CBL WEALTH MANAGEMENT
REGISTERED INVESTMENT ADVISOR LIC. # 289564

Market Brief

February 20, 2020

Market Snapshot	
Closing Values as of 02/20/2020	
Dow	29,220
S&P 500	3,373
Nasdaq	9,751
Gold	$1,620

A little optimism (and Central Bank stimulus) goes a LONG way

An honest and thoughtful look back on the global economy and overall strength of the markets reveals that despite the relative strength and stability of the U.S. economy and the phenomenal year end performance of the stock markets, there wasn't much else about 2019 to be terribly excited about. Global economic growth continued to slow, driven lower by further contractions in global manufacturing and trade. The escalating U.S./China trade war, politicizing of the USMCA trade agreement and unresolved global trade issues created substantial trade disruptions that had a significant negative impact on many of our trading partners, adding further stress to the already weak global economy.

Global weakness and the US/China trade's resulting tit-for-tat tariffs put pressure on corporations to adjust profit estimates, alter supply chains, and ultimately impacted consumer sentiment. With the domestic consumer less excited and less demand from the global consumer, Year over Year (YoY) corporate earnings growth entered a technical earnings recession, shrinking in the first 3 quarters of 2019, inflation has run well below 2% and GDP came in at 2.3%.

Late in 2019 the Federal Reserve began a series of repo market activities and T-bill purchases that would continue through *"at least"* April 2020, creating significant additional liquidity in the monetary system. Further emboldened by the promise to "do whatever it takes" these extraordinary measures taken by the Fed imply, consumer sentiment rapidly improved and investors plunged extra cash into the equity markets. Despite a lack of fundamentals to support the expansion, equity market valuations have risen dramatically since the initial injection of liquidity, forward P/E ratio of the S&P 500 now stands at 19.2x, the highest since 2002 and 18% higher than the 25 year average of 16.28x. The total market value (including dividends currently yielding 1.67%) now stands at 158.1% of total GDP (Feb 2020, more than 80% higher than the long term norm...meaning the market is 'significantly overvalued' (anything over 115% is considered 'significantly overvalued'). Predictably, the Fed intervention has induced a liquidity driven flow of cash into risk assets.

This is not the first time equity markets have experienced a liquidity induced valuation expansion without supporting fundamental data. The rapid injection of liquidity into the monetary system has historically led to an increased appetite for risk taking as interest rates are driven even lower. One concern with the current valuation spike is that the valuations have run (and continue to run) higher than any other liquidity induced event by historical comparison. The extremely low Fed Funds rate and the reductions in rates that preceded the initial Fed actions in 2019 suggest the markets may not be as overvalued as they first appear, despite their historical excess.

Main concerns for 2020 markets

If you had asked me in January, before the Coronavirus became a major concern, what I thought the year ahead might look like for global and domestic economies or the markets in general, my thoughts would be somewhat different than they are now. As the year began, global growth appeared to be improving, aided by positive trade developments and pick-up in global manufacturing. In contrast to last year's shrinking corporate earnings and tepid GPD growth, I felt 2020 offered a strong case for improved corporate earnings growth and a pick-up in the pace of GDP. Provided global conditions remained relatively stable and there were no major setbacks in trade caused by Brexit or the ongoing US/China trade war, I expected a best case equity markets return in the 9-11% range (including dividend reinvestment) with a moderately balanced portfolio capable of returning 7-9%...assuming no major interest rate shocks and a final GDP reading around 2.5%.

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Prior to the introduction of the Coronavirus variable, I was cautiously optimistic with just two potentially serious disrupters weighing on my mind. As I saw/see it, the main disrupters threatening equity markets (and possibly the long term economic expansion) in 2020 are the evolution of and eventual unwinding of the current liquidity induced market bubble, and the presidential election. Neither of these events are occurring in secret or without historical precedence but the current economic, social and political environment and a very unique twist making these potentially significant market disrupters. Within just a few days the Coronavirus went from a potential concern to full fledge epidemic, becoming the (first?) black swan event of 2020 with an unknown and exponentially evolving potential to disrupt global economic activity...adding a whole new market risk to consider, possibly challenging my mostly optimistic 2020 outlook.

As I see it, the biggest threats to the markets in 2020 will stem from the Fed's willingness to keep rates lower (or lower them further) and if/how/when they decide to taper or end their current T-bill purchasing program. The sustained expansion in valuations in the weeks following the introduction of the Coronavirus variable is an indication of how successfully the Federal Reserve's intervention is able to mask fundamental data and real risks in equity markets. When fundamental data and external risks are no longer masked by Federal Reserve intervention, I believe investor appetite for risk will be vastly reduced resulting in a rapid repricing of the markets. Like it or not, the market is addicted to easy money and any hint that rates might rise or liquidity might be removed will have a negative impact on momentum, regardless of fundamental data.

Historically, presidential election years tend to be a little more volatile as candidates vie for attention and the slate is ultimately decided. Normally, movements in the market driven by election year politics are transient and not worth being concerned about, but I think the social/political environment has changed dramatically over the years. My concern is twofold; First, that the trend away from a clear popular vote winner will continue and will lead to anger/distrust in both, the primaries and the presidential election. Second, that the social populist trend has led to more polarizing political candidates and political rhetoric, potentially resulting in a more aggressive response to outcomes perceived as personally unpopular. I think the first test of the market will be following the Democratic primaries where I strongly suspect a lack of clear winner will lead to a contested convention (challenging the popular vote) and the resulting candidate's political ideology might be unfavorable for Wall Street or a particular business sector.

It is far too early to know how widespread the epidemic will become or how significant the economic impact will be. Based on economic models (yes, we have economic models for epidemics and pandemics) the impact to global GDP might be as little as 0.5 or as much as 1 percentage point off the total year end GDP, still not resulting in a technical global recession. . Most studies indicate the potential impact to U.S. GDP growth at less than 0.5 percentage points, with a potential worse case estimated GDP around 1.9% annualized. Regardless of the projections and studies I am inclined to think the first 3-5 months of the year are going to be significantly impacted GLOBALLY and the U.S. corporations and economy won't escape that. Most estimates are for a Q1 GDP of 1% but I would not be surprised at all if we see a negative U.S. GDP print. I know this is a strange statement given the phenomenal stock market performance and perceived economic strength but I believe the Fed liquidity is masking the pain and investors are ignoring the obvious, betting on future recovery.

There is some potential good that can come from the black swan if the worst cases are avoided. An early peak in viral expansion would contain the economic impact to the first half of the year, with a rebound in demand and production in the last half of the year. Central bank stimulus in China (and the U.S.) in response to the outbreak has created an extraordinarily 'easy money' environment that is supportive of economic growth **and** growth in risk assets, providing a supportive environment for the global equity markets. While tourism dollars (airline, casino, hotel/hospitality) lost in Q1/Q2 won't be recovered, supply chain items and personal item purchases that were delayed are likely to be made in the last half of the year. Many of the dollars not spent as a result of the viral epidemic have either been diverted or delayed rather than 'destroyed', and much of what was truly lost may be made up through central bank stimulus.