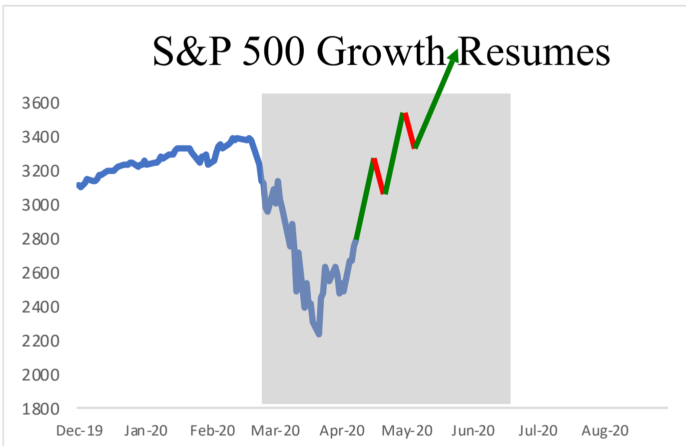
Market Commentary

04-12-2020

Market Bottoms & Recessions

It is not too soon to start thinking about what the “other side” will look like. Life after the Pandemic. Some are already planning for it - an instant recovery, economic prosperity and no more Pandemic.

The chart in the middle of the page sums up what many people think will happen.



Hypothetical forecast of market action. This is not a prediction or advice or our opinion on where the market twill go. This is our interpretation of how some may feel the market could perform.
Source: Ycharts.com; Format, CIS

Unfortunately, that is not likely to be what awaits us on the other side.

Once the euphoria about surviving the Coronavirus wears off, investors are going to find themselves knee deep in a nasty recession.

Investors will quickly realize the market has several hurdles to clear. A major recession, re-starting the broken economy, questionable consumer demand & trust, a potential housing bust and oh yeah… a possible return of the coronavirus. This Commentary will deal with one of the issues, the relationship the market has with recessions.

Recessions are not new or rare. There have been 14 since 1930. Some were longer than others, some deeper, but all part of the natural economic cycle.

Data from The National Bureau of Economic Research (NBER) shows that the average Recession lasted 1 year, 2 months. This is a data point to remember.

This is likely to be the most anticipated recession in US history because we created it. The closings of restaurants and non-essential businesses will have an immediate and un-measurable impact on the economy. The reason it is un-measurable is because nobody really has any idea what will happen. Estimates for 2nd quarter GDP range from 0% to a decline of 50%, and everything in between. It is like economists around the country are trying to see who can come up with the scariest number.

At Cornerstone, we are referring to it as the “Artificial Recession”, but with real world ramifications. It is artificial because it is the direct result of proactive Government policies that were obviously going to cause a recession. How could shutting down businesses and stay-in-place orders not cause an econoic slowdown?

Since we know a recession is coming, does that make it better? Not really. Many are acting like it is already over. But it has barely begun.

Many people have become tired of doom and gloom predictions. The virus was supposed to kill hundreds of thousands of Americans. Thankfully, it didn’t even come close.

So now when people hear about how bad the economy and market are going to get, they react with a “ho-hum…. heard it before”. It’s like weatherman’s warnings of a blizzard coming, but you get only a dusting. After a while, you don’t run out to get milk and bread. And then a big one hits to remind you why you should take the weatherman’s forecasts seriously.

The warnings about the economy and market should be taken seriously. Tens of millions are out of work and don’t know when they will go back to work, if at all. That is going to have a huge ripple effect throughout the economy.

So when should investors expect the market to bottom, or has it already? By looking at past recessions we can get an indication of what to expect.

When does the market bottom in a recession?

	No. of Times	% of Time
Near Beginning	2	14.30%
Middle	5	35.70%
Near End	6	42.90%
Went up	1	7.10%

We created the chart above with data from NBER. This should give investors a good idea of when markets bottom in a recession.

This table would indicate that a short recession with the market bottoming in the beginning of the recession is not likely. Here’s a breakdown of what we glean from the table.

First, markets tend to bottom in the 2nd half of a recession, usually towards the end.

To put a finer point on it, markets have bottomed near the beginning of a recession only 2 times, that is **14.30%** of the time. And the times the market did bottom early in the recession, it did it in the **third month** of the recession, not the first month.

