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The April Paradox

April will go down as one of the worst months ever for economic activity. It will also be remembered as one of the best months for stocks. This paradox has many perplexed. Who could be buying right now with so much uncertainty?

Recent Interview

I was interviewed this week on markets and answered some tough questions. We recorded and transcribed the conversation.

What would you say is the biggest controversy facing investors right now?

What I'm calling the "April paradox." Take this week as an example. Gross Domestic Product is a measure of economic activity. On Wednesday, we learned that it shrank by 4.8% in the first quarter1. This is the largest decline since 2008. Considering the economy was doing fine in January and February, March so much of a disaster that it pulled the entire quarter down. Yet despite this print, the S&P 500 soared higher to end the day up 2.7% (1). That's a paradox.

This wasn't an isolated event either. It's been a pattern since late March. Think about where we stand as a country today:

• Air travel is down 96% (2)

• Hotel occupancy is down 68% (2)

• Box office receipts are down 100% (2)

• New home sales are down 15% (1)

• Gasoline consumption is down 44% (3)

• Durable goods down 14% in March (1)

• Over 28 million Americans filed for jobless claims in the last 6 weeks (1)

April will go down as one of the worst months ever for economic activity. But it will also be remembered as one of the best months for stocks. The S&P 500 posted its biggest monthly gain since 1987, climbing 13% (4). It had its best April in 82 years (7). That's simply amazing. The two extremes create the paradox, and it's one that appears to be fueling a lot of disbelief.

Some would argue this was more ignorance than paradox. Why did this happen?

The source of the paradox is a directional mismatch. Economic data tells us what has already happened, but the stock market is anticipatory – it looks ahead and then prices in future expectations today.

Let's go back to Wednesday. A scary GDP number leads to a great day for stocks. But we already knew it was going to be awful. That was baked in long ago, so whether the final number is 4.8% or 10% or whatever, it's in the past.

I've talked extensively about how we need to see a light at the end of the tunnel before this rally can stick. Therefore, anytime the market rises on days like these, I look for something that would indicate a brighter light. That day, it was a press release from a biotech company called Gilead. A study had shown that one of its experimental drugs had reduced the time it took for patients with Covid-19 to get better (5).

There may also have been a cumulative effect. On its own, positive data for a drug is flimsy. But combine this with news that some U.S. states and European countries are reopening, and that light gets brighter.

Brian Wesbury at First Trust had a great quote recently that went something like this – "Investors need to keep in mind that when they invest in stocks, they're not buying shares of GDP. They're buying shares of specific companies that offer an always changing flow of goods and services."

The point here is that there can be an ugly past and a bright future at the same time. This was April in a nutshell. When it comes to investing, the future is all that matters.

But wouldn't you agree there is a lot of uncertainty looking forward?

No question. I don't think I've seen more uncertainty in my career. Think about it this way – to be buying right now means that you should expect the government to provide enough stimulus, open the economy very soon, get people to then go out into the economy, and do so in a way that is safe while they develop a vaccine.

Of these, I'm least concerned about the science. I know nothing about vaccines and even less about viral replication, but the brainpower that is on this one and the money backing it are powerful forces. My bet is they figure this out and very soon.

The real uncertainty lies in the government. This whole situation has become political, and that increases uncertainty because we must factor in the incentives of those who are making the decisions. Rarely do these coincide with logic and reasoning.

You mention stimulus. How can we pay for all of this? Doesn't this just create more uncertainty and problems down the road?

Couple things here. First, let's not put the cart before the horse. The government shut down the economy, so they have to do this.

Second, we will pay for it with lots of debt. Trillions of it. Before the CARES act was passed, I guessed that the total stimulus could come in as high as $3.5-$4 trillion. But that assumed the economy would reopen by end of April. Who knows now? It could easily double, but that's ok.

Government debt doesn't work like personal and corporate debt. It almost never gets paid back. It just gets "rolled" – old debt gets serviced by creating new debt. Most of the time, this is a perfectly fine way to run a country. Several companies even do it.

In fact, U.S. debt has risen pretty much every year since 1950. It hasn't been a problem yet because nominal GDP has grown faster than the annual budget deficit. More importantly, compare interest payment to GDP, and less than 2% of the country's income services debt. This hasn't changed much in the last 80 years. So no, our grandkids won't have to pay all of this off.

