



MORNING BRIEFING

March 10, 2020

Pandemic Pandemonium

Check out the accompanying [chart collection](#) and [podcast](#).

(1) Fear continues to spread faster than reported virus cases. (2) Balance of good vs bad news on virus tips toward the former. (3) Virus stats in China and S. Korea improve as those in Italy and France worsen. (4) Panic Attack #66 is the most fearful of them all. (5) It all depends on whether the virus goes away or stays. (6) Was that a capitulation bottom yesterday? Maybe not. (7) Putin and MBS playing chicken in the oil patch, with both hoping to hurt each other along with US frackers. (8) Flight to quality has turned into a panic in Treasury market. (9) Reaching for safety instead of yield. (10) Credit quality spreads widening. Signs of a credit crunch? (11) Déjà vu: Energy-related junk bonds in distress, as in 2015.

Strategy I: Good & Bad Viral News. The pandemic of fear continues to spread faster than the cause of that fear, namely, the COVID-19 virus. As an investment strategist, I've been more concerned about the spread of fear than the spread of the virus. As a virologist (remember, we are all virologists now), my working hypothesis—based on everything I've been reading and conversations with a few medical professionals—is that COVID-19 is very similar to other coronaviruses that cause colds and the flu.

COVID-19 is also similar to the coronaviruses that caused SARS and MERS. It seems to be more contagious than these next of kin, however, with relatively mild symptoms for 80% of those infected. As I observed yesterday, many of the mild cases may be so mild that they aren't detected and aren't reported.

While the pandemic of fear continued to spread in financial markets yesterday, the balance of good versus bad news on the spread of the virus tipped toward a happier outcome than widely feared:

(1) *Good news on the virus.* The news out of China actually improved yesterday. Authorities there reported the fewest number of new cases of coronavirus since infections started being tracked in January. China's National Health Commission reported 40 new cases of the virus yesterday, down from 44 new cases the previous day. China now has 80,735 total cases,

among which 19,016 remain in treatment and 58,600 have been released. More than 3,000 have died. In South Korea, the number of new cases slowed on Monday to 367 from 483 the day before. Until recently, South Korea had the most cases (7,478) outside of China.

(2) *Bad news on the virus.* But the pandemic is continuing to spread rapidly elsewhere around the world, with the details reported on Monday rattling global stock markets.

Italy is about to surpass South Korea as the country outside China with the most cases. Italy has been put under a dramatic total lockdown as the coronavirus spreads in the country. Prime Minister Giuseppe Conte announced that he is extending restrictions already in place in the north. The government is also shutting down its museums, which include access to the Sistine Chapel, until April 3. France is banning events of more than 1,000 people to limit the spread of the coronavirus. Iran has suspended all flights to Europe. Everyone arriving in Israel will be required to self-quarantine for 14 days to prevent the spread of the coronavirus. Saudi Arabia has suspended pilgrimages to the Muslim holy cities of Mecca and Medina. It has also cordoned off access to many towns in the east of the country.

Strategy II: Infecting the Markets. As I've observed in recent days, the response to the fear is more damaging to the global economy than the virus itself. The Fear Factor is much greater in Panic Attack #66 than in all the previous ones.

Ginning up the Fear Factor are fearful responses to the virus by the media, governments, and the public. The media loves the story and is covering every detail everywhere on a 24x7 basis. Government officials are resorting to extreme measures (quarantines, travel bans, border closings, school closings, and dire warnings), partly to show that they are "doing something." Businesses are curbing business travel, cancelling group meetings, and asking their employees to work from home. Universities are preparing to have students take courses remotely and are starting spring breaks early.

These fearful responses are already depressing the global economy, commodity prices, and stock prices, while sending interest rates to record lows.

We all know what the economy, earnings, and stock prices will do if the virus doesn't go away soon. They will all go down. Do we really want to stay home all day with the kids? We may just have to learn to live with the virus as best we can (washing our hands often, etc.) until vaccines and cures are formulated.

