March 12, 2020 Market Update

On 11 March the US market began discounting a recession, although arguably the bond market had moved there two weeks ago when the yield curve inverted and long rates began to crater to levels heretofore unseen. A recession, even a short one, produces earnings declines and that is what the market is currently partially discounting. I say partially because fair value at the close of the market (3/11/20) suggest another flat earnings year rather than a decline. The market has yet to price in an earnings decline due to a recession. There is likely further room to fall as market panic sets in—after all it was only three weeks ago that this looked to be a China-centered hit. And we are at the beginning of containment measures in the US with much uncertainty. Amazingly we have yet to see any data point which reflects the contraction in demand which is surely underway.

Price action in and of itself could be a threat to markets. We don’t know the extent to which the stress in energy credits will bleed into other parts of the credit markets. Financial, industrial, and hospitality spreads have already widened considerably, threatening a different kind of contagion. With households most exposed to equities in a generation, the negative wealth affect could quickly work its impact on the real economy through a decline in consumption. These economic impacts are surely around the corner given the violence of the recent downdraft.

Nevertheless, while we stand at the precipice of the real economic impact to the US economy, investors must take a deep breath and think clearly. Now is the time to think about modeling trajectories of the hit to the economy. A V-shaped trajectory suggests a bottom could be near as the market will begin to price in the recovery which could begin three to six months on the other side. A U-shaped trajectory, which suggests some credit dislocation in addition to a demand destruction, suggests further downside ahead of us as markets price in a recession and a larger hit to earnings. An L-shaped recovery, the most pessimistic scenario likewise suggests further downside from here. Ultimately the supply chain disruption and the fear of contagion could hasten a deglobalization with a permanent shaving of growth potential.

To put fresh capital to work today, investors need to believe the economic impact in the US, even if deep, will be limited to at most six months with signs of improvement by the third quarter. For those who fear a credit or a deglobalization event, patience is called for. With more available tests comes more information and knowledge is power in modeling the impact to the economy. The uncertainty itself on a multitude of issues: the virus trajectory, containment strategies, the hit to the economy, credit involvement have all worked to create this violent move. If anything, the power of asset class diversification was lay bare during recent weeks and should be a reminder for investors to be disciplined in both directions.
Chart 1: S&P 500 Market Downturns in Post-World War 2 Recessions  
*sorted from left to right by highest to lowest downturn in percentage terms*

# trading days calculated assuming 252 trading days per year. Data as of 1:40 pm EST on March 12, 2020. Source: BNY Mellon using data from Bloomberg.

Chart 2: S&P 500 Performance through 20%+ Bear Markets Since 1970*

*Dashed lines correspond to non-recessionary bear markets, all others correspond with recessions. Data as of 1:40 pm EST on March 12, 2020. Source: BNY Mellon using data from Bloomberg.*
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