Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY May 21, 2020

Lowered Expectations for Economic Recovery May Be a Good Thing

In the early days of the Covid-19 lockdowns, many held out hope that the temporary pause to economic activity would give way to a robust recovery in the second half of the year. It was common to hear talk of a "v-shaped" recovery.

As the weeks drag on and negative economic data continues to flood the airwaves, however, expectations for a swift and strong recovery continue to march lower. The "V-shaped recovery" turned into a "U-shaped recovery," which in turn has now become a "swoosh-shaped" recovery resembling the Nike logo. The implication of a "swoosh-shaped" recovery is a long, slow, fairly uninspiring return to pre-pandemic economic growth. In all, I've been noticing over the weeks that expectations for the economic recovery continue to fall.

And I think that's a good thing, here's why:

I am certainly not rooting for a slower recovery – just the opposite in fact. But throughout my career, I have consistently held that equity markets care far less about economic outcomes in vacuums and far more about whether those *outcomes exceeded expectations.* With investing, it almost always boils down to expectations versus reality. If expectations are low and falling – which I think they are now – it is much easier for the economy to surprise to the upside, producing a favorable outcome for stocks.

As part of the swoosh-shaped recovery narrative, there are still many economic dominoes yet to fall. Even as economic restrictions ease across the country, many are saying that fewer shoppers are likely to make their way into stores. Data from April supports this narrative, as U.S. retail sales fell 16.4% from a month earlier, and industrial production recorded its steepest drop in records dating back 100 years. The unemployment rate was at a 50-year low just three months ago, and is now being compared to the Great Depression.[1] A decades worth of job gains was wiped out in a single month.

Many American households are feeling the pain firsthand, and many others are worried that financial hardship is coming. In April, Americans' views on the job market and personal finances declined dramatically. More Americans than ever were worried about losing their job, while a record number also had low expectations for future earnings, income, and spending. Similarly, the small business optimism index recorded its biggest two-month decline in the index's history, with a majority of small businesses around the country not expecting a rebound for at least six months. The University of Michigan's index of consumer sentiment fell -26.3% year-over-year, while the index of consumer expectations fell -27.6%.[2]

Those projecting a swoosh-shaped, U-shaped, or even L-shaped recovery (where the economy essentially never recovers) are using this data to forecast more store closures, business bankruptcies, missed mortgage payments, bad loans, and never-ending Fed bailouts. I am not necessarily saying any of these forecasts will be totally wrong. But if they are and the economy performs even modestly better than any of the in-the-gutter forecasts, then I think stocks will hold up just fine. It's all about expectations versus reality.

Bottom Line for Investors

On CBS News' "60 Minutes" last week, Federal Reserve Chairman Jerome Powell said that the economic recovery could stretch into the end of 2021.[3] That's a long time. No one can really say for sure how long the recovery might last, and what shape it will ultimately take. But my take on the matter boils down to two points: 1) The economy *will* recover; and, 2) I believe it will recover better and faster than most people appreciate, particularly if expectations continue to fall.

Reports this week showed that a company called Moderna produced some positive, early results on a vaccine, which sent some optimism through the markets and airwaves.[4] We could very well see sentiment start to shift quickly if hopes for a vaccine continue rising, which could turn my argument in this week's column on its head quickly. Being overly hopeful and optimistic can lead to disappointment if the outcome is not as good as many expect, which could put pressure on stocks. Again, it's all about expectations versus reality.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, May 15, 2020. https://www.wsj.com/articles/coronavirus-lockdowns-trigger-record-spending-drops-on-shopping-eating-out-11589535000

[2] The Wall Street Journal, May 15, 2020. https://www.wsj.com/articles/coronavirus-lockdowns-trigger-record-spending-drops-on-shopping-eating-out-11589535000

[3] The Wall Street Journal, May 18, 2020. https://www.wsj.com/articles/powell-says-fed-prepared-to-use-full-range-of-tools-to-support-economy-11589832108?tesla=y&mod=article_inline

[4] The Wall Street Journal, May 18, 2020. https://www.wsj.com/articles/powell-says-fed-prepared-to-use-full-range-of-tools-to-support-economy-11589832108?tesla=y&mod=article_inline

