What Shape Will the Recovery Be?

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U.S. stocks are in a holding pattern but there are four potential recovery scenarios.

Key takeaways

- The S&P 500® Index has gained 27% from the March 23 low—retracing 54% of the decline. After such a rally, some consolidation seems likely.
- The disconnect between rising stock prices and falling earnings is a sign that the market is pricing in an eventual recovery.
- Using the discounted cash flow model (DCF), I now think that a more likely path for stocks might be a "swoosh," i.e., a sharp contraction followed by a gradual recovery.
- This swoosh scenario suggests a fair value of 2,600 for the S&P 500, compared to the current price of 2,825.

Since walking back from the abyss in late March, equities have rallied strongly in anticipation of a peaking of the COVID-19 curve and a reopening of the economy.

The S&P 500 has gained 27% from the March 23 low and has retraced 54% of the decline. Believe it or not, the S&P 500 is back to its trend line from the 2009 low. It's an impressive feat, considering the economic devastation that the COVID-19 crisis has unleashed.

U.S. stocks are in a holding pattern

In recent weeks the pace of the rally has slowed, and for the past two weeks the market has been treading water. Basically the market has entered a holding pattern in the middle of the range, while it waits for new data.

The recent gains have become more narrow and uneven, led by the same familiar secular growers as before. Students of market history typically want to see a broadening of gains to confirm that a new cyclical bull market is underway. Usually the stocks that go down the most (small caps, cyclicals) also recover the most. That is not happening, at least not yet. To the skeptics, this lack of participation is a sign that this is nothing more than a QE-induced bear market rally.

Technical analysis

The advance off the low has so far followed a corrective-looking a-b-c pattern, and recently the market became technically overbought on a short-term basis. This suggests that some consolidation and retracement is in order. The ability for the market to hold on to its recent gains is an important test. So far, in my view, it is passing the test.

If we look at the equal-weighted S&P 500 Index (SPW), the market has rallied the same 27% as the cap-weighted index (SPX), but because it fell further (-39% vs. -35%), it has retraced less of the decline (44% instead of 54%). As a result, the SPW is sitting 23% below the February highs while the SPX is only 16% below. The cap-weighted index (SPX) is organized by company size—bigger companies are a larger proportion of the index. In the equal-weighted index (SPW), the index is divided proportionally among the 500 companies.

At the same time, while market breadth (advancers minus decliners as a percentage of issues) has not been robust enough to confirm that we are out of the woods, but it hasn't been terrible either. The percentage of stocks above their 50-day moving average has improved from almost zero in March to +36% last Friday. That's below the +55% at the highs, but that is to be expected given that we have only climbed halfway back from the lows.

Likewise, the breadth oscillator (a measure of the momentum of breadth) has improved as well, although it has leveled off in recent days. In both cases, the market's internals are tracking favorably compared to the 1987 and 2008 analogs.

Have markets priced in too much of a recovery?

Markets are always discounting the future, and after discounting a depression-scenario a month ago it now seems to be discounting a severe but short-lived recession followed by a recovery. There is little doubt in my mind that the rapid and robust coordinated fiscal/monetary policy response is in large part responsible for this course correction. Don't fight the Fed, as they say, especially when it is coming out with guns blazing.

But now the question is whether the markets have priced in too much of a recovery. Until the economy actually reopens we can't really know the answer. Hence the holding pattern. The market is waiting for new information.

Price leads earnings

Because price leads earnings, the market picture has become confusing, to say the least. With price up 27% and earnings estimates falling rapidly (down 36% in Q2 and down 19% for 2020), by conventional valuation metrics the market is now more expensive than it was at the pre-COVID peak. The forward price-to-earnings (P/E) ratio (using expected earnings for the next 12 months) is now 19.2x vs. the February peak at 19.1x. Casual observers might understandably conclude that Wall Street is out of touch with Main Street.

