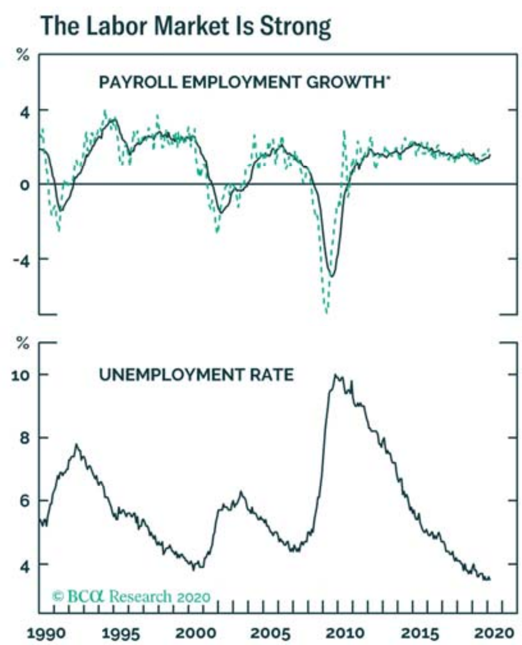
Notes From the North: Market Outlook

March, 2020

The economic and market forecasts earlier this year (before Covid-19 was declared a pandemic and before Saudi Arabia and Russia started an oil price war) now seem naïve and hopelessly outdated. Sure, there was talk of price volatility in 2020, but no one predicted a 20% price decline in 3 weeks or the wild swings of the last few days. One of the arguments being made at year end was that stocks typically do well, except during recessions. Given the strength of the market in 2019 and the length of the current business cycle expansion, *everyone* had been on "recession watch" for months, but they were looking for signs of a more typical business cycle-driven, "cyclical" recession, not this.

Before the virus outbreak, the U.S. economy looked strong. Employment levels, shown on the chart below, were particularly robust. Global growth indicators were rebounding and inflation was under control. Now, in an abrupt turn, a number of economists are saying that a recession has probably begun. Considering that the market is often a good example of "hive" intelligence trying to ferret out the future, it did a pretty good job earlier this year when before any of the current news was known, the stocks that were doing the best were the ones that would hold up best during a recession (think consumer staples and utilities).



BCA's latest thinking was that this recession will be different in that the unemployment rate will not rise as much as usual, inventory levels could rise rather than shrink, and growth could recover quickly once the panic subsides. This is entirely possible; the slowdown is not *structural* (think the dot.com bubble of 1999 and the mortgage bubble of 2008) or *cyclical* (as mentioned above; this type is typically driven by the Federal Reserve raising interest rates too high in an effort to rein in cyclical growth). Instead, it will be driven by an *exogenous event*, as 9-11 was an exogenous event. This type of recession has historically healed relatively quickly, although *not* instantly.

If one were to look at individual stock charts, it would be easy to find stocks that seem to be oversold. Consider, however, that the market was not undervalued before the price slide. Although other measures are less alarming, the price to sales ratio in January (chart, left) did not paint stocks as being bargains. The important question now is, "How much will sales and earnings decline, and when might they start recovering?" David Kostin of Goldman Sachs, for example, is now expecting a 5% decline in overall 2020 earnings, a level which is much lower than pre-virus forecasts.

One side effect of the virus going global has been aggressive monetary policy. For now, the recently announced monetary stimulus has rattled the markets rather than reassured them. It may not help in the near-term, but loose monetary policy will be a tailwind when we turn the corner. The Federal Reserve has reduced short term rates twice to a new targeted range of 0-25 basis points. Already-low interest rates on safe investments are now even lower. Cautious investors should not reach for higher yields by buying longer term bonds. BCA is warning that bonds are massively over-valued. From this level, long-term treasuries will be disappointing if and when rates begin to normalize.

The corporate bond market has recently become a bit of a mine field. Spreads have widened and bond market liquidity has gone from a shallow pool to a tiny puddle. Junk bond prices have fallen even as Treasury bonds rose in price. David Rosenberg warns that 30% of “BBB” rated (investment grade) bonds actually have a “BB” (not investment grade) credit profile. A recession could be the trigger for downgrades which would cause prices of those bonds to fall. This will be clearly seen in the price action of junk bond funds such as HYG, the iShares high yield corporate bond fund. After firing its “bazooka” policy last week, the Federal Reserve has even more recently reopened its commercial paper window to non-financial companies. This step has eased some of the tension in the bond market, at least for now.

Effective fiscal stimulus (both here and abroad) will hopefully be forthcoming. Fiscal policies would ease the downturn and the dislocation caused by the accelerating closures of public gathering places and the impact of the “Stay inside” directive on small businesses dependent on human traffic. Fiscal stimulus could also add fuel to future rallies.

We are looking to use recent price gyrations as an opportunity to fine-tune our portfolios. We know there are bargains to be had, but there is no hurry to add to stock exposures overall. One modification we’ve made is to give insider trading a larger role in our search process. Insider trading reports are issued with little lag time, the presidents and chief financial officers know their firms better than anyone else, and historically insiders have a reasonable track record for buying near market bottoms.

Corporate earnings could begin returning to normal by the second half of this year, but there is no clarity to be had on the issue. Note, however, that the country’s mood will likely improve as federal, state, and local communications converge into a more coherent message. The market’s mood would improve with a decline in the rate of new infections in Europe and the U.S. (Italy may be a good barometer to watch in this regard.) It goes without saying that everything would change on a dime (again) with the creation of an effective vaccine or treatment for the virus. Even if it wouldn’t be available in the next week, just knowing it’s in the pipeline would let the market see the light at the end of the tunnel.

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