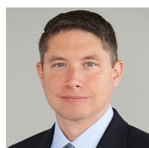
The Long View: Will Shock & Awe Be Enough?



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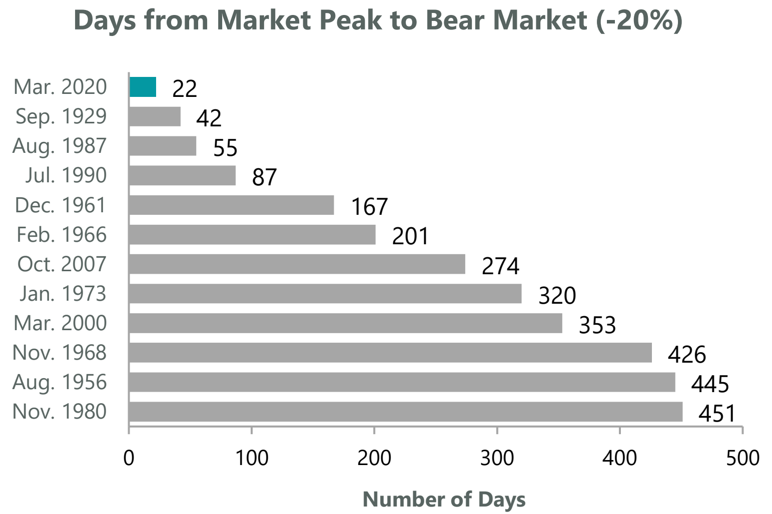
"There are decades where nothing happens, and there are weeks where decades happen." - Vladimir Ilyich Lenin

Key Takeaways

- The global coronavirus pandemic has unleashed historic volatility and turned the ClearBridge Recession Risk Dashboard red, suggesting a recession is underway.
- The initial liquidity-driven downturn has largely played out as correlations are normalizing and leverage has come down. Stocks should now be driven more by fundamentals as investors handicap both the virus outbreak and its associated recession.
- We believe a durable bottom for equities and the economy will form when the virus spread comes under control and credit markets confidently turn upward.
- An unprecedented policy response to the economic shutdown should help avoid a worst-case outcome and accelerate a recovery, but the speed in which aid reaches small businesses will be critical. We have introduced a new ClearBridge Recovery Dashboard to track progress toward resumption of growth.

Almost every aspect of the recent market collapse has been unique, from its cause (a global pandemic) to the speed of the market selloff to the response from policymakers around the globe. Black swan events are by definition nearly impossible to predict, as each one results from a deviation from normal and brings its own individual signature. The extent to which a previously unknown virus has led countries to close borders and limit both business and personal activity is unprecedented. Global supply chains, an initial concern two months ago when the coronavirus was still believed to exist only within China, have been upended. Once it became clear that COVID-19 was spreading largely unchecked within the U.S., investors fled equities and rushed for the safety of government bonds. This caused yields to plummet to all-time lows, with even the 30-year Treasury briefly yielding less than 1%, and the S&P 500 Index saw its fastest decline of -20% (a bear market) from a prior peak in just 22 days. To put this in perceptive, the second-fastest drawdown took twice as long and occurred over 90 years ago as the country descended into the Great Depression (Exhibit 1).

Exhibit 1: Fastest Bear Market from Peak In History



Source: ClearBridge Investments.

The velocity of the recent drawdown was particularly pronounced for several reasons. Lofty valuations, combined with a sharp and severe increase in the probability of a recession, produced a liquidity crunch that exacerbated the initial selloff. Coming into February, equity multiples were stretched, with markets largely pricing in a soft-landing from an economic soft patch. S&P 500 earnings growth was expected to reaccelerate and grow 10% in 2020. However, as it became clear that COVID-19 was going to cause substantial economic damage over an indeterminate period, the new reality and greater uncertainty warranted a change in valuation. This dramatic shift in expectations created a much more damaging liquidity crisis as many systematic investors were crippled by the combination of rising correlations and leverage, which led to forced selling to stay within margin requirements. Volatility across nearly every asset class skyrocketed as this negative feedback loop perpetuated itself. It appears, however, that this second leg of the downturn has largely played out, as cross-asset correlations are now returning to normal levels and leverage has come down. Going forward, we believe equity markets should be driven more by fundamentals as investors try to handicap both COVID-19 and its associated recession.

