

2nd Quarter 2020 Market Outlook: The Black Swan Has Landed, and the World Has Changed

By Mark Simenstad | 04/03/2020

Economists have long theorized about the impact of significant events that are unexpected and extremely rare and have a profound effect not only on the economy and the markets but across our societies at large. Such events have been dubbed “black swans” because they tend to be as rare and improbable as a black swan sighting in the wild. The coronavirus is that “black swan” event.

Although pandemics have occurred throughout history, this is the first time one has significant impact to our highly-interconnected global economic and financial system. The ramifications have been swift, shocking and far-reaching.

Pre-coronavirus environment

As the new year began, the global economy, including the U.S., was showing nascent signs of emerging from a tariff-induced manufacturing slow down. The Federal Reserve (Fed) and other central banks were engaged in lowering interest rates, the employment market was healthy – particularly in the U.S. – earnings expectations were improving, and stock markets were at record levels.

However, there were other dimensions to this backdrop that were not so favorable. Brexit and Eurozone politics were a concern, oil markets were in flux, and the U.S. was facing an uncertain political future with the upcoming presidential election. All of that seems like ancient history now.

The coronavirus black swan

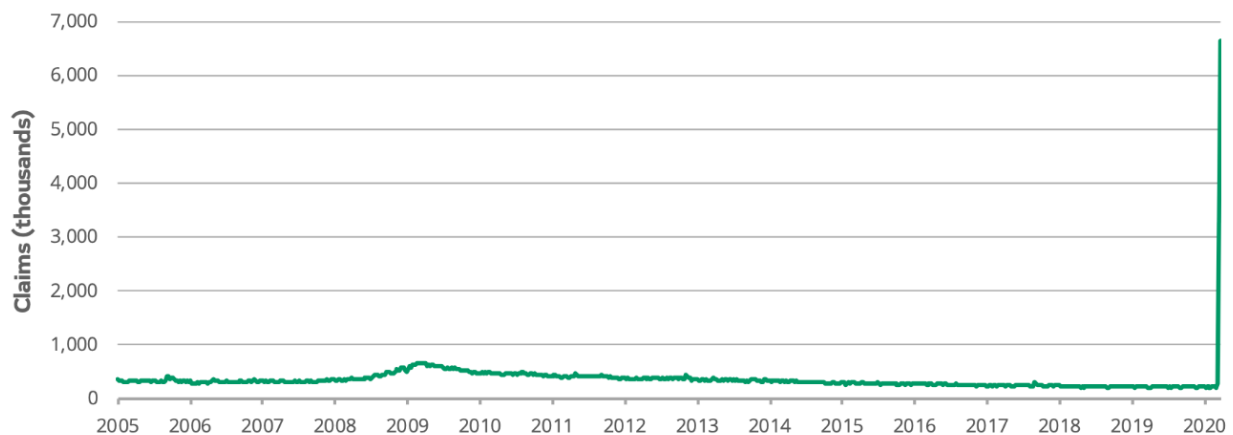
We are now painfully familiar with the necessary steps that health officials and governments around the world have put in place to fight this virus and save lives. In doing so, it has required the unprecedented lock down of the global economy.

The consequences of these actions have been pervasive, with the major impact being the immediate, large scale loss of jobs and, thus, income. The banking and credit systems have been thrown into some disarray, as borrowers may not be able to service their debts due to a loss of income and cash flow. The shockingly swift, pervasive and sizeable loss of jobs is shown in the U.S. unemployment statistics (below) . The final figure, 6.65 million claims, is from the week ending March 28:

Initial unemployment claims

January 1, 2005 – March 27, 2020

Exhibit 1



Source: FactSet

This market crisis is unique in that it has not been caused by a financial, economic or policy event. Instead it is a biologic event, the complexities of which are extremely difficult for policy makers or investors to grasp. Because it is a biological health event, the conclusion of this unique financial crisis will require a biological-related solution, a clear “flattening” of the coronavirus infection rate and/or breakthroughs in testing, treatment and vaccination.

In the meantime, most economic and market metrics that would drive an outlook and investment strategy in a normal environment will be of little value now. However, government programs used to deal with this crisis can certainly be evaluated from a historical perspective to gain some degree of insight as to what to expect longer term.