But what if the virus behaves like previous coronaviruses, disappearing in not too long? If that's the course it takes and if that course becomes more obvious soon, just as the tulips are popping out of the ground and the cherry trees blooming with their blossoms, then Panic Attack #66 might still play out as simply the latest panic attack to be followed by a relief rally.

Let's have a closer look at the implications of yesterday's fearful response to the latest news:

(1) *S&P 500*. After plunging 7.6% yesterday to 2746.56, the S&P 500 barely remained in correction territory with a drop of 18.9% since the record high on February 19 ([Fig. 1](#)). By the way, yesterday was March 9, exactly 11 years since the current bull market started, measured on a market-close basis, at 676.53 ([Fig. 2](#)). Keep in mind that the S&P 500 is still up 306% since then.

The bull market would have ended yesterday, on its birthday, with the start of an official bear market had the S&P 500 fallen to 2708.92, putting it 20.0% below its February 19 record high. Now the index need fall only another 1.4% to confirm that a bear market, rather than a correction, has been underway since February 19.

For trendwatchers, it's notable that the S&P 500, which fell 10.0% below its 200-day moving average yesterday, also found support at its trendline connecting the bottoms of October 3, 2011 and December 24, 2018 ([Fig. 3](#) and [Fig. 4](#)). If that support doesn't hold, then the odds are that we will be entering a bear market very shortly. Joe and I still think it would be more like the bear market during late 1987 than something worse.

For contrarians, the good news is that sentiment has turned increasingly bearish. The Bull/Bear Ratio (BBR) compiled by Investors Intelligence fell to 2.04 during the March 3 week, down from 3.31 during the final week of 2019 ([Fig. 5](#)). The bad news is that most of that drop reflected a drop of bulls (from 58.9% to 41.7%), as many of them moved to the correction camp (from 23.3% to 37.9%). That certainly doesn't indicate panic or capitulation. The percentage of bears rose slightly from 17.8% to 20.4% since the end of last year through the March 3 week. Debbie and I expect more signs of capitulation in today's data from the March 10 week after yesterday's selloff.

(2) *Crude oil price*. Yesterday's stock market rout was triggered by the collapse in the price of crude oil. On Saturday, Saudi Arabia announced massive discounts to its official selling prices

for April. Reuters reported that the Saudis are planning to increase their production above 10 million barrels-per-day mark. The Kingdom currently pumps 9.7 million barrels per day but has the capacity to ramp up to 12.5 million barrels per day. Their action was prompted by the unwillingness of Russia to participate in a production-cutting deal with OPEC.

While this game of chicken between Russian President Vladimir Putin and Saudi Crown Prince Mohammed bin Salman is dangerous for both men to play, the biggest loser might be US shale oil producers. That collateral damage must be appealing to both of them.

Data for November of last year (the latest available) from the US Energy Information Administration show that the US plus Canada produced a record 17.4 million barrels per day ([Fig. 6](#)). That well exceeded Russian and Saudi output in November, at 10.9 million barrels per day and 9.9 million barrels per day, respectively. During February, US crude oil production has been hovering around a record 12.9 million barrels per day ([Fig. 7](#)).

OPEC's share of world oil production fell from a recent peak of 42.4% during September 2017 to 37.7% during November of last year ([Fig. 8](#) and [Fig. 9](#)). Of course, the immediate underlying problem for all the oil producers is that oil demand has been depressed by the global health crisis, as flights have been cancelled, cruise ships have been quarantined, and people have been driving less.

The plunge in the price of a barrel of Brent crude oil this year back to the lows of early 2016 is depressing the revenues of world oil producers ([Fig. 10](#) and [Fig. 11](#)). The hit could be as big as \$500 billion, at an annual rate, compared to a year ago. That's bad for energy-related capital spending, but it is a big windfall for consumers and other users of petroleum products. However, the stock prices of the most obvious beneficiaries of lower fuel prices, such as airlines, still saw their stock prices tumble yesterday on virus and recession fears.

