



MORNING BRIEFING

March 12, 2020

Fear for All

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

(1) It's officially a pandemic. (2) Global recession is underway as both healthy and sick people stay home. (3) Lowering our US GDP forecast to a growth recession for Q2 & Q3, but also raising odds of outright recession from 35% to 45%. (4) No change in our earnings recession forecasts for Q1 & Q2. (5) S&P 500 target: Pushing 3500 to mid-2021, while aiming for 2900 by year-end. (6) The kids are home. (7) Governor Cuomo and Chancellor Merkel saving us or scaring us? (8) Credit-quality spreads signaling credit crunch. (9) Waiting for a policy response: Helicopter money? (10) Fed, running out of ammo, may ask Congress for permission to buy corporate securities. (11) Clash of the Titans in the Oil Patch.

Strategy I: Cutting Our Estimates Again. The World Health Organization yesterday declared that the COVID-19 viral disease is now officially a pandemic. The resulting pandemic of fear continues to spread and is bound to cause a global recession. Even before the coronavirus outbreak, Germany and Japan were on the brink of recessions. Now Italy is in a recession for sure. China may ease the global pain if in fact its economy is starting to recover from its downturn at the beginning of the year.

What can we expect from the US economy? Given the bad news for the travel, entertainment, leisure, and energy industries resulting from the virus fears, initial unemployment claims are likely to move higher soon. Measures of consumer and business confidence are likely to drop sharply soon as well. A recession isn't inevitable, but it certainly is becoming more likely. We'll do our best to keep on top of the many fast-moving parts to the economic and financial outlook. Here are updates on our forecasts for the economy and the markets in light of recent developments:

(1) **GDP.** We are keeping our real GDP growth rate estimate at 1.9% (saar) for Q1. But we are lowering it to 0.0% from 1.5% for Q2, lowering it to 0.5% from 2.7% for Q3, and boosting it to 3.5% from 2.3% for Q4. So we are anticipating a growth recession during Q2 and Q3, followed by a recovery during Q4. (See [YRI Economic Forecasts](#).)

(2) *S&P 500 earnings*. We aren't changing our estimates for S&P 500 earnings because they remain consistent with our outlook for global economic growth. S&P 500 earnings per share should be flat this year compared to last year, with the following year-over-year quarterly growth rates: Q1 (-5.5%), Q2 (-8.0), Q3 (2.0), and Q4 (7.1). For next year, we are estimating growth of 7.4%. (See [YRI S&P 500 Earnings Forecasts](#).)

(3) *Recession odds*. In Monday's [Morning Briefing](#), we put the following odds on three alternative scenarios: the Good (65%), the Bad (25%), and the Ugly (10%). The probability of a recession and a bear market (the Bad) are increasing for the reasons discussed below. So we are amending the odds to 55%, 30%, and 15%—thus, in effect, putting the odds of a recession at 45%. Why not raise the odds of the Ugly scenario by more? We still expect a policy response that will avert the “Zombie Apocalypse.” We also expect that, as in 2015, distressed asset funds will resuscitate lots of the recently distressed assets.

(4) *S&P 500 targets*. Joe and I warned earlier this year that the P/E-led meltup in stock prices could be followed by a correction, as the S&P 500 was approaching our year-end target of 3500 well ahead of schedule. It hit a record high of 3386.15 on February 19. So far, the 19.0% drop in the S&P 500 was still a severe correction, but it's on the verge of becoming an outright bear. If it becomes one, we think it will be more like the late 1987 bear market than the bear market of 2008 and 2009. However, we are pushing out our 3500 target to mid-2021. By the end of the year, we are targeting 2900 instead.

Strategy II: The Kids Are Home. So far, the US has had relatively few cases of COVID-19. However, cases have been reported in 38 states and Washington, DC so far, and the number is probably understated because testing for the virus has been limited.

