Weekly Market Insights

March 30, 2020

A Positive Conclusion? Perhaps.

This past week, the equity markets were exceptionally volatile. Happily for investors, the week ended positively. The Dow gained 12.84%, the S&P was up 10.26% and the NASDAQ increased 9.05%.

If the financial crisis hasn't focused everyone's attention on the virus, then the announcement that Prince Charles and Boris Johnson testing positive will.

As we all know, the force behind the market's fall has been the progress of the coronavirus and what steps governments are taking to help. Many people have been writing about the epidemic, but not much is actually known. Therefore, readers must be very critical in their reading.

Investors, analysts and policy makers are concentrating on three vital areas: the virus, the economy—both global and national—and financial markets. We will leave the virus to the medical experts and concentrate on the latter two.

The Federal Reserve

The Federal Reserve has, up to now, been bearing the brunt of keeping the economy and markets afloat. The Fed Chair, Jerome Powell, announced that the Fed will do whatever it takes and whatever actions are necessary to restore stability to the financial markets. The Fed has enormous firepower at its disposal, about $4 trillion. The Fed is not about to lose its firepower. But, the Federal Reserve cannot do it alone.

The Economy

There is no doubt that the global economy is slowing at an alarming pace. Unemployment claims have exploded, and analysts expect other economic indicators to follow. This is to be expected. The important questions are how bad and how long? A large part of the answer lies in the question, when a cure for the virus will be found. As we wrote earlier, that question, at the moment, is unanswerable. A reasonable view is it will remain unanswered for quite a while.

In the United States, the newly minted stimulus package will help quite a bit. It is vital that the various programs are enacted quickly, and, unfortunately, there is no guarantee that will happen. Each delay will intensify the economic damage. An important part of the program that we can follow is putting money into the hands of consumers. The coronavirus and the economic downturn has injected a lot of fear into consumers. It sounds odd, but in this case, we want consumers to overcome fear and spend, rather than save, the funds they receive. It is a textbook case of the 'Paradox of Thrift.' Even though it may be a positive for an individual family to save, if large numbers of families hold on to their stimulus check rather than spend it, aggregate demand will not increase and that part of the plan will go for naught.

Last week, we wrote it is possible that this recession may be shorter than many analysts believe, with a fast financial/market recovery. The reason is the uniqueness of this recession. It was not brought about by an economic failure as in 1929, but by an outside force. This past week, former Fed Chair Ben Bernanke expressed a similar opinion. He argued that he sees a very sharp recession, followed by a "fairly quick rebound." He, of course, has qualifications. "Nothing is going to work, the Fed is not going to help, fiscal policy is not going to help if we don't get the public health right…making sure the risk has declined sufficiently before putting people back in the line of fire." That, of course, is a big if, and there seems to be some doubt in the Administration's view about when to send people back to work. Mr. Bernanke's view was reinforced by St. Louis Fed President, James Bullard, saying he also expected a 'big short-term hit but a strong rebound.'

Weekly Market Insights (cont'd)

Another reason investors may hope for a strong economic recovery is the system of supply chains, many of which are recovering in China. When the recession starts to recede, there will be a great need for massive inventory accumulation. Resupplying inventories will give a large boost to the economy. The importance of inventories is explicitly addressed in an economic theory arguing business cycles are created by inventory cycles.

The other point concerning supply chains is, after this difficult experience with supply lines, corporations may decide to build supply chains closer to home. If this does occur, it will act as a private sector fiscal policy boost.

Europe is facing the same crisis, but solving their economic problem will be far more difficult. Their unique problem lies in the fact that the European Union is a far less cohesive than the United States. For instance, Christine Lagarde, President of the European Central Bank, has argued for the same fiscal/monetary policy action as in the United States. Her predecessor, Mario Draghi, has said the same. There is, at the moment, considerable blowback from some Northern European capitals. So, at best, there will be a delay.

The Equity Markets

Equity markets have been battered by both the realization of the damage to the economy and the disjointed government response to it. This combination has led to a dramatic drop in market liquidity. The past week was an excellent example. Investors were encouraged by the massive stimulus package. It is certainly remarkable considering both the size and breadth of the package. When the Senate finally passed the program, the equity markets had a remarkable rally. On Friday, the market reversed and fell 3.1%. Although this is a substantial drop, it could have been expected. Many investors thought the market had rallied too much and too quickly. The problems had not been resolved, although some relief was in sight. Another reason for Friday's weakness may well have been traders' book squaring. Book squaring is when short term traders clear their books, whether short or long, locking in profits and eliminating risk. No one knows what may happen over the weekend, so they protect themselves. Short term traders were instrumental in the rally and also Friday's fall. Few traders would want to carry long positions into the weekend with so much uncertainty.

One other point which may be a signal that the extreme fear may be subsiding—during times of extreme economic and market fear, there is a tendency for global investors to move into U.S. dollars and dollar-denominated securities. We saw this in the remarkable strength of the dollar. This appears to be moderating.

Conclusion

Alas, there isn't, at this time, a concrete conclusion. We have painted an optimistic picture of the future. This was an attempt to paint how a positive outcome may come about, not a forecast. Even if this comes to fruition, we may very well see the market test the lows of the past few weeks.

- Michael Olin Clark
moclark@1919ic.com

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