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Harman Wealth Market Bulletin

Maintaining Caution While Facing Recessionary Forces Ahead

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Considering the initial "shock and awe" containment collapse in markets, many investors are now dismissing the risk that markets fall further. Meanwhile, macro-economic realism shows recessionary forces on the way. Be forewarned.

First, Understand Where We Started

Rolling back to the start of 2020, the assembly of evidence painted a very risky outlook for what could occur if the economic expansion were to eventually end.

- The U.S. economic expansion was the longest in U.S. history.
- The S&P 500 was experiencing the second longest bull market in history.
- As a result, the Shiller CAPE† ratio for the S&P 500 was 31.23. There have been higher valuations in only 4% of the measurements for the last 150 years.
- The S&P 500 PE ratio based upon trailing twelve-month earnings was 24.66, in the top 6th percentile of PE ratios since 1870.
- Starting in 2017, the ratio of total corporate debt to GDP exceeded 47%. This was the highest ratio in the history of the U.S.

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So, in light of these facts, it is easy to conclude this backdrop was one of the most overstretched, overvalued, overborrowed environments in history, perhaps only exceeded by the market climate of 1999.

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(†The Shiller CAPE ratio is a cyclical adjusted price to earnings ration developed by Nobel prize winning economist Robert Shiller. It is generally applied to broad equity indices to assess whether the market is undervalued or overvalued compared to a long historical context.)

So, in essence, historical valuation metrics clearly show markets, even in light of the recent devastating declines, are nowhere near value or cheap levels.

Second, Understand Where We Have Arrived

The market calamity, in terms of declines and volatility, has achieved historic proportions, but has changed the overarching risk picture very little. Even considering the almost -34% decline in the S&P 500 (and much worse for many other asset classes) here are the new conclusions to be made in relation to the first set:

- The shock to employment, incomes, corporate balance sheets, and eventually credit defaults have likely set the wheels in motion toward an extended recession.
- The second longest bull market is over, and the next long-term bull market is not likely to commence just yet in the face of a new recession beginning.
- Even after the recent decline, the Shiller PE is still in the top 13th percentile on a historical scale. (see Chart 1)
- Even after the recent decline, the 12-month trailing earnings PE ratio is still in the top 17th percentile on a historical scale. (see Chart 2)
- Overstretched corporate debt, stung by a revenue disruption, is about to suffer the greatest level of cascading credit downgrades ever witnessed.

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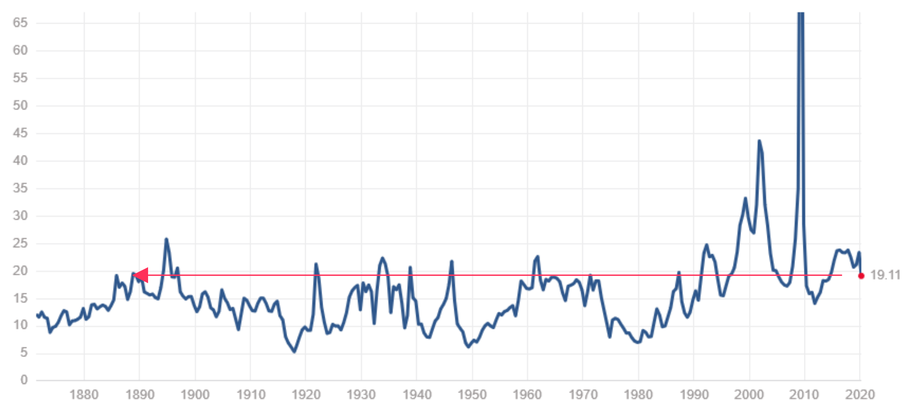
Chart 1: S&P 500 Shiller CAPE Ratio to 1870

Source: https://www.multpl.com/, Robert Shiller

Chart 2: S&P 500 12-Month Trailing PE



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We must also recognize the probability of a recession just beginning. It is likely March will eventually be designated as the first month of the recession of 2020. Unless averted, the economy and corporate footprint will be smaller a year from now. Of the many reasons market prices fall in recessions, one is the simple fact that prices adjust downward to the new lower level of earnings and profits.

Considering the U.S. (and fellow global peers) had carried out the largest credit bubble in history prior to the Coronavirus outbreak, it is a sound conclusion severe revenue distress and missed loan payments follow. Even with massive aid packages and zero-bound interest rates, the cycle of downgrades and defaults which lie ahead will demand a lengthy amount of time for normalization.

For the sake of clarity, lets sum up one more time. Markets are not cheap, pre-existing overvalued markets are ripe for severe drawdowns, a recession is likely developing, and the credit cycle must go through several years of restoration after the expected rise in defaults.

But…Markets have Already Fallen so Far; They Must be Attractive

Without a deep, macro perspective for how markets have suffered steep historical declines in the past, many are failing to understand how much risk still exists in the markets.

"Look how far markets have fallen. It's a great time to buy at discount," so goes the argument.

The counterpoint: First markets are still not cheap. And, second, it is never wise to be long and unprotected at the start of a recession…especially in very extended, over-valued conditions.

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As evidence I'll point to two unsettling examples.