New York Governor Andrew Cuomo has sent the National Guard to contain the virus outbreak in New Rochelle, where I went to high school. The Centers for Disease Control and Prevention has advised senior citizens to stockpile food. Public schools and colleges are closing. Both of my college kids have been told to finish their second-semester courses online. Local public schools on Long Island (in my neighborhood) have suspended classes after two bus drivers were diagnosed with the virus. New York State and New York City officials openly worried on Tuesday that the coronavirus outbreak could wreak havoc on New York's banking and tourism industries—blowing new holes into their budgets.

Overseas, the situation looks grim in Europe, but the worst may be past in China and South Korea.

All of Italy—Europe’s third-largest economy—is on lockdown. In Germany, Chancellor Angela Merkel said that the focus should be on slowing the virus’s spread, as 70% of the population is likely to be infected. That seems irresponsibly alarmist given that there have been 124,830 cases of coronavirus so far in all of China, which has a population of 1.4 billion!

In China, new daily cases had been dropping for several days, but this reversed on Wednesday; the uptick is being attributed to people returning to the country from overseas. Beijing on Wednesday ordered people arriving in the city from any country to go into 14-day quarantine. In Hubei province, the pandemic’s epicenter, businesses and transportation services are being allowed gradually to resume. The infection rate in South Korea has slowed in recent days, suggesting possible stabilization there.

Strategy III: Market Reactions. So we are seeing some progress in the areas where the virus had been the worst. But the pandemic of fear continues to spread and intensify. In the financial markets, that’s evident in the recent weeks’ volatile stock price declines and rapidly widening credit spreads.

The S&P 500 is down 19.0% from February 19 through Wednesday’s close ([Fig. 1](#)). The S&P 500 VIX rose on Monday, March 9, to the highest reading since the Great Financial Crisis. It backed off a bit on Tuesday but remained on high alert on Wednesday. It tends to be a good coincident indicator of the high-yield corporate bond spread, though the former is much more volatile than the latter ([Fig. 2](#)).

The high-yield corporate bond yield soared from a recent low of 5.02% on February 19 to 7.05% on March 10 ([Fig. 3](#)). The plunge in oil prices at the start of the week caused yields on energy-related junk bonds to soar, as they did in 2015. Credit-quality spreads also widened dramatically so far this week ([Fig. 4](#)).

Strategy IV: Policy Responses. The Fed undoubtedly is monitoring tightening credit conditions, and likely soon will cut the federal funds rate even closer to zero. The Fed is also likely to resume QE bond purchases. However, with the 10-year US Treasury bond below 1.00%, it’s not obvious why bond purchases would help. Last Friday, Boston Fed President Eric Rosengren suggested that it’s time to change the Federal Reserve Act to “allow the

central bank to purchase a broader range of securities or assets.” The Fed created all the corporate zombies with ultra-easy monetary policy. Now it has to scramble to keep them from being buried.

Rosengren also called on fiscal policy to do more. The Trump administration is considering tax cuts, which would boost consumers’ income but also bloat the already bloated federal budget deficit. I won’t be surprised if President Trump and Fed Chair Jerome Powell agree to implement so-called “helicopter money.” Fiscal policy would cut taxes, and monetary policy would buy the Treasury bonds issued to finance the fiscal stimulus.

However, given that the Fed’s bond purchasing might not make any difference with the bond yield already below 1.00%, the Treasury could simply issue bonds at yields below 1.00%. If the yield rises significantly as a result of the larger deficits, then the Fed could start buying bonds.

Energy: Oil’s Bruising Week. Boxers have the best nicknames—“Smokin’ Joe” Frazier, “The Louisville Lip” (Muhammad Ali), “Sugar” Ray Leonard, “El Terrible” Jose Luis Castillo—and often their personalities are just as colorful. Who can forget Ali’s promise/threat to “Float like a butterfly, sting like a bee”?