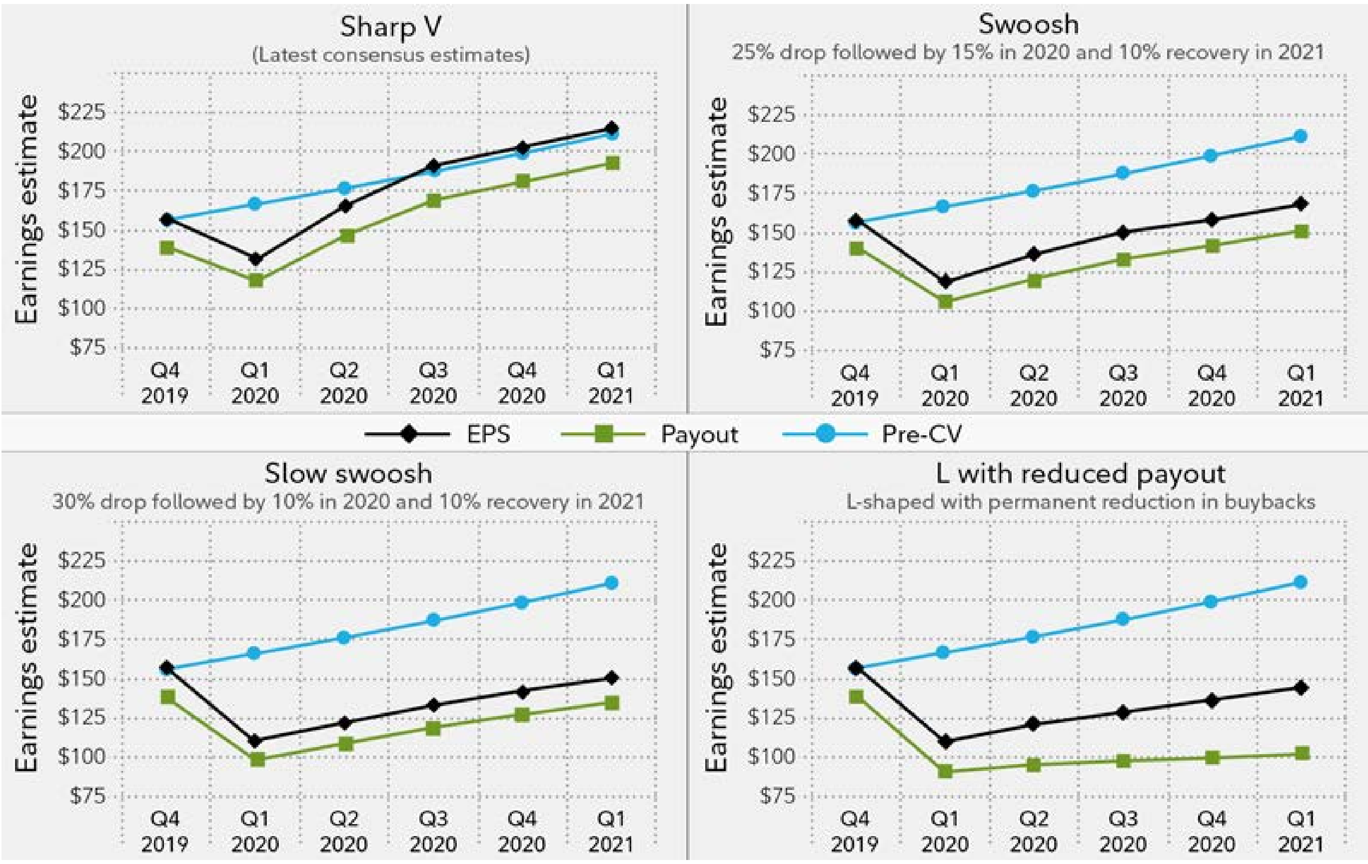
DCF (Discounted cash flow model)

As investors we have no choice but to come up with some assumptions about what the future might look like, including the entire arc of the recession/recovery cycle. That will give us some clues as to what is priced in and what is not, and from there we can try to infer the market's likely next move.

For me, the discounted cash flow model (DCF)* remains a useful tool to help me figure out what is possible and what is priced in.

Below are four different recession/recovery scenarios, from a best-case "sharp-V" to a worst case "L" to two different versions of a "Swoosh" in the middle.

Four potential scenarios for the S&P 500



In the chart, payout is the sum of dividends per share and buybacks. Source: Fidelity Investments. As of April 2020.

