Federated Hermes

Coronavirus framework update: Markets plumbing for a bottom

News flow improves but bottoming is a process so expect continuing volatility.

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The good news is we've made progress on multiple fronts even though it may not feel like it. Clearly, we are entering a temporary period of reduced economic activity, prompting us to cut our economic outlook for March and Q2 to negative growth (*see* ***Phil Orlando's companion piece for details***). The key issue for investors off these market levels is the length of the economic pullback and the damage it does to the broader economy and the longer-term outlook for stocks.

Markets are trying to price in the worst-case scenario, so we are remaining constructive at these levels even though our previous year-end target (3,500 on the S&P 500) will need to be pushed out into 2021. While we acknowledge we are clearly in a short-term (cyclical) bear market, we are not giving up on the longer-term secular bull story and are holding to our present equity overweight as we await the right place to add more. Our experience trading bear markets is that bottoming is a process, not a single day. Averaging in through them, rather than trying to time them, is the best way to pursue long-term wealth. The worst way is to sell them.

Our next levels to review adding to stocks will come if and when we get a retest of Thursday's lows in the weeks ahead and, if it falls below that, a retest of the 2018 Christmas Eve low of 2,350. In the meantime, we are sticking with our recommended 61% equity allocation in our PRISM® stock-bond moderate growth model. Crisis history tells us that in markets like this, holding on to equity positions, and adding to them for the brave, is the very best way to seek long-term wealth.

Here's the framework update:

VIRUS NEWS

1. **Infection rates globally**. Good news out of China/South Korea as infection rates seem to have stabilized. This is important only in helping all of us think through how deep and long the valley we are entering will be and how to adjust accordingly. On the bad news side, warm weather Manila has entered lockdown mode, implying the virus could be with us until new viral treatments under development start getting released later in the spring/early summer. Based on the SARS experience, until we see a peak in the number of cases outside of China (early April is often cited), it may be difficult for the market to rally in a material way, although an up-move could come sooner if Italy peaks and the public grows more confident in the timeline.

2. **Preventive measures.** A number of familiar celebrities were infected, and the NBA et al cancelled games. Many companies have gone to virtual operations. This is bad news that is really good news on one point: we are now taking this seriously as a country, and we are in effect entering the

second phase of the contagion, when accidental spread is alleviated by preventative measures and we wait to see who is really infected and get them treated and/or quarantined. The test-kit issue is being resolved daily and though not totally fixed yet, our sources tell us we are less than two weeks away from optimal.

3. **News flow bias starting to correct?** Stories emerging of virus survivors. The New York Post ran a good one this morning, and I expect we'll see more of these. This will begin to help address the selective reporting bias we highlighted last week, where people overstate their odds of contracting the virus and being killed by it because only the "losers" get announced. As we collectively get to the point that we understand that the nation will survive this—and that the vast, vast majority of us will—while also understanding that we need to all collectively take prudent steps to limit its spread, the pure fear that is reigning now will transform from fear to prudence. Positive for the intermediate term.

ECONOMIC NEWS

1. **Not a lot yet that's relevant.** Mostly good, underscoring that we are entering the valley strong, not weak like we did the day Lehman went down. One early, and expected, negative signal is that hotel occupancy rates fell 1.7% last week. I do think most businesses will use their liquidity to keep staff on the payroll as long as good health news above keeps coming, suggesting the economic valley will be relatively short.
2. **On the negative side, most economists including our team have taken down their numbers for the first half of this year.** Consensus is forming around the idea that we are at least entering a brief but sharp economic pullback; the debate is around how long it lasts.

POLICY RESPONSE

1. **The Fed.** It's all in, moving late Sunday afternoon to slash its benchmark funds rate a full point to a range of 0-0.25%, launch a new round of quantitative easing that will boost its balance sheet by at least $700 billion and take additional steps to boost market liquidity beyond last Thurday's $1.5 trillion injection into the overnight funding markets. The inter-meeting moves, coming just two days before the regularly scheduled March meeting of policymakers, signals the Fed gets the nature of the problem it's up against: near-term temporary liquidity crisis versus longer-term financial crisis.

2. **Fiscal.** Politicians in Washington are talking about the right things, i.e., helping the little guy get through the valley via special programs. As with the initial struggles in getting the Troubled Asset Relief Program passed during the financial crisis, the market has a way of disciplining the politicians to get them to develop the correct response. Thursday was a major public spanking. If Congress and the White House fail to produce a large and extensive package Monday, we're heading lower but then they'll head back to the drawing board and do better. We'll see.

MARKET SIGNALS

1. **Investor positioning improving.** Thursday clearly was a big liquidation day. We doubt it was the last, but the more of these we see, the closer we will be to a more solid bottom. Yesterday may have been the risk parity guys unwinding positions (they are long stocks, long credit bonds, and underperformance vs. objective may be triggering forced sales.) Not sure how much more they would have behind this but it was a good sign for the longer term.

2. **Fear indicators maxing out.** We are in the levels last (briefly) touched in 2008-09. Human beings have difficulty running at "DEFCON 5" for

extended periods. Some of us break down but most of us recalibrate, adjust to the new reality and push on. We are getting closer to entering that phase, which is usually more constructive.

3. **Valuations becoming compelling.** Many large, stable companies that clearly have the balance sheets and liquidity to manage through the coming valley are now trading at single-digit P/E multiples and mid-single-digit dividend yields. More cyclical names, even the ones that have fortress balance sheets, are off 40-50%. Ditto for many of the big financial firms that again have the balance sheets, stress-tested repeatedly by the regulators over the last 10 years, to withstand a crisis of even this proportion. Also, structural growth rates in many sectors such as Technology have remained intact, if not strengthened, by the virus. Valuations this compelling will begin to attract long-term investors who believe the world is in fact, not ending. Valuation is never a perfect short term timing tool, at these levels, it helps.

Stay safe, and know that all of you are in our thoughts and prayers. The storm is upon us. Stay the course.

TAGS

CORONAVIRUS EQUITY MARKETS/ECONOMY VOLATILITY

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