

## COVID-19 VS. THE ECONOMY

“Black Swan” events seem to always happen when we least expect them. Who would have thought that Saudi Arabia would cut oil production in 1973 and cause oil to skyrocket, and subsequently inflation as well? In 2000 the Technology stocks called “dotcoms” were going strong. Who thought that there was a bubble and, when the dotcoms mostly failed, they would take the stock market with them? In 2007 everything was going great until the financial crisis happened because of leveraged real estate loans and securities. Only a handful of people realized it was coming, most of them unknown people in the industry. The Review & Outlook for the fourth quarter of 2019 was titled “Goldilocks” for very good reasons. Everything was just about perfect. We know from past experience that when things are perfect that is the time to worry. The stock market was very overvalued but justified because of the low interest rates caused by the Federal Reserve that had lowered rates during the financial crisis and kept them low thereafter to spur on the economy while inflation stayed low. The Fed attempted to raise rates in 2018, but when it announced that it was on autopilot to a 3.5% Fed Funds rate the stock market corrected. The Fed was doing the right thing but got cold feet in January 2019 and reversed course. If it had stuck to its guns the overpriced stock market would have pulled back to a more reasonable price, and today the Fed rates would have a greater effect by lowering interest rates than it has.

All of that said, we are where we are. The Fed, the Treasury and Congress have thrown everything they can to fight the economic slowdown caused by the COVID-19 virus. Everyone knows this is unprecedented and we have to be on our toes going forward. Monroe Vos clients predominately, with few exceptions, entered this crisis at between 40-50% equities in their portfolios. We recommended all clients go to 40% equities in October 2018 and remained that way throughout 2019. The stock market took the percentage to between 45-50% in 2019. Returns were very good. January 2020 started off well also. Then in late February and certainly in March 2020, the stock market dove due to the shutdown of businesses mandated by states and cities. March 23 may be the bottom in this market cycle when the S&P 500 hit 2,191. The market has rebounded with the hope that the number of cases and deaths will slow because of “social distancing” with businesses shut and everyone working from home. It is certain that the U.S. has entered a recession in the second quarter.

It is anticipated that unemployment could hit 10-20% and GDP could fall by 30% in the second quarter. The longer the economy is closed, the greater the danger. The market knows this. It has gone up since March 23 in anticipation of what will happen after this is over and taking into account the programs that the Treasury and the Fed have put in place. What it is trying to figure out is will we have a “V-shaped” recovery or a “U-shaped” recovery? Time will tell. No one knows no matter what they say or what comparisons they draw from prior Black Swan events. This is like nothing they have ever seen before.

## **FactSet**

As of April 24, 2020, Factset Earnings Insight has calculated the following from analysts:

### **Earnings: Analysts Expect Earnings Decline of -15.2% for CY 2020**

For the first quarter, S&P 500 companies are reporting a decline in earnings of -15.8% and growth in revenues of 0.1%. Analysts expect earnings decline of -15.2% and a revenue decline of -2.3% for CY 2020.

For Q2 2020, analysts are projecting an earnings decline of -31.9% and a revenue decline of -8.2%.

For Q3 2020, analysts are projecting earnings decline of -16.9% and a revenue decline of -3.4%.

For Q4 2020, analysts are projecting an earnings decline of -7.4% and revenue growth of 0.1%.

For CY 2020, analysts are projecting an earnings decline of -15.2% and a revenue decline of -2.3%.

### **Valuation: Forward P/E Ratio is 19.1, Above the 10-Year Average (15.0)**

The forward 12-month P/E ratio is 19.1. This P/E ratio is above the 5-year average of 16.7 and above the 10-year average of 15.0. It is also above the forward 12-month P/E ratio of 15.6 recorded at the end of the first quarter (March 31). Since the end of the first quarter (March 31), the price of the index has increased by 8.2%, while the forward 12-month EPS estimate has decreased by 11.0%.

At the sector level, the Consumer Discretionary (29.5) sector has the highest forward 12-month P/E ratio, while the Financials (12.8) sector has the lowest forward 12-month P/E ratio.

