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Weekly Commentary

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Macro View

By Hubert Marleau

Over the Next Two Weeks the Market Will Be in A Bullfight

Submitted June 27, 2020

What Happened In the Market Last Week Ending June 26:

Rising Covid-19 cases in some U.S. states have forced them to delay reopening plans and residents in those states have voluntarily reiterated self-imposed precautionary measures. The moment of truth is approaching. Unfortunately, this has happened at a time when international trade and election pressures are emerging. The Trump administration is considering expanding and raising tariffs on $7.5 billion of imports from the European Union and U.K. which were imposed in 2019. Further, a New York Times/Siena College poll found that Joe Biden is way ahead of Trump for the presidency by 14 points, leading among women, non-white and college educated voters who are likely to favour income and wealth redistribution policies.

As a result, investors manifested some concerns that the market recovery may be in jeopardy and the business recovery more grueling, giving credence to the International Monetary Fund's grimmer outlook for global economic activity. The IMF warned that the world economy will shrink by 4.9% in 2020 compared to an earlier estimate of 3.0% and bounce back only 5.3% in 2021. By the end of next year global GDP is set to be 6.5 percentage points smaller than the fund had forecast at the start of the year. Interestingly, the IMF estimates that "the crisis cost governments around the world more than $10 trillion in lost revenues plus the cost of support measures such as additional spending, business loans and guarantees." As a consequence, global public debt is expected to hit a record 101% of aggregate GDP in 2020, up 19 percentage points from 2019. Gita Gopinath, the chief economist, argued that all countries will need to focus on reigning in wasteful spending, widening the tax base, minimising tax avoidance and progressivity in taxation rates.

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The worsening picture has caused stock prices to tumble. In the week ended June 26, the S&P 500 decreased 2.9% to close at 3009. The fallout was concentrated in the banking sector and communication services. The overall situation gives cause for caution; I therefore decided to further reduce my estimated trading range for the S&P 500 to 2850 to 3200. Coincidentally, it has technically been an unexciting consolidation phase since the end of May. The pause was probably a good thing. It's giving investors the needed time to figure out which broad factors they should concentrate on.

Productivity and Saving Will Become More Important Than the Virus

The recovery path is still on, but its pace is ebbing. The big bounce in high frequency data in states that reopened early is leveling off, reflecting increased caution in the face of contagion. While I recognize that the flare-ups warrant watching, original lockdowns are not coming back. The economic pain is unacceptable. People will learn to cope with the virus in a responsible fashion under trial and error. Many clusters are related to crowds, bars and church gatherings. Until we get a distributable vaccine, masks, testings and social distancing will become a way of life.

Moreover, the recent outbursts should be put in proper context. The new hotspots are nowhere near in intensity, severity, length of stay in ICU and numbers compared to what was experienced in NYC in April. According to health officials, the resource consumption was lower, and the incidences were effectively monitored and contained.

Unfortunately, in the last week there has been an explosion in the number of cases across the U.S. The percentage of people tested in states with aggressive opening-up strategies which possess the disease has significantly increased—Arizona to 17%, Alabama to 12%, Florida to 10%, Texas to 9% and Georgia to 8%. Thus, it became important for the authorities in those states to react quickly and partially reverse their reopening plans to make sure that the virus does not take control. It may work and the virus may burn itself out. Deaths from the latest surge will not be known for 14 days. Careful analysis will be needed because levelling off of deaths could be more to do with improved conditions in nursing homes and continued caution in the elderly susceptible group.

In my judgement, the market is much more likely to eye the trillion dollars of new personal savings that sit in money market funds, high-grade bond funds and bank saving accounts and the 19.5 million of workers that are

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unemployed. How these two major variables will do from here on will determine the broad growth path and characteristics of the economy. Will businesses hire the mass of unemployed workers and will the rich spend their massive pile of savings?

My best guess is that we are going to get a jobless but robust recovery. So far, conventional economic measures are suggesting that the economy is about half-way back to normal. Interestingly it has occurred without significant new hirings nor declines in private savings. According to a study by the Becker Friedman Institute at the University of Chicago the lockdowns were responsible for only a fifth of the decline in the level of economic activity. As FT's Mike Mackenzie pointed out the main driver of the decline was the shift in consumer behaviour. The study was based on mobile phone records of more than two million businesses.

Indeed, we are starting to get indications that the economy is moving surreptitiously in a direction contrary to what one would think is natural. Indeed, there is growing evidence that businesses are likely to rehire only a portion of the layoffs and the rich are about to spend most of their newfound wealth on discretionary items.

Firstly, businesses are currently and rapidly digitising their models. Many are realizing that having staff working from home has resulted in lower cost, in faster completion of projects and less time wasted on commutes, small talk and leisurely coffees. In many cases, the pandemic has become an opportunity to reduce labour input, cut space, eliminate the middlemen and lessen administrative loads. There is more to the closing of stores and intention to reduce employment by numerous companies than meets the eye. The result of these actions is decreasing input cost and generating efficiencies and productivity--accomplishing more with less and where less is more. Corporate earnings may surprise investors to the upside.

Secondly, the accumulation of savings is already flowing into the online spending stream. Unlike wars where the destruction of capital closed supply lines and past pandemics when online shopping was absent, the wealthy cohort can purchase just about anything that industries can offer. History is clear that the rich tend to spend a lot when the wealth effect is strong, the prospect for price-inflation is rising and the real cost of money is abnormally low. In May, personal savings amounted to $4.12 trillion, representing 23.2% of people's personal disposable income in spite of an all-time record increase in personal consumption of $989.9 billion. The BEA May report on personal income is difficult to decipher. Nevertheless, surveys and anecdotes show that consumers are eager to

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return to the marketplace. They want to spend money on cars, domestic travelling, clothes, big-ticket items, and home furnishings. Incidentally, women are getting their nails done and hair styled.

Where Does This Leave Us

While I acknowledge that a pullback is more likely than not because P/E multiples are a bit higher than the median since 1949, I say “stay put”. We’ve done enough dip buying for now. However, I wouldn't underweight stocks. The S&P 500 implied equity risk premium (forward earnings yield less the yield on 10-year Treasuries) stands at 400 bps compared to the 25-year average of 270 bps and that is cheaper than most of the time since 1996. Interestingly, the ERP was -300bps in 2000. That was irrational exuberance--not now. The Bank of America ran numbers on where the S&P 500 would go from here over the next twelve months if it followed previous bear-market rallies. The projection would land the S&P 500 between 3300 and 3600.

Allocation of Capital for the Long Haul

There is a large body of traders which is of the opinion that there is no way to know a priori which stocks will do better than others. It is based on the notion that at any moment of time stocks pretty much reflect all known factors that could or should affect relative valuation. In other words, the market is sufficiently efficient, especially in the short term, that it does not matter much which one is the chosen one. In other words, the argument is that picking stocks randomly does not make any difference to the performance of your portfolio. The argument is not true and seasoned investors would say that picking stocks randomly is a bad way to invest. Joe Weissental, an editor at Bloomberg, looked at two studies, one by Research Affliates’s Rob Arnott and another by Hendrik Bessembinder of Arizona State University and found that picking stocks in that manner will bring a lot of losers along with terrible performance or complete losses. Bessembinder’s study showed that the entire net gain for the overall market since 1926 can be attributed to just 4% of all stocks. Thus, it’s wise to pick visionary companies with strong management and that have access to capital so that they can capture the benefits from futuristic themes and/or long-term prospects that their industry offers.

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