Divergence between the financial markets and the economy

In this issue of the Thinking Man, we tackle the main question in the minds of our clients. Why have financial markets rallied, when the economy is in the worst shape since the Great Depression? This apparent divergence is not only in the mind of clients, but also is in the forefront of debates by financial media outlets and market analysts.

We believe that the rally in the market has been justified, as it has been supported by an unprecedented monetary and fiscal stimulus. Most recently, investment sentiment has continued to improve as countries lift lockdown restrictions and preliminary reports from clinical tests of drugs and vaccines against Covid-19 show promise.

Even as the economy is in the worst shape since the Great Depression, and many economic reports are showing their worst readings on record, it is important to remember that these figures are lagging indicators. The market is aware that the economy is having a terrible second quarter, but investors are discounting that the economy will have a sharp rebound in the second half of 2020, and the situation should normalize in 2020.

1. Financial markets have rallied

Covid-19 cases were first reported in the U.S., Europe and other regions around the world at the end of January and beginning of February. However, there was widespread belief that the virus would be contained, as had been the case with the recent SARS and MERS outbreaks. During the first weeks of February, investors were much more concerned with the impeachment of President Trump and the signing of the Phase 1 Trade Agreement between China and the U.S. However, a few weeks later, countries in Europe, particularly Italy and Spain, were becoming major epicenters. Some weeks later most of Europe was forced to implement lockdown measures and the market started to tumble as investors started to acknowledge the gravity of the situation.

The Thinking Man's Approach

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- The U.S equity market, fueled by fiscal and monetary stimulus and aided by the slow reopening of the economy, has almost completed its V-shaped recovery.
- On the other hand, the global economy is still suffering from the dramatic effects of the lockdown measures implemented to contain the spread of the coronavirus.
- However, the market as a discount mechanism seems to be writing off 2020 and focusing on the economic recovery expected towards the end of 2020 and during 2021.
- Our base case scenario remains that after two terrible quarters, the virus is significantly contained allowing the economy to recover.
- There are three main risks that could derail the recovery of the economy and the consolidation of financial markets:
  - A second wave of Covid-19
  - An escalation of the geopolitical tensions between the U.S. and China
  - The November presidential Election in the U.S.

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The market entered into a full panic mode since the beginning of March, when the epicenter of the disease moved to the U.S. and investors realized that the country would also be forced to implement country wide lockdown measures. From February 19 to March 23, the S&P 500 fell approximately 34%, marking the fastest bear market in history. Similarly, spreads in high yield bonds expanded to levels last seen since the Great Financial Crisis (GFC), and safe haven assets such as the 10-year U.S. Treasury fell to a record low yield of just above 0.5%.

TABLE 1. MARKETS PERFORMANCE AS OF 06/08/2020

Market	Price	YTD (%)	3 Mth (%)	Since 3/23 (%)
Equities				
U.S. Large Caps (S&P 500)	3,232.39	0.94	9.33	45.09
U.S. Small Caps (Russell 2000)	1,536.90	-7.33	6.48	53.78
Europe All Cap (Stoxx Europe 600)	374.12	-8.57	3.26	34.87
Japan Large Caps (Topix)	1,630.72	-4.06	12.17	27.75
Emerging Mkts (MSCI EM)	1,007.46	-8.83	0.24	33.64
Global (MSCI ACWI)	543.77	-2.75	6.40	42.49
Fixed Income				
Treasuries U.S. [1]	2,538.46	7.12	-0.92	-0.64
IG Corporate U.S. [2]	3,366.05	3.88	-1.76	15.36
HY Corporate U.S. [3]	2,150.74	-1.47	0.36	22.83
Europe Sovereign [4]	257.31	0.79	-3.12	1.62
IG Corporate Europe [5]	241.49	-1.26	-2.10	7.74
HY Corporate Europe [6]	394.45	-4.47	-1.83	19.06
Emerging Mkts USD [7]	1,199.91	-0.78	-3.34	14.47
LATAM HC [8]	991.78	-4.65	-6.49	21.97
IG Global [9]	524.07	2.42	-1.97	5.48
Currencies				
EUR/USD	1.1294	0.72	0.09	5.30
GBP/USD	1.2724	-4.02	-2.48	10.24
USD/JPY	108.43	-0.17	2.88	-2.52
DXY	96.6180	0.24	0.70	-5.73
Commodities				
Oil (WTI, $/barrel)	38.19	-37.45	-7.49	63.48
Gold Spot (Spot, $/oz)	1,698.53	11.95	1.48	9.35
Copper (Spot, $/lb)	2.58	-7.62	1.64	22.82
Baltic Dry Index	698.00	-35.96	13.13	13.13

