Underestimating the Damage

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April 2020

Testing New Lows?

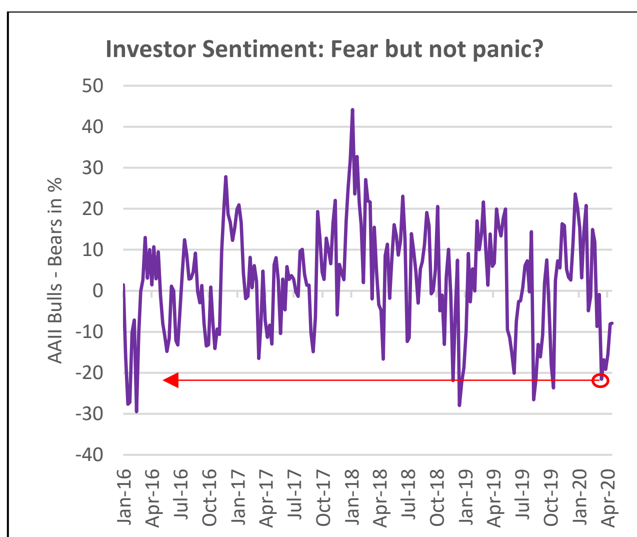
Since the March 23 market low, global equities have rallied more than 25% (MSCI World Index). While the pandemic selloff was swift, the rebound has been no less impressive. In recent weeks, optimism has returned full bore. Equity and credit markets have stormed higher on a combination of overwhelming policy stimulus and nascent signs that COVID-19 infections are peaking or have already peaked in various regions.

Yet while risk assets have rallied significantly, the economic data has gone from bad to worse. While it is often said that “the market is not the economy,” this dichotomy cannot persist forever. Eventually asset prices will reflect longer-term economic realities. Market bears expect the bottom to fall out soon. Market bulls have clearly been looking past the Coronavirus Shutdown Recession to a future where things return to normal. With these divergent views, the #1 question on everyone’s mind is whether global equities will retest their lows.

Spoiler alert: We have no idea. At this point, global equities would have to fall nearly 20% to revisit the bottom. While certainly plausible, it’s a stretch to call it probable. Guessing the market’s next directional move is hard enough – never mind guessing its magnitude. However, we do believe that ***another bout of significant selling pressure and increased volatility is likely to occur before a more durable rally can proceed.***

No Washout

Although they can’t be completely dismissed, we don’t espouse technical theories like “bottoms are always retested” or “the bottom is a process, not a day.” Our skepticism is rooted in a simpler notion: It seems unlikely that the equity fallout from the broadest and deepest recession in modern history would be fully captured in 23 business days (February 19 – March 23).



Source: Bloomberg, Natixis Investment Strategies Group, 1/1/16–4/16/20 (weekly). AAII: American Association of Individual Investors.

Unlike previous bear markets, investors almost seemed to take the coronavirus collapse in stride. Many may have thought a good, healthy selloff was overdue, and while the ride to the bottom was swift, it was mitigated to some extent by quarter-end rebalancing. Flows into equity mutual funds and ETFs fell significantly, but nothing extreme by historical standards.

Retail sentiment, as measured by AAII net bulls minus bears, fell sharply but didn’t breach the lows that had been seen nearly a dozen times during the 11-year bull market. Moreover, a decomposition of the data shows that almost the entire shift came from “neutral” investors who turned bearish. Bullish respondents hardly budged. Defensive put buying spiked, but only briefly. During the week the S&P 500® bottomed and the CBOE Put/Call ratio effectively returned to neutral. For investors who believe the worst has passed, it’s troubling that there was no washout in sentiment. No point of capitulation and despair.

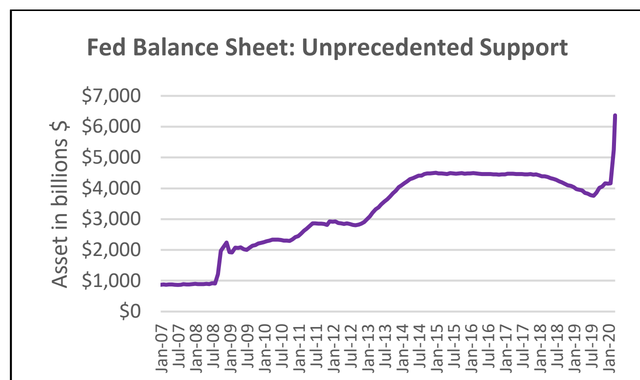
Something Close to Normal?