The Recession of 1974.
The stock market plunge of 1973-74 stands out as the most severe market decline between the periods of 2001 and 1937. On a price basis, it fell -48.2%.

What's notable for this period is markets fell -16.4% prior to the first month of the recession. If, like today, investors believed markets were at discount irrespective of the economic risk, they would have suggested markets were at a good buying point. To the contrary, the S&P 500 fell another -38% once the recession commenced and further deepened.

The Recession of 2001.
What is euphemistically referred to as the tech bubble crash was really the recession of 2001. Like the recession of 1974, markets fell substantially in front of the recession start date of March 2001.

In the twelve months preceding the start date, the S&P saw a peak-to-trough decline of -18.8%. Without having a macro understanding of the economy, many would have assumed the markets couldn't go much lower. However, in the ensuing economic contraction, investors saw the S&P 500 decline another -37.4% before the market bottomed in October of 2002.

For a more extreme example, let's consider the NASDAQ composite index over the same period. For 2000, the year before the recession, the Nasdaq composite saw a slide of -53.8%. Again, that was before the recession started. The Nasdaq composite saw another -52.2% slide from January 2001 until hitting bottom twenty months later.

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So, what's to conclude from these examples? At the utmost, it is to be forewarned of recessionary markets slides. Know that market declines in front of recessions can do little to prevent further declines. As unemployment climbs, corporate earnings shrink, and corporate buybacks dry up, recessionary forces have consistently facilitated further market declines.

But…Congress and The Fed have Provided Massive Support

There is another compelling notion prodding some investors to dismiss risk – it comes from the encouragement they feel from the massive relief package just passed through Congress. Likewise, there are good feelings from the urgent and extreme measures implemented by the Federal Reserve.

Looking for historical perspective, we have one shining example of similar measures from the last global financial crisis of 2008. In the wake of a deepening recession, September was an incredibly tough time. Within a few short weeks, investors saw the Lehman bankruptcy, the Washington Mutual bankruptcy, and the Fed bailing out AIG. Markets suffered through a liquidity crisis proportionate to our own situation today.

In response, Congress passed the Emergency Economic Stabilization Act of 2008 on October 3rd, creating the $700 billion TARP program. By that time, the S&P was already down -29.3% from its high and the economy was nine months into the recession. So, what happened from there?

Rushing to stabilize markets in crisis is vitally necessary. Likewise, providing urgent aid to fill the income gap from lost wages is crucial and humane. However, just as in 2008, neither of these measures stop the recessionary forces already at work.

From October 3rd, the S&P 500 continued to fall another -39.3% over the next five months before bottoming on March 3rd. The recession continued until the final month in June of 2009.

What's our takeaway?

Rushing to stabilize markets in crisis is vitally necessary. Likewise, providing urgent aid to fill the income gap from lost wages is crucial and humane. However, just as in 2008, neither of these measures stop the recessionary forces already at work.

The Threat of Drawdown Remains Exceptionally High

It's tempting to assume severe risks in the markets have passed when we see a series of positive up days. After the unprecedented declines and emotional trauma of the last month, it is relieving to see a rally offering hope the worst is over.

However, bouncing off of lows doesn't define the future risk environment as we stare at a freight train of recessionary data heading our direction. In one week, initial claims for unemployment jumped to a staggering 3.28 million new claims. By adding to the unemployment data from last month, the unemployment rate immediately jumps up to 5.5% from 3.5% (in one week!). It is likely we see similar jumps in each of the next three weeks.

If you doubt my sentiment about serious risks ahead, perhaps you'll trust the opinions of those most experienced at dealing with recessions.

- This morning in a televised interview, Federal Reserve Chairman Jerome Powell stated, "We may well be in a recession." This is coming from the man whose words are the most scrutinized on the planet. He wouldn't say this recklessly or loosely.
- Earlier this week, PIMCO funds acknowledged a recession is their base case scenario in the outlook ahead. This is coming from a company possessing Ben Bernanke and Jean Claude Trichet (former ECB president) on their Global Advisory Board.

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- In a March 18th article published in the Financial Times and jointly authored by Ben Bernanke and Janet Yellen, they wrote, " if critical economic relationships are disrupted by months of low activity, the economy may take a very long time to recover."
- After a Monday, March 23rd emergency gathering of G20 central bank leaders, the managing director of the IMF started her summary statement, "First, the outlook for global growth: for 2020 it is negative—a recession at least as bad as during the global financial crisis or worse. But we expect recovery in 2021."

Summary Conclusion

The lessons of the past I want to bring forward can be stated quite simply:

Recessionary forces create the highest and severest form of drawdown risk to stock market investors.

When you consider (1) the historically high stock market valuations we've started from and (2) the immense amount of lending we've channeled to keep the expansion moving, then understand our potential drawdown risk was already higher than most recessionary starting points.

In spite of the up and downs of the last four weeks, further risks in the economy and markets remain exceptionally high. Be forewarned.

*(For fantastic work on the relationship between valuations and drawdown risk, see Keimling, Norbert, Predicting Stock Market Returns Using the Shiller CAPE — An Improvement Towards Traditional Value Indicators? January 21, 2016.)

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For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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