ClearBridge Investments

The Long View: FOMO or FOGO?

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"No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future." - Ian H. Wilson (former GE Chairman)

Key Takeaways

- Swift and aggressive policy actions to combat the fallout from economic shutdowns could make the current recession the shortest in history and have likely put in a durable economic and equity market bottom.
- The ClearBridge Recovery Dashboard turned green in June, boosted by improvements in Business Confidence and Financial Conditions, indicating that the economy is back in expansionary mode and confirming the brevity of the recession.
- We expect the recovery to be sluggish due to ongoing labor market weakness and the reticence of some consumers to spend, however equity markets typically follow the robust rally we saw in the second quarter with further gains over the following year.

FOMO (Fear of Missing Out) vs. FOGO (Fear of Going Out)

When trying to reconcile the current bifurcation between financial markets and the economy, a common paradox comes to mind: What happens when an unstoppable force meets an immovable object? In this case, the unstoppable force is the tenacious determination of our policymakers, the Fed and Congress, to avoid falling into the next Great Depression. The immovable object is a U.S. economy that remains extraordinarily fragile and faces several ongoing headwinds from increasing coronavirus infections, an extremely weak labor market, a rising surge of bankruptcies and a potentially hesitant consumer. So far, the market is giving the unstoppable force the edge, with policy support overwhelming economic weakness.

The primary reason we believe policymakers have won the opening salvo is the unique visibility they have been afforded due to the dynamic of a recession largely caused by shutdowns. The National Bureau of Economic Research (NBER) officially declared the current recession just four months after it began, the fastest on record. Similarly, policymakers were able to respond with swift and aggressive actions to combat the economic impacts of the shutdowns and stave off a financial meltdown. The Fed moved nearly at light speed — doing what took quarters during the Global Financial Crisis (GFC) in just weeks — in providing liquidity to credit markets. Congress also deserves credit, having provided over $3 trillion in fiscal stimulus and distributed much of those funds to small businesses and consumers in record time.

The ability of policymakers to step in aggressively was paramount for jump-starting the next expansion faster than was widely anticipated.

To put the recent stimulus package in perspective, the Marshall Plan to rebuild Europe after World War II cost approximately $140 billion in current dollars. The Vietnam War cost around $1 trillion in today's money. With further stimulus widely expected later this summer, the recent crisis will likely end up costing closer to $4 trillion at the low end, a figure 29x the Marshall plan and 4x the Vietnam war. This startling amount of intervention over the course of four months has largely been behind the second quarter move in equity markets.

Last quarter, we introduced the notion that counter trend rallies and the process of retesting market lows are normally preconditions for a durable bottom. However, with the benefit of hindsight, we believe this process has been short-circuited due to the current policy response. Typically, there are several false starts in finding a bottom; today, these intense and decisive policy actions helped put a floor under markets sooner and with little uncertainty. While the NBER is unlikely to declare the recession formally over for some time, we believe it has already concluded. Due to the somewhat mechanical nature of the shutdown and then reopening process, it is hard to see how the economy cannot have already returned to growth at this point, with activity picking up from extremely depressed levels. Whenever the trough is officially declared, this will likely become the shortest recession on record (four to five months), taking the place of the six-month recession in early 1980.

These views rhyme with the signals emanating from the ClearBridge Recovery Dashboard. In May, the overall signal advanced to yellow, suggesting an improving backdrop. This month, that positive momentum continued, and the overall signal has progressed further to green, driven by two positive underlying signal changes as well as further improvement in several other indicators that did not warrant a change of signal.

Exhibit 1: ClearBridge Recovery Dashboard

		June 30, 2020	May 31, 2020	April 30, 2020
Confidence	Consumer Confidence	⬆	⬆	⬆
	Business Confidence (ISM)	⬆	✕	✕
	Investor Sentiment	✕	✕	✕
Economic	Housing Starts	✕	✕	✕
	Initial Jobless Claims	●	●	✕
	Philly Fed	⬆	⬆	⬆
Financial	Credit Spreads	●	●	✕
	Fed Policy	⬆	⬆	⬆
	Financial Conditions	●	✕	✕
	Overall Signal	⬆	●	✕

⬆ Expansion ● Improvement ✕ Recession

Source: ClearBridge Investments.

The first underlying signal change is Business Confidence (ISM), which has improved directly to green from red. Business Confidence is crucial to any economic recovery and the ISM Manufacturing survey is its best measure. The survey provides an excellent read on corporate spending intentions, which have historically led economic activity. The headline number recently bounced clearly into positive territory at 52.6 (50+ is expansionary) following a decline into the low 40s in April. We focus on three subcomponents of the survey: New Orders, Supplier Deliveries and Production. The recent aggregate strength of these metrics has allowed this indicator to skip yellow and head straight to green, even collecting $200 along the way (for the Monopoly fans out there).

