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ON OUR MINDS

The Four Questions

Michael A. Tyler, CFA®, Chief Investment Officer

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Three weeks ago, we published "The Fear Pandemic," in which I articulated four markers of a bear market bottom. As it turns out, that very day (March 23) may in retrospect turn out to have been the stock market's nadir; it's been almost straight up ever since. In fact, the S&P 500 has already recouped about half of its plunge, and now sits only 19% below its all-time peak. This begs the obvious question: Did we miss the evidence we were seeking, or is the stock market getting ahead of itself? Much has happened in these past three weeks, so a fresh look at the evidence may suggest some answers.

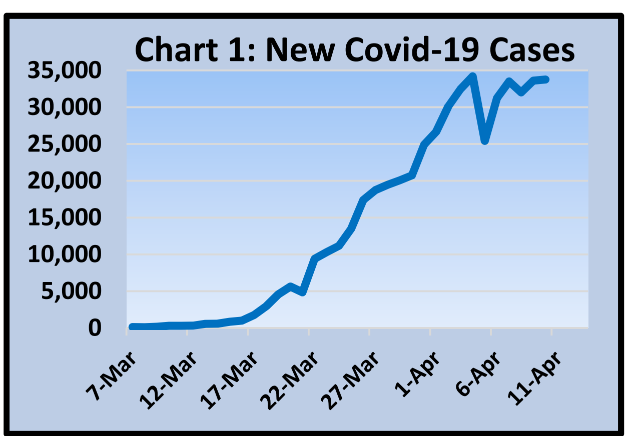
The four questions I asked on March 23 were:

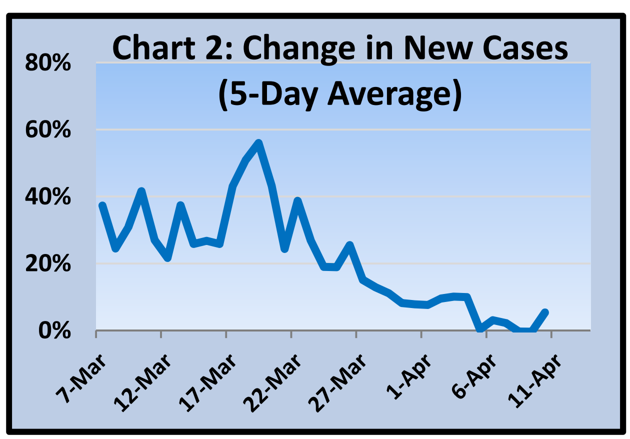
- Has the number of new Covid-19 cases in the U.S. begun to decelerate or even decline?
- Has the federal government enacted effective fiscal and monetary relief?
- Have corporate earnings expectations adequately reflected the economic downturn?
- Has stock market volatility subsided?

Three weeks ago, the answers to all of these questions were emphatically *no*. Is the situation meaningfully different today?

Epidemiology

Chart 1 shows the number of new U.S. Covid-19 cases on a daily basis since the beginning of the outbreak, and Chart 2 shows the five-day rolling *percentage change* in the number of new cases. Both charts offer glimmers of hope: The number of new cases seemed to slow recently, although the pace picked up again last week. It's important to remember that the data is for a very short period of time and is at best an approximation of the true state of the pandemic. We don't know, for example, whether shortages of tests have resulted in undercounting the number of cases, or whether the rise in new cases last weekend was just a statistical fluke.