The rally in risk assets (i.e., rising stock prices, falling credit spreads) has been driven by optimism on three fronts: positive medical developments, massive global policy stimulus, and early indications that the economy may get back on track relatively soon. To be sure, the market is pricing in a lot of prospective good news. However, in the coming months, investors are likely to be disappointed by the progress in any or all of these areas.

On the medical front, the worst appears over for China. The outbreak may also be peaking in the US and in European hotspots like Italy and Spain. But “flattening the curve” is only the start of a long process, not the successful completion of one. In the absence of comprehensive testing, fully containing the virus will prove difficult. Pockets will continue to flare up while second and third waves could emerge over the summer and into fall. The data on reinfection is inconclusive (which is extremely worrisome), and a vaccine remains months, if not a year or more away. With no magic elixir coming any time soon, the economic imperative to get businesses open and workers back on the job will only make containment more difficult. For now, markets seem to anticipate a smooth and rapid improvement on the medical front, but we suspect that containing the virus will take longer and prove more difficult than investors believe.

Monetary policy offers no grounds for complaint, however, as it has now gone to places that were unthinkable just four months ago. We have negative and zero percent overnight rates forever, unlimited asset purchases, and an alphabet soup of lending facilities designed to prop up nearly every form of credit in existence. So far, it has worked. Volatility in the credit and overnight lending markets remains elevated, but fear and panic have dissipated. No wonder stocks have rallied 25%. In the short run, how could they not? In the coming months, however, reality may begin to intrude. Given the size and scope of intervention to date, markets are massively distorted and the price of credit and

value of money have lost almost all meaning. The unprecedented hit to global activity certainly justified a "shock and awe" response, but it hardly provides a healthy foundation for future growth.



Source: Bloomberg, Natixis Investment Strategies Group, Jan. 2007 – April 2020.

The fiscal response has been no less impressive. Europe, after nearly a decade of austerity, has begun to open the spigots. US stimulus in three phases has totaled close to $2.5 trillion – with a potential Phase 4 stimulus package on the horizon. Even though these measures are all positive developments that support the markets, they don't constitute "stimulus" in a traditional sense. They are emergency fiscal actions designed to mitigate disaster, not spur growth – more like the airbags in an automobile than the accelerator. And like airbags, if they are too small or engage too slowly, they provide little benefit. Fiscal measures to date offer only a temporary reprieve for business and workers – and an imperfect one at that. The Phase 3 CARES Act in the US will support families for only a month or two. The emergency business lending program rolled out too slowly and has already exhausted its funds. Much more will need to be done – soon – or we may be back in the same predicament by May. To be clear, policymakers have thrown a life preserver to markets, but they have not rescued the economy.

Last, and most importantly, the jump in stock prices globally suggests that the dominant narrative is one in which the global rebound post-coronavirus is both quick and strong. In February, this V-shaped recovery scenario seemed plausible. The hit to the economy would be sharp, but relatively brief. As a result, risk assets were looking past the current carnage and imagining a return to normal.

Today, that view seems hopelessly naïve. Investors have underestimated how slow the economic recovery is likely to be. Major chunks of the global economy may be closed for two to six months. US unemployment is on pace to exceed 20% in the next two months alone. Many employees who have kept their jobs are working fewer hours. Global trade is plunging. Many small-to-mid-sized businesses will either not receive the help they need, or that help may come too late.

Policymakers have talked about "reopening" the economy, as if it were as simple as flipping the sign on a door. But the longer businesses and factories remain closed, the slower the recovery will be. Many firms will have to "restart" – a longer and more costly process than simply reopening. Production, even after it resumes, will be spotty and staggered by country, region, and industry.

Moreover, the recession will leave scars that last long after the economy reopens. Families and businesses will likely become more circumspect as they work to rebuild their savings and capital. Social distancing will likely remain a part of daily life for many consumers and workers. Some industries will be irreparably altered or impaired. The best hope over the next 12–18 months isn't a return to normal, but a return to ***something close to normal*.**

More Room for Disappointment

No one can say for sure whether "the bottom is in" or if we will revisit the stock market lows of March. It is clear, however, that risk assets have taken a very optimistic view – one that leaves little room for exceeding expectations but plenty of room to disappoint investors.

We remain hopeful that corona carnage is setting markets up for a strong run over the next 2–3 years. However, markets have only begun to digest the economic fallout, so we suspect the next 2–3 months will be more problematic.

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