'Corona Crisis' framework update: Sizing up the mountain, the valley and the Sherpa

Bottoming process continues.

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It was another rough week in the markets as investors grappled with two big unknowns: what is the shape of the coronavirus epidemic curve we are trying to flatten, the "mountain." And how long is the economic pullback we have now entered, the "valley." It's hard to know the second without knowing the first. Short summary: the mountain could be taller than projected and the valley deeper and a little longer. The only real good news was the policy response to both, which has become increasingly aggressive as predicted as the news on the two-front war got worse. Phil Orlando has a good detailed summary of our virus framework **in his piece this week**. Here's my take on what we've learned.

CORONA MOUNTAIN

Our view is that markets won't make a definitive bottom until the shape of the virus curve begins to become clearer.

1. **Infection rates globally: Growing.** The good news here is that new Chinese infections have peaked, at least for now, and South Korea has as well. Italy remains terrible but should be the next to turn, hopefully. On the U.S. side, it's not good as an increasing number of cities and even whole states are going on semi-lockdown in the face of rising numbers. More testing is coming in, and with it, increased reporting of infections.

2. **Preventive measures: Increasing.** More testing kits are being produced, more states are adopting statewide "shelter-at-home" policies and most public gatherings everywhere are being cancelled. We still don't know whether all the steps taken to date will eventually flatten the corona mountain peak, which still seems to be at least three to four weeks away, perhaps longer. Our view is that bad news might be good news here in that an increased number of Americans are realizing this is serious and are heightening "social distancing" practices. But we just don't know yet. And as testing rolls out on a bigger scale this week and next, we will see an inevitable rise in infection rates, of which most are aware but will still make scary headlines and soundbites. The markets are expecting this so the question will be "how scary."

3. **Italy:** A turn in Italy, which though older and more densely populated is more similar to the U.S. than China in terms of ability to enforce isolation procedures, would certainly help the market begin to size the corona mountain. Hopefully, next week.

4. **Southern Hemisphere: worsening but still low.** Infection rates in the warmer Southern Hemisphere remain low but are rising. These will be watched carefully to either substantiate or refute the warm weather theory. We just passed the spring equinox.

5. **Treatment therapies.** News flow is picking up on this (again, see Phil's report). We are particularly watching news on chloroquine, an existing

drug that has had good results in a scientifically incomplete French research study. Importantly, this drug is easy to administer (oral tablets), has had good (though not conclusive) results in reducing viral loads, and is potentially available in large volumes quickly in generic form. Two of the largest generic drug manufacturers in the world are already ramping up production. This could be good news, but we'll see if it works and how important the timing of treatment matters.

ECONOMIC VALLEY

Though the trailing economic indicators look fine, forward-looking ones, such as small business confidence, have plunged. Many restaurants, particularly in hard hit New York and California, have furloughed or fired workers and closed their doors. Ditto retail, though a few such as Amazon and Walmart, actually announced big job adds. Goldman Sachs notoriously cuffed a number of 2 million for next week's jobless claims report, which could take the unemployment rate up back north of 4% from its 3.5% now.

As noted last week, Federated's macroeconomic policy team lowered its GDP forecast for Q2 and the first part of Q3 to negative growth. We will probably reduce it again in the weeks ahead. At this point, the debate within the economic community ranges somewhere between a V-shaped recovery, a U-shaped recovery, and for the deeply pessimistic, an L-shaped. We are sticking with a V or at least a cross between a V and a U, but it is hard to forecast until we know the depth of damage from the epidemic and as importantly, the policy response.

POLICY SHERPA

Climbing a tall mountain or navigating through a hidden valley with a good Sherpa usually works better than not, and investors' confidence will be boosted

for sure as they see bold and creative policy responses. News flow on this was particularly good this week and helped markets hold, at least temporarily, the December 2018 lows.