Boxing came to mind this week as the world took it on the chin watching the slugfest between Russia and Saudi Arabia over oil production. With oil demand falling fast in February because of COVID-19, the two producers have been unable—and/or unwilling—to come up with production cuts to reduce some of the market’s excess capacity. In fact, they’ve done just the opposite. They’ve vowed to pump all out, shocking the market. The price of Brent crude oil plunged 24% to \$34.36 a barrel on Monday, bouncing back a touch to \$37.22 by Tuesday’s close ([Fig. 5](#)).

We expect that both heavyweight oil-producing countries will see more to lose than to gain in this prizefight, and their leaders will come out of their corners and back to the negotiating table. Here’s Jackie’s blow-by-blow analysis of this battle of wills:

(1) *Why did oil hit a slick?* The price of oil was hit by a triple whammy. First, oil demand tumbled due to the global COVID-19 outbreak. The pandemic has reduced economic activity in two of the largest consumers of oil, the US and China, and curtailed travel, whether by plane, boat, or car, around the world.

Global oil demand declined by 1.7 million barrels per day (mbd) in February, according to the US Energy Information Administration's (EIA) latest [report](#). The 1.7% year-over-year drop in demand means more oil was produced in February than was consumed, to the tune of 720,000 barrels per day. The EIA expects the world market to remain oversupplied through November, before returning to some semblance of balance next year.

Oil prices also fell sharply because OPEC+ producers failed to cut production. OPEC+ had cut 2.1 mbd of production going into their March 6 meeting and was expected to make an additional 1.5 mbd of production cuts. Russia declined to make any additional cuts, according to news reports. The statement released at the meeting's conclusion made no mention of cuts, implying that the production shackles were off—countries could produce whatever they wanted.

Then the news got worse. Saudi Arabia reportedly began offering customers massive price discounts and opened the spigots, and yesterday signaled its intention to increase production capacity to a record 13 mbd, up from its 12 mbd current capacity and 9.7 mbd of production earlier this year. Russia jabbed back with its own production increase: another 500,000 barrels per day in the “near future.”

(2) *Why are the gloves off?* Russia, Saudi Arabia, and the US are, without a doubt, the oil market's heavyweights, but their pecking order over the past decade has changed dramatically.

OPEC's production of crude oil and other liquids has fallen in recent years, to 33.6 mbd in February from 36.8 in February 2016. Saudi Arabia, the organization's largest member, could be pumping more, but it has held back to keep the price of oil aloft. The former Soviet Union's production has gradually grown—to 14.8 mbd up from 14.3 mbd—even though Russia has made some production cuts in the past. And in the US, production has soared—to 20.6 mbd from 14.8 mbd—spurred on by companies, many of which are highly leveraged and produce as much as possible ([Fig. 6](#)).

Russia's unwillingness to cut production is believed to be the country's attempt to hurt US shale producers. Cutting production, and thereby artificially elevating the price of oil, only helps US producers continue to increase production while Russia is forced to cut its output. And if hurting US shale producers hurts the US, all the better because US sanctions have hurt Russian energy companies. The US sanctions targeted the trading arm of Rosneft operating in

Venezuela last month and halted the construction of Russia's Nord Stream 2 gas pipeline to Germany.

(3) *Low oil prices hurt budgets.* The combination of a lower oil price and flat volume is problematic for Saudi Arabia because it relies more heavily on oil revenue to fund the government than Russia does. To balance its budget, Saudi Arabia needs an oil price of around \$80 per barrel, compared to the \$40 a barrel that's sufficient to balance Russia's budget, a March 9 Reuters [article](#) reported.

But that's not the end of the story. While Saudi Arabia has to generate more money from oil to balance its budget, the country's cost of production per barrel of oil is less than for any other country. The average cost to produce a barrel of oil in 2016 was \$8.98 in Saudi Arabia, \$19.21 in Russia and \$23.35 in the US shale basins, an April 15, 2016 *WSJ* [article](#) reported. So, if the price falls far enough, Russia's oil producers could be unprofitable, while the Saudis can still make a profit.