As highlighted in our mid-March blog, we believe a U.S. recession is forthcoming given the sheer volume of disruption the economy is facing. Our belief was subsequently confirmed, with the ClearBridge Recession Risk Dashboard's overall signal turning "red" or recessionary at the end of the month (Exhibit 2). Several indicators have worsened, most notably Jobless Claims and ISM New Orders, both of which have turned red.

Exhibit 2: ClearBridge Recession Risk Dashboard

		March 31, 2020	March 15, 2020	January 2020
Financial	Yield Curve	Recession	Recession	Recession
	Credit Spreads	Recession	Recession	Expansion
	Money Supply	Expansion	Expansion	Caution
Inflation	Wage Growth	Recession	Recession	Recession
	Commodities	Recession	Expansion	Caution
Consumer	Housing Permits	Expansion	Expansion	Expansion
	Jobless Claims	Recession	Expansion	Expansion
	Retail Sales	Expansion	Expansion	Expansion
	Job Sentiment	Caution	Caution	Expansion
Business Activity	ISM New Orders	Recession	Caution	Caution
	Profit Margins	Recession	Recession	Caution
	Truck Shipments	Expansion	Expansion	Expansion
	Overall Signal	Recession	Caution	Caution

Expansion Caution Recession

Source: ClearBridge Investments.

A strong labor market and broader consumer strength had been the foundation for a soft landing, despite weakness in manufacturing driven by trade-war uncertainty. However, jobless claims set consecutive new all-time highs in each of the last two weeks, going from 211,000 at the start of the month to 3.28 million two weeks ago and 6.64 million this week. The previous high in jobless claims was 695,000 in 1982, when there was a much steadier and more gradual increase in claims over an 18-month period. With 9.92 million people laid off in just the last two weeks, we believe the unemployment rate will increase into the low double digits over the coming months from February's 3.5% mark. Nearly 40 million Americans work in industries directly impacted by lockdowns. While not all will lose their jobs, we believe there will unfortunately be more layoffs in the coming weeks as companies shed workers in an effort to remain solvent. Given the scale of shutdowns forcing businesses to close, recent data suggest the second quarter of 2020 change in GDP could set a new low for the worst single quarter in U.S. history. This dubious claim to fame is currently held by the first quarter of 1958, which saw a post-war record of -10%.

With a recession likely already underway, many investors are attempting to quantify the further drawdown stocks may face. History is a common starting point in these efforts. Since 1948, the S&P 500 has fallen 30% on average from peak to trough during 11 recessionary periods. The 34% decline from the February 19 peak to the March 23 low has already eclipsed these. While the ultimate trough will be known only in hindsight, the fall to date suggests quite a bit of negativity had been baked into equity prices. Importantly, stocks tend to anticipate turning points in the economy

(albeit with many false starts) and have troughed an average of three months before the end of past recessions (Exhibit 3).

Exhibit 3: Stocks Anticipate Economic Recoveries

Economic Recessions vs. Market Lows

Recession Start	Recession End	Length of Recession (Months)	Market Low	Market Low to End of Recession	S&P 500 Peak to Trough
Nov-48	Oct-49	11	Jun-49	4 Months Prior	-30%
Jul-53	May-54	10	Sep-53	8 Months Prior	-15%
Aug-57	Apr-58	7	Oct-57	6 Months Prior	-22%
Apr-60	Feb-61	9	Oct-60	4 Months Prior	-14%
Dec-69	Nov-70	10	May-70	6 Months Prior	-36%
Nov-73	Mar-75	16	Oct-74	5 Months Prior	-48%
Jan-80	Jul-80	6	Mar-80	4 Months Prior	-17%
Jul-81	Nov-82	15	Aug-82	3 Months Prior	-27%
Jul-90	Mar-91	8	Oct-90	5 Months Prior	-20%
Mar-01	Nov-01	7	Oct-02	11 Months After	-49%
Dec-07	Jun-09	17	Mar-09	3 Months Prior	-57%
			Average	**3 Months Prior**	**-30%**

Data as of March 2020. Source: National Bureau of Economic Research, FactSet. Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

We believe a durable bottom for equities and the economy will form when the following key conditions are met: a suitably strong policy response emerges, COVID-19 begins to come under control and credit markets confidently turn upwards, pacifying solvency concerns. Strong fiscal and monetary policy responses have materialized in recent weeks, helping to buoy stocks and stabilize credit. However, the virus continues to spread rapidly, preventing financial markets from rebounding closer to pre-outbreak levels.