On the other hand, **markets have bottomed in the middle to second half of the recession 78.60% of the time**. The odds of the market bottoming in the 2nd half of the recession are **5.50 times greater** than bottoming in the beginning of the recession.

The March low may have been the low for the year, but the odds are against it. A market that bottoms in the 1st month of a recession has never happened before in the US.

Second, we can be pretty confident that the March to June recession forecast has little chance of being accurate. The average recession is over 1 year long and many predict this recession will last until the end of the year, if not longer.

Third, there are still too many variables to accurately forecast the economy and markets at this point.

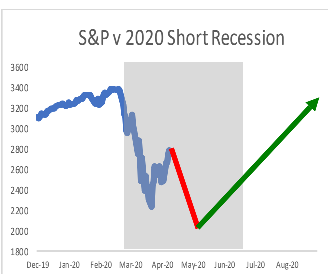
- When will the virus be over?
- When will new cases go to zero?
- Will the virus come back again in the fall?
- When will everybody be tested?
- When will there be a vaccine?
- When will there be a cure?
- How high will unemployment go?
- When will everyone be back to work?
- How long will the recession last?
- How many companies will go bankrupt?
- How bad will the housing bust be?
- What will the long term impacts be?

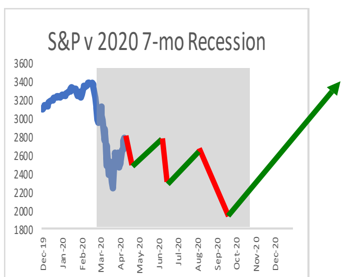
There are a lot of educated guesses here, but no answers.

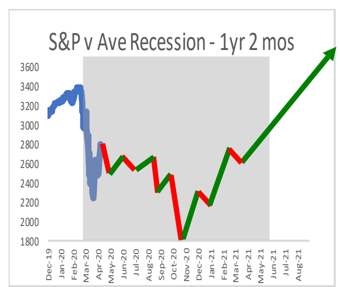
We believe the key to everything is the vaccine. Once everyone gets the vaccine, people will have the confidence to go to the store, restaurants, ball games, and generally live a normal life.

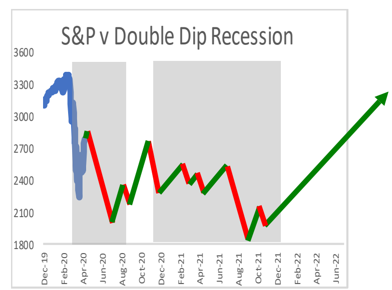
But we will still be cleaning up the debris caused by the virus. Defaults on loans, mortgage defaults, housing slump, bankruptcies, both business and personal. If those won't weigh on the market, I don't know what will.

Realistic Expectations of the Recession and the Market









Let me say right off the bat that these are 4 hypothetical illustrations out of literally millions of possibilities. The data is from Ycharts (Blue lines) and the red and green are our hypothetical projections. Recession is grey area.

Short Recession - This chart shows a recession that ends in June, 2020. We believe it is the least likely scenario, but one that investors seem to be betting on. Even still, we show what a market low in the 2nd half of the recession could look like. (Remember, 78% of the times, the market bottoms in the 2nd half of the recession)

7 Month recession - This would be a recession that lasted until October, 2020. A higher probability, but still well below average. However, combining all the money the Fed is throwing at the system and an election in November, I could make a case for a recession ending in October.

In this scenario, the market trades sideways for a while before bottoming towards the end of the recession.

Average Recession - 1yr 2 mos - This is the average length recession. Several economists have forecast the recession will extend into 2021. So this is a possibility. This illustration shows the market bottoming in the middle of the recession.

Double Dip Recession - This is also a possibility. It has happened a few times in the past, most notably in the early 1980's.

In our view, the first recession is due to the coronavirus and its immediate economic impact. But the economy struggles to right itself, only to knocked back down again by the long term effects of the pandemic, namely, business bankruptcies, a housing slump, debt defaults and maybe a second wave of the virus. The 2nd recession would be longer term and not benefit from the Fed's current bailouts.

Conclusion:

We have no favorite scenario. We let the numbers tell us what has happened and what has the highest probability of happening again. A second half market low seems probable. We are keeping our powder dry, looking for extraordinary opportunities as they present themselves and setting ourselves up for the eventual recovery. - ***JJR***