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MONITOR
CRISIS UPDATE

Corona Crisis Update

The bull gets the virus

It's looking like a U-shaped recovery is the most likely outcome

BY: **STEPHEN AUTH**

The last three weeks have been unprecedented for all of us.

Previously, the economy and markets were sailing along on all cylinders, with a very positive outlook in the near and long term. Then, out of some horror film no one thought possible, COVID-19 arrived on our shores in force. From there, we witnessed unprecedented events in all of modern economic history: a sudden stoppage, on a dime, of the entire global economy and with it, the fastest-ever (22 days) 30 per cent drop in the S&P 500 from its February 19 record high and ultimately off 35 per cent at intra-day lows. There followed a potential financial crisis as even high quality corporate credits found themselves strained to issue even short-term debt as financial markets froze. The potential for a complete meltdown of the markets and with them, the economy, loomed.

History told us that in times of potential meltdown, even a very fast-paced one such as this, modern governments will not step back and let it happen, Herbert Hoover style. Collectively, they've learned from that mistake. But this one was so potentially broad across the economy and so quick in coming, questions loomed around how big would they go and would they be able to juggle all the many balls dropping at once? Last week, the Fed and the government both "broke the glass" and responded with the largest and widest Fed intervention in history by a mile (could top $5- to $6-trillion once the Fed piece of the fiscal bill is fully leveraged up). Then Congress and the White House passed an extensive $2 trillion+ bipartisan stimulus bill (which I prefer to call a bridge loan) to bridge the broader economy, especially small businesses and workers, through this shutdown period. This should get us through the worst economic period that looms in Q2. The rough plan is to be back up and running at least in part later this quarter, hopefully starting in mid-May or maybe even sooner. Markets responded with another big move, this time to the upside, of nearly 20 per cent.

So where are we now? At Federated Hermes, we have re-evaluated our economic, earnings and S&P forecasts in light of the renewed situation. Our conclusion is that the bull has gotten the virus, and that we find ourselves in the midst of what we've seen in some other great secular-bull markets: a short term "cyclical bear" that typically sees a 20 per cent to 30 per cent decline in stocks from the highs, and occasionally a decline as high as 35 per cent to 40 per cent, followed by a choppy period of solidifying the new base before eventually going on to new highs. We believe we made that important -35 per cent low last week, putting it at the extreme end for a cyclical bear, and believe the low is now in. At the same time, we expect the recovery off the low to be rocky at first. We think it could take as long as 18 months or so to get back to the old highs before eventually powering higher. I would note that our visibility on this is still cloudy, and when the future looks especially cloudy, we typically resort to scenario analysis to better think through the range of outcomes and the outlook for each.

To simplify it, we think there are three potential paths forward from the sharp decline we have just experienced: an equally sharp V-shaped recovery bounce back by summer; a Great Depression-like era L-shaped economy and market that's too devastated following the initial collapse to recover for a decade or more; and a U-shaped recovery that portends a rocky but relatively short period of slow and choppy growth this summer and fall before starting a more sustained advance a year or so from now.

The V Scenario We Think Is Unlikely

In the V scenario, the virus peaks in New York City in a couple of weeks, and lockdowns/social distancing elsewhere prevent further outbreaks. The economy starts coming back online in late April, and by mid-summer we're back to more normal economic activity across most sectors. The bridge loan just injected by the Fed/Congress keeps the whole thing afloat in the meantime. The liquidity infused by the

Fed and other global central banks lights a match and by 2021, we're back to three per cent GDP growth rates. In this scenario, the bull, ever forward looking, could break out of its fever in a hurry, and break through the pre-crisis highs in 2021. Impressive if it happens.

Although some of our most bullish Wall Street colleagues see a path here, we are less sanguine. Too many people have been left in shock by the last three weeks to recover fully by summer. Some or many small businesses may be impaired. And post-virus world "winners" and "losers" will emerge, leading to a period of creative destruction that, though a long-term good thing, will be a near-term drag on growth. Overall, we think the odds of this scenario is now a low probability; call it 10 per cent. There likely will be too many small and midsize corporate bankruptcies ahead, and too many traumatized consumers will be slow to get back to their freer-spending ways of 2019.

The L Scenario We Think Is As Improbable As The V

In the L scenario, the current dislocation in the economy fuels further disruption in the financial markets, whose further plunge begins to create a "negative wealth effect" that feeds back negatively to the private economy, then back again to the markets. It doesn't end until all that's left is the government, food/staples, telecommunications, cigarettes, video games, Coke and guns – lots of them. You get it. Pretty grim. This is what markets were trying to price through the last three weeks, and had yet found a way to do so.

