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SKBA Market Update

The Rocky Road Rally

Is it true that markets climb a "wall of worry?" It sure didn't seem so as "worry" was rising rapidly with the spread of COVID-19 and the "shelter in place" (SIP) orders shutdown the global economy in February and March. The market's panic and plunge was quite the opposite of this investment adage.

So why then did it rally so sharply off the lows of March and through April? Was the worry gone? Quite to the contrary, the worry rightly persists. Yet when selling pressure becomes so rampant, the market tends to run out of sellers. New bad news and worry just couldn't drive it any lower.

The wall of worry is most easily seen at a market bottom. This is where pessimism is so great that even minor upside surprises may trigger a rally. It appears that a "switch was flipped" in mid-April. Negative news became less negative. We began to see the slowing of the rate of change of the growth in reported COVID-19 cases in various locations. Investors began to envision that cases might eventually decline even in places where they had yet to show decline. And so the market climbed the wall of worry focused on the death rate for COVID-19 cases and plunging economic statistics.

From our own multi-scenario forecasting perspectives, the March lows represented a significant example (albeit not like March of 2009 or February of 2003) where too much fear was baked into individual stock valuations. The subsequent rebound or climb, however, was dramatic with major U.S. market indexes rising 11-13% in the month of April.

Does that mean the stock market is "off to the races" again? Probably not. It's more likely to be a rocky road than a smooth advance. The rocky road has sharp rocks and pot holes to deal with along the way, like the plunging real economy and the potential for renewed outbreaks of COVID-19.

We now have a sense as to the negative impact on the U.S. economy during the first quarter as the preliminary real GDP change was -4.8% (annualized). The difference in the contribution of GDP components tells an interesting story below.

Real Gross Domestic Product (GDP) – As Reported by the Bureau of Economic Analysis		
GDP Category	% Change (Seasonally Adjust Annual Rate)	% Contribution to GDP Growth
Real GDP	(4.8%)	(4.8%)
Personal Consumption	(7.8%)	(5.3%)
Non-Durables	+6.9%	+0.9%
Gross Private Domestic Investment	(5.6%)	(1.0%)
Non-Residential Fixed	(8.6%)	(1.2%)
Residential Fixed	+21.0%	+0.7%
Government (All Levels)	+0.7%	+0.1%
Change in Inventories	--	(0.5%)
Net Exports	--	+1.3%

The decline in personal consumption expenditures (-7.8%) and gross domestic private investment (-5.6%) were the key drivers of the overall decline in GDP that came mostly in March. The modest gain in government expenditures (+0.7%) didn't come close to offsetting the weakening private economy. The table highlights only a few components of GDP, yet there were two subsectors that actually saw positive contributions to overall GDP, non-durables and residential investment. The non-durable piece is not hard to understand given the pace of hoarding of disinfectants, toilet paper and paper towels. We've all heard about it and here it is showing up in the national statistics. Yet until the SIP, residential investment, both remodeling and new homes construction, was rising.

Two contributors to changes in GDP cannot be calculated on a rate of change basis, rather, only on a contribution to GDP basis. Inventory changes subtracted -0.5%, meaning there was a net liquidation in overall inventories in the economy. In contrast, net exports, added +1.3% to GDP in the quarter. This resulted from a faster contraction in imports to the U.S. relative to exports from the U.S.; which is very typical during a recession.

When announced, the second quarter decline in real GDP will be horrendous. The month of May alone might represent the trough in economic activity, but at a 25-30% annualized decline in GDP. With an easing of SIP requirements state by state, June might be the only month in the quarter of a "V"-shaped recovery as employers begin to rehire.

Yet here is an example of the rocky road of this recovery using your neighborhood barber shop as an example. If the owner has six chairs and six barbers, under evolving social-distancing rules, only three chairs might be able to be occupied at any point in time. Furthermore, each chair would need to be disinfected between customers, each cape would need to be sent to the wash after every use (requiring 2-3X as many capes or the expense of disposable capes), and all tools would also need to be disinfected between each use. Altogether, this most likely results in a 50% decline in productivity. Since rent and utilities are fixed costs, prices would have to go up to bring the shop owner back to breakeven. Businesses everywhere will have to cope with these new circumstances, which means it will take many months or quarters for a full recovery to occur.

Yet financial markets discount not just current events but expected future events. Here are few likely items in our future:

1. By year end, we will probably have thoroughly washed our hands 10 times more each day than we would have without the virus.
2. As the economy reopens, some sort of social distancing with masks will remain part of our lives. Production of N95 masks and ventilators will grow exponentially over the summer.
3. Massive increases in testing both for the virus, and for the antibodies, will more clearly identify those who are more likely to be safe in returning to work as opposed to those still vulnerable.
4. Massive federal government support payments, as well as liquidity from the Federal Reserve Board, will help restart the economy by June.
5. Even without a vaccine, new treatments like Gilead's Remdesivir will improve the survival rate of serious cases.
6. Future outbreaks resulted in narrower quarantines of vulnerable populations, compared to state and national SIP orders.
7. Americans will go to the beaches, parks, open lands, and national parks again.
8. Corporate earnings will recover.

Widespread panic seems unlikely to drive markets lower again as it did in the first quarter. So one shouldn't lose hope that despite a rocky road full of potholes along the way, both the anticipation and reality of hitting bottom in the economy and recovering from these horrendous lows should lead to further financial market gains in the coming year.

Our very best wishes to you,

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