The second signal change is Financial Conditions, which has improved to yellow. We focus on the Chicago Fed's National Financial Conditions Index, a broad-based measure of approximately 100 underlying data points that gauge liquidity and the health of the financial system. The strong support from the Fed has helped to ease financial conditions over the past several weeks. Given the Fed's indications that policy will remain extremely accommodative for the foreseeable future, we would not be surprised to see this indicator continue to improve and turn green later this summer.

These changes, along with more modest improvements in other signals, have pushed the overall signal of the ClearBridge Recovery Dashboard into green or expansionary territory. This is a very important dynamic as it suggests that both the economy and financial markets have found durable bottoms following the (likely) worst quarter for U.S. GDP in modern history. We believe the ability of policymakers to step in aggressively was paramount for creating this floor and jump-starting the next expansion faster than was widely anticipated.

Bounce Back Rally Could Have Room to Run

Importantly, the nature of the crisis helped set the backdrop for its brevity. Just over a decade ago, Wall Street was blamed for tanking the economy on the back of excessive leverage and unsavory dealings in the housing market. While bailing the banks out was unfavorable, it was likely necessary to avoid a depression. Today, the coronavirus has caused a very different setup. No single entity or individual is to blame for the pandemic, providing expedient political cover for government support to individuals and businesses. This dynamic appears unlikely to play out again in the future, meaning the policy supports experienced in this crisis may not be there in the next. As a result, we believe that the more typical experience of a longer recession, with counter trend rallies and a retest of the lows, is more likely in the future.

As a reminder, the ClearBridge Recovery Dashboard was designed with the aim of turning green slightly after the lows in equity markets, in order to avoid the whipsaw from counter trend rallies. While this was not the case in this recession and the markets have moved strongly higher from the March lows, we do not believe investors should succumb to the fear that they have "missed out." Historically, the S&P 500 has rallied another 96% on average after the recession has ended, during the ensuing expansion. This has come in addition to the 28.5% that the market has historically gained between the market bottom and the recession's end. Focusing on expansions that occurred during secular bull markets, which we continue to believe is the case with the current market , the average return jumps to 149% (Exhibit 2). Regardless, history would suggest that ample upside exists from current levels for longer-term investors due to the likely recent conclusion of the recession.

Exhibit 2: Market Returns During Economic Expansions

S&P 500 Returns During Economic Expansions

Trough Month	S&P 500 Level	Peak Month	S&P 500 Level	Duration (Months)	Change	Secular Trend
Nov. 30, 1970	87.2	Nov. 30, 1973	95.9	36	10.0%	Secular Bear
Mar. 31, 1975	83.4	Jan. 31, 1980	115.1	58	38.1%	Secular Bear
July 31, 1980	121.7	Jul. 31, 1981	130.9	12	7.6%	Secular Bull
Nov. 30, 1982	138.5	Jul. 31, 1990	356.2	92	157.1%	Secular Bull
Mar. 28, 1991	375.2	Mar. 30, 2001	1160.3	120	209.2%	Secular Bull
Nov. 30, 2001	1139.5	Dec. 31, 2007	1468.4	73	28.9%	Secular Bear
Jun. 30, 2009	919.3	Feb. 28, 2020	2954.2	128	221.3%	Secular Bull
Average:				**74**	**96.0%**	
Secular Bull Average:				**88**	**148.8%**	
Secular Bear Average:				**56**	**25.7%**	

Source: FactSet, NBER.

The path forward will not be straight up and to the right, however. The probability of a correction in the coming months remains high, in our view, following the 38.6% market rally over the last 15 weeks. Historically, the first drawdown following a rally off major market lows has ranged from -3.6% to -14.7%, with an average of -9.3% (Exhibit 3). Given the magnitude and velocity of this rally, we wouldn't be surprised if the first drawdown were toward the higher end.