Hence the illiquidity in most markets except stocks and the eye-popping speed of the latter's decline.

The policy response out of Washington has largely taken this "left-tail event" off the table. Still, mistakes could be made or the virus could be even far worse than we already all now expect. That seems a remote possibility, especially knowing that the Fed and Congress already are all-in and would clearly do more if they needed to. We also have this probability at a low 10 per cent.

The U Scenario Is The Likely Path Forward

In the U scenario, the virus' expansion rate peaks in mid to late April, but it takes until June to snuff it out fully. The shut-in parts of the economy gradually come back online, county by county and business by business. Some – the weaker retailers, the previously less successful restaurants, the shakier oil companies – never make it back in the post-virus "creative destruction." Many marginal oil industry players close their doors. On the other hand, the global liquidity and stimulus measures already passed, and probably more to come, provide a tailwind. In a series of fits and starts, the economy gets going again, and by this time next year, a more sustainable advance is underway. The market chops wood through this spring, with each new data point on the spread of the virus and its containment providing the key inputs most investors need to forecast the length of the slowdown. The inflow of company earnings and guidance in Q2, which will either provide comfort or sorrow to investors, could also drive choppiness. And further along the way, small bankruptcies might pick up, along with maybe a few larger ones – "aftershocks" of the great corona shock we are currently living through. In a U, we think GDP this year will be negative dramatically in Q2, positive in Q3 in the immediate bounce back and then a low one to two per cent in the next few quarters.

By next spring, as the winter weather begins to clear, the economy starts a more sustained advance, with run-rate earnings recovering in 2021 to where they started in 2019. The market, always looking ahead, has a terrific year in 2021 and re-achieves this year's highs by early 2022, officially breaking away from the bear, and resuming the secular bull advance.

For long-term investors, holding on through shorter-term bear markets like the one we are now in almost always makes the most sense, ideally spiced up by a few tactical additions to stocks on significant sell-offs. Though we do expect that a retest of Monday's dramatic low is probable, or at least an attempt to probe it, we think the lows are in. That would put potential downside risks from here in the 10 to 15 per cent range. Against this, the upside for patience over two years is probably closer to 30 per cent and could be higher if we get a little lucky, and/or plucky as an economy and a people.

The history of previous cyclical bears within secular bulls supports our view that holding on is the most prudent course for long-term investors. For the previous eight cyclical bears over the last 65 years, investors who held on following the first 20 per cent down move (our present circumstance) were rewarded within three years with cumulative returns of 37 per cent. (Indeed, even for the two scarier cyclical bears that posted greater-than-30 per cent declines, holding on from this point earned the patient ones 27 per cent over the next three years. This return is strikingly similar to our separately estimated upside target of 30 per cent in two years.)

Of course, a perfect savant capable of timing the precise bottom of this bear could sell here and reinvest his entire cash hoard exactly at the ultimate low, doing a little better – up 47 per cent in three years. The likely outcome though, given that the news at the low – if it is indeed ahead of us and not behind us already – is likely to be bad, and this attempted timing strategy would miss that low altogether. Having done so, rather than chase the very violent rally that in the past tends to carry the market off a big retest level such as last Monday's, this investor would sit in cash all the way back up for the duration of the bear. That outcome would be a miserable nine per cent, thus locking in more than half of the 20 per cent in capital losses endured so far.

The brave and patient would do even better than most everyone by averaging in further from this point; those who did so in the end would do just about as well as the savant, up 44 per cent – just three percentage points shy of the savvy market timer but seven per cent better than the more cautious buy-and-holder. Remember, bear markets don't end until they've made fools of both bulls and bears alike. Only the tortoise wins.

The Federated Hermes PRISM committee has decided to keep its equity weighting intact for now at four per cent in our moderate allocation portfolios, the level the market has taken it to following the correction. This represents a modest overweight to equities, which we think is appropriate given the U scenario. Importantly, we do not intend to rebalance back to our pre-crisis strong overweight position of seven per cent. That higher equity overweight was established during the February, "pre-corona" pullback phase which, at that time, had the makings of a more normal short and brief correction before resuming the advance.

For now, we'll continue to watch the medical progress of the fight against the corona, the coming bad economic news, the strength of the policy measures adapted to fight through it, early signs of the economic fallout from all the above, and most importantly the economic green shoots we expect to start sprouting in mid spring. For now, the bull has the virus. We think there's now an 80 per cent chance he fights through it on his own without needing intensive care. **BPM**

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