(3) *Treasury bond yield*. The flight to quality has turned into a panic for quality in the US Treasury bond market. Since January 24, when the coronavirus outbreak first made headlines, the 10-year US Treasury bond yield plunged from 1.70% to only 0.54% yesterday ([Fig. 12](#)). Over that same period, the comparable TIPS yield fell 47 basis points to -0.45%, while the expected inflation spread fell 69 basis points to 0.99% ([Fig. 13](#)).

(4) *Credit quality spreads*. While the 10-year US Treasury bond yield has dropped close to zero in recent days, other long-term yields haven't dropped as sharply or have moved higher.

This strongly suggests that investors have stopped reaching for yield and are now stooping for safety in the Treasury market. That increases the risks of a widespread credit crunch, which have always caused recessions in the past. Before that happens, the Fed will likely cut the federal funds rate to zero and resume QE (quantitative easing) bond purchases, including possibly corporate bonds (which would require a change in the Federal Reserve Act, as we discussed yesterday).

Since January 24 when the coronavirus first made headlines, the corporate junk bond yield rose 194 basis points to 7.17% on March 9 ([Fig. 14](#)). Its spread over the 10-year Treasury bond yield rose from 353 to 663 basis points over the period ([Fig. 15](#)). That may be the start of déjà vu all over again. It's very reminiscent of the widening of this spread during 2015 as energy-related junk bond yields soared while oil prices plunged.

The 30-year mortgage rate has lagged the drop in the Treasury bond yield, especially in recent days as the spread between the two soared from 200 basis points on February 12 to 297 basis points on March 6 and likely surpassed 300 basis points yesterday ([Fig. 16](#)). The spread between the AAA municipal yield and the 10-year US Treasury bond yield turned positive in recent days for the first time since 2012 ([Fig. 17](#)).

CALENDARS

US: **Tues:** NFIB Small Optimism Index 102.9. **Wed:** Headline & Core CPI 2.2%/2.3% y/y, Monthly Budget Statement -\$240.8b, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

Global: **Tues:** Eurozone GDP 0.1%q/q/0.9% y/y. **Wed:** UK GDP 0.2%m/m/0.1%3m/3m, UK Headline & Manufacturing Industrial Production -2.6%/-3.5% y/y, UK Trade Balance - £356m, UK Government Announces 2020 Budget. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for two of these three indexes last week. LargeCap's was down for the first time in four weeks to a seven-week low, and SmallCap's dropped the most since August to a nine-week low. These indexes had begun a forward-earnings uptrend during March 2019 but stumbled from July to November. While LargeCap's is just 0.4% below its record high at the end of January, MidCap's and SmallCap's are 3.4% and 6.2% below their October 2018 highs. Index changes for the SMidCaps at the

end of 2019 helped MidCap's forward earnings improve from November's 18-month low, while SmallCap's is up from September's 17-month low. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings dropped to a six-week low of 3.8% y/y from 4.3%, which compares to an eight-month high of 4.4% at the end of January and a 38-month low of 1.0% in early December. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's improved w/w to -0.5% y/y from -0.8%. That compares to a five-month high of -0.2% in mid-February and -5.5% in November, which was the lowest since December 2009. That also compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's fell w/w to a 1.1% y/y from a nine-month high of 2.0%; that's still up from -9.6% in mid-September, which was the lowest since December 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 during late 2018, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2019, 2020, and 2021: LargeCap (0.7%, 7.0%, 11.8%), MidCap (-6.0, 9.4, 10.9), and SmallCap (-0.8, 8.5, 14.5).

S&P 500/400/600 Valuation ([link](#)): Valuations were mostly lower last week for these three indexes. LargeCap's forward P/E rose 0.2 points w/w to 16.7 from 16.5. It had been at 18.9 during mid-February, which was the highest level since June 2002 and compares to a five-year low of 13.9 during December 2018. Of course, that's still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E dropped w/w to a six-month low of 14.9 from 15.1. That's up from 13.0 during December 2018, which was the lowest reading since November 2011. MidCap's P/E is down from a 22-month high of 17.4 in mid-December and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E decreased w/w to a 14-month low of 15.1 from 15.2, and is down from mid-December's 16-month high of 18.1. That's well above its seven-year low of 13.6 during December 2018 and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is also below LargeCap's. It had been below for four months through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With analysts looking ahead to March quarterly earnings expectations, earnings revisions activity will begin to pick up shortly and

