March 27, 2020

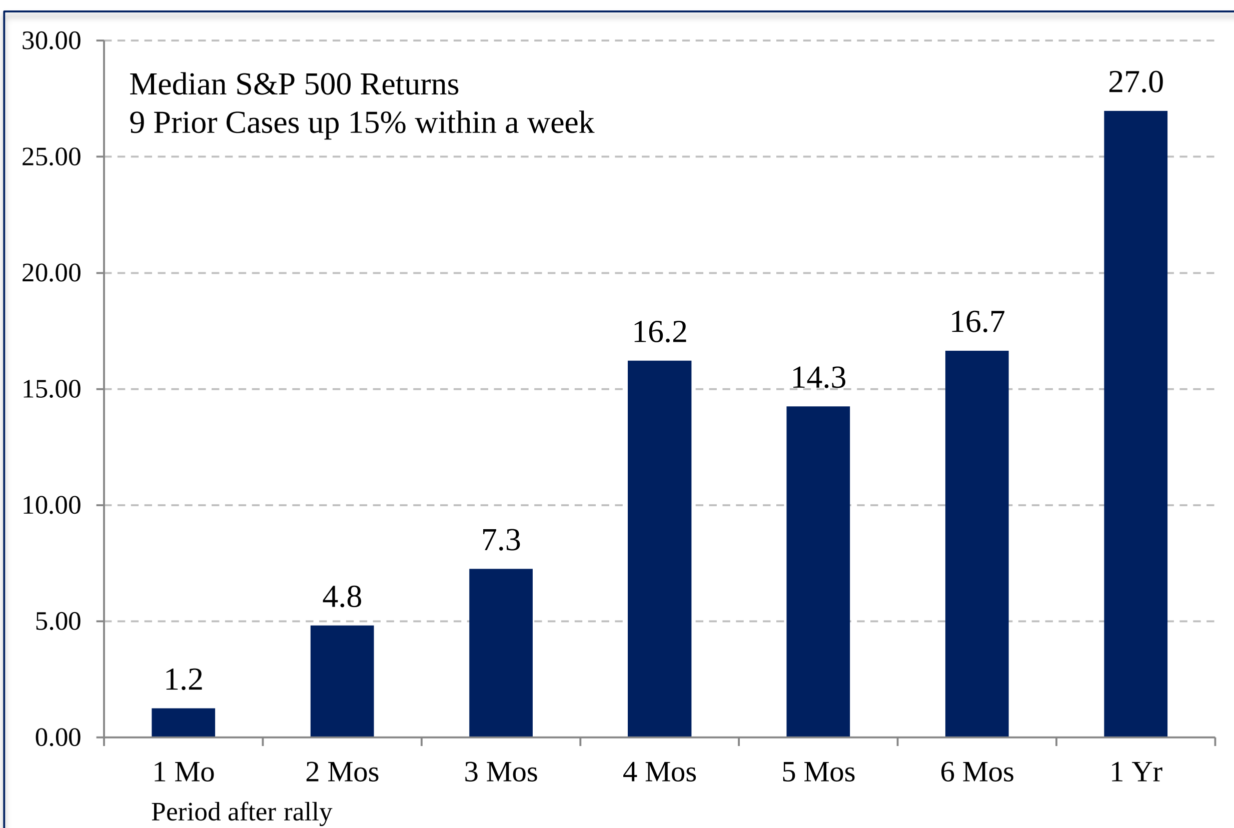
Although virus cases are still accelerating in the US, market volatility remains high, and economic releases like unemployment claims are showing severe economic weakness, our indicators improved this week with the rebound in equities, the Federal Reserve launching unprecedented stimulus, and Congress passing a stimulus bill. Combined, the Fed programs and fiscal spending are over 18% of GDP reflecting a massive effort on the part of the government to try and contain the economic effects of the virus.

Markets

In our last note we wrote that despite the volatility and 30% decline in stocks, we retained our neutral rating for equities. We thought at some point investors would see past the virus-induced economic shutdown to an economic recovery. This week that may have happened. The S&P 500 rallied 17.5%, in just three days, from Tuesday to Thursday. Incredibly, they were the first consecutive days of gains since the decline started in February. The move retraced 1/3 of the full decline since February.

These kind of sharp "relief" rallies are typical in past bear markets and especially in past crashes. In the short-term volatility will likely remain. For instance, in the 9 prior cases since 1928, returns 1 month later had mixed results. However, longer term the outlook is better. 6 months after these cases the median return was +16.7%, with 7 of 9 cases higher.

Chart 1: 17.5% Rally This Week is Positive: 9 Prior Cases 1928 - 2020



Please also read the important disclosures at the end of this report.

Federal Reserve: All In

On Monday morning the Fed announced an unlimited quantitative easing program. Specifically, they set up programs with unlimited funds to support commercial real estate, consumers, small and medium businesses, corporate bonds, consumer credit, and municipal finance. For investors worried the Fed had no "bullets" left, Fed Chairman Powell clarified in a Today Show interview Thursday morning saying "We are not going to run out of ammunition. That is not going to happen."

