Market bottom: Getting closer?

Further declines could be likely but there may be a light at the end of the tunnel.

Originally posted March 24, 2020

Jurrien Timmer I Director of Global Macro I LinkedIn: jurrien-timmer-fidelity I Twitter: @TimmerFidelity

Key takeaways

- The big questions are when will the growth rate of new COVID-19 cases peak and will the fiscal and monetary policy response be enough?
- The significant drop in the stock market has been made significantly worse by the oil price war between Saudi Arabia and Russia, as well as forced deleveraging and a soaring dollar.
- Earnings estimates for the next few quarters tumbled last week, and will likely fall further in the coming weeks.
- While further US stock market declines are quite possible or even likely, my technical work suggests that the momentum of this decline may diminish in the weeks ahead.

As financial markets continue to come to terms with the sudden devastating demand shock across much of the world, made systemically worse by a massive liquidation among leveraged investors, we continue to look for answers to the following questions: When will the growth rate in COVID-19 cases level off, and will the fiscal and monetary policy response that is now underway be enough to help people and markets navigate to the other side of this crisis?

We know things are bad and getting worse, as evidenced by the now incoming economic and earnings data, but what we don't yet know is how long it will remain bad and how quickly (or slowly) the world can recover once the pandemic has been contained. Only when we get a handle on this can the markets start to stabilize and can volatility and inter-market correlations start to come down. It's at that point that we can start pricing in a recovery.

Fidelity INVESTMENTS

The next 3 weeks may well seem like an eternity

With Italy now presumably (hopefully) nearing the peak of the COVID bell curve, and the US possibly 2 to 3 weeks behind Italy, hopefully by mid-April the growth rate in new cases in the US will start coming down. However, even if that best-case scenario comes to pass, these next 3 weeks may well seem like an eternity. My daughter, an ICU nurse, just told me that her ICU has now been designated as the COVID ICU at her hospital. For her, the next 3 weeks are bound to seem even longer.

Oil, deleveraging, and the dollar put more stress on markets

Making matters exponentially worse for the markets was the massive de-risking by hedge funds and other leveraged players, as well as the collapse in oil prices resulting from the Saudi-Russian price war. This has led to a contagion among all asset classes not seen since the Great Financial Crisis (GFC) of 2007–2008, with cash (in dollars) being the only asset class left unscathed. High-yield credit spreads are now at distressed levels (above 1,000 bps), and the high-yield energy credit spread is at 2,260 bps. At these levels, we may see casualties in the oil patch.

A soaring dollar was also a big part of the stress on markets last week, as were sharply rising real rates. High demand for dollars caused supply to dry up, and the lack of liquidity threw markets into disarray. In times of crisis, all correlations go to one, (the asset classes move in the same direction) and that certainly has been true this time around. For some form of calm to return to the markets, the dollar needs to weaken, real rates need to come down, and credit spreads need to stabilize. It wasn't happening last week, but hopefully it will happen this week.

Significant stimulus coming from the Fed, Congress close behind

You can tell from the price action that the stock market's plumbing is distressed. Fortunately, the Fed is throwing everything it has at the problem, and doing so much faster than it did in 2008 (back then it still had to come up with the programs that it now can rapidly re-deploy). The Fed's balance sheet has now risen to $4.67 trillion, up from $4.31 trillion just a week ago and $4.16 trillion 3 weeks ago.

And now things are moving on the fiscal side as well, with Congress reaching a deal with the White House to provide a stimulus package worth $2 trillion. That's about 9% of GDP which, added to the already-large budget deficit (4.5% of GDP), will put a hole in the budget of about 14% of GDP. The deal was struck early in the morning Wednesday, March 25.

Between the Treasury and the Fed, there are now estimates that the total monetary/fiscal policy response will be on the order of $4 trillion. Those are eye-popping numbers and hopefully they will be enough.

Earnings estimates take a hit

As of last week the S&P 500 had declined 32.8% from intraday high to intraday low, and 29% from February's close to last Friday's close.

On the earnings front, last week brought the first sizable hit to estimates for companies in the S&P 500. It surely won't be the last. It looks like Q2 is where the fastest declines are likely to be.

For the S&P 500, the forward P/E ratio has come down to 13x–14x and the equity risk premium (the difference in valuation between stocks and government bonds) is near 700 bps. Whether this valuation haircut has discounted enough bad news is unknowable in real time, but at this point I would say that a lot of bad news is priced in.

