ClearBridge Investments

The Long View: Buy the Dip or Recessionary Double Dip?

Jeffrey Schulze, CFA
Director, Investment Strategist

Key Takeaways

- The economy continued to gain steam in the third quarter, with supportive policy and an improving labor and consumption backdrop fueling an initial V-shaped recovery.
- The ongoing market rally appears to be well supported by fundamentals, with the September pullback more about repositioning than a sign of headwinds on the horizon.
- With no changes to the ClearBridge Recovery Dashboard this month and an overall green signal, financial markets should be able to weather election-related volatility given the improved economic backdrop.

Recovery Has Played Out Surprisingly Well So Far

With the S&P 500 Index 50% above its March low, a healthy degree of investor skepticism has emerged about the durability of the rally and whether the economic rebound is in fact genuine. This perception is not uncommon in the early stages of a new economic expansion as shell-shocked investors continue to focus on lingering challenges related to the recently-ended recession, a behavior known as anchoring. While the pace of growth in the third quarter is a subject of debate, not a single economist surveyed by Bloomberg (out of 62) has an expectation that the economy shrunk during 3Q. The recent pullback has some pundits calling for a double-dip recession. We continue to believe, however, that this is a pullback and not the start of a larger downturn.

Our views continue to be informed by the broad-based strength emanating from the ClearBridge Recovery Dashboard. Tools such as this help us avoid behavioral traps like anchoring by forcing an objective and periodic review of incoming data, making it easier to adjust our views as the facts change. Of course, no model is perfect, and we firmly believe a combination of "art and science" leads to the best outcomes. The recovery dashboard turned green at the start of the third quarter and saw several indicators improve over the ensuing months. There are no changes to the dashboard this month, and with seven green, one yellow and one red signal (and an overall green), we continue to believe that a durable economic market bottom has formed.

Exhibit 1: ClearBridge Recovery Dashboard

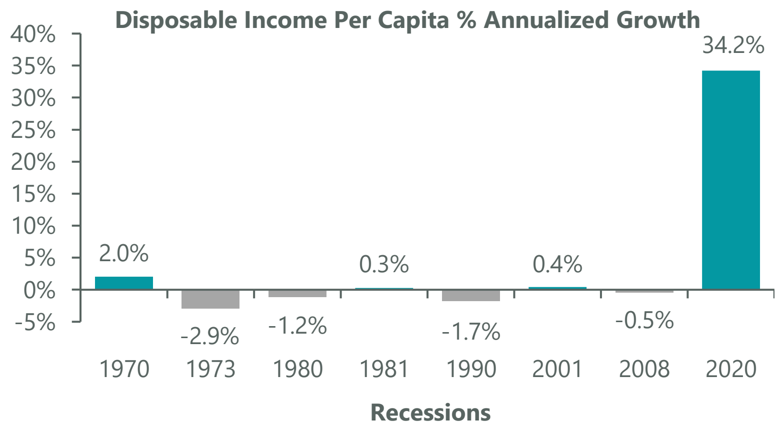
		Sept. 30, 2020	Aug. 31, 2020	July 31, 2020
Confidence	Consumer Confidence	⬆	⬆	⬆
	Business Confidence (ISM)	⬆	⬆	⬆
	Investor Sentiment	✖	✖	✖
Economics	Housing Starts	⬆	⬆	●
	Initial Jobless Claims	●	●	●
	Philly Fed	⬆	⬆	⬆
Financial	Credit Spreads	⬆	⬆	●
	Fed Policy	⬆	⬆	⬆
	Financial Conditions	⬆	⬆	⬆
	Overall Signal	⬆	⬆	⬆

⬆ Expansion ● Improvement ✖ Recession

Data as of Sept. 30, 2020. Source: FactSet, Bloomberg, Conference Board, Census Bureau, Federal Reserve, FRBPA, Chicago Fed, ISM, Dept. of Labor, Bloomberg/Barclays, AAII, Investors Intelligence, and Moody's.

One key question investors struggled with as the economy shut down earlier this year was what the shape of the recovery would look like. Against the odds, so far it looks more like a V than anything else. To illustrate this point, look no further than U.S. retail sales, which have now recouped their pre-pandemic peak in just six months. Contrast this with a 34-month recovery during the global financial crisis (GFC) and 16 months during the 2001-2002 recession. There is little doubt that the CARES Act was the primary support for the current rebound, with government transfer payments more than offsetting declines in wages and salaries. Disposable incomes actually rose during the recession and while this is not uncommon during a downturn, the magnitude of improvement (+34.2%) stands out.