Exhibit 3: First Pullback After a Major Low

S&P 500 First Drawdown Following Initial Rally Off Major Low

Market Low	Initial Rally	# of Days	1st Drawdown	# of Days
Oct. 1957	7.0%	26	-5.6%	13
Jun. 1962	14.3%	40	-10.5%	43
May 1970	13.3%	6	-9.3%	23
Oct. 1974	20.8%	25	-13.6%	20
Aug. 1982	21.9%	27	-3.6%	7
Oct. 1987	14.9%	2	-13.3%	31
Oct. 1990	12.3%	50	-6.1%	11
Oct. 2002	20.9%	35	-14.7%	69
Mar. 2009	39.9%	67	-7.1%	19
Average			**-9.3%**	**26**

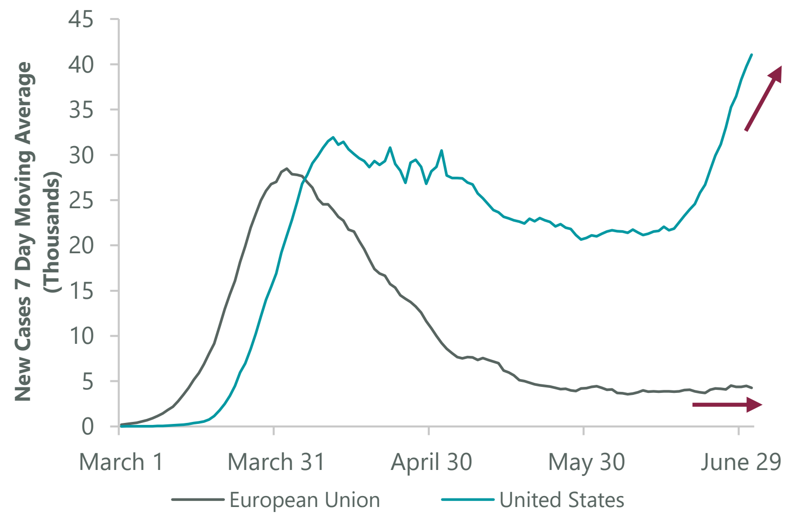
Source: FactSet.

Ultimately, the size of the next drawdown and where the market settles are contingent on the shape of the economic recovery. We continue to believe the economy will experience something that looks more like a backward "J," which is to say a sluggish recovery where we do not fully recoup the prior level of economic activity for quite some time.

Labor Market Weakness Could Persist Through Second Half

While the initial economic thrust off the lows has surpassed consensus expectations, the moment of truth will come in the second half of the year. Many states are slowing, and in some cases reversing, their reopening plans due to increasing coronavirus cases. Unfortunately, the piecemeal state-by-state approach to lockdowns has been much less successful in flattening the curve compared to Europe (Exhibit 4), a risk we laid out in last quarter's Long View. The good news is some portions of the country are improving, and shutdowns are likely to be more localized due to improvements in the health systems' ability to manage cases. Compared with March, the future economic damage will likely be more limited.

Exhibit 4: Flattening the Curve?



Data as of March 1 – June 30, 2020. Source: Our World in Data, European Centre for Disease Control (ECDC).

Another hurdle comes from the potential lack of engagement from older U.S. consumers. Recent cases have been more concentrated among younger Americans, who appear to be “testing the waters” given lower fatality risk. However, individuals over the age of 55 account for 40% of consumer spending. This cohort appears to be more cautious in terms of venturing out, and we believe they will remain so even if social distancing measures are further eased.

The health of the labor market is another reason we believe the pace of the recovery is likely to be sluggish after the initial bounce off the bottom plays out. Sixteen weeks into the crisis, initial jobless claims are still running at 1.4 million or just over 2x the peak rate during the GFC. Importantly, many of these layoffs could be permanent, as most companies have reopened their doors. With about 1% of the workforce being laid off weekly, this could be a sign of trouble among small businesses as well as larger firms aiming to stay lean given the uncertain economic backdrop. In a similar vein, continuing claims remain stubbornly high, suggesting labor market weakness will persist well into the back half of 2020.

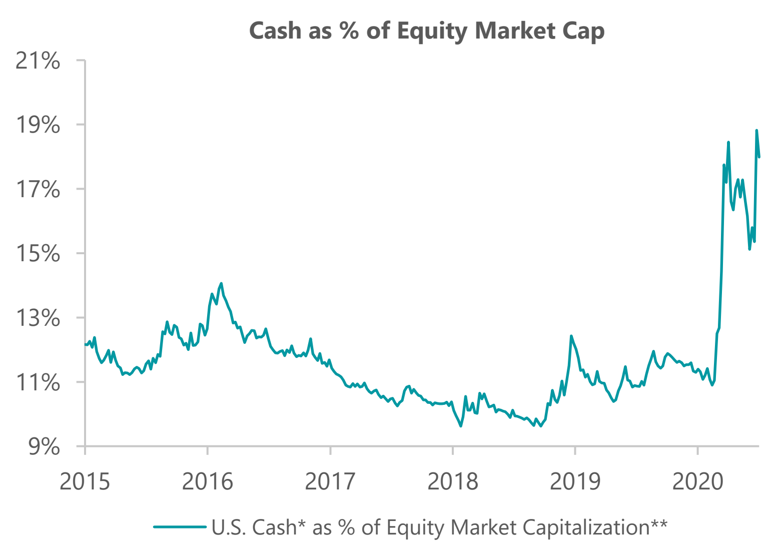
Right now, over 30 million Americans are receiving unemployment benefits. Prior to the crisis, the nationwide average weekly unemployment benefit was about $375 per week. Congress added an additional $600 weekly payment as a part of the CARES Act, which is set to expire on July 31. While some of these funds have been saved, the elimination of this expanded benefit would likely lead to a decline in consumer spending. We believe more fiscal support is warranted, but policy fatigue may be setting in as financial markets continue to recover. The full expiration of these benefits appears unlikely at the current juncture, but the key for the economy and markets will be how much is preserved. The unstoppable force needs to continue to win the battles in order to win the war.

