ARIA | CAPITAL

INVESTMENT INSIGHT

A weekly look inside the investment world.

> ***Employers only handle the money. It's the customer who pays the wages.***
> *Henry Ford*

Friday, 15 May 2020

In this week's Investment Insight

Predicting the unknowable
Following the shortest bear market in history (from February 19 to March 23), equities have staged a massive rally. Over the past week, however, the rally has paused as investors face the near impossible task of assessing the longer term outlook - there are simply too many unknowables at this point to make accurate short-term predictions. Investors are wondering whether markets have bottomed or will instead revisit their March lows. Some commentators, including some with vested interests in markets falling, have expressed the view that the US market is substantially overvalued. To gain confidence in a bear market low, equity investors traditionally need some visibility into the scale of a recession's damage to corporate profits. In other words, investors typically need to see an end to the earnings downgrade cycle to believe that the worst is behind them. But equity market behaviour with respect to earnings expectations can differ markedly across cycles, as an examination of the last three US recessions and associated earnings and market cycles makes clear. In *The Inside Track* we take a closer look.

Six months is a long time
Ever pricklish, Donald Trump's irritability has noticeably increased in recent days. In the earlier part of his presidency stimulative policies helped to drive markets higher. Now he faces the prospect of November polling at a time of record unemployment and unprecedented economic hardship. As Harold Wilson quipped, a week is a long time in politics, let alone six months, so the die is far from cast. If things aren't going well, Trump's instinctive reaction will be to blame somebody else. China will do nicely, but the stock market mightn't like it. In *Pic of the Week* we look at the current polls.

Newswire
Some interesting nuggets from this week's newswires.

Market view
A visual snapshot of recent market performance.

The Inside Track: Predicting the unknowable

The timing of stock market movements doesn't necessarily correspond to movements in current economic conditions. JPMorgan's Patrick Schöwitz looked at previous recessions to see how those experiences might guide us in the current situation.

In the 1990-91 U.S. recession, 12-month forward EPS - the metric equity investors tend to focus on most - only began to fall once U.S. equities had already hit their cycle low. By the time EPS bottomed some 8% lower, stocks had already fully regained their pre-recession levels. Following the bursting of the dot-com bubble in March 2000, equity market timing was quite divorced from earnings fundamentals, as in this case markets lagged, experiencing a long unwind of bubble valuations. Forward EPS expectations peaked in November 2000, and fell by around 20% over the following 12 months. However, equities kept falling for nearly another year, not bottoming until October 2002. In the global financial crisis (GFC) of 2008- 09, markets and earnings expectations both moved much faster and were more in synch during the decline. Earnings expectations collapsed following the Lehman Brothers bankruptcy in mid-September 2008, falling by roughly a third between October 2008 and May 2009. In this period, equity market levels and earnings were fairly synchronised: markets began to recover in March 2009, roughly two months before EPS expectations hit bottom.

How does today's crisis compare in this historical context? Given the swiftness of the COVID-19 shock to economies and markets, the GFC seems the closest parallel. As societies around the world have gone into lockdown, business activity has collapsed along with equity earnings forecasts, which now stand at -20% for the S&P 500. As recently as March, just two months ago, bottom-up consensus anticipated positive earnings growth, 7% for the S&P 500 and 8% for the global ACWI. In our own forecasts, we expect roughly a 30% decline in U.S. earnings, with an even steeper plunge in cyclical regions such as Europe.

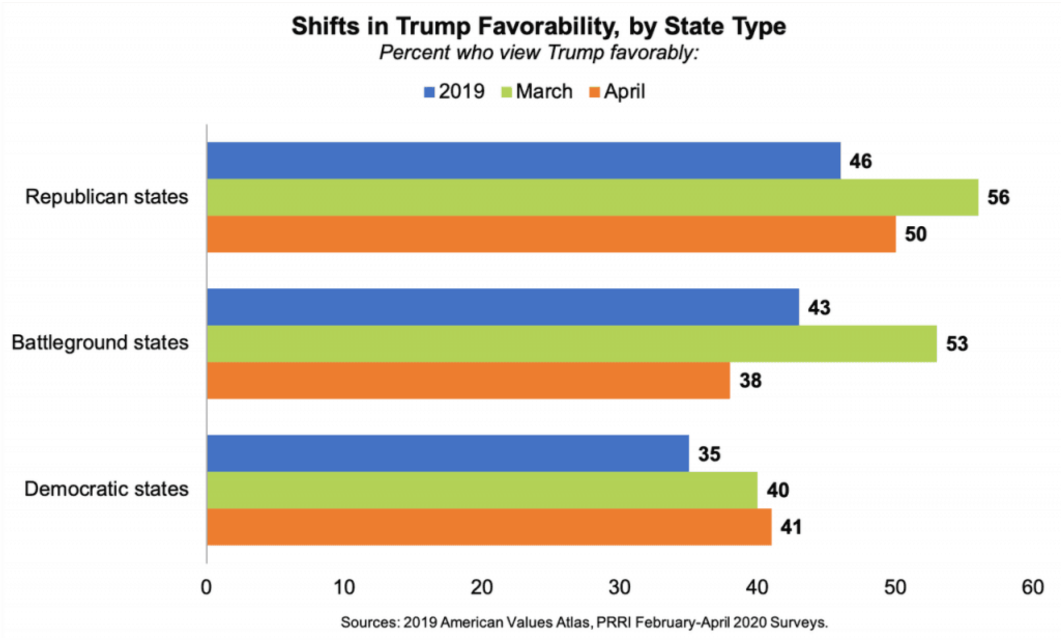
There's a silver lining here: If our ballpark estimate of a 30% drop in 2020 U.S. earnings is roughly correct, then we probably have already seen more than half of the required downgrades, and with virtually all of it happening in just the last two months! If downgrades continue at their current pace, earnings forecasts could reach the low for this cycle over the next month or two. In that case, the downgrade cycle would have lasted a mere three to four months - yet another speed record for this cycle. It would also put the equity market low in late March well within the range of the historical experience of earnings and market cycles discussed above and support the idea that late March did in fact register the low for this market cycle. We note, too, that just as 2020 earnings growth expectations have declined, expectations for 2021 have begun to improve, reflecting positive base effects and an assumption that an economic recovery will be underway in the second half of this year. Of course, that's no sure thing, but it does seem likely; an economic recovery in 2H is our base case scenario. As the prospect of strong growth in 2021 starts to loom ever larger on the horizon, investors will likely begin to look at sharply rising 12- month forward growth numbers as well.