There will be side effects, but I'm going to worry about those later. For now, I'm grateful that I live in a country that can do what most cannot – print huge amounts of a currency the entire world wants (particularly during a 4 crisis like this). Our ability to instantaneously create "rainy day funds" is a powerful weapon, not a problem (yet). It's also one that we will likely see more of.

Won't one of those side effects be inflation?

Didn't we learn that from the 1970s? The money supply has surged. No doubt. But this is not the 1970s. Not even close. There are a lot of fearmongers out there who are oversimplifying what happened back so they can compare it to today. In addition to oil and other commodity prices crashing, which is a pretty big deflationary force, cash is king right now. If demand for money rises alongside supply, the effect should be less severe.

However, I can't say definitively that inflation will remain under control two years from now. The reason why we never saw inflation from all the money printing after the financial crisis was because that money never made it out into the economy. The government printed it, gave it to big banks, and they then deposited it with the Fed. That's like creating a lot of inventory, giving it to your distributors, but not allowing them to sell any of it. This round of printing is already out there, so it's something I plan to watch closely because demand could change.

If inflation does rise any higher than what we've seen over the last several years, then stocks could become even more attractive. They can act as a hedge against inflation because companies are able to pass along their costs to customers. But that only works so long until valuations explode.

Well then who is buying right now?

Large institutional buyers. Money managers who either see perceived deals they can't pass on or can't stay in cash for too long. Most mandates restrict it. Also, we talked about incentives. If the market moves higher and a manager is in cash for too long, they risk underperforming for the year. If so, say goodbye to their bonus.

For individuals, those who own stocks tend to be wealthy and educated, and they work in service-based industries that can be done from home. Many of these paychecks are still getting cashed.

Take this cohort and then consider the Pavlovian response that has developed over the last decade to "buy the dip." This strategy is literally batting a thousand. Every time the market has tanked, it's surged back within weeks. So, there are those who have made money buying the dip and those who have not but watched their neighbors make money buying the dip.

How will the world change after this?

Go back to 9-11. That changed us in so many ways. Thousands died and it took years to move on. But in the process, our country became safer and stronger. Try to name a single hijacking that lasted for more than 90 seconds since then. They don't happen anymore in developed countries. The mistakes made over the last two months will make our society stronger the next time one of these viruses pops up.

Furthermore, how many board room discussions are currently underway about adjusting their supply chains? How much of this economic activity could come back home to the U.S.? What breakthroughs will take place as we search for therapies and vaccines to bat-borne viruses?

The pandemic has also created the urgency to try out new ideas. Overnight, we built another infrastructure – a digital one - to support distributed workforces and remote work. How will this impact large cities and productivity now that the pipes have been laid for people to work from anywhere?

So, while there are questions that we may not want to know the answer to - like how bad the economic data will get, there are probably just as many that we do. As an investor, I'm focusing a lot of time here. I must assume others are as well, given what we saw the stock market do in April.

It's been a month since you suggested the panic had subsided. How could it return?

If we see a second wave that causes another lockdown, expect the panic to return. But it would have to be a serious round two, and that seems unlikely.

We talked about how the world may change, but so much has already - human behavior especially. We won't be shaking hands in business meetings for some time. Social distancing will remain. We will wash our hands more than ever before, so Covid-19 is going to have to overcome all of this to cause this much chaos again.

Antibodies could also help with herd immunity. A recent study was published on the prevalence of coronavirus antibodies in Santa Clara County. Based on blood tests of 3,300 volunteers during the first week of April, they estimated that between 2.5% and 4.2% of the county population had been infected. That’s 50 to 85 times the number of confirmed cases (6). There are several other studies that confirm this trend. This could help because that means more people probably won’t get sick again.

Also, the Department of Homeland Security just released a report concluding heat and humidity kill it faster (8). Apparently, it can’t survive longer than half an hour versus several hours in cold, dry weather. Never have I been more excited to feel humidity.

Last question. Do you still think we see a V-shaped economic recovery?

When I made that call back in late March, it was predicated on the government reopening by the end of April. Now that so much of the country appears to remain locked down through the end of May, that V will probably now look more like a U.

But the good news is that it will still recover. It may just take longer. And it doesn’t really 6 do much to my investment plan. I try to avoid any strategy that is overly dependent upon our government to act.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

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