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The Virus and Markets

David R. Kotok
Fri Feb 21, 2020

“Global equity markets have been able to look through the bearish threat from the spreading Covid-19 with nearly all indexes, excluding the CSI and the Shanghai Comp, higher on the month.

"Optimism that the virus won’t become a pandemic, and that the impact will be transitory (and fairly modest outside of China) are supportive. And helping underpin that hopeful outlook is the hefty amount of liquidity in the system, along with expectations for ongoing support from monetary policy. The PBoC’s injections have indicated that this is its ‘whatever it takes’ moment. Chair Powell essentially confirmed in his testimony that rates will remain lower for longer. However, some distrust over China’s handling of the virus, weaker Q4 growth data out of Europe, and disappointing U.S. sales and production figures will sustain a cautious tone near term.” *(Action Weekly!* [by subscription only], Feb. 16, 2020)

We agree.

The market outlook has become extremely momentum-driven and foresees higher stock prices in 2020. Other issues (politics, oil and commodity prices, labor force weakening, inflation) are still around in the background and can exert powerful effects at any time. But right now, COVID19 has put all central banks on the stimulus track, and the growth of world liquidity is driving stock prices higher and keeping bond yields very low. At Cumberland we are nearly fully invested in our US ETF strategies, and our quantitative strategies are fully invested and positioned offensively. On February 1, 2020, our quant strategy completed four years of GIPS-verified results. We can send the public disclosure to anyone interested in a review.

So add low interest rates to suppressed inflation (temporarily) coupled with slowing worldwide growth, and we get a powerful upward force for stock prices. Our upside target for the S&P 500 Index is now 3600 or higher.

Let’s think of that in the following way. We reduce the 2020 earnings estimate because of coronavirus shocks. We are taking our estimate for the 2020 calendar year down to $165 with a plus or minus range of $4. But we are also lowering the equity risk premium (ERP), which translates into raising the P/E of those earnings. Here’s why.

Older models of ERP calculations would have kept you out of the stock market for some time now and would still keep you out. Why? Because they were derived when both inflation and interest rates were higher. Does a 300-basis-point ERP apply when the running 10-year Treasury yield is around 1.5-2%? It did apply when that yield was 4%. But should it now be reduced?

We think the answer is yes, if one believes the 10-year yield is now likely to hover around 2% or even lower. The coronavirus has pushed out any rise in interest rates and has added a lot of liquidity fuel from central banks. So we believe the ERP must be smaller now.

Consider what it would mean if the ERP were 200 instead of 300 basis points. Apply a 25 running P/E to our earnings estimate. 4% earnings yield minus 200 basis points of ERP is the base case for a 25 p/e. It is easy to see how the S&P 500 can trade between 3600 and 4000 even as the coronavirus reduces 2020 earnings. Please note that at that S&P 500 level, the yield on the S&P index is about equal to or above the yield on the 10-year Treasury.

So, we're leaning to full investment in our portfolios. We don't like a natural disaster that is sickening many and killing folks every day. We think the spread of the virus will continue. We've seen credible estimates as high as an eventual 4-5 million cases and a baseline 2% to 4% fatalities rate worldwide.

But the investment outlook now is for a massive central bank liquidity response, and that means higher multiples for stock markets around the world.

Of course, things could change at any time. The same is true for our managed portfolios.

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Email | Bio

Wuhan Coronavirus Series
by David R. Kotok

https://www.cumber.com/wuhan-coronavirus/

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