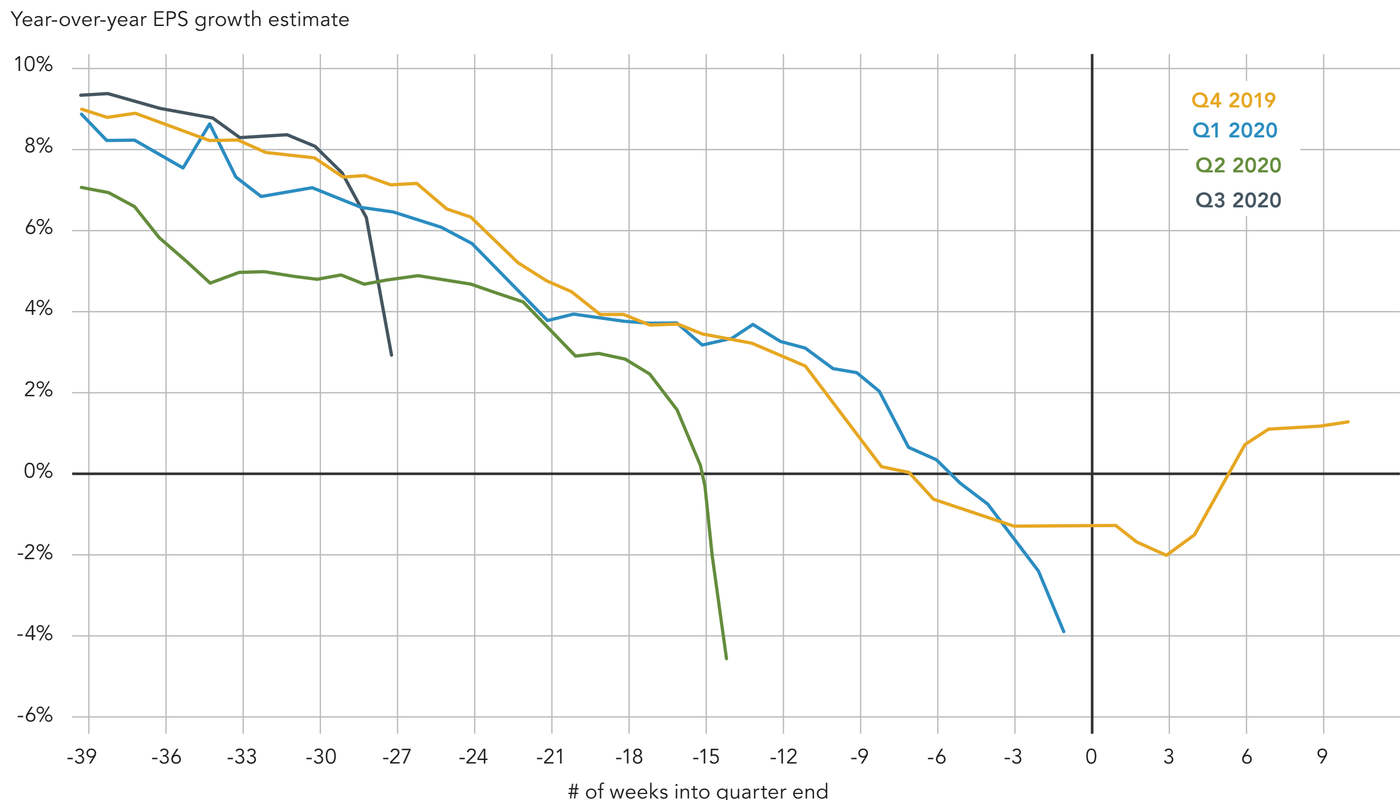
A technical look under the hood

To say that the stock market is now extremely oversold would be the understatement of the year, in my view. Analyzing technical indicators to compare recent events to previous dramatic downturns may yield some clues about what's to come.

A measure of market breadth (i.e., measuring the number of stocks going up against those going down) in the S&P 500 shows that last week's new highs minus new lows (–80%) was the **third lowest in history**, after 2008 (–82%) and the 1930s (which includes the 1929–1932 and the 1937–1938 periods). This means more stocks have been hitting new lows, compared to those hitting new highs – and not only that, last week's number is absolutely stunning given that the S&P 500 is "only" down 33%. In 2008 when this number hit –82% the S&P 500 was already down 47%. This puts some context around the declines that have been taking place in the markets these past few weeks. The index-level data don't do it justice.

With the exception of the 1930s (which produced an 86% decline followed by the Great Depression), by the time the market became this extreme, most (but not always all) of the downside was complete. The 1930s were different because the Fed committed a policy error by tightening reserve requirements, and there were no fiscal circuit breakers. This time we are getting an overwhelming policy response of up to $4 trillion.

