Macro

Why markets are floating past the economic collapse

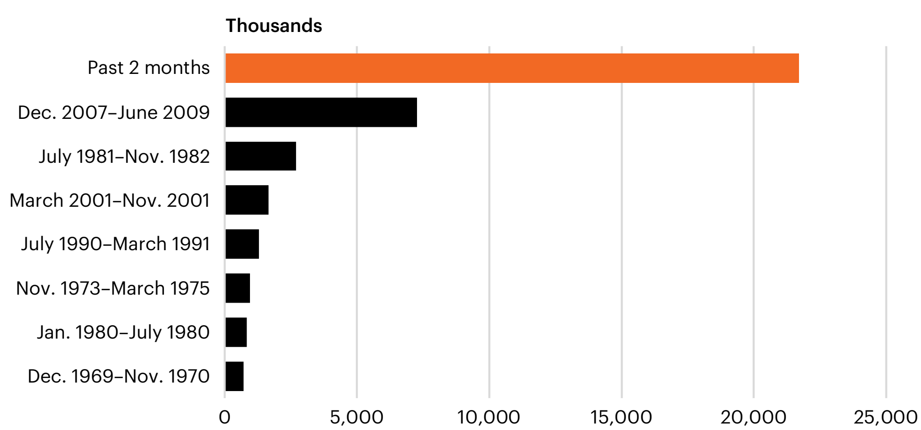
April saw employment fall by 20.5 million people and the unemployment rate jump to 14.7%, the most severe job losses since the Great Depression. The S&P 500, however, had its best month since 1987. We break down recent market performance in the face of an epic economic downturn, as well as what investors need to prepare for next.

KEY TAKEAWAYS
- A historic dislocation in labor markets is underway, and we assume the economy entered a recession in March 2020.
- S&P 500 performance has been strong, but is largely driven by the FANG+ stocks, masking weaker broad market performance.
- As the recession evolves, investors will likely look for increased diversification and have reduced tolerance for volatility.

Markets are experiencing a moment of optimism after suffering the sharpest drop into a bear market in history. The S&P 500 rose 12.7% in April, the biggest monthly gain since 1987, and is up 28.8% from its bottom on March 23. The economy, meanwhile, is in apparent freefall. The COVID-19 pandemic caused widespread shelter-in-place orders that shuttered businesses and caused massive layoffs. GDP fell -4.8% in Q1, the biggest drop since the Great Recession, and expectations for Q2 are the stuff of nightmares. Estimates range from a decline of -15% to -50%. Anything in this range would be a record-setting quarterly contraction.

The economic pain is most obvious in the deep dislocation the labor market. Job losses have been staggering and in only two months dwarf job losses in prior recessions. The unemployment rate now stands at 14.7%, up from just 3.5% in February. Often, workers who lose their jobs simply opt to leave the labor force, which has fallen by more than 8 million over the past two months, a further hit to output.

PAYROLL LOSSES IN RECESSIONS



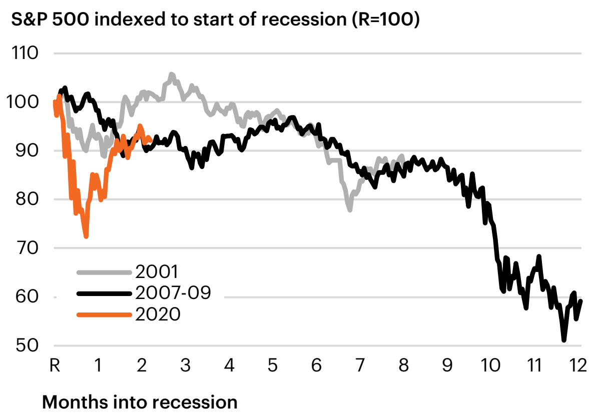
Source: Bureau of Labor Statistics, FS Investments, NBER, as of May 8, 2020.

Dissecting market optimism

Solid market performance in the face of such a weak economy has led to a lot of questions—and perhaps a little disbelief—about where this optimism is coming from. The rally in the S&P 500, the large-cap bellwether tied to so many retail and institutional portfolios, could use a little dissection.

First, markets should be careful about reading too much into the past seven weeks of gains. The S&P 500 is down -14.9% from its February 23 high[1] despite a strong recovery in April and is down -10.8% year to date. In the past two months, markets have been exceptionally volatile. The drop in valuations in February was so acute that the recovery over the past month has seemed especially positive. If we had slowly drifted from March 1 valuations to today, we would simply be on a more normal track for the start of a recession.

EQUITY PERFORMANCE IN RECESSIONS



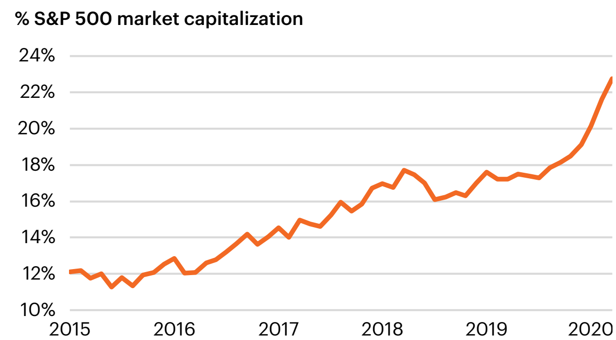
Source: Macrobond, FS Investments, NBER, as of May 7, 2020. Graph assumes recession began in March 2020.