Pic of the Week: Six months is a long time

While a rash of recent polling shows Vice President Biden leading President Trump, national polling this early in the election cycle is seldom reliable. With little clarity about the trajectory of the virus – and the extent to which voters may hold President Trump responsible for the economic fallout – it is too soon to draw any real conclusions, except that like in 2016, it most likely will be another close election.

While national polls garner significant attention, the presidency will be determined – once again – by a handful of swing states. Most important in this election cycle are Arizona, Florida, Pennsylvania, Michigan, and Wisconsin. It is notable that two of these states – Michigan and Pennsylvania – have disproportionately shouldered the economic burden of the pandemic fallout, seeing nearly one in every four individuals of its labour force file for unemployment. Nevertheless, Trump's approval ratings across all five states have held up for now, but his popularity and the economic metrics in these states are worth monitoring.

Investors should expect more sabre-rattling on China in the coming months. Not only are there legitimate questions about China's handling of the coronavirus outbreak, but President Trump – perhaps rightly – sees the issue as a political winner for his re-election. Recent polling suggests that the majority of Americans have a more negative view of China than at any time in recent history. It is too early to say whether the tough talk turns into more punitive action against China, although we would expect the US to pursue other actions – such as export controls, visa and travel restrictions, and sanctioning of individuals – before increasing tariffs given the potential harm to the economy and because the US has already implemented tariffs on $360 billion of goods from China. We also cannot rule out President Trump pulling out of the Phase 1 trade deal and escalating the trade war once again.



Newswire

...on Monday
Banks, mining and travel shares continue to bear the brunt of investor worries.

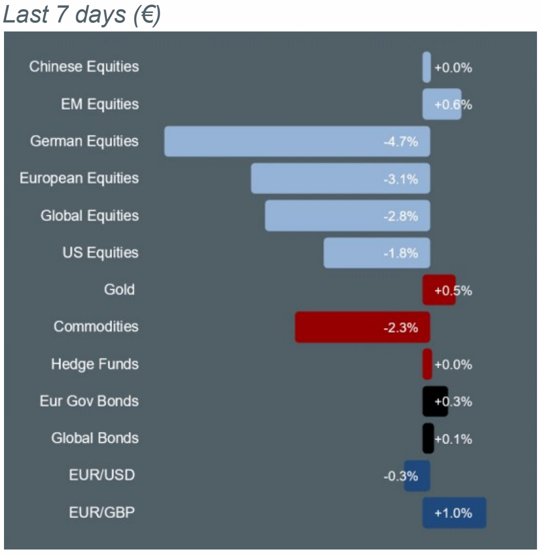
...on Tuesday
European shares move modestly higher with telecom stocks leading the way as Vodafone maintains its dividend.

...on Wednesday
Federal Reserve Chair Jerome Powell pushes back against the notion of deploying negative interest rates.

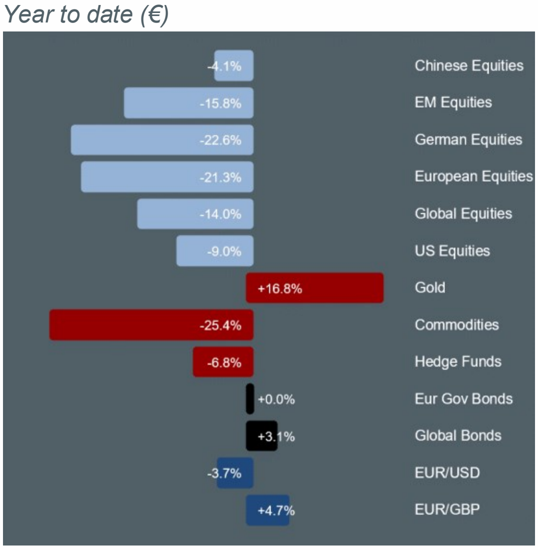
...on Thursday
European markets fall led by travel and auto stocks.

Market View

Last 7 days (€)



Year to date (€)



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