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- A look at Powell and Mnuchin's differing views
- Could unemployment benefits impact the labor markets?
- Signs of stability in the oil markets
- Inside the U.S. and China's turbulent relationship

The Fed Chair and Treasury Secretary Offer Diverging Views of Economy

Online congressional hearings took place on Tuesday, with Federal Reserve Chairman Jerome Powell and Treasury Secretary Steven Mnuchin taking questions. Though Chairman Powell and Secretary Mnuchin are very much working together to respond to the economic crisis at hand, Secretary Mnuchin is pursuing the Trump administration's economic goals while Chairman Powell oversees the politically independent Federal Reserve. It follows that the two men posited diverging views of the U.S. economic recovery, and what is required to facilitate it. Secretary Mnuchin believes that the biggest risk of permanent damage to the U.S. economy comes from not reopening. Delaying reopening and leaving restrictions in place too long will prolong the recovery and inhibit a "V-shaped" recovery, in his view. Secretary Mnuchin also favors a wait-and-see approach to more fiscal and monetary stimulus. Chairman Powell offered a different perspective, stating that the biggest risk to the economic recovery was consumers and businesses' attitudes about the risk of Covid-19 infection. Chairman Powell believes that more stimulus is needed now to buy more time for the infection to come under better control, a vaccine to hit the market, and/or both.[1] In the meantime, Chairman Powell thinks that more spending is needed by Washington to prevent structural damage from high unemployment and a wave of bankruptcies.

The Topsy-Turvy Economic Relationship with China

Tension between the United States and China is decisively ratcheting higher. The United States is actively questioning China's role in the pandemic as well as lack of transparency between China and the World Health Organization, while China defends itself and its actions with an air of hostility. Overall, relations between the world's two largest economies have chilled, to say the least. Corporations are responding somewhat differently. On the one hand, the pandemic laid bare the risks of complex supply chains with heavy exposure to China and other developing economies. Corporations are strongly considering restructuring supply chains as a result, or reshoring them altogether. On the other hand, companies with strong consumer presence appear to be doubling down on China's projection for long-term growth potential. Companies like Walmart, Tesla, Starbucks, and even Popeye's are increasing their local presence and unveiling plans to open more stores and sales channels into the future.[2]

Signs of Stability in the Oil Markets

Many readers likely remember the oil price collapse earlier in the year, when for a moment some oil futures fell into negative territory. The tables appear to be showing signs of turning now that the worst of the pandemic appears to be behind the world. In the futures markets for Brent Crude and West Texas Intermediate, traders were bidding up the price of December delivery for barrels of oil.3 It is not common for traders to actively trade in contracts so far into the future, but the bidding up of December contracts may reflect a consensus that demand is likely to rebound in the second half.

Will Unemployment Benefits Impact the Labor Market?

A working paper released this week by three University of Chicago economists suggests that unemployment benefits during the Covid-19 pandemic may have some inhibitive impact on the recovery. As it stands today, more than two-thirds of unemployed Americans receiving benefits are being paid more than they were at their old jobs. These payments are in addition to the $239 billion that the IRS has paid out in stimulus checks to tide households over. While the economists argue that the payments offer a much-needed bridge to keep households liquid and consumption steady during the crisis, the thrust of the paper also suggests that receiving high benefits may "create distributional issues and may hamper efficient labor reallocation both now and during the recovery."[4] In other words, Americans may be less in a hurry to get back to their old jobs if they're making more today than they were before.

ZACKS INVESTMENT MANAGEMENT, INC.
www.zackspcg.com

[1] The Wall Street Journal, May 19, 2020. https://www.wsj.com/articles/powell-mnuchin-set-to-face-lawmakers-over-crisis-lending-programs-11589880602

[2] The Wall Street Journal, May 19, 2020. https://www.wsj.com/articles/neither-coronavirus-nor-trade-tensions-can-stop-u-s-companies-push-into-china-11589880603

[3] The Wall Street Journal, May 18, 2020. https://www.wsj.com/articles/the-oil-market-is-betting-people-want-crude-for-christmas-11589794202

[4] Becker Friedman Institute, May 2020. https://bfi.uchicago.edu/wp-content/uploads/BFI_WP_202062-1.pdf

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable. Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.