



The Reopening

May 2020

- As the economic, political, and social costs of lockdowns increased, segments of the U.S. economy gradually reopened in May.
- By contrast, the rebound in markets has been anything but gradual: from its low in March, the S&P 500 Index has rallied over 40%, bringing it to within less than 6% of its all-time high.
- The growing disconnect between markets and the economy can be largely explained by excitement over the reopening, the relative unattractiveness of cash and bonds as long-term alternatives to stocks, and a tidal wave of liquidity from central banks. A surge of speculative mania is a final factor.
- Collectively, these forces have the potential to drive markets higher in the short term, but high valuations and a host of risks—including a second wave of COVID-19 infections in the fall—should not be overlooked.

The Reopening

Even as the American economy is reopening tentatively and gradually, the markets have come back with a fast and furious rush. From its low in March, the S&P 500 Index has rallied over 40%, bringing it to within less than 6% of its all-time high. The technology-heavy NASDAQ 100 Index hit an all-time high on June 4. High yield bonds are down just 4.7% for the year. All other risky assets rallied for the month, paring their losses for the year substantially. This impressive rebound has occurred during one of the most widespread global pandemics in 100 years, the worst economic collapse since the Great Depression, and a rising wave of social unrest, leaving investors to question the rally's sustainability. But there is even more to this disconnect than meets the eye. We are in the midst of one of the most heated bull versus bear debates in our lifetimes. In this commentary we delve into the two sides of the debate in order to understand the sources of hope as well as the reasons for doubt.

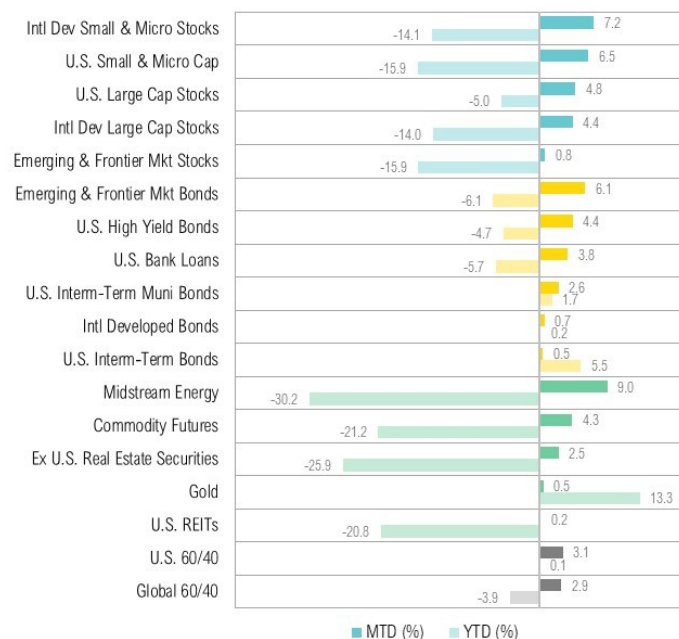


The Bull Case

According to MarketWatch, the 40% rally over the past 50 days has been the sharpest ever for the S&P 500 during that amount of time, and its year-to-date losses have been trimmed to just 5%.¹ What began as a welcome rebound from a bear market has morphed into a relentless run that seems so disconnected from what is happening in the rest of the economy as to be baffling, if not concerning. But there are several powerful drivers of the market recovery.

The first is that the stock market is forward-looking. As the economy reopens—if we assume a second wave of COVID-19 either does not materialize or if a viable vaccine or treatment is discovered—life will normalize, people will return to work, and corporate earnings will rebound. In 13 of the past 14 recessions, the stock market hit its low point more than three full months before the recession officially ended, showing that market returns often telegraph economic conditions.² The strong May jobs report is a good example of this point. Notwithstanding data collection errors that may have overstated the improvements in employment rates, the report gave analysts hope that the economy is on the right track. History has shown us that, especially during severe downturns, disconnects between stock indices and the economy are common, and market rallies often presage economic recovery.

Key Market Total Returns, As of 5/31/2020



Source: Bloomberg, Gross of Fees

A second reason for the market surge is the relative attractiveness of stocks compared to bonds, at least on the surface. So slim have been the pickings in bond land that investors adopted the Thatcherism “TINA” (“there is no alternative”) to refer to the idea that stocks may be the only asset class capable of generating long-term gains. It’s worth noting that “TINA” was first adopted by investment professionals in 2013—when rates were significantly more attractive than they are today.³ In that year, short-term rates were near zero, but longer-term yields, as measured by the U.S. 10-year Treasury note, averaged a relatively juicy 2.4%. Compare that to May 2020: short-term rates are again near zero, but the 10-year Treasury note yield is down to a paltry 0.65%. TINA may be more relevant today than ever!