Right tail: Sharp V

Let's start with the tails. For the best case, "V," I am simply using the currently available consensus earnings estimates from Bloomberg. I think this scenario is unattainable, not so much because the near-term estimates are not bearish enough, but because the more distant estimates for 2021 and beyond are calling for a super-charged V-shaped recovery.

Those outer-estimates are generally too high anyway, but they seem more so to me this time around. I suspect that this is simply a function of analysts not updating their growth estimates because companies have pulled their forward guidance.

Based on the above scenario the DCF model produces an intrinsic value of 3,291, based on an equity risk premium (ERP) of 5.5% and no change in the payout ratio (the amount of earnings returned to shareholders in the form of dividends and buybacks). The February high was 3,394, so this scenario implies that the market will return back to the highs in relatively short order. That is unlikely, in my view.

Left tail: L-shaped with reduced payout

A left tail scenario might be an L-shaped cycle composed of a sharp decline with only a modest recovery and a declining payout ratio. Essentially it assumes some permanent impairment to the corporate sector in a way that reduces the amount of capital that can be returned to shareholders in the form of share buybacks. That, or a shift in the balance of power between capital and labor.

This scenario produces an intrinsic value of 1,787, which implies a further decline of 37% from current levels. While the issue of share buybacks may well become a major obstacle for the market in the coming years, for now I think the market has been correct in walking away from the abyss. Again, I credit the robust and timely policy response for this.

Swoosh

That brings me to some sort of in-between scenario as a more plausible outcome. I have been using a "U" and a "V" recovery as scenarios for this, but a V-shaped path seems too optimistic to me now, given the likelihood that the economy will reopen only gradually and with plenty of bumps along the way. I now think that a more likely path might be a "swoosh," i.e., a sharp fall followed by a gradual recovery.

This swoosh scenario has an intrinsic value of 2,593, which is 8% below the current price of 2,825. That suggests very little upside from here, but also not a ton of downside. Assuming we are now in a holding pattern or trading range of say 2,500–2,900, this scenario suggests that we stay in that range until further notice.

Slow swoosh

I have added a second, but less robust, swoosh scenario, which we can call a slow swoosh for the lack of a better term. For this scenario, I come up with an intrinsic value of 2,319. That's 18% below the current price. This scenario suggests that the market is too optimistic about the earnings recovery, although even an 18% decline from here would leave the SPX above the March 23 low of 2,192.

The table below highlights the fair value for these four scenarios.