The Policy Response: Fiscal

The speed of passage and size of the Coronavirus Aid, Relief and Economic Security (CARES) Act deserves praise. Congress quickly put together a $2.2 trillion fiscal stimulus package, equivalent to 10% of GDP. On paper, this package should help blunt the impacts of social distancing measures that currently impact over 75% of the population. The stimulus bill is enough to offset a 25% decline in GDP for five months. What remains to be seen is how quickly this stimulus can arrive in the hands of both corporations and individuals. A longer delay will translate into a more prolonged and deeper hole to dig out of. History would suggest caution is warranted here. Following the passage of the last two recessionary fiscal packages (2001 and 2008), it took about three and a half months for consumers to receive checks. As a result, neither package stemmed the tide of those downturns.

Stocks tend to anticipate recoveries and have troughed an average of three months before the end of past recessions.

Equally important, with limited cash reserves, most small businesses cannot survive an environment where revenues fall to zero for a prolonged period. Keeping smaller companies afloat is a paramount concern because it allows a much faster recovery if workers have a job to return to when social distancing measures are eased. But getting capital to these small businesses will likely take some time as the sheer volume of applications makes administration more difficult and many small businesses do not have relationships (and thus documentation) in place with the entities disbursing funds (loans) under the stimulus bill. However, Treasury Secretary Mnuchin has discussed the idea of streamlining the Small Business Administration (SBA) loan process to allow for quicker disbursement of funds. To that end, the SBA recently released the loan application document for this program, which is only four pages, although the process for getting a loan is not as simple as just filling out a short application. While minimizing abuse is an important concern, hopefully these programs can be administered with minimal red tape.

The Policy Response: Monetary

The Federal Reserve has also been extremely busy attempting to prevent the exogenous shock of COVID-19 from triggering worse problems such as a liquidity or credit crunch. In two weeks, the Fed deployed its entire arsenal from the Global Financial Crisis, and then took additional pages from the playbooks of the European Central Bank (ECB) and the Bank of Japan. The Fed effectively took a kitchen sink approach, then found a second kitchen sink and tried that one too. This was Chairman Powell's "Do Whatever It Takes Moment," which was what then-ECB President Mario Draghi said during efforts undertaken in 2012 when the continuing existence of the eurozone was coming into question.

The Fed has introduced an alphabet soup of programs, including an open-ended quantitative easing (QE) program that has been expanded to include new types of bonds. It has also announced programs intended to provide liquidity and support to various markets, including those for investment grade corporate bonds, repurchase agreements (repos), money markets, municipal bonds, commercial paper, small business loans, student loans, credit card loans, auto loans and even exchange-traded funds (ETFs).

Beyond cutting interest rates to zero, the Fed will provide trillions of dollars of liquidity to help stabilize financial markets. Many corners of the credit markets that previously had been showing strain, such as repos, are starting to normalize. Furthermore, credit issuance has resumed after a nearly two-week pause with the latter third of March perhaps the strongest period of investment grade credit issuance on record. Driven by this burst, high-quality issuance set a new all-time high in March. While monetary stimulus is not the textbook tool to fight a supply shock, the Fed has gone

to extraordinary lengths to prevent these issues from worsening and causing "echoes" in credit markets. When the economy eventually turns the corner, accommodative policy and the trillions of dollars made available for lending (nearly 35% of GDP combined) should help accelerate the recovery.

The Spread of COVID-19

The final piece of the puzzle necessary for a durable bottom will come from a very different area: medicine. Ultimately, the threat presented from COVID-19 needs to be reduced or eliminated for the social distancing measures impacting the economy to be eased. This can come in several forms. A medical breakthrough that allows for better treatment of sick patients (both in terms of hospital stay duration and mortality) would help. Development of a vaccine would be even better, and while we are not medical experts, our colleagues tell us this is still likely 12–18 months away.