1. **The Fed.** As we've noted for the last two weeks, the issue at present isn't stimulus or bailouts, the issue is liquidity—how to help an otherwise healthy economy bridge over the coming economic valley and prevent a liquidity crisis become a broader economic and financial debacle which will take years to recover from? Liquidity crises are difficult to manage because they happen quickly and time is of the essence. The Fed is the only institution of the federal government capable of acting with this kind of speed, but even for it, the trick to speed is to use the implementation tools and relationship it already has set up, rather than try to set up completely new relationships. The latter would just take too long and would be too late. This week the Fed introduced a variety of important new tools to address the credit crunch in the large corporate side of the economy. Importantly, this included creatively feeding cash to the large corporates using a facility that can deliver cash to the commercial paper market through the money market funds via the banks. The next step will be to provide liquidity to the smaller businesses, which again the Fed doesn't have relationships with but many smaller and regional banks do. Given the spate of proposals we're hearing bandied about by the experts, we could get something on this next week. Let's see.

2. **The European Central Bank (ECB).** Central banks around the world are also on the case, and importantly the ECB announced late Wednesday night that it was extending its massive QE program beyond government debt to corporate debt, trying to free up the freeze up in the corporate debt markets. This was the move we'd hoped for in Lagarde's moves a week ago, but she got there and that brought some relief to investors.

3. **Fiscal response.** As the Senate debates the House's bill extending unemployment insurance, Speaker Pelosi and Secretary Mnuchin already are at work on part 3. The good news is it seems they are working together well, but the bad news is it is taking time. In addition to the short-term fix of helping people unemployed by the downturn, which everyone agrees with, markets are looking for a big package/authorization for Treasury to oversee that can react quickly as hot spots emerge in the valley ahead. Some developments are probably likely this weekend. In the meantime, markets are putting lawmakers on notice that the longer it takes to bridge the economy across the next three months, the worse is the potential long term damage.

MARKET REACTION

As we noted last week, bottoming in even a short-term "cyclical" bear like we are probably in is a process, not a single day or point. Some indicators of that market bottom being reached that we are watching include:

1. **Fear gauge: peaking.** The VIX index peaked near the old 2009 highs last earlier this week, and has since receded modestly but remains extremely elevated. We'd like this to establish clearly a downtrend to say definitively that the peak is in. But the good news is we're at least close.

2. **Credit markets: rough week.** Credit markets have really frozen up this week, which in the words of an old markets mentor of mine, "there are more sellers than buyers." The buyers are lacking because of the dearth of liquidity and uncertainty around the economic outlook. The Fed actions this week are still being implemented and we expect will start to loosen up these markets soon. Signs of credit spreads stabilizing will be good news when it comes.

3. **Valuations: attractive.** Near-term valuations are hard for investors to evaluate because visibility on earnings is so poor. On a longer term basis, if S&P 500 earnings could simply get back to our original 2020 forecast within three years (consistent with a modest U shaped recovery), the market is already looking pretty cheap at under 13 time earnings. More importantly, an increasing number of the companies that populate our active portfolios, with generally solid balance sheets and franchise businesses, are trading cheap now on our view. And many dividend yields are extraordinary, including ones of companies' whose dividends are relatively secure in our view. So valuation is a support, but it's not usually a good timing signal.

4. **Technicals: Bottoming process continuing.** Many technicians thought the market could hold to the old December 2018 lows when a coming recession was last being forecast, but given the flood of bad news on the virus and the worsening economic impact of business shutdowns in the face of it, that proved impossible. Friday's late day sell-off was discouraging, but did bear the mark of more forced sales from index players (across the board selling on heavy volume.) Markets will watch next week if the break through 2,350 was definitive or if new lows will be plumbed. We expect the latter.

In light of the above, our PRISM® committee decided not to leg further into equities with our dry powder when we first hit the 2,350 target earlier in the week. As we've noted, "bottoming is a process" and there's too many uncertainties in the present environment in our view. So for now, we stand and wait for the bottoming process to play out.

TAGS

CORONAVIRUS | EQUITY | MARKETS/ECONOMY | VOLATILITY

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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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