Moscow said it has enough liquidity to plug any budget holes created by \$25 to \$30 oil for 6 to 10 years. The country's National Wealth Fund had liquid assets of \$150 billion, or 9.2% of Russia's GDP, a March 9 [article](#) on oilprice.com stated.

The US oil producers have also started to respond to the price cuts. Occidental Petroleum cut its dividend almost 90% on Tuesday. By doing so, the company lowered its cash-flow break-even level to the low \$30s using the Western Texas Intermediate crude oil price and excluding the benefit of any hedges. In addition, Occidental cut its 2020 capital spending to between \$3.5 billion and \$3.7 billion, a reduction of roughly \$2 billion.

The company isn't alone. Diamondback Energy and Parsley Energy, two shale independents, are reducing their drilling commitments and rig counts in the Permian Basin, a 3/10 *FT* [article](#) reported. More cutting is expected, as the North American drillers have more than \$200 billion of debt maturing over the next four years, Moody's Investors Service calculates.

(4) *Some numbers to consider.* More than politics will affect the outcome of this Russia vs Saudi Arabia matchup, however. There are also the relative economic positions of both countries to consider. Here are a couple of relevant data points:

Saudi Arabia's GDP contracted 0.3% year over year during Q4-2019, following a 0.5% drop in Q3, while Russia's GDP accelerated 1.7% year over year during Q3 ([Fig. 7](#) and [Fig. 8](#)). Unemployment in both countries is relatively low. Saudi Arabia's unemployment rate was 5.5% in Q3-2019, while Russia's was at 4.5% during January of this year ([Fig. 9](#) and [Fig. 10](#)).

Both countries have a big stockpile of foreign reserves: \$500 million in Saudi Arabia and \$570 million in Russia, a March 9 Reuters [article](#) reports. Russia does have a bit more economic flexibility in that the ruble floats, and is down 14% year to date, while the Saudi riyal is pegged to the US dollar ([Fig. 11](#)).

Oil and gas account for 50% of Saudi Arabia's GDP and more than 30% of Russia's GDP. The energy products account for 70% of Saudi's export revenue and 60% of Russia's export revenue. Saudi Arabia had a budget deficit of roughly 4.7% of GDP last year, while Russia had a surplus of 1.8% of GDP. The price war could put the brakes on Saudi Crown Prince Mohammed Bin Salman's Vision 2030, which involves many multi-billion-dollar projects aimed at diversifying the Saudi economy away from oil.

For now, however, a budget surplus and floating currency may give Russia the upper hand in this prize fight. But if the bout goes nine rounds, both countries stand to be bloodied regardless of who wins. That realization should prompt both countries to return to the negotiating table sooner rather than later.

CALENDARS

US: **Thurs:** Jobless Claims 218k, PPI Final Demand -0.1%/m/m/1.8%/y/y, EIA Natural Gas Storage. **Fri:** Consumer Sentiment Index Total, Present Situation, and Expectations 95.0/113.0/88.2, Import Prices -1.0%/m/m/-1.6%/y/y, Baker-Hughes Rig Count. (DailyFX estimates)

Global: **Thurs:** Eurozone Industrial Production 1.4%/m/m/-3.1%/y/y, ECB Central Bank Rate 0.00%, ECB Marginal Lending Facility & Deposit Facility Rates 0.25%/-0.50%. **Fri:** Germany CPI 0.4%/m/m/1.7%/y/y, Mexico Industrial Production -1.5% y/y. (DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators ([link](#)): The Bull/Bear Ratio (BBR) fell for the third week this week after rising the prior two weeks, as the seesaw movement between the bullish and