In the interim, we believe a peaking of the growth rate for new infections could serve as a catalyst for a durable bottom. If investors can begin to accurately gauge when social distancing measures might begin to be lifted, they can start to price the impact to corporate earnings and solvency with greater confidence.

Some investors are looking to how the virus, economy and stock markets responded in places like China to gain additional insight because the spread of coronavirus began later in the U.S. Chinese authorities imposed a forceful quarantine as it became clear there was an outbreak and newly reported confirmed cases peaked 21 days after the lockdown began. By contrast, the U.S. employed a more informal and regionalized lockdown, which started only in mid-March. The less aggressive lockdown, delayed initial response and lack of adequate testing are key differences that will likely prolong the U.S.'s battle.

Given these variations, Italy could be a better case-study for what might be coming. Although the U.S. and Italy also have some important differences, if we were to follow Italy's trajectory, markets would likely remain in limbo for the next two to four weeks until greater clarity begins to emerge.

Consensus currently expects the U.S. to experience a deep, short-lived recession. This viewpoint relies on two important assumptions: first, that the battle with COVID-19 will be over by the end of spring, which would allow social distancing measures to be lifted; and second, that there will be no future outbreaks or contagion. This outlook represents a best-case scenario, as any further delay to lockdowns would prolong the duration of the recession. Perhaps even more importantly, a second wave of COVID-19 cases could require social distancing to be re-introduced regionally if not nationally, which would lead to another leg lower and further economic pain. While China is

currently attempting to return to normal as the virus has largely come under control within its borders, the country is still operating at below-normal levels (economically speaking) and has closed its borders to foreigners (and restricted the entry of its own citizens) to try and prevent the re-importation of the virus.

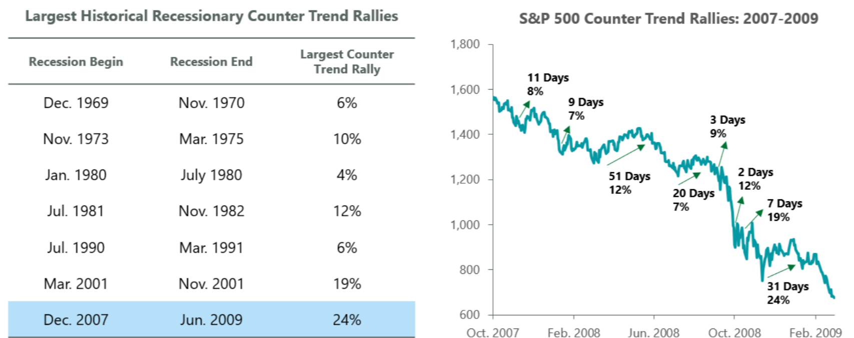
A peaking of the growth rate for new COVID-19 infections could serve as a catalyst for a durable bottom for stocks.

Counter Trend Rally?

Ultimately, this recession's end date will only be known with the benefit of hindsight. However, there is a cohort of investors who believe we have already seen the lows for this cycle, with the S&P 500 rallying 17.6% off its March 23 low in just three trading sessions, before ending the month 11.6% above the recent bottom. In fact, the three-day advance last week was the largest in 90 years. Although it's certainly a possibility that we've seen the low, calling a market bottom at any point can be challenging due to the prevalence of countertrend rallies.

A counter trend rally is a strong (and often short-lived) rally that occurs amid a larger market drawdown. Often, these periods of market strength fool investors into thinking a bottom has been formed, only to disappoint them when the market later rolls over and resumes its larger decline. During prolonged bear markets such as those occurring during past recessions, investors that have fallen victim to several failed countertrend rallies often under-allocate to equities or sell out completely, which can be detrimental when a new bull market eventually starts. Deeper recessions appear to generate larger countertrend rallies, with 15%–25% moves higher in stocks during the 1973–75, 2001, and 2007–09 recessions. These do not tend to be one-off events within a recession either. Between February 2008 and January 2009, there were eight notable counter trend rallies (Exhibit 4).