Exhibit 2: Aren't Recessions Supposed to be Painful?



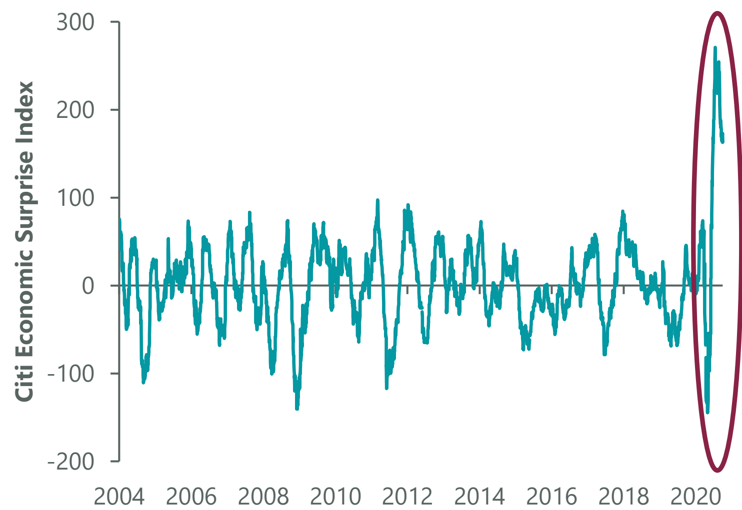
Data as of June 30, 2020. Source: BEA, FactSet.

A second positive driver of incomes has been the labor market, which continues to heal much quicker than was anticipated. The unemployment rate has now fallen from 14.7% in April to 7.9% for September and just over half of the jobs lost have been recovered. By contrast, it took three and half years after the end of the GFC before half of the jobs lost had been regained and five years to proportionally retrace the drop in the unemployment rate.

The ongoing market rally appears to be well supported by fundamentals after being jumpstarted by supportive fiscal and monetary policy.

Perhaps the best illustration of this V-shaped recovery can be seen from the Citi Economic Surprise Index (CESI), a broad-based measurement of whether economic data is on balance beating or missing consensus expectations. This index made record highs (by almost 3x) as the economy reopened, indicating that economic data consistently came in ahead of expectations in late spring and into summer as the economy reaccelerated.

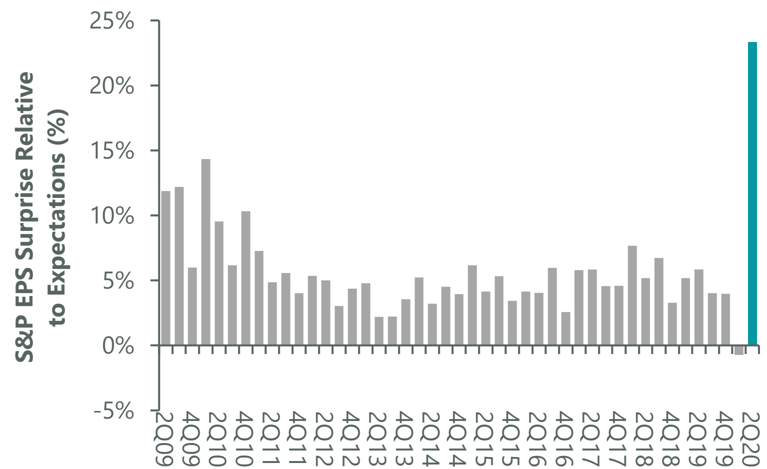
Exhibit 3: Historic Economic Surprise



Data as of Sept. 30, 2020. Source: Citi, FactSet.

Just as the economy began to improve, so too did earnings estimates. Second quarter earnings results came in well ahead of consensus expectations and surprised to a greater degree than during any quarter coming out of the GFC. On top of this, company management teams broadly provided positive guidance, which helped drive upward revisions to earnings expectations. Over the course of the third quarter, S&P 500 earnings expectations for 2020 improved by 4% and for 2021 by 2%.