Source: Bloomberg

1. Bloomberg Barclays US Treasury Total Return Unhedged USD; 2. Bloomberg Barclays US Corporate Total Return Value Unhedged USD; 3. Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD; 4. Bloomberg Barclays Pan-European Aggregate Treasury TR Index Value Unhedged EUR; 5. Bloomberg Barclays Pan European Aggregate Corporate TR Index Value Un; 6. Bloomberg Barclays Pan-European High Yield Total Return Index Value U; 7. Bloomberg Barclays EM USD Aggregate Total Return Index Value Unhedged; 8. Bloomberg Barclays Emerging Markets LatAm Total Return Index Value Unhedged USD; 9. Bloomberg Barclays Global-Aggregate Total Return Index Value Unhedged USD

Having learned from the Global Financial Crisis (GFC), both the Federal Reserve (Fed) and the U.S. Federal Government issued unprecedented monetary and fiscal stimulus, not only in size (75% of U.S GDP) and scope, but also with tremendous speed. The Fed restarted Quantitative Easing (QE) purchases and revived many of the "alphabet soup" facilities created during the GFC.[1] If the Fed pulls through with everything It has promised, its Balance Sheet is expected to balloon in size to a staggering $11 trillion.

Similarly, the U.S Government issued a $2 trillion fiscal stimulus package, called the CARES Act, with two main objectives. First, the program would issue a one-time payment for low-income individuals, in order to help them get through the lockdown. In addition, the program provided loans to small businesses that would effectively turn into grants, if they retained and continued to pay their employees.

[1] Alphabet soup facilities refers to special lending facilities created during the GFC and have expanded the Fed's balance sheet by over $1 trillion in terms of total assets.

Both programs achieved the goal of calming investors, restoring the proper functioning of credit and financial markets, helping to avoid a solvency crisis that would have caused devastating long-term consequences. Investors' mood was boosted in April, by medical developments, showing promising data from preliminary drug and vaccine tests. Towards the end of April and the beginning of May, the U.S. started to slowly lift its lockdown restrictions which added to the optimism in the investment community. As cases in the country peaked and have started to slowly descend, even in the face of expanded testing and lifting of restrictions, the optimism of investors has continued to increase.

Governments around the world have also taken similar measures to protect their economies from the devastating effects of lockdown measures. As a result, since the trough of March 23, risk assets worldwide, especially in the U.S., have had a spectacular recovery as can be seen in Table 1. As of the second week of June, the technology-oriented NASDAQ pushed through to an all-time high, while the broader S&P 500 went positive on a year to date basis. Similarly, spreads on investment grade and high yield debt have compressed significantly, while volatility levels have sharply decreased. As more countries reopen and life returns to "normal", prices of commodities, especially oil which was severely punished reaching negative prices at some point towards the end of April, have also rebounded aggressively. The only losers as of today seem to be emerging market equities where the coronavirus is still spreading uncontained, especially in the larger countries such as India and Brazil.

2. The state of the economy

Looking at the recent performance of the markets, it is hard to believe that the world is still in the middle of what could be the greatest global recession in history. A survey of economic analysts by Bloomberg, predicts that the global economy will contract by 3.3% during 2020. In the U.S. economic growth prospects are similarly discouraging. Gross Domestic Product (GDP) contracted by 5% in the first quarter on an annualized basis, even as lockdown measures were only implemented towards the end of the quarter. Since the country remained in total lockdown through April, and in other parts of the country, well into May, growth expectations for the second quarter are discouraging. The same survey predicts the U.S. economy will contract by an annualized 42% during the second quarter. Even as the economy is expected to have a sharp rebound during the second half, the survey expects that the U.S. will contract by 6% in 2020.

Before the pandemic, the U.S. was at what is considered technical full employment, with an unemployment rate of just 3.4%. Since the start of the lockdowns, more that 43 million Americans have applied for unemployment benefits, with more than 20 million remaining on benefits as of the latest reading. The unemployment rate had jumped to 14.7% in April, before declining to 13.3% in May, which remains by far the highest level since record keeping began in the 1940s. Even as the U.S. Government tried to prevent massive layoffs through the CARES act, more than 20 million people still lost their jobs. The expectation is that as businesses are able to reopen, the majority of the 20 million people who lost their jobs will be rehired.