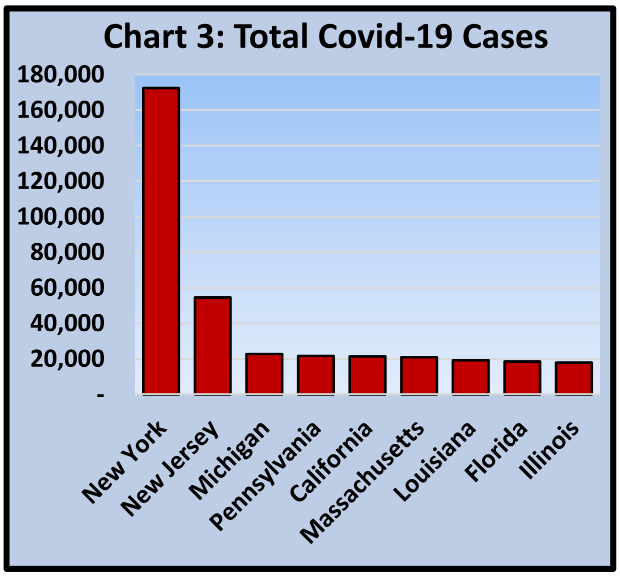


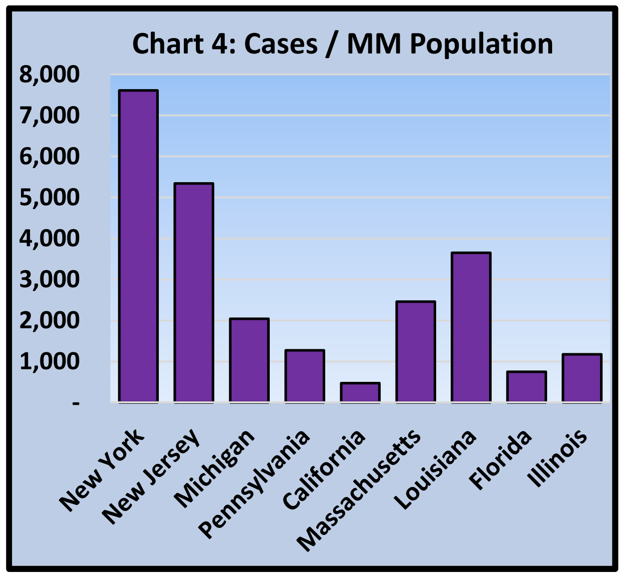


Source (both charts): Worldometers

One way of assessing the accuracy of this data is to compare the experiences of individual states. Chart 3 shows the total number of Covid-19 cases in the states most affected by the epidemic as of April 10, and Chart 4 shows the number of cases per million inhabitants (infection rate). The charts show just how different New York is from the rest of the country, which has skewed the national data shown in Charts 1 and 2.

New York is both the most populous and most densely populated city in the country, and the Covid-19 virus thrives in crowded places where it's easy to spread; so it's no surprise that New York State has by far the largest number of cases, nor that it has the most cases per million inhabitants. What is truly shocking, however, is that the New York numbers are off the charts on a global scale, too: The state now has both more cases and a higher infection rate than any other entire country in the world.[1]





Source (both charts): Worldometers

The critical question implied by these two charts is therefore why there have been so few cases in states like California, Texas, and Florida (among others), and whether they will continue to lag far behind the Big Apple. These less-affected states seem to fall into two categories: the West Coast and everywhere else.

California's experience is especially noteworthy: San Francisco is the nation's second most densely populated major city and Los Angeles is the second most populous, but the Golden State has only about 6% as many cases per million inhabitants as New York does; the most likely reason for California's success is the early action taken by Governor Gavin Newsom and Mayors London Breed and Eric Garcetti to enforce stay-at-home guidelines.[2]

[1] To be strictly accurate, the tiny city-states of San Marino and Vatican City both have higher infection rates than New York, but those rates reflect fewer than 350 cases combined.

[2] Washington State, which had some of the first cases in the U.S., also took early physical-distancing action and appears to have kept its infection rate very low.

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Even if San Francisco and LA can sustain low infection rates, it's less clear that other major urban areas – including Boston[3] – will be as successful. Massachusetts and other states did not implement stay-at-home guidance in a timely fashion, and the results of their delays are becoming evident. The infection rate in Massachusetts has doubled just in the last week despite stay-at-home orders, and it's tripled in Rhode Island. If a sudden surge in cases can happen in New Orleans as shown in Chart 4, it can also happen in any other metropolitan area. In other words, while the apparent slowdown shown in Charts 1 and 2 is encouraging, it doesn't mean we're anywhere close to out of the woods yet.

So can we affirmatively answer the first of the four questions? Has the number of new Covid-19 cases in the U.S. begun to decelerate or even decline? At this point, the answer seems to be a cautious *maybe*, but there is also legitimate reason to be wary of a re-acceleration nationally (especially if stay-in-place restrictions are lifted) or of new pockets of contagion in previously unaffected areas.

Monetary and Fiscal Policy

The Federal Reserve has unleashed essentially unlimited liquidity to ensure that the nation's banks and securities markets can function normally and remain solvent until Covid-19 is subdued. These programs include backstopping the commercial paper and money markets; eliminating bank reserve requirements; activating currency swap lines with other central banks; providing liquidity and buying loans originated by commercial banks; buying debt directly from corporate issuers; buying municipal bonds; and much more.