At $517 billion in the last 4 weeks alone, the Fed program is unprecedented in scope and size. For comparison in scale, the Fed was buying $200 billion per month in March 2009, which was enough to mark the low in stocks. Fed purchases could reach 9% of GDP. "Don't fight the Fed" applies today more than ever.

Chart 2: Fed Easing Unprecedented and Bullish: Over 2x the 2008 Rate

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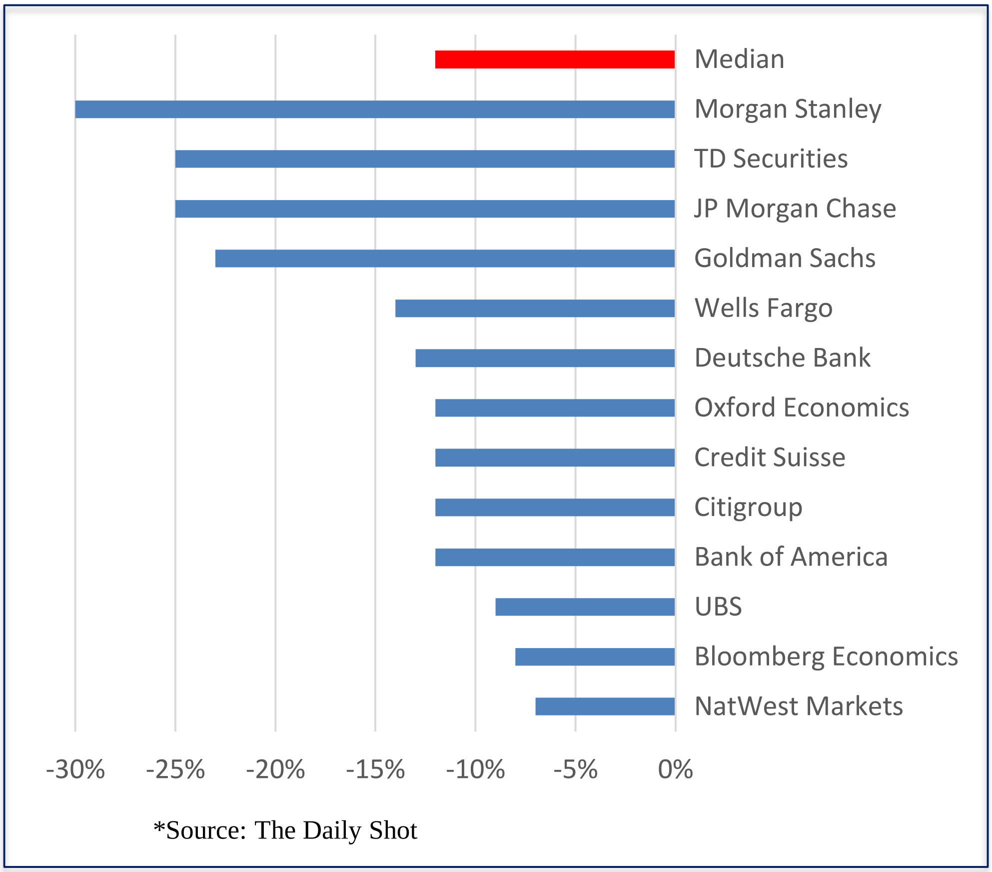
Fiscal Stimulus

On top of the massive Fed move, Congress passed a $2 Trillion spending bill, also 9% of GDP. This aid will help individuals, businesses, and state and local governments. For comparison, the 2008 spending bill was just $800 billion (5.5% of GDP). This aid will help dampen the economic damage in the 2nd quarter, where estimates range from -8% to -30%.

Chart 3: Q2 GDP Growth Forecasts*



Raising Emerging Markets to Bullish 5 Rating

We are raising emerging markets equities to a bullish 5 rating based on the extreme valuation on both an absolute and relative basis. The Shiller P/E ratio for emerging markets is just 10x, lower than any prior time since 1995, even during the 2008 financial crisis. This P/E averages earnings over 10 years to smooth out cycle volatility. We cannot predict the low, but for long-term investors, this is a valuation extreme with the highest expected long-term returns of any area in the world.

The dollar has a strong negative correlation to emerging markets returns. For instance, in 2008 after the last comparable Fed actions, the dollar fell 13% in 2009 and the MSCI emerging markets index rallied 100% from the low. When the Fed buys for their balance sheet, they are directly and rapidly increasing the supply of dollars, so it is logical the dollar would fall in value. This pattern may be repeating again this year, with the dollar down 4% in the last week since the Fed announced QE "unlimited."

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Chart 4: Schiller P/E Ratios Around the World

As of 3/19/20 | Source: GMO

In summary, we are retaining our neutral 3 rating for U.S. and developed equities due to the indicator improvement, and we may raise the ratings if conditions improve further. In 3 of the 4 prior largest quarterly GDP declines, the S&P declines were less than the 34% the S&P declined already this year. In other words, the stock market may have already priced in the economic weakness we will see ahead.

Thank you for your support and please contact your advisor with any questions.

Michael Schaus
Director of Market Research

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