The government black swan response

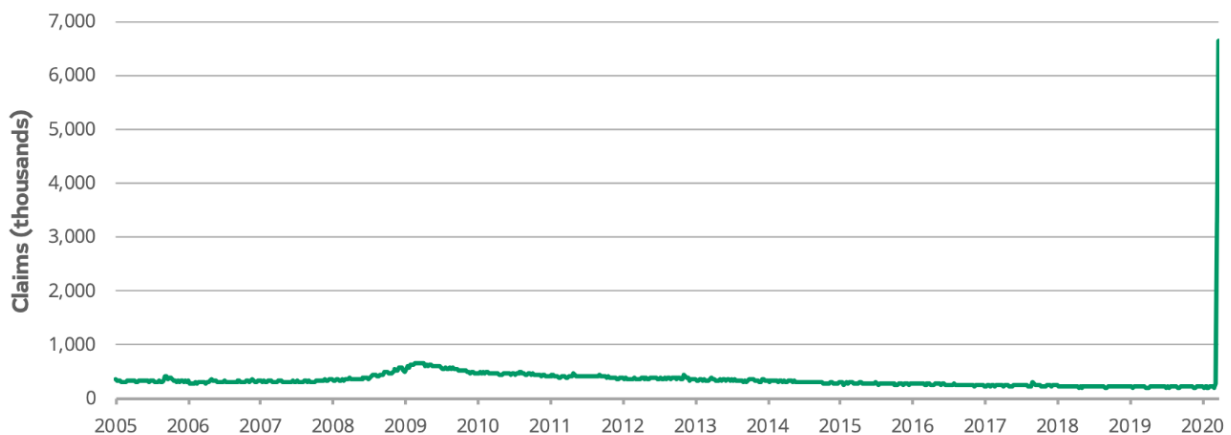
To deal with a black swan event, governments must counter with their own black swan. The worldwide government response to the economic crisis caused by the coronavirus has been surprisingly swift, comprehensive and of a magnitude that we have never seen before. The “first responders” to this economic crisis, as is typically the case, have been the central banks, led by the Fed.

The Fed cut short-term interest rates to zero or below (see Fed Funds chart below), purchased massive quantities of bonds to lower long-term interest rates, and installed credit facilities to support the smooth functioning of the payment system and the credit markets. This immense injection of liquidity and support has worked like a defibrillator, jolting the credit markets back to life.

Initial unemployment claims

January 1, 2005 – March 27, 2020

Exhibit 1



Source: FactSet

Congress has now joined in the effort to support the economy by passing an unbelievably massive piece of legislation, the CARES Act. This legislation appears to offer sizeable and well-targeted immediate relief to consumers and small businesses, while providing vital support to the health care system, states, municipalities, and key elements of American industry.

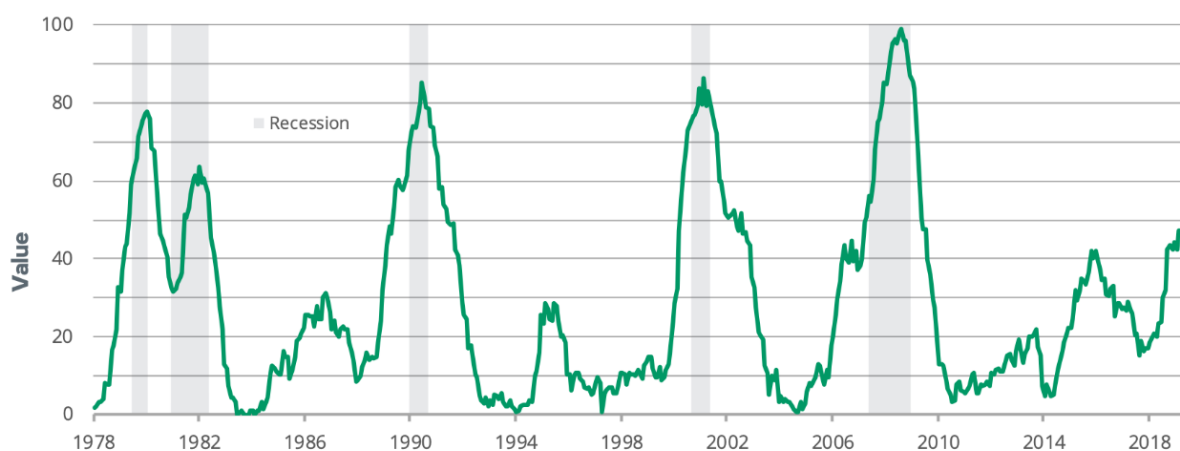
Market response and outlook

As mentioned previously, economic statistics will be somewhat irrelevant in developing an outlook given the lag in reporting. We fully expect our proprietary TECI index (shown below), to vault higher in the months ahead to show significant economic distress.