A look at prior recessions shows that periods of equity gains are not at all uncommon. We have no specific forecast of equity markets; uncertainties surrounding the arc of the pandemic are too pervasive. But every recession but one since 1970 has experienced an equity market rally of over 10% before eventually hitting a recession-low between 3–6 months before the recession ends.

This leads to another critical point: We are only in the early innings of this economic cycle. Markets may be latching onto some optimism that some states are reopening. Yet, as we recently wrote in The Great Reboot, the deep job losses will likely lead to sluggish spending and growth throughout 2020. The average recession lasts for a year. A gradual lift-off from current shelter-in-place regulations may not be the same as a broad economic recovery.

Finally, it is hard to ignore the fact that recent equity gains have been hyper-concentrated in a small number of the largest tech companies. The FANG+ Index is up 10.7% year to date, while an equal-weighted S&P 500 is down -18.7%. We often remind investors that the equity markets and the economy are not the same. Now we should layer on that the FANG+ is not the equity market. The median stock price is down -25% from its peak, which is perhaps a better reflection of pervasive economic uncertainty.

FANG+ EQUITY GAINS DOMINATE S&P



Source: Bloomberg Finance, LP, FS Investments, as of May 7, 2020. FANG+ Index components are Facebook, Amazon, Netflix, Alphabet, Apple, Microsoft and Tesla.

Seeing the bright side

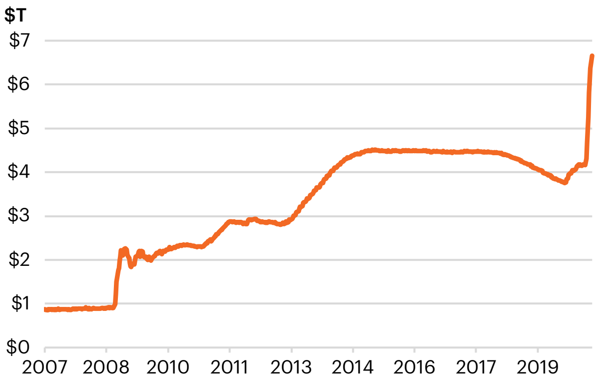
It is equally important to examine the factors driving equity markets higher. First and foremost are the unprecedented monetary and fiscal policy responses which have clearly had a positive impact on market psychology and calmed the most acute volatility of February and early March.

The Fed has historically responded to recessions by slashing interest rates, typically more than 400 bps. This time, the Fed had limited ammunition on the interest rate front. With its policy rate starting the year at 1.50%–1.75%, the Fed quickly cut rates to 0.00%–0.25% and began aggressively adding to its balance sheet with a fresh round of quantitative easing.

The rapid and extraordinary expansion of the Fed's balance sheet, which we expect to continue for some time, has been an undeniable support to markets. In addition, the Fed added broad-reaching facilities to support a variety of credit markets, the implementation of which helped arrest the freefall in financial markets.

1 As of May 7, 2020.

FED BALANCE SHEET, TOTAL ASSETS



Source: Federal Reserve, as of May 7, 2020.

Another support for equities is low interest rates. Because the Fed is buying U.S. Treasury debt, the government is able to issue hundreds of billions of dollars of fresh debt without causing interest rates to spike. Indeed, with the 10-year Treasury averaging 0.66% over the past month and cash earning 0%, investors are going to be hard-pressed not to consider going back into the equity market to some degree.

FOMO vs. the recession

The disparity between market performance and the economy is top of mind for investors these days. At the root of this is most likely the concern that they have missed out on the rebound. However, if we have learned one lesson from multiple economic cycles, credit cycles and bouts of volatility, it is the danger of catching a falling knife. In other words, you can't look back at a graph and be upset that you missed a bottom. Investing is a marathon, not a sprint.

Right now, we may be seeing some of the worst of the economic data. April will likely—hopefully!—be the cruelest unemployment report of this cycle, and job losses will hopefully slow going forward. However, the economic ramifications of the COVID-19 pandemic are only just beginning to unfold. Markets are naturally forward looking, which can easily swing both ways. Should the pandemic last longer, or should a surge of new cases cause another round of shutdowns, markets could react with fresh volatility.

Finally, the idea that markets "can't fight the Fed" is a false premise. Fundamentals still matter, and right now the future is less certain than ever. During the earnings season that is just winding down, fully one-third of companies abstained from giving 2020 guidance (another unprecedented event—or rather, non-event). For investors, this is like trying to navigate a plane through the Himalayas without windows or a good map. We expect the Fed to continue to be active with policies that pull us away from the cliff of a financial crisis. But the economy is facing severe challenges which will feed through to company balance sheets, revenue and profits for the next several quarters at least.

The fear of missing out is strong right now. But for investors, the recession will likely have a bigger psychological impact that could continue for months. The day-to-day uncertainty of seeing friends, neighbors and family become unemployed or perhaps lose their business, on top of the continued health crisis, will increase the desire to limit losses and reduce the tolerance for volatility. The very human desire to time the market should not overshadow the long-run investment goals of diversification and income, which could become even more important during the economic challenges in the months ahead.

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Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economy and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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