### **Targets & Ratings: Analysts Project 13% Increase in Price Over Next 12 Months**

The bottom-up target price for the S&P 500 is 3169.65, which is 13.3% above the closing price of 2797.80. At the sector level, the Financials (+22.1%) sector is expected to see the largest price increase, as this sector has the largest upside difference between the bottom-up target price and the closing price. On the other hand, the Consumer Discretionary (+9.1%) sector is expected to see the smallest price increase, as this sector has the smallest upside difference between the bottom-up target price and the closing price.

Overall, there are 10,266 ratings on stocks in the S&P 500. Of these 10,266 ratings, 52.9% are Buy ratings, 41.3% are Hold ratings, and 5.8% are Sell ratings. At the sector level, the Energy (63%) sector has the highest percentage of Buy ratings, while the Consumer Staples (44%) sector has the lowest percentage of Buy ratings.

Keep in mind that the S&P 500 is looking past the bad projections in Q2 and Q3. It always looks forward at least 6-12 months.

## Hoisington

The following commentary is from the Hoisington Investment Management Company “Quarterly Review and Outlook First Quarter 2020”:

### **Is This Time Different?**

Recent articles have suggested that the Federal Reserve and the Department of the Treasury are engaged in Modern Monetary Theory (MMT) or some form of “helicopter money”, the famous Milton Friedman phrase also referred to by Ben Bernanke. The inference is that once the virus is contained, these new efforts will yield different and more powerful economic and inflation results than did the Quantitative Easing periods following the 2008-09 Global Financial Crisis (GFC). Further, the suggestion is that the fiscal policy actions taken this year totaling \$2.7 trillion will be far more effective than the \$2 trillion stimulus package of 2009. Are these assertions that MMT is in place and monetary and fiscal actions will spur economic and inflation rates higher true? The short answer is no.

### **The Monetary System, Yesterday and Today**

The size of the Federal Reserve’s new operations in March was totally unprecedented. The most recent Fed statement (March 25, 2020) noted that the monetary base totaled \$3.9 trillion, up \$700 billion from the recent 2019 low. The increase in the monetary base and total reserves in the four weeks ended March 25 exceeded any four-week period in history and even larger increases can be expected over the next several months. Before the end of April, the monetary base will exceed \$5 trillion, compared with the \$3.4 trillion level established in December 2019.

### **Record Levels of Total and Government Debt Ahead**

The two fiscal virus relief measures that passed in March will raise the budget deficit by approximately 13% of 2019’s GDP, driving the deficit to 20% of GDP, the largest since World War II. The government debt-to-GDP ratio will jump from a record 107% of GDP to well above 120% of GDP. The denominator (GDP) of this ratio will fall sharply and possibly thrust the ratio into a range of 125-130% of GDP. As a result, total public and private debt will surge above the Lehman peak of the GFC. Since rising unproductive debt results in a lower level of GDP growth (diminishing returns), each additional dollar of debt means weakened future economic performance.

The academic research shows that above a 50% ratio to GDP, government debt has a deleterious effect on the trend rate of economic growth and that this effect worsens as the ratio rises. When government debt-to-GDP exceeds 90% for five consecutive years, the U.S. economy loses one-third of its growth against trend. At the expected levels of government debt relative to GDP, the loss should be considerably larger, but no historical record exists to calibrate its magnitude.

Deficits of the magnitude that lie ahead can also be evaluated in terms of the economic equation  $I = S$ , where  $I$  is physical investment and  $S$  is saving out of income. Saving out of income has three components – private, government and foreign. In late 2019, net national saving (the combination of all three) as a percent of national income was just 2%, down from the average of 6.4% since

1929. Private saving was 8.4% but government saving (dis-saving) was -6.4%. In view of the fiscal actions taken to date, government saving could easily drop more deeply negative, resulting in a negative net national saving rate, the first time this has happened in the U.S. economic history since the Great Depression. Thus, physical investment will also decline, resulting in the economy's inability to grow in the future and generate a rising standard of living.