Thrivent Economic Conditions Index

Exhibit 3

August 1978 – March 2020



Source: Thrivent Asset Management

Thrivent Economic Conditions Index (TECI) is a proprietary risk measure that tracks the trends of a multitude of underlying economic indicators in the U.S. to predict the likelihood of a recession. The higher the index, the greater the number of indicators that are trending negatively. The indicators include, but are not limited to, components of GDP, employment data, payroll data, retail, industrial and manufacturing data, housing data, sentiment indicators and a wide variety of other data sources.

However, the massive government response, both monetary and fiscal, is already showing signs of stabilizing markets and consumer and business confidence. It is expected that this black swan event could reduce U.S. gross domestic product (GDP) by up to 15% over the near term. However, the combined government responses may be equivalent to this loss in economic activity. Furthermore, additional government support is being considered and will probably come to fruition.

Although economic statistics, corporate earnings and other critical data will be of limited value in the near term, investors can look at prior periods of severe economic and market crisis to gain some insight as to possible outcomes.

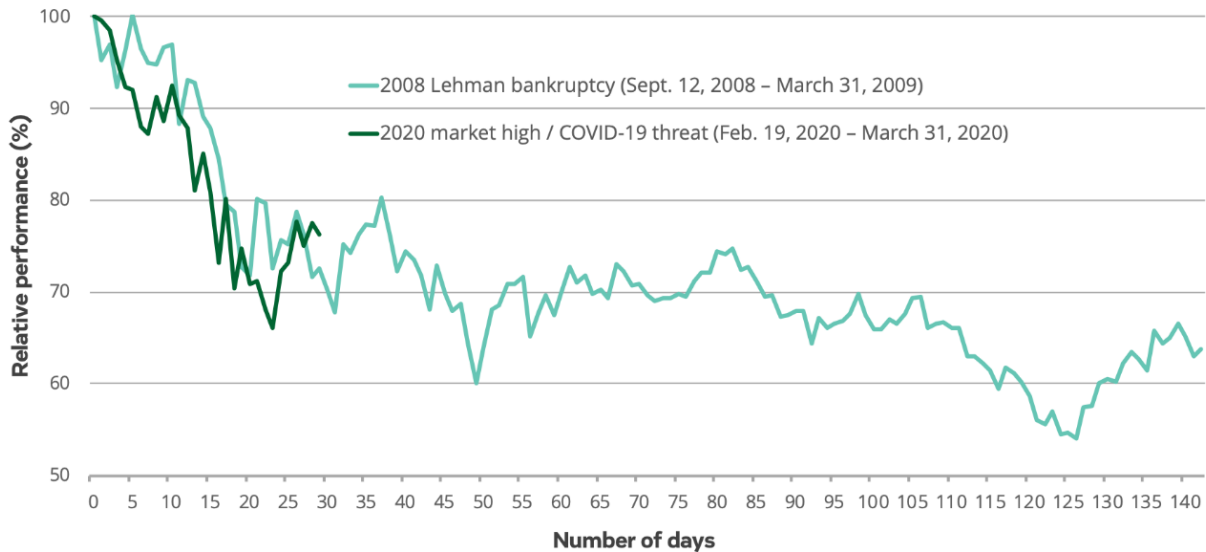
The best historical precedent we have is the Great Financial Crisis (GFC) of 2008. At the time, it was considered the greatest challenge since the Great Depression. Similar to the current crisis, very novel and bold government initiatives were taken to salvage the economy and the markets. It is instructive to track how the market is behaving since the start of the coronavirus crisis relative to how the market behaved during the GFC.

As the chart below shows, although the current crisis has been relatively short, there are real similarities. Longer term the initiatives taken during the GFC, although controversial, were ultimately effective. The economy went on a historically long

expansion, and investors in risk assets of all types enjoyed extremely attractive returns.

Comparison of 2008 and 2020 crisis (S&P 500 performance)

Exhibit 4



Source: FactSet

As society and governments deal with this public health crisis, we expect markets to remain very volatile, with the real possibility of risk markets reaching even lower levels. However, we are encouraged that the credit markets have stabilized. Historically credit markets recover first, and early opportunistic investors in those markets have been rewarded.

Although credits markets have moved materially from their lows (low prices/high yields), we believe there is still long-term value in this area, particularly corporate and municipal bonds.

We believe stocks may take more time to recover given the highly uncertain nature of earnings going forward. However, once the economy stabilizes with the help of immense government support, the earnings picture will become less uncertain. With interest rates expected to remain low for the foreseeable future, valuation metrics such as the P/E multiple, will look reasonable if not very attractive for long term investors.