Other economic data have been equally negative, highlighting the degree of economic destruction. Retail sales, a measure of consumption that accounts for two thirds of U.S. GDP, fell by 16% in April. Meanwhile personal spending fell by 13%, leading to a historic 33% personal savings rate. This could be terrible news if people are just not spending because of fear of a severe economic recession, or alternatively, good news if it is just pent-up demand waiting to be deployed during the second half of the year. Finally, industrial production for the same month fell by 11%.

All the previous information has been supported by a significant decrease in economic surveys. The manufacturing ISM for May remains in contraction territory at 43.8, with the non-manufacturing also in contraction territory at 45.4. Similarly, consumer sentiment measured by the University of Michigan has fallen from 100, before the pandemic, to around 73, a level last seen since the taper tantrum of 2013.[2]

There is no doubt that the economic destruction has been severe, especially for small businesses. However, the size and scope of the fiscal and monetary stimulus programs enacted by the Fed and the government seem to have backstopped the U.S. economy. As states and businesses have reopened, many economic indicators have started to improve. Americans are eager to resume their normal lives and take advantage of the summer months, which should help the economy going forward. Even though certain states started reopening their economies more than one month ago, new coronavirus cases have not exploded as was expected. Apparently, after all speculation, warm weather could indeed be slowing the spread of the disease. If this trend continues, it would appear that the Fed and the government were successful in bridging the economic gap. Nevertheless, the possibility of a second wave should not be completely discarded, as we will mention later in the document.

3. Causes for the divergence

With everything we have discussed so far, it is difficult to understand the difference between the bullishness of financial markets with the apparent economic devastation in the U.S. and abroad. To address this apparent divergence, it is important to mention that during the first weeks following the trough of March 23, only a few companies boosted the market. Because of global isolation measures, the biggest winners were companies whose business models could benefit from having people stay at home. Coincidentally, many of these companies were the same mega cap FAANG stocks that had led the rally during the previous decade.[3] As these companies account for approximately 20% of the U.S. equity market, their performance easily drove the movement of the total market. A recent analysis by Barron's estimates that the 10 largest stocks in the Nasdaq have gained, in aggregate, almost $1 trillion, while the

[2] Taper tantrum refers to the 2013 collective reactionary panic that triggered a spike in U.S. treasury yields, after investors learned that the Federal Reserve was slowly putting the breaks on its quantitative easing program.

[3] FAANG is an acronym referring to the stocks of the five most popular and best-performing American technology companies: Facebook, Amazon, Apple, Netflix and Alphabet (formerly known as Google)

other 2,600 stocks lost approximately $300 billion in value. Even as the Nasdaq is reaching all-time highs, the typical stock of the index is actually down year to date, close to 15%.[4]

In addition, the expected bigger losers from the current crisis such as airlines, aerospace manufacturers, cruise operators, mortgage related stocks and office supplies were among the hardest hit in the February-March crash and had also underperformed in the rebound. Furthermore, if investors were not aware of the coronavirus and its economic consequences, they would have aggressively piled into these stocks, which looked particularly attractive from a historical valuation perspective. It was not until the last few weeks, where economies reopened, and virus concerns started to fade, that these beaten-up stocks gained momentum and joined the equity rally (which were comprised mainly of cyclicals, financials, and small caps).

It is also important to remember that financial markets are discounting mechanism that anticipate future developments. Even as the current economic picture looks like a horror movie, the base case scenario remains that the coronavirus will continue to be contained and we experience a sharp economic recovery during the second half of 2020. The Bloomberg survey mentioned before predicts a rebound in economic growth in the U.S. during the third quarter at an annualized 24%, which would be the beginning of the U-shaped recovery. For similar reasons, investors are writing off 2020 earnings and focusing entirely on 2021. Several analysts believe that by 2021, earnings for the S&P 500 could match or even exceed the earnings of 2019. These same analysts argue that valuation could seem stretched, even using earnings expectations for 2021, but P/E multiples of 18-20x are reasonable given current levels of interest rates and inflation.

