April 2020

“Sir! The possibility of successfully navigating an asteroid field is approximately 3,720 to 1!” “Never tell me the odds!”

This quote was from Star Wars – The Empire Strikes Back – Episode V.

State of the Union

The quote above gives a general impression of what doctors, nurses and first responders must be facing as the COVID-19 numbers continue to rise. Our hearts go out to them and the families that have been affected by the ongoing events.

Black Swan

When we talk about probabilities, we know that about every 10 years we have some type of economic event that right-sizes balance sheets and rationalizes the economy. The Black Swan types of events, we hope, are only a once in a lifetime occurrence. Today, the odds of this have changed forever. After 2008, the world felt reassured that we would never have the type of economic impact and event as meaningful as the events of that year. Well, we have. In looking at the past drawing board, it was clear that valuations were high, not crazy high, but measurable. The game plan coming into 2020 and looking forward was a balanced approach to risk assets. When the virus showed up in China it seemed like it was a containable situation and for the most part, geographically centred and contained. In a very short time, we got to a global pandemic.

Oil

They say oil and water do not mix. Well, the Russian and Saudi energy conflict is not mixing well either. This global commodity hits home harder than most. Its kind of a good thing we cannot travel to the US because it just became a lot more expensive. The chart below shows the CAD/USD relationship and the short-term impact it has taken during these unsettling times.

Source: Thomson Reuters

Jobs

The loss of jobs for most of us today is going to be unprecedented. The US recently reported a staggering number of 3.2m unemployment claims. The next expected number will likely be higher. We continue to move forward, but with significant headwinds.

Next Moves

This is where the quote at the beginning of our newsletter has some relevance. The daily data dump is a bit like an asteroid field. Some of the information is well articulated and relevant and some of it seems like complete lies or weird interpretations of the bent truth.

We believe that this is not a one and done event. We have had one bad month and most markets are off measurably. Some companies have reduced their dividends, and some will file for bankruptcy. This is the normal course of an economic slowdown. Today we have almost an economic stoppage. We feel this should have a greater impact than economic slowdown and should be somewhat longer in its reach? For us, this remains the daily conundrum. The offsetting argument would be the stimulus. The FED has basically opened a blank chequebook and we are now hearing about another 2 trillion-dollar (insert Dr. Evil voice – Austin Powers pop culture digression) infrastructure package. This type of economic stimulus will have some teeth, there is no doubt about it, we are hesitant to join the line and drink the Kool-Aid.

WHEN will the water be warm? Today this stands as the trillion-dollar question. When we looked back at 2008, the market declined for the better part of 12 to 14 months depending on where you start your measure. The chart below shows the period of decline. We also marked in the 6 rallies it had during this period. Those rallies are what market players are calling bear market rallies, dead cat bounces, and a host of other names. This look back has kept us balanced and conservative. Note that this is a view of 2008 and the 6 tradeable rallies before the market bottomed in March of 2009. As you can see from 2008, it would have been easy to make a mistake.

Source: Thomson Reuters

Will the market repeat itself? It's impossible to know. What we can guess is that this current market reaction is only one month old, and we are on our second rally. Many are saying the bottom was reached on March 23rd, 2020?

Source: Thomson Reuters

Fundamentals

This is where the dialogue gets a bit mathy (new word 😊). Companies have earnings per share and the multiple that they trade at creates the price of the stock. For example, a company with $1 in earnings trading at 18 times has a stock price of $18.

NOW, let's supersize this to determine the earnings of the S&P 500 an entire index of companies and stocks. On March 30, 2020, Credit Suisse put out their Fresh Estimate of the earnings of the S&P 500. The chart is posted below:

Figure 1: Bottom-Up Consensus S&P 500 2020 EPS

Note: "Fresh Estimate" based on an aggregation on revised analyst estimates over the past 7 business days; Historical Trend based on 2020 estimates on 9/30/19 and follows historical revision trend during 2011-2017