Exhibit 4: Historic Earnings Surprise



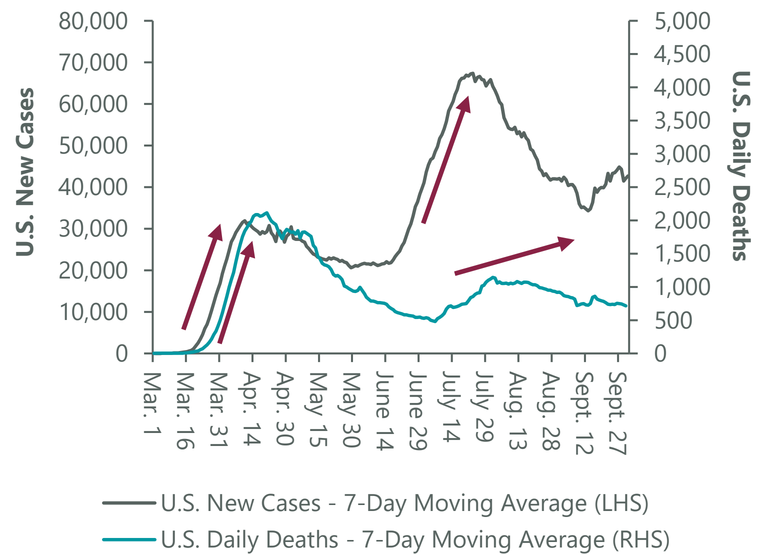
Data as of June 30, 2020. Source: FactSet.

Putting this all together, the third quarter saw dramatic improvement in the economy and earnings, contradicting the narrative that goods and services activity has diverged from the markets. While it's true that valuations surged coming off trough levels, this dynamic is typical early in a recovery. Against this backdrop, the ongoing market rally appears to be well supported by fundamentals after initially being jumpstarted by supportive fiscal and monetary policy. Despite this surprisingly positive environment, many continue to perceive several potential hurdles for financial markets.

New Bricks in Wall of Worry Emerge

The first of these is the ongoing battle against coronavirus. Several countries in Europe have recently tightened restrictions (although not to lockdown levels) in the face of accelerating virus transmission rates, including Germany, France, Spain, the Netherlands, Great Britain and Ireland. With cases on the rise in the U.S., investors are questioning if a similar tightening of measures might be implemented. The good news is that when U.S. cases flared over the summer, the mortality rate remained low due in part to better treatment protocols and a greater concentration of cases in younger individuals. If the decoupling between case counts and deaths remains and there continue to be advances on the medical front, hospital systems should remain less burdened which makes a return to the lockdowns of March and April unlikely.

Exhibit 5: Winter is Coming

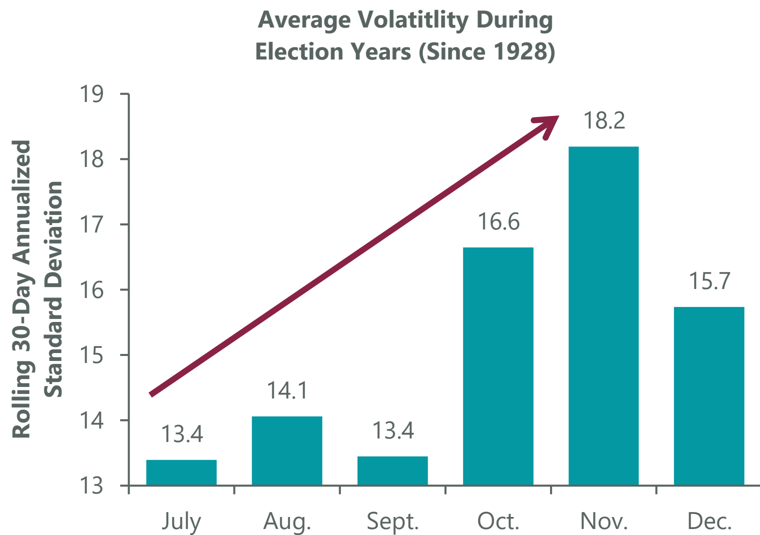


Data as of March 1 - Sept. 30, 2020. Source: Our World in Data, European Centre for Disease Control (ECDC), Covid Tracking Project.

A second concern is waning fiscal support. The most recent personal consumption data shows that Americans, in aggregate, are dipping into savings to keep paying their bills, while many remain out of work and are receiving smaller unemployment checks after the extra $600 per week payment expired at the end of July. While the Lost Wages Assistance program should help, it will only provide $44 billion in total, hardly offsetting a consumer savings decline of over $700 billion in September. At the current pace, consumers have at least a few more months' worth of reserves built up due to an unusually high 14.1% personal saving rate, but the longer policymakers wait to continue support, the greater risk of a policy error. We believe another round of stimulus will be passed in the next quarter or two.

The third and perhaps largest source of market anxiety is the upcoming U.S. election. Volatility typically rises as Election Day approaches, as investors try to anticipate the potential for policy shifts. Top of mind for equity investors is the prospect of higher corporate and personal tax rates being proposed by the Biden campaign. While handicapping what campaign proposals may eventually become law is challenging, several potential positives could partially offset the drag from higher taxes including increased government spending, a potentially larger round of future fiscal stimulus and less tariff uncertainty. Furthermore, there may be reluctance to raise taxes given the fragile state of the economy, a similar backdrop to 2009 where tax increases took four years to materialize.