looks to be the worst in many years. The Q1 EPS forecast fell 19 cents w/w to \$38.96. That represents a decline of 0.5% y/y on a frozen actual basis and an increase of 1.8% y/y on a pro forma basis. That compares to a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Besides the small y/y decline in Q3-2019, the last time earnings fell markedly y/y was during the four quarters through Q2-2016. Seven of the 11 sectors are expected to record positive y/y earnings growth in Q1, with one rising at a double-digit percentage rate. That compares to eight positive during Q4, when two rose at a double-digit percentage rate. Six sectors are expected to beat the S&P 500's pro-forma 1.8% gain in Q1, down from six in Q4 and seven in Q3 but up sharply from just three beating the S&P 500 during Q2-2019. Three sectors are expected to post improved (or less worse) growth on a q/q basis during Q1: Communication Services, Energy, and Materials. On an ex-Energy basis, the consensus expects earnings to rise 2.0% y/y in Q1. That compares to ex-Energy gains of 6.0% in Q4, 2.2% in Q3, 3.9% in Q2, and 3.0% in Q1 but is well below ex-Energy's 25.0% and 14.2% y/y gains in Q3-2018 and Q4-2018, respectively. Here are the latest Q1-2020 earnings growth rates versus their final Q4-2019 growth rates: Communication Services (13.2% in Q1-2020 versus 8.2% in Q4-2019), Information Technology (7.6, 9.3), Health Care (4.2, 9.9), Utilities (3.3, 17.8), Real Estate (2.7, 7.1), Financials (2.0, 10.3), Consumer Staples (0.8, 2.6), Energy (-4.2, -41.2), Consumer Discretionary (-7.2, 2.2), Materials (-7.6, -12.4), and Industrials (-13.2, -9.3).

GLOBAL ECONOMIC INDICATORS

Germany Manufacturing Orders ([link](#)): Germany's orders began 2020 on a tear—posting the biggest monthly gain since July 2014—though the impact of the coronavirus outbreak has yet to hit the data. The Economy Ministry noted that with business confidence stabilizing, “manufacturing should have reached the turning point. Yet the impact from the new coronavirus risks remains to be seen.” Orders rebounded 5.5% in January, more than recouping the 2.9% slide during the last two months of 2019. Foreign orders soared 10.5% in January—with both billings from inside (15.1%) and outside (7.8) the Eurozone posting impressive gains; domestic orders fell 1.3% after a two-month gain of 3.3%. Capital (7.1), consumer nondurable (4.4), and intermediate (3.5) goods orders all posted notable gains. The jump in capital goods orders reflected double-digit advances from both inside (20.8) and outside (13.1) the Eurozone, while the strength in intermediate goods billing centered on orders from within the Eurozone (7.9), along with domestic (5.1) demand. The increase in

consumer nondurable goods orders was widespread, with both domestic (3.1) and foreign (5.5) orders up; billings from both inside (7.2) and outside (4.1) the Eurozone were in the black.

Germany Industrial Production ([link](#)): Both Germany's headline and manufacturing production rebounded in January, after plunging in December to their lowest levels since January 2015 and August 2014, respectively. Headline production—which includes construction—jumped 3.0% following a 2.2% drop in December—which was smaller than the initial 3.5% drop. Excluding construction, January's gain was 2.7%. Manufacturing output rebounded 2.8% after a 1.9% decline in December. The main industrial groupings show intermediate (5.1%) and capital (2.1) goods production were up, while consumer goods production was flat—as an increase on nondurable goods production more than offset the decline in durable goods. February data will likely be hard hit by the coronavirus outbreak, though yesterday the German government unveiled a package of measures to help companies hit by the virus. Olaf Scholz, the finance minister, pledged that Germany was prepared “to do everything needed to stabilize the economy and secure jobs. We will ensure that there is always enough liquidity available for business.”

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