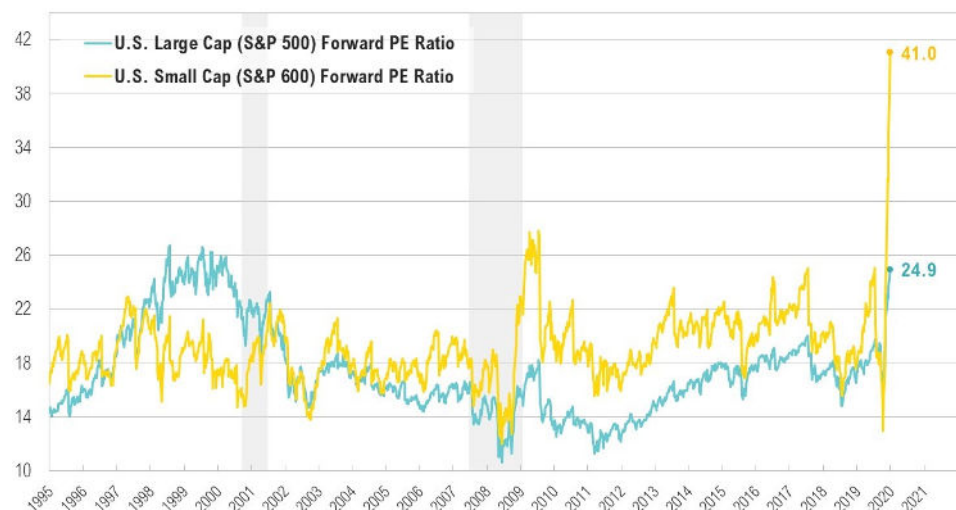
A third reason for the market rally is the unprecedented intervention in the markets by central banks. The Fed's balance sheet was already elevated before the pandemic, but its total balance sheet assets have since rocketed by more than \$2.9 trillion or 13.6% of 2019 U.S. gross domestic product (GDP).⁴ These asset purchases have allowed the U.S. Treasury to issue a record amount of debt—funding a record \$3.7 trillion expected deficit—without the bother of having to find a buyer.⁵ These newly created dollars are fungible; they flow through markets and support asset prices, as they were designed to do. This works hand in hand with the massive amounts of fiscal stimulus that have also been pumped into the economy (totaling 11% of GDP as of the end of May).⁶

The Fed-subsidized borrowing and spending doesn't stop at the government level. Corporate bond issuance exploded in April and May in anticipation of the Fed's imminent support.⁷ That support arrived late in the month of May as the Fed's *Secondary Market Corporate Credit Facility* (SMCCF) kicked into gear, buying U.S.-listed corporate bond ETFs, a first for the Fed. According to Bloomberg, net issuance in the second quarter through May 14th for both investment grade and high yield bonds was higher than the previous five quarters combined.⁷ Boeing's \$25 billion debt sale, the sixth-largest investment-grade bond offering ever, was a perfect example of this. These bond offerings have allowed companies to shore up their balance sheets and decrease their solvency risk. They have also signaled to the rest of the capital markets that the worst-case scenario for many companies is off the table.

The Bear Case

Despite the compelling reasons for the market rebound, there is another side to the story, even if it has so far taken a back seat. Yes, stocks are forward-looking, but what are they looking forward to? Not a rebound in earnings, apparently. According to Refinitiv, consensus estimates for S&P 500 operating earnings per share (EPS) for 2020 were cut by over 30% from \$180 on January 1 to \$125 at the end of May.⁸ Forecasts for 2021 and 2022 EPS have also been cut—by 17.3% and 13.7%, respectively.⁸ Those estimates are yet to turn higher. Although the future is always uncertain, several market-disrupting issues are lurking: the prospects of renewed trade war with China, a no-deal Brexit, a contentious presidential election, and potentially higher taxes to fund off-the-charts deficits (or inflation if those deficits continue to be funded by “printing” money). Another factor, which does not seem to be getting much attention recently, is the potential for a

