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TPWC Market and Economic Update
Correction Time

The Markets

First, the "bad" news. The Standard and Poor's 500 Stock Index (SPX) dropped 11.49% for the week ending the month of February. That puts the SPX down 12.76% since its recent record high on February 19. As a short-term market decline of 10% or more is the classic definition of a "correction", we have one. It also leaves the SPX down about 8.6% year-to-date. The good news is that first, the index has retained a gain of 5.37% for one year. A second point of good news is that the decline seems to have leveled off on Friday. As a matter of fact, if one charts the opening SPX value as the start point on Friday, the index rose about 2% by the end of the day. That is not to say the carnage is over, but an out-and-out panic is not currently happening. The other good news is that this market decline is a classic uncertainty "V" shaped correction. More on that below.

We've been saying for some time that the stock market was overdue for a correction and the economy for a recession and the correction chicken has come home to roost. Last year, S&P 500 earnings growth was essentially flat but the SPX rose nearly 29%. That is the classic sign of the end of a bull market as the stock market ignores reality and surges to record highs. When it "corrects" to account for reality we get, logically, a correction.

The ten-year U.S. Treasury note ended the week yielding 1.168%, as far as we can tell, a record low yield. That record cements into place a severely inverted yield curve. The bond market sees a recession this year as a clear threat and so do we. West Texas Intermediate oil (WTI) was in full agreement with the bond and stock market and closed around $45.35, down over 15% for the week and about 26% year-to-date.

The Economy

The stock market is not the economy, but it is one of the leading economic indicators. Last week we reported that the U.S. Purchasing Manager's Output Index (PMI) composite turned negative in January. That signaled at least a temporary contraction in business activity across both the manufacturing and services side of our economy. It also signaled an expansion that likely was running low on potential future growth. There was no specific issue that caused the PMI decline other than at some point consumers can no longer raise their spending without suffering pain. Once an economy hits a plateau, as ours experienced all last year, at some point an unexpected shock will come along triggering a temporary pullback. The unexpected shock historically has been something that injects a significant level of uncertainty into the carefully figured calculations as to what the stocks in the market will generate in future earnings. The COVID-19 coronavirus is that unexpected shock, commonly known on Wall Street as a "black swan."

If the infections were limited to China, the most likely outcome would be a stagnant first half of the year followed by a rebound in the second half. COVID-19 is highly contagious and can easily be spread by people who have no idea they are infected. This correction started when traders concluded there will likely be widespread infection in the U.S. When that happened in China, its services sector effectively shut down. Manufacturing there, like here, was already in a slump, at least partly from the trade war, but as people did not show up for work, it ground to a near halt. Our economic growth over the last six months was solely from consumer activity in the services sector. If a coronavirus panic hits the U.S., we will likely do as the Chinese did and stop gathering at restaurants, movies, or anywhere else. That will put the services sector into a recession and the whole economy will follow suit. That's the bad news.

The good news is that viral epidemics do not last forever. This one has already peaked in China with new cases each day dropping. It probably took three months for it to peak and may take another three months to decline to the point that normal life and economic activity can return to normal. Once that occurs, the economic rebound will probably be quite substantial.

If the virus gets loose in the United States, there will very likely be a recession. That downturn will reveal that there are more than a few companies that are only profitable in good times and will fail. We need that to happen from time to time lest the number of "zombie companies" build up to the point that when they do fail, they cause a major economic contraction. In short, going too long without a recession is dangerous. As the epidemic fades away, probably by or before the end of the year, the economic rebound is likely to be dramatic and will mark the beginning of a new bull market.

Another point is worth mentioning here. Epidemic-caused market declines and recessions then to be "V" shaped with a rapid decline and an enthusiastic and rapid recovery. The recession we had in 2008-2009 was a "financial" recession. Those tend to be "L" shaped with a lengthy and slow recovery. The key for investors is to know that guessing when to bail out to miss the downside and when to jump in to catch the upside is a losers game. To the best of our knowledge, no one has been able to consistently get that right and a lot of money has been lost trying.

Until next week, we remain at our posts, vigilantly watching the tea leaves of the economic data for signs of the future.

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