Source: Standard & Poor's, FactSet, Thomson Financial, Credit Suisse

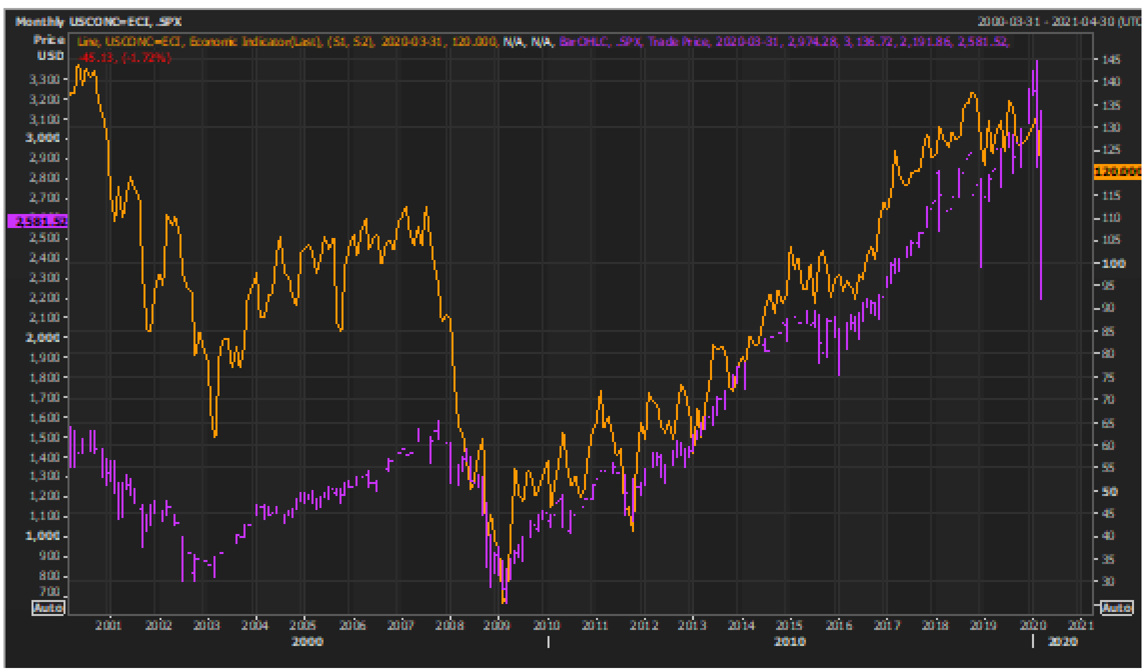
Using the same math as above $143.38 times 18 equals 2580. Conveniently the S&P 500 today March 30th, 2020 is 2607. This estimate is a full year estimate, suggesting that the index will be at this level by year-end. If we felt that their analysis was spot on there would really be no benefit of investing today unless we believed that the multiple would expand to 20 times – meaning we could make about 10% return from now till the end of the year.

In good times the markets trade between 20 to 25 times, in average times we can trade at 15 to 20 times, and in ugly times we can trade below 15 times. The multiples generally reflect consumerism and growth expectations.

This brings us to the consumer. The recent report shows a modest adjustment in sentiment. We have posted this before and have some reservations about the future of consumer confidence. The data seems a bit disconnected. If you are unemployed, on furlough, in an economic slowdown or about to be unemployed we find it hard to believe you have any confidence in consumption?

Source: Thomson Reuters

In the past, we have suggested as the market goes or confidence goes so to does the opposing. For now, the market has led to the downside. The negative wealth effect should/could affect consumerism.



Source: Thomson Reuters

Upside

It will happen and we will cycle through this. In all of history, there has been recovery. The rate and degree of recovery remain unknown variables, but there will be recovery. We feel this is part of the human condition. Wars have been fought, won and lost, and after each war there was recovery. This too it will come to an end, and we will move forward.

Wrapping up, we wondered what the real odds were of navigating an asteroid field would be and looking a bit deeper into the internet of things our search found the following:

The actual odds would entirely depend on what asteroid field you were talking about and a variety of other factors. But for reference, NASA estimates the odds of one of their probes travelling through the asteroid field actually hitting an asteroid to be about one in a billion.

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