Stock Market Valuations, Jan-1995 - May-2020



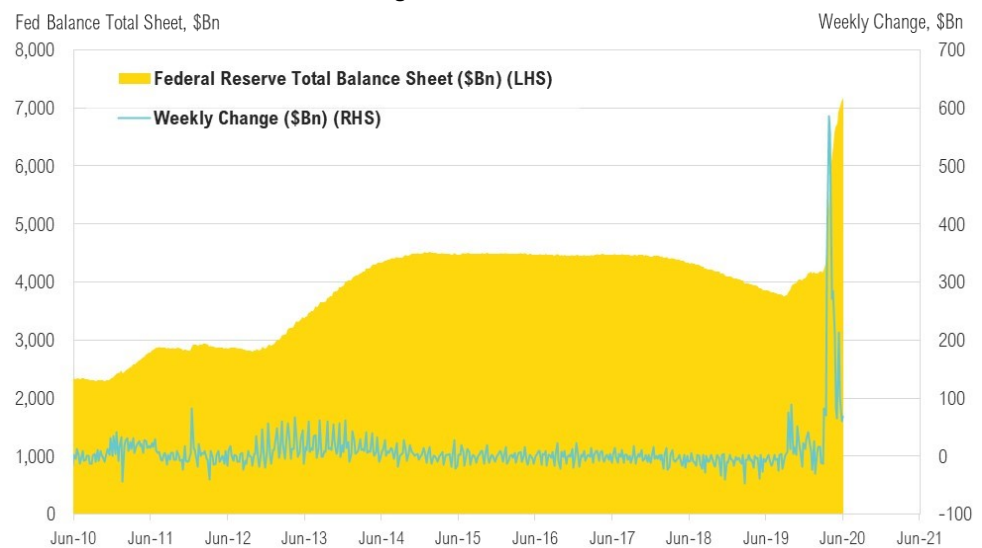
Source: Bloomberg

second COVID-19 wave. By global measures, the pandemic is not slowing down. On June 3, more than 100,000 new cases of COVID-19 were reported in the world ex-U.S., a new high. The worst growth rates are occurring in parts of Africa, India, and Central and South America. In the U.S., the seven-day moving average of cases (excluding New York and New Jersey) has been rising steadily since May 29.⁹

What about the TINA appeal of stocks? Through the lens of current yield, the roughly 2% dividend yield on the S&P 500 is attractive relative to government bonds. But this yield is not set in stone: some estimates anticipate that dividends could fall anywhere from 15% to 35% for companies around the world in 2020.¹⁰ Further, relative to their earnings expectations for the next 12 months, large cap companies are valued near the upper end of their long-term ranges while small caps are pricier than they have ever been.¹¹ Forecasts can change, of course, but the point remains that stocks may not be as much of a bargain when examined from other perspectives than just a simple comparison to bonds.

In terms of central banks propping up economies, there seems to be no end in sight, especially given the political pressure on the Fed during an election year, but the tide of easy liquidity is already slowing. At its peak in late March, the Fed was buying over half a trillion dollars in bonds every week. For the two weeks leading up to June 3, that number declined to \$68 and \$60 billion, respectively.¹² These are still enormous numbers, but they should be viewed in the context of the \$3.7 trillion deficit estimated by the Congressional Budget Office, which implies a weekly borrowing need of just over \$70 billion by Treasury.⁵ Further, as the economy reopens and activity ramps up, the chances that the Fed will fall behind the curve, relative to an improving labor market and rising inflation, increases. While core inflation (which excludes the volatile food and energy components) came in at only 1.4% year-over-year in April, expectations for future inflation are already increasing.¹³ According to the Conference Board, consumer expectations for inflation one year from now jumped to 6.2% in May, one of the highest readings of the past 25 years.

Fed Balance Sheet Growth Slowing



Source: U.S. Federal Reserve Board

A final reason for the rally that is concerning—though extremely bullish while it persists—is the budding speculative mania that has gripped retail investors. Stuck at home, with no sports to watch and seemingly lots of time on their hands, hordes of small, often first-time, investors are speculating on the stock market in record numbers. New accounts at the major online brokers—Robinhood, Charles Schwab, TD Ameritrade, and E*Trade—jumped 170% for the second quarter through mid-May.¹⁴ The trade *du jour* involves buying call options (contracts that represent a one-sided, leveraged bet on higher stock prices). According to SentimenTrader, at the peak of the market in February 2020, retail investors purchased 7.5 million call option contracts in one week—a record high. In the first week of June, retail investors purchased 12.1 million calls—61% higher than the previous record!¹⁵ On the other side of the coin, demand for single-stock hedges, called put options, has plummeted. According to the CBOE, the number of put options traded for every call option has dropped to the lowest in six years.