Exhibit 6: Elections Spark Higher Volatility



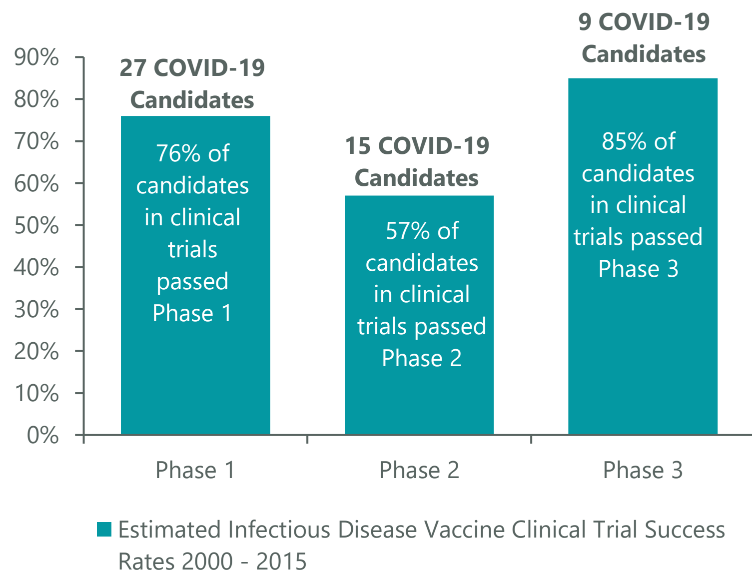
Source: FactSet.

While volatility may not ebb until closer to year end, the September drawdown has yet to be accompanied by meaningful moves in bond markets. Treasury yields and credit spreads remain stable, as do inflation expectations. In our reading, this supports the notion that the recent selloff has been more about repositioning and consolidation, rather than the beginning of a reassessment about the health of the economy. Put differently, we ultimately believe it's a buy the dip moment for long-term investors rather than the start of a double dip recession.

Don't Rule Out Further Upside Surprises

As colder weather approaches and we move toward the holiday season, many will begin to offer forecasts about what 2021 might bring. Few pundits last year envisioned that a global pandemic would drastically reshape almost every element of human life, work and interaction. In our recent conversations with investors, many seem to underappreciate the chances of the global economy returning to something akin to a pre-pandemic normal in the coming year. This "right tail" scenario largely depends on medical advances, such as the successful development and distribution of a vaccine (or robust therapeutics). At present, there are nine potential COVID-19 vaccines in phase 3 clinical trials. The historical success rate of vaccines for infectious diseases in phase 3 trials is 85%, suggesting that at least one of these candidates has a good chance of being approved. While initially an approval may come in the form of an Emergency Use Authorization and be limited to health care providers and the most at-risk populations (those in nursing homes, for example), broader distribution will likely follow in short order given that stockpiles of vaccine candidates and distribution plans are already being developed.

Exhibit 7: Lots of Shots on Vaccine Goal



Source: "Estimation of clinical trial success rates and related parameters", Biostatistics, Volume 20, Issue 2, April 2019, Pages 273–286; WHO, New York Times.

As a vaccine becomes more broadly available, governments should be able to quickly lift restrictions, providing a boost to both business and consumer confidence. With personal savings built up and pent-up demand, the period following vaccine availability could see "revenge spending" that drives economic growth above long-term averages. Additionally, inventories are at low levels with many businesses trying to cut costs in any way they can, and a restocking cycle would further drive economic activity. More so, the macro backdrop should provide a boost to both businesses and consumers due to the combination of lower interest rates, a weaker dollar and reduced energy costs. These have historically been key ingredients in fueling robust economic recoveries.

Importantly, there weren't any glaring structural imbalances within the U.S. economy before the pandemic began in February. This is a very different setup from the experience of the last recession, where both households and banks had to delever and work off their excesses from the previous cycle in the following years. Without the traditional recessionary overhangs weighing on the economy, the possibility of a much faster than average recovery is a distinct one. This scenario is dependent on government support continuing to keep the macro damage in check. Crucially, policymakers appear to be fighting the last battle, with the Fed positioning itself to remain ultra-accommodative for the foreseeable future. While the "right tail" scenario may prove to be overly optimist as bumps in the road inevitably occur, we believe the long-term prospects for the U.S. economy under more of a "base case" scenario remain bright.

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