COVID-19 and the Equity Markets

March 12, 2020

Equities Are Pricing Fear and Lack of Visibility

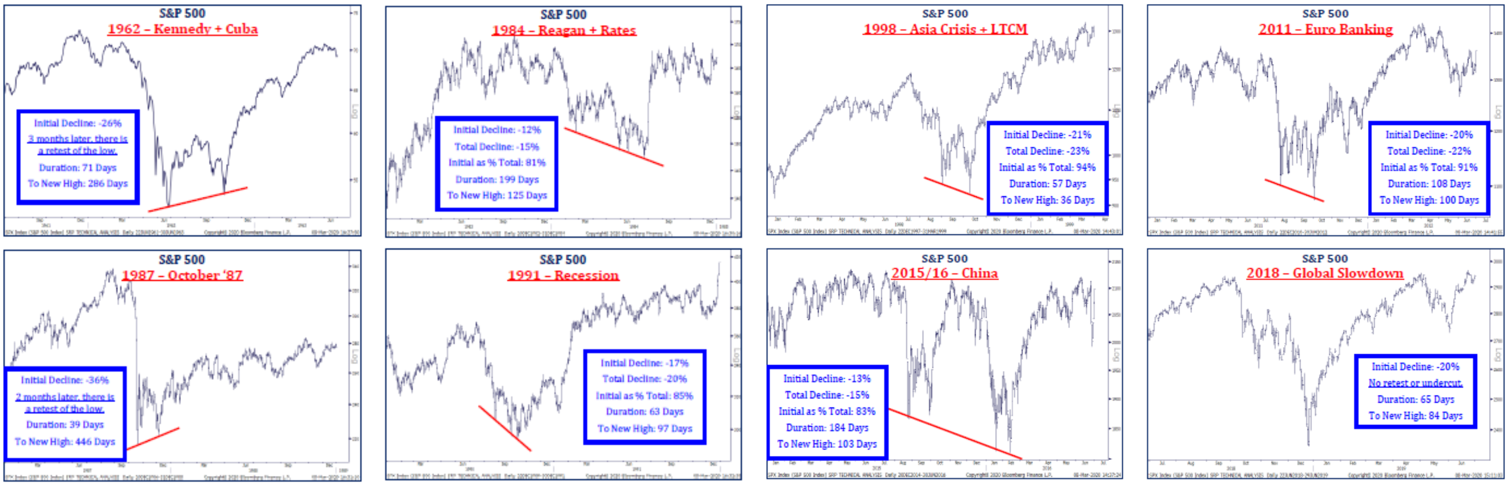
Markets hate uncertainty and, to say the least, there is an abundance of it right now. It is impossible to yet know the ultimate impact of Coronavirus on the global and US economies either in terms of severity or duration, therefore investors are frantically trying to price in different scenarios.

When fear is running high, investors often look at extreme scenarios instead of the most-likely case and react with a short-term view. Although over more extended periods markets are a forward-looking discounting mechanism, we expect high volatility until the light at the end of the tunnel is more clearly visible. As mentioned in March's Review and Outlook, finding a bottom is often an unstable process with large swings in both directions taking place within short windows of time.

Bottoming is a Process….

1962/1984/1987/1991 Examples

1998/2011/2015/2018 Examples



Source: Strategas Research Partners

Source: Strategas Research Partners

Strong Policy Response is Anticipated

Appleton believes that a combination of monetary and fiscal policy measures, along with a rigorous public health response, will be needed to regain confidence. Markets rallied on March 10th partly on hopes of a substantial fiscal stimulus package, but rapidly gave those gains back and more as tangible details have yet to be provided.

What ultimately gets implemented via executive order, Congress or the Federal Reserve remains uncertain, yet we believe support drawn from a combination of extended unemployment benefits, guaranteed paid sick leave, payroll tax cuts, and tariff relief will materialize alongside additional monetary policy easing. Badly needed healthcare resource funding should also provide stimulus.

The equity markets were quick to shrug off the Fed's inter-meeting 0.50% rate cut based largely on the premise that cheaper money will not solve a fear-driven healthcare issue.   Although most observers, including us, expect another sizable cut at the regularly scheduled March 18th meeting, we also anticipate aggressive government spending over the coming weeks. The need is growing given the severity of day-to-day commerce restrictions, including just announced temporary European passenger travel ban.

Mitigation Demands Patience

The accompanying graphic from Bloomberg highlights the magnitude of challenges our healthcare system faces if the virus continues to spread at a high rate without an effective public mitigation response. Monetary and fiscal policy can help maintain fluid credit conditions, but it does not directly address the need for hospital beds, medical professionals and a return of normal business and consumer activity. As the graphic suggests, slowing peak virus levels is critical to reducing widespread fear, thereby giving consumers and investors a badly needed dose of good news.

Figure

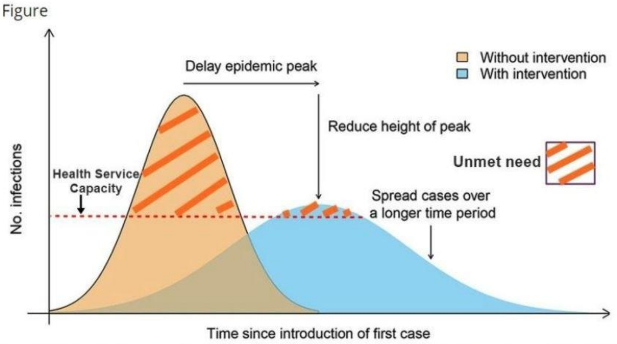


Figure 1: Intended impact of enhanced hygiene and social distancing measures on the COVID-19 pandemic adapted from Fong.[8]

Source: Bloomberg

Look Towards Latter Part of 2020 for a Rebound

The risk of a recession (two consecutive quarters of negative growth) has undoubtedly risen over the past two weeks, with acute weakness likely in Q2 and Q3. As this point, we believe this is a pronounced but transient economic shock that should lead to a reasonably timely rebound. We will be watching for signs of layoffs and protracted declines in consumer spending, as that could signal a more problematic and sustained demand-side shock. Preventing this is a fundamental policy objective and we feel sizeable monetary and fiscal stimulus is forthcoming.

Markets are cyclical and at times highly volatile, but the effects of the virus will ultimately subside, after which we expect a resumption of trendline economic growth. It’s also worth remembering that markets look ahead and may start to rebound before growth resumes. Unfortunately, we are likely in for an unsettling few months as investors digest the daily headlines.