

The Cost of Stimulus?

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Fiscal and monetary intervention help now, but may eventually slow growth.



Key Takeaways

- The S&P 500 index® has now retraced 57% of its 35% decline in 19 days. It's impressive but it doesn't mean that the lows are in.
- Market breadth has become mixed with more U.S. stocks declining over the past week than advancing despite the fact that the S&P 500 index closed the week up 3%.
- Ironically, the massive fiscal-monetary intervention that seems to have mitigated the downside may, over time, dampen the strength of the recovery and could lead to another cycle of slow growth and low interest rates.
- Using the discounted cash flow model (DCF) the market seems to be pricing in a U- or V-shaped stock market recovery. To me, the U seems more realistic which may suggest that we have seen most of the gains for now.

After another surreal week cooped up at home, watching stock prices recover, while the economic and health-related news flow went from bad to even worse, the S&P 500 index (SPX) made a new recovery high of 2,875.

The index has now gained 28% from the low on a closing basis (31% on an intra-day basis), and sits a mere 15% to 17% below the February all-time high (depending on how you measure). The SPX has now retraced 57% of its 35% decline in 19 days.

2008 vs. 2020

Just to give you some historical context, during the Global Financial Crisis (GFC) it took 9 months from the March 2009 low for the SPX to retrace half the decline. Granted, it's a bigger feat to retrace a 57% decline than a 35% decline, but still.

During the GFC the market tried three times to rally off a major momentum low (10/10/2008, 11/21/2008, and 3/6/2009). The first two were bear market rallies. The third one was the charm.

In 2008, the SPX was never able to retrace more than 23% of the decline during the first two attempts. So, the current retracement of 57% is much more impressive than those rally attempts.

Can we conclude that the lows are in, based on this favorable comparison? I wish this were the case, but unfortunately market history does not provide a consistent answer. There are plenty of examples of sharp 50% retracements followed by new lows. It's always a mosaic of empirical and anecdotal evidence. It's a puzzle that is very difficult to solve in real time.

Narrowing sector leadership

After an initial broad-based surge off the March 23 momentum low, the gains have become more selective in recent days.

If we look at weekly breadth (advancers minus decliners as a percentage of issues) by sector, we see that after several weeks during which everything got hit, we had several weeks where everything went up. That's fairly common during the crashing and recovery phase of a bear market—especially this time around, given the severity of the selloff leading into the March 23 momentum (internal) low.

The real test comes after. For a rally to be sustainable (i.e., a new bull market instead of a bear market rally), it needs to produce broad leadership. Last week was a mixed bag at best. While the SPX gained a respectable 3% last week, breadth for the "T3K" (our internal index of the 3,000 largest U.S. stocks) produced slightly more decliners than advancers (—5%).

Those decliners were concentrated in energy, financials, industrials, materials, and REITs. The advancers were led by tech, utilities, consumer discretionary, consumer staples, and communication services. It's a familiar story, since that's how things have been for a long time (with the exception of REITs).

Fiscal-monetary intervention: A tale of reduced tails?

It is common for the sector leadership to change from cycle to cycle, but that hasn't happened so far. That might suggest that we are not yet in a new bull market cycle and that the sharp retracement so far is merely a bear market rally.

It's possible but I'm not ready to jump to that conclusion yet. For one, the secular tide of aging demographics and the resulting search for yield hasn't gone away, and if anything it has gotten more urgent now that a good chunk of the Treasury curve is near zero. So, anything that produces stable cash flow via dividends and buybacks may be able to continue to lead. Whether share buybacks will continue at the same pace as before is a huge question, of course. But we will save the "labor vs. capital" discussion for an upcoming report.