### **Diminishing Returns**

By early next year, total private and public debt could reach a new all-time peak of approximately 405% of GDP, compared with 402% at the time of the Lehman failure. Such estimates are highly tentative and are subjective based on the length of time until the economy can begin on a path to more normal operations. If this tentative assessment is accurate it will mean that significantly less GDP can be generated by adding an additional dollar of debt. This process is formally known as the Marginal Revenue Product of Debt (MRPD). In 2019, a dollar of debt generated about 40 cents of additional GDP. We estimate that the MRPD will fall to 25 cents should total debt soar to 405% of GDP. As the other major economies are also taking on unprecedented amounts of new debt, the marginal revenue product of debt will still be lower in China, the Euro-currency area, the UK and Japan than in the United States. Each dollar of public and private debt in these foreign economies may only be generating 20 cents or less of GDP.

### **Economic Conditions and The Treasury Yield Curve**

In view of the initial conditions when the virus hit, the U.S. economy is facing a deflationary recession. Based on the trends at hand, this downturn will be more severe than the three previous worst post-war recessions of 1973-75, 1981-82 and 2008-09.

This will have a noticeable impact on inflation. Measured from the peak before or during the recession until the cyclical trough, the average decline in the core PCE deflator, the Fed's preferred inflation target, was 432 basis points, with a range of minus 165 basis points for the 2008-09 recession to minus 696 points for the 1981-82 recession.

One of the reasons for the variability in this range was that highly volatile oil prices rose in two of the recessions and although energy prices are not measured directly in the core PCE deflator, they have a strong indirect influence. From peak to trough, oil prices declined 49.2% for the 1981-82 recession, but in all three recessions the average price was virtually unchanged. From the cyclical peak in oil prices to the current level, the drop in oil prices is nearly 72%, unprecedented for a major recession. Extrapolating these trends from previous recessions the core PCE measure could deflate 200 to 300 basis points and possibly more while the broader PCE measure could contract 400 basis points. This means that core PCE could recede to a 1% rate of deflation, with the overall PCE measure deflating at 4% or more.

Once the virus is contained, the output gap, a measure of real GDP relative to its potential will be massive both domestically and globally. A recovery in business activity will occur and may appear to be V shaped but will be at a much lower GDP level than the 2019 measure of activity. In other words, the economy will stagger, not march forward. Five to seven years will likely elapse before the output gap returns to late 2019 level. This suggests that once the cyclical decline

in inflation has occurred, the economy will be mired in a protracted period of mild deflation and that firms with the weakest pricing power will need to try to lower nominal wages, something for which modern business managers have no experience.

Thus, the Treasury yield curve will be anchored close to the zero bound for a very lengthy period. Without the legal and structural impediments to crossing the zero bound, both variables in the Fisher equation (the real rate and inflationary expectations) will tend to push yields toward negative territory.

## **Conclusion**

During 2019 we did not recommend increasing the equity percentage target from 40% because of the very high valued stock market at a 27X P/E ratio and the overleveraged corporate market. Most market pundits thought that the next problem would be corporate debt, especially the non-investment grade debt. We did not recommend rebalancing back to 40% during 2019 as the stock market went up but let the percentage in equities rise with the market (except for the Asset Allocation Strategies in 401(k)/403(b) Plans). We consider 40% equity and 60% fixed income/alternatives to be a neutral asset allocation based on the optimization work that we do. This allocation protects some on the downside but allows upside participation when the market goes up. We will be discussing asset allocation among other things in our quarterly meetings.

We will continue to see volatility in the stock market for the rest of the year as good and bad news about the economy is reported and we approach the November election.

Jamison Monroe  
Chairman & CEO  
Director of Consulting

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- The 2<sup>nd</sup> largest independent registered investment advisor (“RIA”) in Texas
- The 8<sup>th</sup> largest independent RIA in the Southeast
- The 54<sup>th</sup> largest independent RIA in the United States

As reported by *Financial Advisor* magazine in July 2019

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