This is clearly the mentality of the Fed, with Chairman Powell not wanting to declare victory early. He recognizes the difficulties that lay ahead and recently mentioned that “we are not even thinking about thinking about raising rates.” When asked about a potential asset bubble, Powell replied that the Fed’s principal focus is on the state of the economy, the labor market and inflation. This is a positive sign that the Fed will keep its foot on the accelerator until we see substantial improvement in labor markets. Furthermore, the Fed has continued to move forward with its corporate bond buying facilities despite the dramatic narrowing of credit spreads. In fact, investment grade yields hit all-time lows last month even as the unemployment rate remains in the double digits. This has important implications because diminished solvency risks resulting from the Fed’s backstop translate into higher equity multiples. It’s clear that the Fed will continue to aggressively support credit with the potential for inflating an asset bubble low on its current list of concerns.

Will Cautious Consumers Blunt Eager Investors?

How does this massive disconnect between the economy and the markets get resolved? No one can know, but we believe much will depend on how much our society shifts from FOMO to FOGO. Many investors may be currently experiencing FOMO after the recent market rally, as both retail and institutional investors are holding substantial amounts of dry powder. In fact, cash holdings are 18.8% of total equity market cap, the highest level since 2012 (Exhibit 5).

Exhibit 5: Dry Powder Abundant



* Institutional & Retail Money Funds – ICI. ** MSCI U.S. IMI Index. Data as of July 3, 2020.
Source: FactSet.

As cash is deployed, this may limit the severity of future downturns. However, this may be overshadowed by the drags from FOGO as individuals remain cautious about personal interaction until coronavirus risks more fully recede. The lengths of the lockdowns have certainly been long enough to help form new habits, and for many continued anxiety could prolong working from home in the coming years. As a result, FOGO could force portions of the economy that rely on human interaction to rethink their business models, or close down entirely in some cases. Given its reduced access to capital and the face-to-face nature of many of its businesses, Main Street may once again feel more pain than Wall Street.

Recessions typically drive negative feedback loops between weak corporate margins, soft labor markets and weak demand. Each builds upon the next, which can maim otherwise healthy portions of the economy. In the past, this weakness has persisted beyond the recession itself, which poses a risk to 2021 earnings in particular.

Thankfully, Congress continues to help put a floor under Main Street and the Fed continues to help put a floor under Wall Street. The bottom line is we are anticipating a bumpy ride in the coming months, with elevated chances of a pullback. Whether the immovable object or the unstoppable force blinks first, it's important to recognize that historically market strength has begot market strength. Since 1975, every single 20%+ 50-day rally has seen positive returns over the following six- and 12-month periods, with average returns of 9.5% and 17.2% respectively (Exhibit 6). Regardless of the path forward, the coming quarter should improve visibility into how the divergence between the economy and financial markets will narrow.

Exhibit 6: Strongest 50-day Rallies in History

Largest 50-Day Gains Ever (Greater than 20%)

Date	50-Day % Change	S&P 500 Index Return		
		3 Months	6 Months	12 Months
March 6, 1975	26.9%	10.5%	2.3%	18.4%
Oct. 22, 1982	35.6%	3.6%	15.6%	19.5%
March 26, 1991	20.4%	-1.3%	2.7%	8.4%
June 24, 1997	20.5%	5.4%	4.1%	26.4%
Dec. 18, 1998	23.8%	10.8%	13.0%	19.6%
May 19, 2009	34.2%	9.7%	20.6%	22.8%
Sept. 16, 2009	21.3%	3.8%	8.5%	5.2%
June 3, 2020	39.6%	?	?	?
Average		**6.1%**	**9.5%**	**17.2%**
% Positive		**85.7%**	**100.0%**	**100.0%**

Dates refer to the end of each 50-day rally. Source: LPL Research, FactSet.