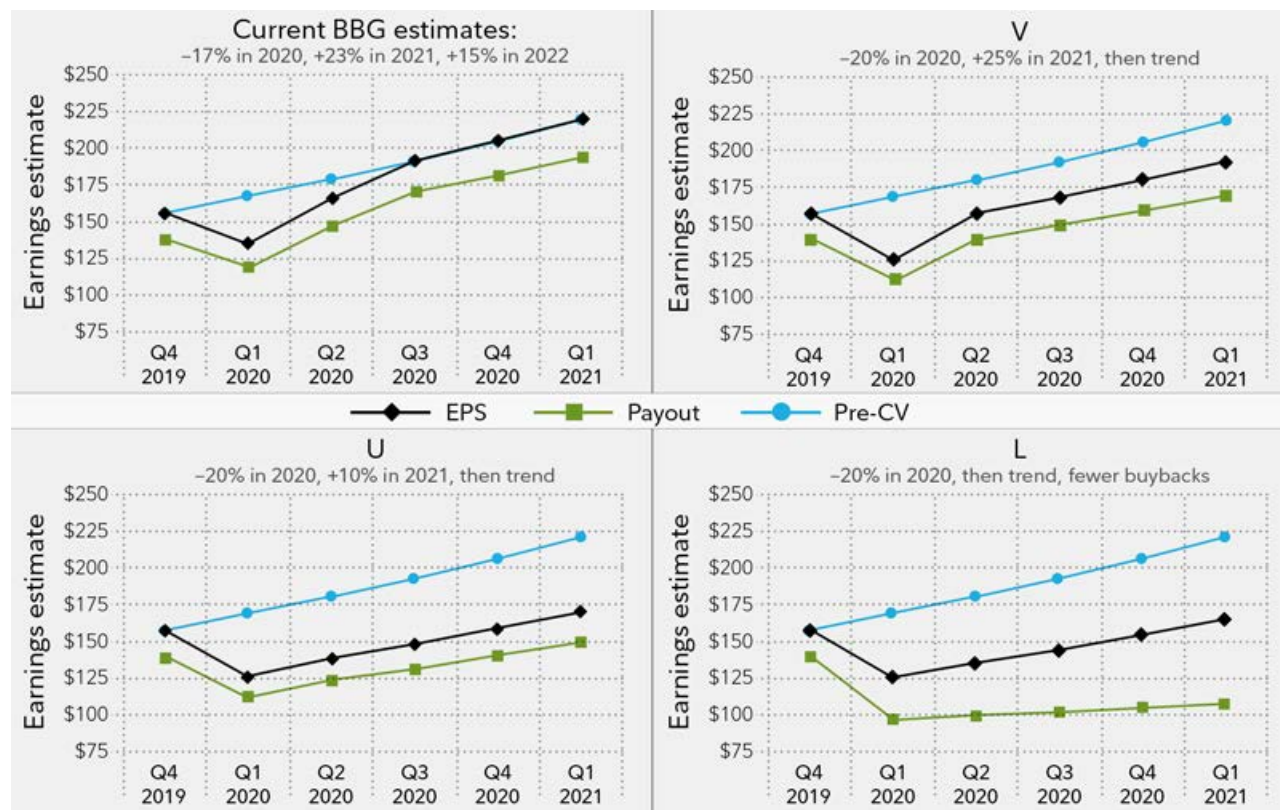
Furthermore, the speed and magnitude of the coordinated fiscal-monetary response, while helping now, might ironically prevent a typical early cycle playbook from unfolding in the months ahead. If businesses and industries which would have otherwise gone insolvent during a recession are able to survive through policy intervention, then perversely maybe the policy response ends up mitigating both sides of the V. Perhaps this is a tale wherein the policy response is effective enough to remove the left tail, but in the process also flattens out the right tail. I am thinking of a Japan analog here (more on that as well in a future report).

Perhaps that will be the price that has to be paid for all this intervention. The result could be a post-COVID regime that isn't much different from the pre-COVID days. In that scenario, we have slow growth and low interest rates, and stable high quality companies with strong balance sheets get rewarded for their ability to generate cash flows for their shareholders, while the financially engineered zombie companies survive but don't thrive. Only this time the government's footprint is much larger, and there might be strings attached—for instance, curbs on stock buybacks for companies receiving aid through provisions in the CARES Act.

DCF still shows that the market is pricing in a U or a V

This brings me back to the DCF (discounted cash flow) model. Last week, I laid out several scenarios of how the full arc of the COVID-19 crisis might play out, and which of those scenarios might be getting priced in. Below is an update. The V-, U-, and L- scenarios are the same as before (but with an updated SPX of 2,875 from which to measure the upside/downside), while the upper-left scenario uses the latest earnings estimates from Bloomberg (BBG).

Four potential scenarios for the S&P 500



In the chart, payout is the sum of dividends per share and buybacks. Source: Fidelity Investments

The table below shows the results for the stock market, measured by SPX.

Valuation scenarios for the COVID crisis and recovery

	Fair value		SPX % change from		
	Price	P/E	High	Last	Low
Pre-COVID (using long-term compound annual growth rate)	3,348	21.3			
Best: -10% in '20, +18% in '21, +13% in '22	3,321	21.1	-2%	16%	51%
Good (V): -20% in '20, +25% in '21, on-trend after	2,916	18.6	-14%	1%	33%
Mid (U): -20% in '20, +10% in '21, on-trend after	2,579	16.4	-24%	-10%	18%
Worst (L): -20% in '20, on-trend after, reduced buybacks	1,871	11.9	-45%	-35%	-15%

In the chart, payout is the sum of dividends per share and buybacks. Source: Fidelity Investments

Based on current consensus earnings estimates (Bloomberg), which are coming down rapidly but are assuming a massive recovery next year, the SPX has 16% of upside from current levels.

As was the case last week, the market seems to be pricing in a U- or V- recovery. At 2,875 the SPX is near the intrinsic value of 2,916 suggested by my V-scenario. The U-scenario is 10% below where the SPX is now trading (2,579). To me, the U seems more realistic than the V, which to me suggests that we have seen most of the gains for now.

Timing is everything

History is quite consistent in terms of price bottoming before earnings. So far during this cycle, price bottomed four weeks ago at a drawdown of -35%, and only now are earnings estimates catching up. From here, I believe that the market will be in a dance between when and where the bottom is for the economy, what the recovery track will be, and what is priced in.

ABOUT THE EXPERT



Jurrien Timmer

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

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- **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 US equity performance.