Looking Forward

The growing disconnect between markets and the economy can be explained largely by excitement over reopening the economy, the relative attractiveness of stocks compared to bonds, a tidal wave of liquidity from central banks, and a surge of speculative mania. Although these factors have pushed markets to dizzying levels in recent weeks, high valuations and a host of risks, especially the potential for a second wave of infections in the fall, should not be ignored. If we have learned anything from recent events, it is that conditions can change quickly and unexpectedly. The rapid evolution of the coronavirus and the possible need for additional interventions by governments necessitate that prudent investors combine discipline with creativity. Discipline will help execute existing strategies, and creativity will enable for quick adjustments to take advantage of emerging opportunities. As always, be cautious of anyone claiming that they can confidently and clearly predict what the immediate future has in store.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited.

Citations

1. MarketWatch: www.marketwatch.com/story/sp-500-index-futures-and-those-for-the-broader-market-rise-wednesday-evening-after-index-notches-best-50-day-rally-in-history-2020-06-03
2. Bloomberg, U.S. National Bureau of Economic Research, SpringTide
3. Wikipedia: https://en.wikipedia.org/wiki/There_is_no_alternative
4. U.S. Federal Reserve Board
5. Congressional Budget Office: <https://www.cbo.gov/publication/56335>
6. Statista: <https://www.statista.com/statistics/1107572/covid-19-value-g20-stimulus-packages-share-gdp/>
7. SIFMA, Bloomberg: <https://www.bnnbloomberg.ca/u-s-corporate-bond-sales-smash-record-soaring-over-us-1-trillion-1.1442406>
8. Refinitiv: <https://lipperealphabet.refinitiv.com/2020/06/this-week-in-earnings-9/>
9. John Hopkins: <https://coronavirus.jhu.edu/map.html>
10. Reuters: 1. <https://www.reuters.com/article/us-global-dividends-report/global-dividends-forecast-to-fall-as-much-as-35-in-2020-janus-henderson-idUSKBN22U1S8>
11. Bloomberg
12. U.S. Federal Reserve Board
13. U.S. Bureau of Labor Statistics
14. CNBC: <https://www.cnbc.com/2020/05/12/young-investors-pile-into-stocks-seeing-generational-buying-moment-instead-of-risk.html>
15. OCC, SentimenTrader

DISCLAIMER

Magnus Financial Group LLC ("Magnus") did not produce and bears no responsibility for any part of this report whatsoever, including but not limited to any macroeconomic views as well as any errors or omissions. Research and data used in the presentation have come from third-party sources that Magnus has not independently verified presentation and the opinions expressed are not by Magnus or its employees and are current only as of the time made and are subject to change without notice. Magnus bears no responsibility for any part of this report whatsoever, including but not limited to any macroeconomic views as well as any errors or omissions.

This report may include estimates, projections or other forward-looking statements, however, due to numerous factors, actual events may differ substantially from those presented. The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. Except for the historical information contained in this report, certain matters are forward-looking statements or projections that are dependent upon risks and uncertainties, including but not limited to factors and considerations such as general market volatility, global economic risk, geopolitical risk, currency risk and other country-specific factors, fiscal and monetary policy, the level of interest rates, security-specific risks, and historical market segment or sector performance relationships as they relate to the business and economic cycle.

Additionally, please be aware that past performance is not a guide to the future performance of any manager or strategy, and that the performance results and historical information provided displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, it should not be inferred that these results are indicative of the future performance of any strategy, index, fund, manager or group of managers. Index benchmarks contained in this report are provided so that performance can be compared with the performance of well-known and widely recognized indices. Index results assume the re-investment of all dividends and interest.

The information provided is not intended to be, and should not be construed as, investment, legal or tax advice nor should such information contained herein be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. An investor should consult with their financial advisor to determine the appropriate investment strategies and investment vehicles. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. This presentation makes no implied or express recommendations concerning the way any client's accounts should or would be handled, as appropriate investment decisions depend upon the client's specific investment objectives.

Investment advisory services offered through Magnus; securities offered through third party custodial relationships. More information about Magnus can be found on its Form ADV at www.adviserinfo.sec.gov.

TERMS OF USE

This report is intended solely for the use of its recipient. There is a fee associated with the access to this report and the information and materials presented herein. Redistribution or republication of this report and its contents are prohibited. Expert use is implied.

DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

About Magnus

Magnus Financial Group LLC is an SEC-registered, independent investment advisory firm located in New York City. Magnus provides customized wealth management and financial planning services for clients in all phases of their lives. As an independent RIA, Magnus provides high-quality service with a personalized client approach. Magnus was founded in 2017 and consists of approximately 18 staff professionals including seven wealth advisors, investment operations, compliance and marketing, research and trading personnel, client service members and administrative support.

Learn more: Visit magnusfinancial.com



90 Park Avenue, Suite 1800,
New York, NY 10016

(800) 339-1367

service@magnusfinancial.com