These are not "bailout" programs as some commentators suggest; they are necessary programs to ensure that banks remain afloat, that borrowers won't be bankrupted by short-term interruptions to their cash flows, that international trade channels continue to supply goods and services across borders, and that financial markets function smoothly.[4]

With respect to fiscal policy, Congress has enacted three separate bills to address Covid-19, and is already talking about a fourth. Most importantly, the CARES Act appropriated over $2 trillion to keep the economy afloat during a time of massive shutdowns. While there is undoubtedly some waste and pork in the legislation, the big dollars are going where they are needed: to help companies meet their payroll expenses, and to help unemployed people until their jobs return.

It's still an open question whether the relief package will be fast enough, big enough, or durable enough to see the country through to a clear recovery. The initial rollout of the Small Business Administration loan program was hampered by faulty websites, late delivery of key paperwork, and overwhelmed bankers. The distribution of $1,200 checks to eligible residents may not happen for another week or more, and some people may not receive money until early May. Congress may yet need to devise a more efficient and faster delivery mechanism.

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[3] Boston is the third most densely populated major city in the country, but its density is just over half that of San Francisco and only about one-quarter that of New York.

[4] You do want your ATM to produce a stack of Jacksons when you put your card in the slot, don't you?

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So can we affirmatively answer the second of the four questions? Has the federal government enacted effective fiscal and monetary relief? Although the effectiveness of the CARES Act remains to be seen, it's fairly clear by now that the Fed's actions have been successful in maintaining the functionality of the nation's financial system (after a few wobbles). The markets are giving the government's actions the benefit of the doubt, which seems to be reasonable.

Corporate Earnings

Macroeconomic data is generally reported with a meaningful time lag, so the most recent government reports have had a wistful feel of nostalgia for when the economy was humming a month ago; but they are useless as forward-looking tools. Corporate earnings reports are also retrospective, covering the three months just ended; but the management commentaries accompanying the reports are among the most prospective information investors typically get.

Over the next four weeks, most large publicly traded companies will report their first-quarter financial results. We already know the results will be bad; Wall Street probably won't care unless the economic downturn has uncovered previously unseen company-specific problems. Management teams probably won't be providing explicit "guidance" forecasts as they typically have done in recent years. Instead, we will be looking for hints about how they are planning for the next few months; how they are handling payroll and debt service issues; what they are seeing in their supply chains; when they expect the economy to reopen (and whether that will be gradually or rapid); and more.

So can we affirmatively answer the third of the four questions? Have corporate earnings expectations adequately reflected the economic downturn? We don't know yet, but we hope to see a much clearer picture emerge over the next few weeks.

Market Volatility

Bear markets often begin with rising levels of volatility: As the prevailing mood oscillates from fear to relief with any given day's news, the amplitude of daily price movement accelerates because trading activity becomes one-sided. As emotions swing more decisively to fear and then to panic, volatility accelerates. Only when sellers are thoroughly exhausted and buyers are utterly despondent does volatility collapse. That is the point at which markets bottom.[5]

Getting to that bottom often involves several false starts, characterized by bear market rallies in which stock prices can jump 20% or more. In these rallies, the bulls muster their courage with every bit of good news, but the next dose of bad news drives prices down again. At a true market bottom, even good news fails to elicit a positive response.

[5] Another sign of the bottom is when investors start wailing at their portfolios with Gregg Allman's despair:

> *My friends tell me that I've been such a fool / But I had to stand by and take it, all for loving you*
> *Drown myself in sorrow as I look at what you've done / But nothing seemed to change*
> *Bad times stayed the same / And I can't run.*
> *Sometimes I feel, sometimes I feel / Like I've been tied to the whipping post*
> *Tied to the whipping post / And oh Lord I feel like I'm dying.*

The CBOE VIX volatility index is a useful measure of the collective mood on Wall Street. It is calculated, in essence, as a ratio of bearish put options to bullish call options. A complacent bull market (such as prevailed in 2019) shows low VIX levels because more investors are buying call options; conversely, a frightened investment community piles into put options, pushing the VIX higher. Chart 5 shows the VIX index over the past year; it peaked in late March at 82, almost double its previous record high. Since then, the VIX has fallen to 42.

Chart 5: VIX Index

Source: StockCharts.com

The combination in the past three weeks of rising stock prices and falling VIX levels is typical of early-stage bull markets. But investors shouldn't mistake "falling" for "low" VIX readings: Volatility remains very high. It's simply not normal for daily stock price movements to be exceeding 2% on such a regular basis – let alone the 5% and even larger moves we've seen recently. Every big daily advance is an indication that Wall Street still has some appetite for risk, and every big daily decline shows that not everyone has soured on the future.

