THE BIG PICTURE
OF GLOBAL ECONOMICS

WITH

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May 11th, 2020

V versus U

- **The grind higher in US equities appears to back the V-shaped recovery view**
- **A possible 25% unemployment rate would signal a U.**
- **We should remain cognisant of the massive relief provided to households**
- **Will households save or spend their 'Trump' cheques? … History suggests saving**
- **Some US equities have seen startling P/E expansion**
- **Keep an eye on emerging market debt… there's some better news**

It is often said that the equity market is a window on the future. Hence the continued grind higher in the US equity market has us looking for the support for a view that the US economy will enjoy a V-shaped recovery. To be fair the scale of the support for the US economy is unprecedented but we still fear a U-shape recovery with a deep floor to the U. Meanwhile the valuation of some stocks looks to be well ahead of reality.

If the US economy is to recover smartly from COV-19, it will need consumer spending to make a healthy comeback after the lockdown. The headlines don't read well, but some economists do point to some good news.

Firstly, the bad news. **Last week's employment report was eye-watering**. A loss of 20.5 million jobs in April lead to an unemployment rate of 14.7%, the highest since 1940. The true scale of unemployment is probably higher. For example, workers that left the workforce

increased by 6 million and are not included in the unemployment numbers. Indeed, the Bureau of Labour Statistics estimated that the unemployment rate hit 22.8% in April. Even Steve Mnuchin the US Treasury Secretary concedes that US unemployment could be closer to 25% before the economy has completed its down cycle.

However, there are several supports for the US consumer:

1. Blackrock estimates that US government policy will put $86 into each household's pocket for the next six months. This alone adds 30% to the average weekly household income.
2. The average mortgage rate has fallen by about 20 basis points.
3. Gasoline prices have fallen by nearly 30% since the start of the year.

The critical question is whether households will just save any handouts they receive from the government. The current trend is that households prefer to use part of the handouts and daily expense savings to pay down some forms of credit. In March households paid off $34 billion of credit card debt. Credit card debt could fall further in coming months. A recent survey showed that 1 in 4 credit card holders or 50 million Americans had seen their credit limits reduced or credit cards cancelled.

This week sees the US retail sales report for April which is the first major data point from the consumer sector during the lockdown. Excluding auto sales, the consensus is expecting an 8.4% month-on-month fall in retail sales, the largest drop in twenty years compounding the March fall of 4.5% which was also a record. Of course, lock downs seriously constrict discretionary spending. The acid test will be when the lockdowns are eased. Will the consumer come back…. The jury is out.

How bizarre is the ongoing rise in equity markets in the face of weak economic activity? Year-to-date the S&P500 is down only 9.3%. Many people still hold that the equity market has a knack of accurately forecasting turning points. We would argue more that the equity market often gives a signal of better times because it picks up marginal improvements in the outlook. When the equity markets fell precipitously in March, this was because the world was facing a collapse in economic activity in the absence of any support from policymakers. As central banks cut interest rates and adopted quantitative easing along with governments the rapidly put programmes in place to support peoples' incomes, the equity markets rebounded.

We, like many, worry that the scale of the equity market rebound has over-discounted the likely pace of the economic rebound. However, it is a narrow group of companies that have been responsible for the bounce in the index. Only 100 out of the 500 stocks are up year to date. The median performer in the S&P500 is the company 3M whose share price is down 15.8% year-to-date against the index down 9.3%. Analysts have cuts have left the mean earning's estimate for 2020 down 28%. Of the analyst community covering the stock Bloomberg reports that there are three buy recommendations, 12 holds, and 4 sells. The dividend is a healthy 3.9%. The average target price is 5% above the current level.

Even among the stocks that have done well, you have to question how far share prices have risen relative to their near-term growth prospects. Amazon is up 28% year-to-date, and yet the analysts have cut their 2020 earnings estimate from around $50 to $33. And their

2022 earnings estimate to $70 from $90. For sure the Amazon's business model benefits from the lockdowns and maybe accelerates online retailing over bricks-and-mortar. Still, analysts were already forecasting long-term earnings growth of 15%. **To put it another way, Amazon's shares have seen an astonishing 60% expansion of the P/E multiple for 2020 and a 66% P/E expansion for 2022.**

Not all S&P 500 stocks have seen a P/E multiple expansion, Warren Buffet's fund Berkshire Hathaway has seen analysts cut by 7%, but the fund has fallen by 23% year-to-date. Either Berkshire Hathaway's fund is breaking with the past and is much riskier than the market or the fund's performance is indicative of challenges ahead for the S&P500.

While investor caution is still warranted in EM debt, it is equally important to start a vigil for solid opportunities.

Emerging Market debt saw some respite last week. Almost across the board, some stability is starting to become apparent. There are still some severe headwinds facing EM sovereigns and corporates in the current environment. Still, a prolonged spell of stability will leave the market in a better position to assess the relative value of the issuers, as well as the severity of the factors impairing their credit outlook.

The good news for EM last week started in the commodity markets, where double-digit increases in oil prices helped a recovery in oil exporters like Columbia, Qatar, Oman and Bahrain. The narrowing of EM spreads was at least partly due to the recovery in oil prices from their multi-year lows. We do not yet sense a material improvement for the outlook for EM. Oil prices at current levels present a significant threat to the funding ambitions of several sovereigns, and it is naive to expect a full recovery in the sector. However, the risk mood seems to have moved to a more balanced one, leaving scope a period of stability and consolidation in the market.

The second snippet of recent good news for EM debt was the continued robust investor support in the new issuance market. Last week alone, $11.9bn of new issuance was absorbed in the market, for a very healthy total in April of $46.9bn. In a period where the underlying economics presents a very troubling outlook, many issuers will find that a robust new issuance market is something a bail-out. While they do not have the Fed behind them, there is still enough demand (with the odd exception) to support the immediate need for liquidity and refinancing.

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