Valuation scenarios for the COVID crisis and recovery

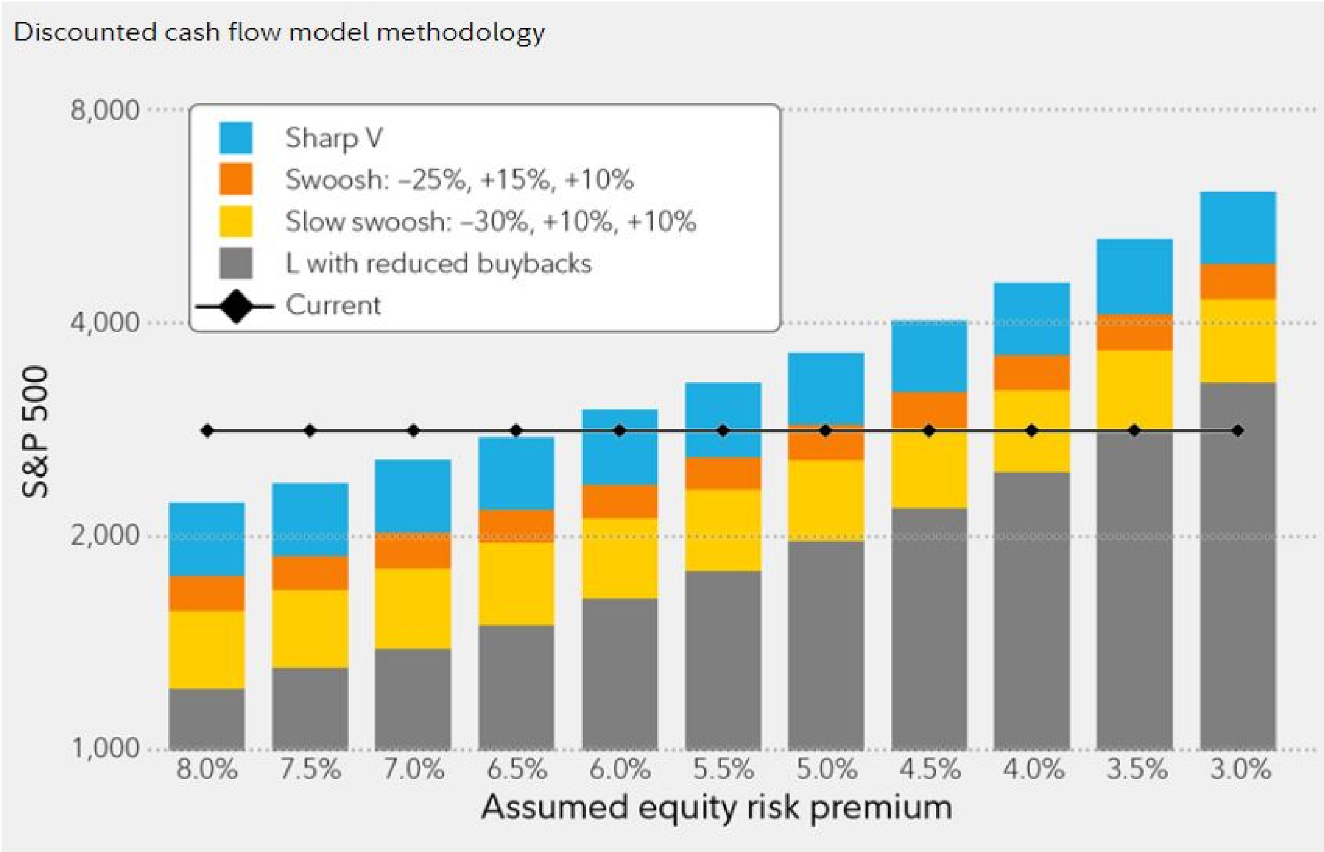
	Fair value		SPX % change from		
	Price	P/E	High	Last	Low
Pre-COVID baseline	3,348	21.3			
Sharp V	3,291	20.9	−3%	17%	50%
Swoosh: −25% drop, +15% in 2020, +10% in 2021	2,593	16.5	−24%	−8%	18%
Slow swoosh: −30% drop, +10% in 2020, +10% in 2021	2,319	14.8	−32%	−18%	6%
L with reduced buybacks	1,787	11.4	−47%	−37%	−18%

Source: Fidelity Investments. As of April 2020.

There are so many variables

All of these scenarios are assuming an equity risk premium (ERP) of 5.5%, which is a stable and conservative assumption in my view. (Equity risk premium is the additional return above a "risk-free" rate investors expect for putting their money into a riskier asset class.) Based on various approaches and time frames, the realized ERP (as opposed to the implied ERP, which tends to bounce around a lot) is between 4% and 6%. As the chart shows below, the ERP that we use to discount earnings makes a huge difference in determining the present value of future cash flows. So getting this part right is crucial.

DCF scenarios



Monthly data. Source Bloomberg, FMRCo. As of April 2020.

The other critical variables are the risk-free rate (i.e., the ten-year Treasury yield), and of course the payout ratio (the amount of earnings returned to shareholders). That last number is currently 89% and has been in roughly that zone since the buyback era began in the mid-2000s. But it hasn't always been this high. During the 1970s the payout ratio was only around 50%. Getting that one right will be very important.

As you can see, the DCF involves a number of variables, from the earnings track to the risk premium to the risk-free rate to the payout. It's like solving a three-dimensional puzzle in real time. That's difficult enough in a normal market, let alone at a time like this.

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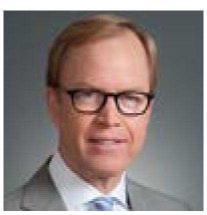

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* Discounted cash flow (DCF) is a valuation method used to estimate the value of an investment based on its future cash flows. DCF analysis attempts to figure out the value of an investment today, based on projections of how much money it will generate in the future. This applies to both financial investments for investors and for business owners looking to make changes to their businesses.

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