When We Have a Vaccine

After the longest bull market in history, the stock market suffered its worst first-quarter in history with the S&P 500, DJIA and NASDAQ Composite declining by -20.0%, -23.2% and -14.2% respectively. From peak to trough, these important benchmarks dropped a stunning -35%, -37% and -30% from February 19th to the March 23rd market lows, representing the most sudden, swift bear market decline in history.

The stock market's precipitous drop expeditiously discounted the government-mandated economic shutdown due to the COVID-19 outbreak. Economist Scott Grannis has called this the "most expensive self-inflicted injury in the history of mankind" and the numbers are staggering. U.S. unemployment is expected to rise from its recent 3.5% low to 15% or higher. Economists at JP Morgan estimate that U.S. GDP will decline at a 40% annual rate in the second quarter. The Yardeni Boom-Bust Barometer which measures the ratio of raw industrial spot prices to initial unemployment claims plummeted 79% to a new record low. The Citibank Economic Surprise Index which measures the pace at which economic indicators are coming in ahead of or behind consensus expectations plunged -211% from a high of 73.8 on March 13th to -81.9 on April 13th. The IMF estimates that the global economy is on track for a cumulative loss of $9 trillion in economic activity over 2020 and 2021. By all these measures, the U.S. and global economy are on track for the worst recession since the Great Depression.

With such gloomy economic news, it may be surprising that the stock market has recovered half of its recent losses. Indeed, the NASDAQ Composite, led by Amazon trading at all-time highs, is now almost flat for the year. You may ask, how is this possible? First, the unprecedented multi-trillion-dollar liquidity bazooka from the Federal Reserve has essentially taken bankruptcy off the table for any company that wishes to avoid it. Not to be outdone, President Trump and Congress worked together to craft legislation providing $2.2 trillion of support to consumers, small businesses, state and local governments and hospital infrastructure. Next, COVID-19 testing has ramped up from fewer than 100,000 nationwide by March 19th to over 3.1 million tested today – that's a pace of 750,000 tests per week. Further, the FDA approved the first serology test for antibodies against COVID-19 and more than 70 companies and institutions are laser-focused on rapid production and commercialization. Antibody testing will perhaps be the most critical component to the gradual reopening of the economy. Most important, the coronavirus outlook has improved dramatically as social distancing successfully flattens the curve.

The collective response by government, Corporate America, the U.S. healthcare system and the American people has been unprecedented in the wake of this pandemic and offers clear visibility that we will win this war against the deadly, invisible enemy, perhaps much sooner than bearish investors had expected.

Many important measures support the probability that we have already seen the bottom for this bear market decline. The VIX Volatility or so-called Fear Index has plummeted over 50% from an intra-day high of 86 to under 40. This sharp drop in volatility indicates that the forced liquidation phase of this bear market has passed. Treasury bill yields have risen over the last month, indicating a reversal of the flight-to-safety trade that turned short-term treasury yields negative during the peak of panic. Market breadth or the volume of stocks rising relative to those falling has steadily improved. The Put/Call Ratio, which measures the relationship between sellers and buyers through bearish and bullish options, recently hits its highest level since 2008 and indicates excessive pessimism. Other measures such as the AAII Investor Sentiment Survey and CNN Fear & Greed Index have made headway from the market lows but remain at elevated levels of pessimism. Meanwhile, a Bank of America survey revealed that professional investors have their highest allocation to cash since the September 11, 2001 terrorist attacks and the lowest allocation to equities since the previous bear market low of March 2009.

We have previously written about the importance of widespread testing and the potential approval for an anti-viral treatment (68% of patients who needed respiratory support showed clinical improvement in a compassionate trial of Gilead's experimental drug *Remdesivir*) as twin pillars to the velocity of the forthcoming economic recovery, especially since it will be many months before a vaccine is approved and ready for mass proliferation. As President Trump and U.S. Governors quibble over who has the authority to reopen the economy, St. Louis Federal Reserve President Neil Bullard weighed in with estimates that the current shutdown is unsustainable and costing the U.S. over $25 billion per day in lost economic output. Bullard argues that this $25 billion daily cost should provide ample motivation for government to invest in widespread testing capacity that ideally would be available for all Americans. Amen, Neil. The pressing need for a cohesive strategy to reopen the economy that includes widespread testing, potential anti-virals, quarantining those most at-risk and technological solutions to track the virus (Apple and Google have collaborated on a smartphone solution) is palpable. Bullard goes on to suggest that "widespread testing would end this crisis."

When we have a vaccine, we expect to look back on the words of Scott Grannis and Neil Bullard as prescient. We implore our leaders to not only understand the economic costs suggested by Grannis and Bullard, but also the "soft costs" to this shutdown (isolation, depression, suicide, domestic violence, alcoholism, addiction) that may prove even more costly than COVID-19 related deaths.

While we readily acknowledge that the imminent reopening of the economy is apt to be gradual and perhaps prone to “rolling shutdowns” as Minneapolis Federal Reserve President Neal Kashkari predicts, we also submit that what happens in 2020 is far less important than the expected economic recovery in 2021 and beyond. It is not a matter of *if* but rather *when* a vaccine is ready. While Moderna expects its COVID-19 vaccine to be approved no earlier than 2021, they do expect doses to be available this Fall on a compassionate basis for those most at-risk such as health care workers. Johnson & Johnson’s primary vaccine candidates are in master-seed production phase and on track for Phase I clinical trials by September – the company has the potential to manufacture up to 900 million doses by April 2021. Pfizer, Roche, GlaxoSmithKline and many other companies are all making similar progress in the race to find a vaccine.

While analysts and investors fret over the immediate blow to sales and earnings that most companies will suffer due to the coronavirus crisis, we will be asking ourselves how the economy and earnings will normalize *when we have a vaccine*. When we have a vaccine, people will walk through downtown streets without masks. Children will attend schools and universities. People will attend concerts and baseball games. Parents will take their children to Disneyland and couples will go out on dates to restaurants and movie theaters. People will exercise at their favorite yoga studio or gym. Imagine a world where we travel on an airplane when we have a vaccine. People will shake hands again and even hug when they greet each other. We will do all these normal activities that we took for granted only several short months ago without fear of becoming infected when we have a vaccine.

Benjamin Graham, the godfather of value investing, famously wrote that “in the short run, the market is a voting machine, but in the long run it is a weighing machine”. The voting machine referenced by Graham is a short-term scorecard about how investors feel about the company or the market at any given moment. The weighing machine refers to the actual economic benefits provided to owners of businesses over long period of time. The recent collapse in stock prices represents the collective vote of panicked investors fearing the unknown calamity from coronavirus and government mandated shutdown. The ongoing recovery in the market points to the realization of the economic reward in owning great businesses for the long haul. Especially with interest rates so low, the long-term reward for owning high-quality companies that offer consistent earnings growth and persistent dividend growth is compelling.

While there will be significant adjustments required of all of us and there will be inevitable new policies and restrictions that will feel like a massive invasion of our civil liberties, we are confident in the American ability to persevere and adapt through the coming reopening of the economy and even more confident in American ingenuity to ultimately solve this crisis.