Finally, the equity market is not entirely representative of the larger U.S. economy. There are huge discrepancies between the two, and as a result, the performance of the market is not indicative of the health of the overall economy. For example, large cap companies in the S&P 500 have ample access to capital markets and are almost certain to be bailed out by the federal government if required. Meanwhile, smaller businesses, which employ around 25% of the total workforce, do not have access to capital markets, and the possibilities of getting a commercial loan to survive are limited. Unfortunately, many of these businesses will not make it through the current crisis and will either be absorbed or replaced by the same mega cap companies that are currently thriving. Table 2 shows the main differences

Table 2: Difference Between Nominal GDP and the S&P 500

U.S. Economy	S&P 500
Domestic	Global
Consuption Driven	Investment Driven
Short Oil	Long Oil
Service Oriented	Manufacturing Oriented
Net Importer	Net Exporter
Prefers Strong Dollar	Prefers Weak Dollar
Net Borrower	Net Saver
Captive to U.S. Taxes	Countries Compete to Attract Capital

Source: Strategas

[4] https://www.barrons.com/articles/only-a-few-big-stocks-are-driving-the-markets-gains-thats-a-problem-and-an-opportunity-51590146101?mod=hp_LEAD_1

between the S&P 500 and the U.S. economy, which helps us finalize our point in explaining why the former is thriving, and the latter is suffering.

4. Is this a "suckers" rally?

Several times in previous crises, the market has staged a rally following a big market crash, only to resume its downturn trend several weeks or months after. This is precisely what happened during the GFC. Since mid-November 2008 to early January 2009, the S&P 500 rallied by almost 25%, technically becoming a new bull market. Nonetheless, the market quickly resumed its downward trajectory, falling by another 27% until the middle of March 2009. Similar "bear" rallies happened also during the internet bubble. Therefore, the big question in investors' minds is if in fact we are in a "bear" or "suckers" rally, or if this is the beginning of a strong, long lasting bull market.

We believe the answer is the latter for several reasons. First, the size, scope and timeliness with which fiscal and monetary stimulus were implemented on a global scale has prevented the health crisis into morphing into a financial one. Additionally, most developed central banks, including the Fed and the ECB, remain committed to supporting economic growth with a "whatever it takes" approach in its efforts to fight any recession. U.S. fixed income has rallied even as the Fed has barely made any purchases from its announced monetary programs. The pledge by the Fed to act seemed to be enough for many investors.

On the coronavirus front, our base case scenario remains that the virus is controlled, and the economy is able to resume its growth in the third quarter of 2020. It seems that tremendous progress has been made in developing either a vaccine or a treatment, that could help return to life as usual towards the end of this year or the beginning of the next. As mentioned previously, new Covid-19 cases have not exploded, although may be rising, even as some states have reopened for more than a month. The ultimate test will be if there is a spike in cases following the massive racial inequality protests of recent weeks.

With this in mind, we believe it is highly unlikely that we will retest the lows of March, or even have a meaningful correction. We believe it is more likely that we will see a rotation from mega cap technological stocks that have led the rally thus far, into more pro cyclical investments. We had been talking for several weeks that the market should enter a phase of lateral consolidation and that was what it had done during much of May, except for the last week. The rally continued during the first week of June stemming from the surprising jobs report. However, unless there is another big surprise, the market should resume the lateral movement it had since the end of April to the third week of May.

Our base case scenario is not without risk, and we believe there are three significant ones. The first, that we have already mentioned, is a larger and deadlier second wave of Covid-19 during the fall and winter months, that would force a second round of lockdowns. That would have a devastating effect on the economy that is almost impossible to quantify. In our view, a second wave of Covid-19 would tumble the market. In fact, as of the writing of this current Thinking Man issue, the market was having its biggest correction since March, as Covid-19 growth rates were starting to increase disproportionately in some parts of the U.S. Furthermore, a mutation of the virus that delays all the medical progress achieved thus far, could also be a big hit to the current optimism of the market.

In addition, we believe that the U.S. presidential election in November will be a major cause of volatility. Financial markets hate uncertainty and that is exactly what will be developing over the next few months, especially as November approaches. The latest polls are showing former Vice President, Joe Biden, as the front-runner with a comfortable lead. It is too early in the race to tell if Biden's candidacy will continue to strengthen. What appears certain is that President Trump will use all the ammunition at his disposal to secure a second term. As the election approaches and the poll numbers narrow, investors will inevitably start to assess the companies that would be winners or losers if either candidate were to win.

The final risk is a continuation of the escalation of geopolitical tensions between the U.S. and China. The trade confrontation between the two nations had resulted in severe economic disruptions globally over the last few years. If the trade confrontation were to resume, or a "cold war" style conflict was to develop, it would hurt the recovery efforts of the fragile global economy. The good news on this front is that we believe it not very probable. President Trump is using China as a scapegoat for his mishandling of the pandemic, a strategy that he expects will be successful towards his reelection bid. However, President Trump is also aware that he needs a quick recovery of the economy in order to enhance his reelection prospects. With this in mind, we think it is highly unlikely that he will go into a full confrontation with China, or for that matter any other country that could jeopardize the recovery of the economy, and as a result, his reelection hopes.

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