Exhibit 4: Counter Trend Rallies Commonplace



Largest Historical Recessionary Counter Trend Rallies

Recession Begin	Recession End	Largest Counter Trend Rally
Dec. 1969	Nov. 1970	6%
Nov. 1973	Mar. 1975	10%
Jan. 1980	July 1980	4%
Jul. 1981	Nov. 1982	12%
Jul. 1990	Mar. 1991	6%
Mar. 2001	Nov. 2001	19%
Dec. 2007	Jun. 2009	24%

Source: National Bureau of Economic Research, FactSet. Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

ClearBridge Recovery Dashboard

The pervasiveness of these false starts helped frame our decision to develop the ClearBridge Recovery Dashboard (Exhibit 5) in order to help us identify conditions that have been necessary for forming historical durable bottoms. This dashboard comprises nine individual indicators that fall into three key areas that we believe are essential for a lasting expansion to take root: Confidence, Financial and Economic. Each indicator can signal continued recession (red), improvement (yellow), or expansion (green). Going back to 1969, on average, the recovery dashboard turned yellow five months prior to the end of each recession and green one month after each end. At present, the dashboard is flashing an overall red signal with six individual red indicators, two yellow and one green. The sole green signal is Fed Policy, which is often one of the earliest indicators to improve, as the Fed has historically cut interest rates at the onset of a recession. Due to the lags associated with monetary policy, it often takes several quarters for this to translate into an improving economy.

Exhibit 5: ClearBridge Recovery Dashboard History

		Current	2007-2009	2001	1990-1991	1981-1982	1980	1973-1975	1969-1970
Confidence	Consumer Confidence	✕	●	⬆	⬆	●	●	⬆	●
	Business Confidence (ISM)	✕	●	●	✕	✕	●	⬆	●
	Investor Sentiment	●	✕	✕	⬆	⬆	⬆	⬆	⬆
Economic	Building Permits	✕	✕	✕	●	⬆	✕	✕	●
	Initial Jobless Claims	✕	✕	●	✕	⬆	✕	✕	✕
	Philly Fed	●	⬆	⬆	⬆	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✕	⬆	●	⬆	●	●	⬆	⬆
	Fed Policy	⬆	⬆	⬆	⬆	⬆	⬆	⬆	⬆
	Financial Conditions	✕	✕	✕	⬆	⬆	●	⬆	n/a
	Overall	✕	⬆	⬆	⬆	⬆	⬆	⬆	⬆
	Months From Green to End of Recession	?	+5	-1	0	-2	+1	-1	+6

⬆ Expansion ● Improvement ✕ Recession

Data as of March 31, 2020. Source: Source: FactSet, Bloomberg, Conference Board, Census Bureau, Federal Reserve, FRBPA, Chicago Fed, ISM, Dept. of Labor, Bloomberg/Barclays, AAII, Investors Intelligence, and Moody's. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

As we close this letter, a quote by Vladimir Lenin comes to mind "There are decades where nothing happens, and there are weeks where decades happen." The global economy will likely be forever altered from the events that have transpired in the last few short weeks (although they have felt much longer). What will the world look like on the other side of this storm? Will supply chains

become shorter and more domestically focused? Will more countries continue to close borders in an effort to suppress the next outbreak? Will American consumers go back to their pre-virus daily lives and gather in churches, malls and restaurants, or at concerts and sports events, and will they travel while there is no available vaccine or cure? On a more personal note, will we go back to traveling to visit clients and speak at conferences as frequently, or will virtual meetings become the new normal?

No one can know the answer to any of these questions. However, we believe changes in consumer behavior and fears of future outbreaks will likely impact behavior in the short-to-intermediate term, which will dampen the economic recovery to something more akin to a backward “J” rather than a full “V.” Businesses impacted by the outbreak have been given a lifeline with recent stimulus, but it may not matter if consumers change their daily routines more permanently.

We believe the Fed’s extraordinary measures have staved off the liquidity crisis plaguing markets earlier in March. This is clearly evident as both the U.S. dollar and credit spreads have begun to re-normalize. With financial tail risks truncated, we believe that the peak in volatility has likely been seen, even if the market may retest its lows in the coming weeks or months before beginning to move sustainably higher. This dynamic would not be unprecedented. For example, the CBOE Volatility Index or VIX, a measure of volatility, hit its high five months before the trough in equities during the Global Financial Crisis. In the interim, we will be monitoring the ClearBridge Recovery Dashboard for guidance on when a durable recovery is forming that would allow economic growth to resume and the markets to move sustainably higher.

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