory to continue as normal until Q2. Beyond then, however, many warn of cuts. Amplified by systematic strategies and option hedgers, the sell-off since the Wuhan province was quarantined on Jan. 23 has been driven by P/E compression. While guidance has turned sharply negative, forward earnings-per-share growth estimates remain largely unchanged in the high single digits. Wolfe Research believes the biggest market risk is the continued paring of risk by fearful investors. Fundstrat puts odds of the market being higher in six months above 90%, with a 1-in-4 chance it'll be up 20% or more.

Meetings toward the end of the week showed more concern as the European and U.S. indexes fell to correction territory and the 10-year Treasury yield hit record lows. An "old bond guy" turned advisor respects the bond market's message, and his colleague expects "the concerned calls from customers to start coming in." So far, the virus's impact on credit conditions has been fairly limited. Credit spreads, while wider, are in line with their 5-year averages, and borrowing costs for businesses are at new lows. If the business cycle were turning, spreads should be surging and the yield curve on the long end should be inverting, not steepening. We had a most enjoyable client dinner with myself positioned between two gentlemen, one of whom is concerned about the virus. Insisting that I'm perfectly well, I coughed all evening, and the group noticed him slowly backing away from me. Hahahahaha, the room loved it! But it was a great week, as advisors joked, "If you want a full row on Southwest, put on a mask and sit in the middle seat." And a charming millennial advisor asked me, "Why don't you run for president?" Speaking of whom, I saw a clip of the Oval Office and Trump readying for an interview last summer. Commencing filming, someone started coughing in the background. Trump ordered them to stop and remove the offender. He told the interviewer, "I hate that. If you're going to cough, leave the room." Oops. I'm going to hole up in my office on Friday.

POSITIVES

- **On the verge of a housing boom?** Low mortgage rates, rising incomes and a jump in household formation rates are fueling a housing rebound. January new home sales hit a 13-year high and pending sales jumped the most in nine years.
- **Virus has yet to waylay consumer confidence** The Conference Board gauge rose in February to a 6-month high and is near its highest level since 2000, though to be fair, the survey was completed before the big sell-off in stocks. In the companion Michigan sentiment survey, net gains in household income and wealth were reported more often than at any time since 1960.
- **A good (albeit pre-virus) sign for capex** Core durable goods orders—a closely followed measure of business investment—posted a strong

gain in January, the first in three months. Capital expenditures (capex) were a drag in 2019 as the U.S.-China trade war disrupted supply chains, a worry many now have about the coronavirus.

NEGATIVES

- **Back in the office, OMG!** Stocks are having their worst weekly stretch since 2008, with the S&P 500 closing at its lows every day, collapsing more than 14% from its highs and violating every level of critical support in decisive fashion. If it does not quickly break this pattern, it could test 2,740, Evercore ISI says, with downside to the 200-week moving average at 2,630.
- **What?!** Bank of America expects three quarters of a "growth recession," as broken global supply chains deplete inventories and delay investment. An even bigger concern—the potential for a negative feedback loop between consumers and markets.
- **Let's think positive** By all standards, the market is now in historic oversold territory (the percentage of issues that are internally oversold in the S&P is the fourth-highest since 1957!) and at levels that historically have created strong forward returns. But Renaissance Macro cautions against trying to catch a falling knife until investors get confirmation of a low.

WHAT ELSE

Primary watch If Sanders breaks even on Super Tuesday and preserves his relative delegate position, he'd still have to win more than 60% of delegates on average in all remaining primaries in order to come to July's Democratic National Convention with the 1,991 he needs for a clean majority. Unless the field narrows considerably, that could be a major obstacle. And if it goes to a second ballot, i.e., a brokered convention, there are no assurances he'd win.

'Bernie Bros' won't love this Super delegates made up of Democratic Party elders become eligible to vote after the first ballot and TrendMacro doubts "fairness" will be part of their thinking. Their duty will be to try to pick the candidate who can win the general election and help down the ballot, qualities many believe Sanders lacks. The upshot: if Bernie wins a plurality but not the nomination, convention riots and disruptions throughout the campaign are possible, if not likely. In 2016, Sanders supporters were so disruptive at a Trump rally in Chicago that then-candidate Trump canceled the event.

Does it matter who the Dems nominate? Even if a moderate emerges from a brokered convention, TrendMacro's quantitative model strongly predicts a Trump win, with the most salient risk being a recession created by a worse-than-expected pandemic. This is notable because its model was considered an outlier in 2016 when it predicted Trump would win.

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Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

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 Consumer Confidence Index is based on a survey by the Conference Board that measures how optimistic or pessimistic consumers are with respect to the economy in the near future.

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.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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