EXHIBIT 1: S&P 500 earnings estimate progression



1987, 2008, and 2020

How does 2020 compare to 1987 and 2008? The 1987 crash was a one-off price and valuation reset that was not associated with an economic downturn (although plenty of people back then thought a depression was coming). The GFC was a massive balance sheet recession, which by its very nature (de-leveraging) took many months to unfold.

Which one will it be this time? Clearly the current downturn is an economic event, which leaves the 1987 analog as a less-than-desirable one. But there are also many differences between now and 2008, the current market contagion notwithstanding. The GFC was a trifecta of financial excesses (banks, households, corporates), which took a long time to unwind. Plus, the policy response was much slower. My guess is that we are somewhere in between these 2 analogs.

Green shoots?

My conclusion from all these indicators is that, unless we are heading into another Great Depression (unlikely in my view with $4 trillion of helicopter money on the way), these extremely negative breadth readings are more consistent with a market in which the bulk of the declines have already occurred, as opposed to one where they are yet to come. That doesn't mean the lows are in by any means.

We are likely at least several weeks away from the peak rate of change in either COVID-19 cases or the resulting economic distress. But the market has moved very quickly to discount this shock. Some lower lows may well lie ahead in the coming weeks, but my expectation based on the above is that the momentum of the decline is probably peaking.

My glass-half-full assessment is further supported by the potentially large rebalancing that is coming our way over the next week. My back-of-the-envelope calculation shows that a 60/40 stock/bond portfolio in mid-February has now become a 51/49 portfolio, entirely on the basis of market action. This is very large drift in a very short time. Given the many trillions of dollars in assets that follow some sort of multi-asset class approach, the coming rebalance could well be in the range of a few hundred billion.

Author

Jurrien Timmer I Director of Global Macro,
Fidelity Global Asset Allocation Division

Jurrien Timmer is the director of Global Macro for the Global Asset Allocation Division of Fidelity Investments, specializing in global macro strategy and tactical asset allocation. He joined Fidelity in 1995 as a technical research analyst.

Views expressed are as of the date indicated, based on the information available at that time, and may change based on market or other conditions. Unless otherwise noted, the opinions provided are those of the speaker or author and not necessarily those of Fidelity Investments or its affiliates. Fidelity does not assume any duty to update any of the information.

Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Investing involves risk, including risk of loss.

Past performance and dividend rates are historical and do not guarantee future results.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

All indexes are unmanaged, and performance of the indexes includes reinvestment of dividends and interest income, unless otherwise noted. Indexes are not illustrative of any particular investment, and it is not possible to invest directly in an index.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

This is original content from Fidelity Investments in the U.S.

The source of all factual information and data on markets, unless otherwise indicated, is Fidelity Investments.

Commissions, trailing commissions, management fees, brokerage fees and expenses may be associated with investments in mutual funds and ETFs. Please read the mutual fund or ETF's prospectus, which contains detailed investment information, before investing. The indicated rates of return are historical annual compounded total returns for the period indicated including changes in unit value and reinvestment of distributions. The indicated rates of return do not take into account sales, redemption, distribution or option charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds and ETFs are not guaranteed. Their values change frequently, and investors may experience a gain or a loss. Past performance may not be repeated.

Certain Statements in this commentary may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "plans", "believes","estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and assuming no changes to applicable tax or other laws or government regulation. Expectations and projections about future events are inherently subject to, among other things, risks and uncertainties, some of which may be unforeseeable and, accordingly, may prove to be incorrect at a future date. FLS are not guarantees of future performance, and actual events could differ materially from those expressed or implied in any FLS. A number of important factors can contribute to these digressions, including, but not limited to, general economic, political and market factors in North America and internationally, interest and foreign exchange rates, global equity and capital markets, business competition and catastrophic events. You should avoid placing any undue reliance on FLS. Further, there is no specific intentional of updating any FLS whether as a result of new information, future events or otherwise.

From time to time a manager, analyst or other Fidelity employee may express views regarding a particular company, security, and industry or market sector. The views expressed by any such person are the views of only that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Any such views are subject to change at any time, based upon markets and other conditions, and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity Fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity Fund.

The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of The McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

Third-party marks are the property of their respective owners; all other marks are the property of Fidelity Investments Canada ULC.

© 2020 Fidelity Investments Canada ULC. All rights reserved. Fidelity Investments
is a registered trade-mark of Fidelity Investments Canada ULC.

US: 923131.1.3 CAN: 301799-v2020325

Fidelity
INVESTMENTS®