Federated Hermes

'Last call ... for a long time'

Social distancing certainly seems necessary but it comes at a steep near-term price.

Published 03-20-2020

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So said the bartender at Mt. Chalet ("Longtime neighborhood hangout with a woodsy cabin feel offering a full bar, pub food & TV sports") as he rang the bell at the last business meeting I and my absolute favorite sales colleague would have at an establishment for some time. This week I traveled in the Detroit suburbs of Grosse Point, Birmingham, Ann Arbor and Bloomfield Hills, racing against closure decisions at eating establishments and advisor offices. We closed down a restaurant earlier for lunch, which an advisor called "the last supper." His colleague, as we discussed what to expect in this unprecedented situation, said to me, "With all due respect, how would you know?" I do hate that opening to a sentence.... At another meeting, a seasoned advisor who'd lived through the global financial crisis and Black Monday thinks it's different this time. (I always pause when I hear "it's different this time.") With lots of older clients, he's receiving calls for redemptions. "Look at fixed income! It's a slower-death medicine." High-yield credit spreads, the gap between high yield and comparable maturity Treasury bonds, more than doubled this month, and even Treasuries were selling off this week. Investors are flocking to cash—money market funds took in $142 billion the last two days, with Wednesday's $93 billion of inflows *the largest day on record, one and a quarter times higher than the second-largest day of $76 billion in August 2007*. At $3.77 trillion, money market fund assets are their highest since early 2009. We packed numerous meetings and conference calls into a few days so I could canvass what advisors are hearing from their clients. Overwhelmingly, their clients are still chill. One advisor shared that his client wants to get a loan to buy an airline stock in size. Another said his clients are calling to calm *his* nerves. Another has reached out to 200 clients the last two weeks and only one wants to liquidate his holdings. No retail panic at all...yet.

So now we have to practice social distancing. But an advisor in Erie, Pa., told us his city hosted a Billiards competition last weekend that attracted 5,000. A Michigan advisor's teenager is happy for the school closure, calling it a giant snow day. "I'll be at the mall for the next month." (No you won't.) Yet another has friends visiting Key West, where the hotels are packed and beaches and streets are filled with spring-breakers. "They're hearing, 'What virus?' " Pittsburgh's South Side was crawling with young St. Patrick's Day partiers, surely a common theme around the country. Perhaps they will social distance starting now?? A lot of the school and business closings and work-from-home policies got underway this week, so the consequences of a shut-down economy are just starting to be felt. Last week's jobless claims jumped to a 2.5-year high of 281,000. There are predictions they'll hit 400,000 this week and keep climbing past October 1982's record high 695,000. The restaurant industry alone expects to lose 5-7 million jobs over the next three months, and industries likely to be most impacted— transportation, retail trade and arts, entertainment, recreation, accommodation and food services—account for about 13% of GDP but a whopping 25% of nonfarm payrolls. If half of the jobs in these industries are lost, the unemployment rate would skyrocket to 15.2%. Our economic system is not set up for a shutdown, particularly a prolonged one, and our infrastructure is not designed for adults and children to remain at home for extended periods. Ultimately, the magnitude of the downturn and speed of the subsequent recovery may hinge on the extent of permanent damage done to the labor market. This is why many are saying the government has to go big. Monetary stimulus has come in waves, but a lot of fiscal help remains stuck in negotiations. I'm reading from my sources up to $4 trillion will be needed.

