Weekly Capital Market Comments

April 17, 2020

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PRIVATE CLIENT GROUP

Market Recovery Meets Economic Reality

Less bad is not good, but that is not how equity markets are reacting to recent economic data releases, or the start of 1Q20 earnings season.

This past week, the U.S. economy witnessed an additional 5.2 million of initial unemployment claims, bringing the aggregate 4-week total to over 22 million. This could imply that the April jobs number falls by over 20 million, driving the unemployment rate to as high as 15%, from a multi-decade low of 3.5% in February. **To put this into perspective, the U.S. has lost as many jobs in the last four weeks as it has gained in the previous ten years.** We also observed negative surprises to retail sales and industrial production, while several housing-related data printed to the downside.

Earnings season starts in earnest next week, with the I/B/E/S consensus estimate for 1Q20 S&P 500 earnings growth at negative 12%, compared to positive 6% at the beginning of the year. But more importantly, we will be provided CEO expectations about future business prospects, both near and long-term, despite many companies already withdrawing full-year 2020 guidance.

If all this weren't enough, several Fed speakers hit the tape on Thursday with cautious messaging. While economic releases will be relatively limited in the coming weeks, there is a Federal Reserve meeting at the end of the month, shortly followed by preliminary 1Q20 GDP, which we expect to be modestly negative. However, it will be the 2Q20 GDP print, not expected until late August 2020, that some Wall Street economists see down anywhere between 20-40% on an annualized basis, suggesting the U.S. is about to enter its deepest (but hopefully shortest) recession since 1929.

Yet the S&P 500 was higher by roughly 0.4% this week (Thursday to Thursday). Further, since the March 23, 2020 low of 2,237, the S&P recovered by almost 25%, and now stands down only 13% YTD, on a total return basis.

We continue to believe a bottom is a process. Still, judging by the recent price action in the equity markets, along with relatively encouraging COVID headlines, it would be easy to suggest, and accept, that the bottom is in. And while we have lost over 29,000 souls across our nation to COVID-19 (according to Johns Hopkins), it seems that infection rates are plateauing in many of the hardest-hit areas of the country, and bio/pharma companies continue to pave inroads to either promote identification or mitigate acuity. Finally, last night, the POTUS conveyed his plan for a staged opening of the economy, whilst leaning on Governors to tailor specific state strategies commensurate with federal guidelines, which helped fuel an early morning rally in stocks.

However, given the recent run in the equity markets, we are becoming increasingly concerned that the ensuing "bottom" may not be the type that many investors are expecting. We believe as more economic data disappoints, the notion of a "U-shaped" economic recovery will take hold, as the country acclimates to the new-normal, thus resulting in a slower than expected pick-up in company earnings. And call us crazy, but we still think you need increasing earnings to support increasing stock prices. Government intervention and helicopter money go only so far.

As a result, we believe equity investors should brace for a "W-shaped" recovery (or double bottom) in equity prices before we potentially march on to new highs. At Thursday's close, the S&P was trading at 18.2x forward 12-month earnings. However, the FactSet earnings estimate for the next twelve months (NTM) is $144. We believe this to be too optimistic. According to Yardeni Research, a more conservative estimate for 2020 and 2021 S&P earnings is $120 and $150, respectively. Splitting the difference, we arrive at roughly $135, which implies almost a 21.0 multiple on the S&P in advance of an economic recession. As a reminder, the long-run average multiple for the S&P 500 dating back through 1997 is only 16.5x. **Therefore, we believe equity investors should brace for a tactical pullback in prices, and not rush into buying at current levels.**

We'd love to hear your thoughts.