So can we affirmatively answer the fourth of the four questions? Has stock market volatility subsided? While the recent direction of the VIX is encouraging, it's still elevated and prices still swing too much every day; after its recent rally, the stock market is vulnerable to more bad news.

Conclusion

Stock prices have rebounded from their March 23 low for several reasons, and justifiably so. The epidemiology curve has improved in many places, including parts of the United States. The scale of government response has been unprecedented; the Fed's action, in particular, has restored market function and provided badly needed liquidity. Volatility is fading.

But the road ahead is still daunting. The country remains at high risk of re-opening too soon and seeing a second wave of Covid-19 infections. We still don't know how badly corporate America has been damaged, though we do know that every extension of stay-in-place guidance threatens to wreak more permanent damage to the economy. We haven't yet seen whether the CARES Act will work, and early reports of overwhelmed websites and call centers hasn't been encouraging. And there are still too many bulls roaming the trading floors of Wall Street.

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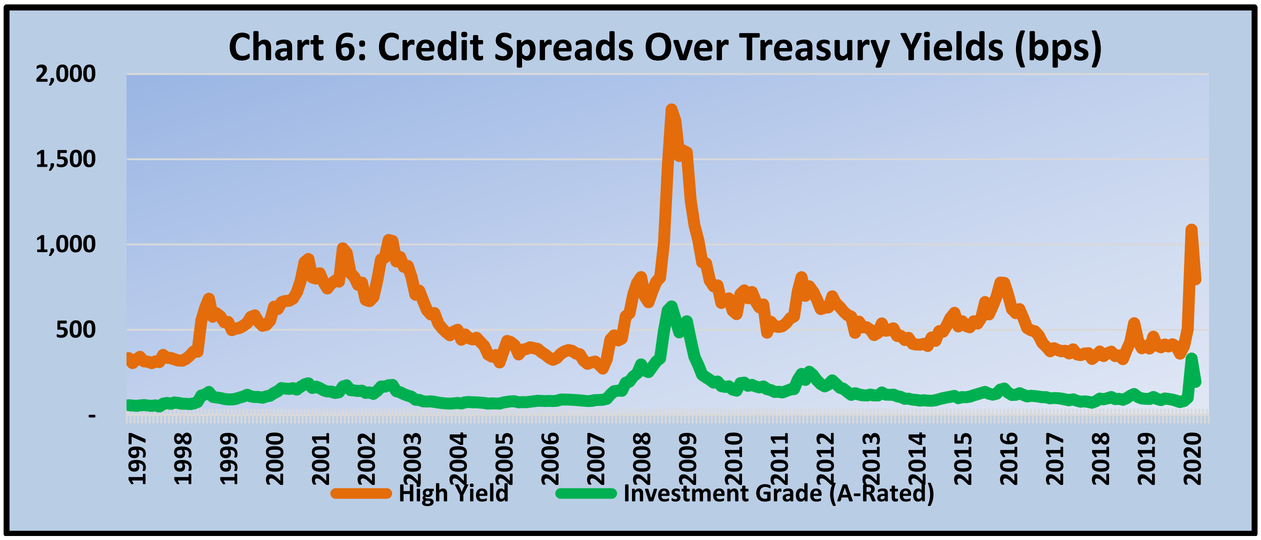
In short, we're not yet ready to shift our positioning. Since early January, we have maintained a defensive position with respect to both asset allocation (stocks vs. bonds) and positioning within each asset class. We debate this positioning every day, but we don't yet have enough evidence to persuade us to become more aggressive.

All the same, the wild gyrations in many markets have created tactical opportunities. For example, as Chart 6 shows, the credit spreads for corporate bonds skyrocketed in early March.



Source: Bank of America Merrill Lynch, St. Louis Fed

Credit spreads represent the extra interest rate required by corporate bond investors in comparison to Treasury debt of similar maturity. Until early March, that spread was about 100 basis points (one percentage point) for investment-grade debt and about 300 basis points for high-yield debt; by March 23, those spreads had gapped to 350 and 1,100 bps respectively – higher than during the dot-com recession of 2002. We took advantage by switching some of our lower-risk mortgage-backed debt into corporate bond funds. In a similar vein, we have also taken advantage of bargain prices to buy some high-quality equity funds in recent days. These trades are tactical moves, not a shift in strategy; we are maintaining our long-term time horizon, remaining fully invested, but still mostly defensive.

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