Helicopter money alone may not help much. The key will be stabilizing businesses hit by the virus. Cash handouts to individuals aren't likely to trickle down to airlines, restaurants, hotels, retailers and other establishments if they're closed due to social distancing. Cornerstone Macro thinks this is why the markets are struggling to find a bottom. The longer and deeper the downturn, the bigger the hit to S&P 500 earnings and multiples. Using an earnings-per-share forecast for 2020 of $138 (a 15–20% decline in earnings) yields a worst-case scenario of 1,800. My technical sources say support at 2,400 must hold or there is a downside risk to 2,100 (38% off the peak), then 1,810 (-47%). Evercore ISI says a hold will be hard with Europe, Japan, Korea, financials, transports, the Russell 2000, REITs, industrials and energy already at or below the equivalent of S&P 2,100-1,810. The S&P has held up on a relative basis largely because it's 10% Microsoft and Apple, which remain well above their 200-week averages. The best fall last. The U.S daily new infection rate may be the most important data point to watch. Wolfe Research says if the rate peaks before a deep downturn, the economy and stocks could rebound quickly. If it drags out, expect the opposite. This is an extremely fat-tailed environment to both the upside and downside. My last Marriott was a fabulous Ford vintage property in Dearborn. Eerily quiet at check-in, the clerk reported mine was one of three rooms booked that night out of 238. "You're one of the brave ones." Hmm. At the conclusion of our final advisor meeting until who knows when, the leader remarked to me, "You obviously love what you do." Yes, I did.

POSITIVES

- **Are you an optimist?** Thursday saw high-beta stocks beat low-beta shares by an impressive 500 basis points, small caps outpace large caps by nearly 700 basis points and semiconductors hit new relative highs vs. an equal-weighted S&P. The key test, Strategas Research says: if the S&P breaks to a lower low over coming days, will fewer individual stocks do the same? While the S&P bottomed in March 2009, many individual stocks made their respective lows months earlier. Correlations among S&P stocks hit an all-time high this week, so it could still be early for the optimists.
- **Contrarian positive** Renaissance Macro's sentiment indicator pinged positive after Investors Intelligence's weekly survey showed bulls plunging and bears climbing to levels historically associated with bullish equity returns over the next 13 weeks.
- **The U.S went into this crisis strong!** State government finances are entering this period with their largest fiscal cushion in at least two decades, according to the Pew Charitable Trusts. As most states closed out their 2019 budget year, a surge in tax collections drove total savings and leftover budget dollars to a record high.

NEGATIVES

- **And so it begins** In addition to spiking jobless claims, the Philly Fed's manufacturing survey slumped into contraction territory, falling a record 12.7 points on plunging demand as opposed to supply disruptions.
- **An unwelcome headwind for stocks** With the Fed is serving as the global lender of last resort, the rush to greenbacks is fueling a surge in the dollar, further hurting multinational stocks already struggling with the virus crisis.

- **Are you a pragmatist?** When the global economy has been in a modest slowdown, global equities have corrected around 20%. But severe slowdowns, for which Ned Davis is seeing rising risks, have been associated with an average 45% decline in global equities. From its Feb. 19 high, the MSCI All Country World Index has slumped around 30%.

WHAT ELSE

My visit to Michigan *was* early in the week While advisors I met suggested the retail investor remains interested in equities, data over the last few trading days suggests sentiment may be shifting fast. Deutsche Bank reports that after a prolonged period of net buying through last week, retail equity ETFs are experiencing large and accelerating outflows.

Be bipartisan, Congress, let's go big The magnitude and rapidity with which monetary, regulatory and fiscal policy is being discussed stands in stark contrast to both 1929, when all government policies became restrictive, and 2008, when political wrangling over bailouts for banks and autos led the Troubled Asset Relief Program to fail in Congress before it was passed. A lesson in the latter case, Strategas says, was the equity market acted as a vigilante to force the government to act.

I'm watching China Reports put China industrial's activities back to 85% of normal, large-ticket items such as home sales improving but still at 40 to 60% and overall consumption ex-autos and travel at 80% to 90%. All Apple stores have reopened there, and FedEx says 65–70% of small businesses and up to 95% of large manufacturers are operating again. Their true productive capacity is still open for debate.

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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.

Past performance is no guarantee of future results.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio, in comparison to the market as a whole.

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

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

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

MSCI All Country World Index (MSCI ACWI): A free float-adjusted, market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of November 2011, the MSCI ACWI consisted of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. The index is unmanaged, and it is not possible to invest directly in an index.

Russell 2000® Index: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. Investments cannot be made directly in an index.

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.

Small-company stocks may be less liquid and subject to greater price volatility than large-capitalization stocks.

The Federal Reserve Bank of Philadelphia gauges the level of activity and expectations for the future among manufacturers in the Greater Philadelphia region every month.

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