Daniel Wildermuth's
MARKETCOMMENTARY

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Ongoing Uncertainty Likely to Drive Continued Market Volatility

Since numerous U.S. equity markets set all-time highs on February 19, 2020, the Dow Jones Industrial Average and the S&P 500 have experienced both a bear market and bull market within about a two-month timespan. After falling just short of 34% by March 24, the S&P 500 bounced back into bull-market territory (up 20% from the low) in just over two weeks on April 8th with gains of nearly 23%. Since then, the market has continued lurching mostly forward with another solid run-up near the end of April, paring the S&P 500's yearly loses to less than 10%. (Note, some would not characterize the recent bull market as a true bull because the market did not set a new all-time high.)

The Coronavirus Relief Bill, or CARES Act, passed rapidly by the U.S. government in late March helped build investor confidence, and expectations of its passage that eventually occurred on March 27th appeared to set the floor on market losses. Later programs and hopes for a rapid economic bounce back have continued to drive the market to a remarkably strong recovery. As April draws to a close, promises by the Federal Reserve to expand support to the U.S. economy have further pushed up equities.

Yet, the economy remains in a free-fall, and the coronavirus era has seemingly created two completely different worlds: one of Wall St. and the other of Main St. During the recent runup, the Dow Jones Industrial Average recorded its best two-week run since 1938,

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yet on Main Street, the forced economic shutdown has decimated the jobs market and the general economy. Through Friday April 23, 26 million people had lost their jobs in just five weeks, surpassing the total number of jobs added in the past 10 years since the recovery after the 2008 recession.

As more data are released, original assumptions around the mortality of Covid-19 are leading many to question the wisdom of shutting down our economy for a virus with mortality rates that are not much higher, and potentially even lower, than the traditional flu. A recent Stanford team study estimates mortality rates around 0.12%-0.2%, in the range of the typical flu at 0.1%, while a large New York study estimates mortality rates around 0.5%. Another study of the Diamond Cruise ship puts mortality rates as low as 0.05% with an upper bound of 1.0%.

Essentially all data provide strong evidence that hospitalizations and deaths are concentrated within a very limited population, primarily those above 65 with another pre-existing condition. Data show that people under 65 without underlying conditions accounted for only 0.7% of coronavirus deaths in Italy and 1.8% in New York City. If you are younger than 65 and do not have a pre-existing condition, your risk of dying from the Coronavirus is exceedingly minimal, and according to the data, potentially significantly lower than the traditional flu. Conversely, for anyone that fits in the high-risk group, like my dad, risks are higher. Had governments had more accurate data as they were formulating initial actions, it seems highly possible and even likely that a very different approach to balancing safety versus economic health would have been employed.

Ironically, healthcare spending alone accounted for nearly half the drop in first-quarter GDP as individuals put off—or were unable to schedule—elective and other apparently nonurgent procedures. Falling demand for all goods and services across the economy has further dropped economic activity, and today's far more complex supply chains have been scrambled by stay-at-home orders.

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The damage to date also captures a minimal time period of the most restrictive measures. President Trump declared a national emergency on March 13, and the earliest state lockdowns only started on the 19th. Second quarter numbers will be much worse. Economists at Goldman Sachs, for example, believe that gross domestic product contracted at a 9% annual rate in the first quarter and forecast that it will fall at an annualized 34% rate in the second quarter. If the projections are accurate, GDP would be down 12% from its year-earlier level in the second quarter, a massive number.

Now, Wall Street is looking past the immediate circumstances toward an eventual recovery, while Main Street is slogging through the dire consequences of putting large parts of the economy on hold. While it is very clear that the longest expansion in U.S. history is over, consensus on a future recovery seems far off. Various economists and Federal Reserve governors suggest that the economy will not take the V-shape (sharply down and back up) broadly hoped for by many investors. Wells Fargo predicts a gradual recovery starting in third quarter, and Federal Reserve Bank of San Francisco President Mary Daly said she expects more economic contraction through 2020 before growth returns in 2021, even if the threat of illness is contained quickly.

Under the best-case scenario, it will take time to ramp up the economy, and government restrictions will likely be lifted at a cautious pace regardless of actual risk. After the media onslaught and forced shutdowns, it will likely take time for people to regain confidence in resuming normal activity regardless of actual danger levels. All these issues point to a slow recovery.

In the midst of the chaos, corporate earnings as a whole will be decimated. The depth of this downturn appears unlike anything experienced since the end of World War II. During the relatively mild recession that occurred following the dot-com bust, GDP declined 1% from a year earlier, but year-over-year quarterly operating profits plunged an average of 30.2% during 2001 according to S&P Dow Jones Indices. Even the mild 1990-91 recession inflicted a bigger hit to earnings than analysts are forecasting so far for this downturn. Clarity has been slow to materialize partly because most large companies are pulling guidance around future earnings given the tremendous level of uncertainty.

The International Monetary Fund on Monday forecast that the U.S. economy will shrink 5.9% this year, more than twice the 2.5% decline in 2009, and the global economy is expected to shrink 3.0% during 2020, the steepest downturn since the Great Depression of the 1930s.

While market levels appear high by most standards given the circumstances, the lack of attractive alternatives could provide enough buoyancy under equities to keep prices elevated while the world slogs through the mess. However, we are not optimistic that today's valuations acknowledge the new economic reality, leading us to expect significant market volatility as investors adjust to altered conditions. A deep recession seems unavoidable, and the current optimism lifting equities to their rapid recovery seems likely to fade. For now, our outlook for equities is negative as we believe the market has gotten ahead of itself based on glimmers of hope about the return to normal life rather than the reality of the coming earnings storm and likely ensuing weakness of a yet-to-materialize recovery.