correction camps continued. The BBR sank to 1.58 this week—the lowest since early January 2019—from 2.89 three weeks ago. Bullish sentiment sank 18.5ppts to 36.2% the past three weeks after rising 7.1ppts (to 54.7% from 47.6%) over the prior two-week period—which followed a two-week drop of 11.8ppts and a two-week advance of 4.3ppts. Meanwhile, the correction count climbed 14.5ppts the past three weeks to 40.9% (the highest since November 2018), after a two-week slide of 6.9ppts (26.4 from 33.3)—following a two-week surge of 10.6ppts surge and a two-week loss of 4.4ppts. (Bullish sentiment was below the correction reading this week for the first time since early January 2019.). Bearish sentiment increased for the third week from 18.9% to 22.9%—its highest percentage since the start of 2019. The AAI Ratio rose to 49.4% last week after falling the prior two weeks from 61.0% to 43.7%. Bullish sentiment rose from 30.4% to 38.7%, while bearish sentiment was little changed at 39.6%.

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): Consensus S&P 500 forward revenues and earnings rose again during the latest week. Although forecasts for 2020 revenues and earnings are falling, 2021's are remaining strong so far and helping the forward estimates to rise. Forward earnings was at a record high for the first time in four weeks, and forward revenues improved to 0.1% below its record high in mid-February. Analysts expect forward revenues growth of 4.6% and forward earnings growth of 8.3%. The revenues measure was down 0.1ppt w/w and earnings improved 0.1ppt. Forward revenues growth is just 0.2ppt above its 41-month low at the end of January and 1.7ppt below its seven-year high of 6.3% in February 2018. Forward earnings growth is down 8.6ppts from a six-year high of 16.9% in February 2018 but is still comfortably above its 34-month low of 5.9% in February 2019. Prior to the passage of the Tax Cuts and Jobs Act (TCJA), forward revenues growth was 5.5% and forward earnings growth was 11.1%. However, annual growth expectations for 2020 are deteriorating. Analysts expect revenues growth in 2020 to match the 4.3% reported in 2019. That's down 0.3ppt w/w and 0.6ppt since the start of the year. They're calling for earnings growth to improve to 6.5% in 2020 from 1.6% in 2019, but the 2020 growth rate tumbled 0.6ppt w/w and is down 2.4ppts since the beginning of the year. The forward profit margin remained steady w/w at 12.0%, which is up 0.1ppt from a 22-month low of 11.9% in late December and is down only 0.4ppt from a record high of 12.4% in September 2018. That compares to 11.1% prior to the passage of the TCJA in December 2017 and a 24-month low of 10.4% in March 2016. Analysts still expect the profit margin to improve 0.3ppt y/y to 11.8% in 2020 from 11.5% in 2019, which would match the 11.8% recorded for 2018. Valuations have been extremely volatile on a daily basis, but the weekly comparisons were little changed. The S&P 500's forward P/E edged down 0.1ppt w/w to a four-month low of 17.6, and is down from

19.1 in mid-February, which was the highest since May 2002. That's up from 14.3 during December 2018, which was the lowest reading since October 2013, and down 23% then from the 16-year high of 18.6 at the market's valuation peak in January 2018. The S&P 500 price-to-sales ratio edged up 0.01pt to 2.12, which compares to mid-February's record high of 2.29. That's up from 1.75 during December 2018, when it was the lowest since November 2016, and down 19% from its then-record high of 2.16 in January 2018.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins ([link](#)): Consensus forward revenues and earnings rose w/w for 10 of the 11 S&P 500 sectors last week. Energy had both measures fall w/w. Forward revenues and earnings remain closest to record highs for 3/11 sectors: Consumer Discretionary, Health Care, and Tech. Forward P/S and P/E ratios are down sharply recently from record or cyclical highs for Communication Services, Consumer Discretionary, Information Technology, Real Estate, and Utilities. Due to the TCJA, the profit margin for 2018 was higher y/y for all sectors but Real Estate. Eight sectors (all but except Health Care, Real Estate, and Utilities) are expected to record higher margins y/y in 2020, up from just two sectors improving y/y in 2019: Financials and Utilities. The forward profit margin rose to record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Since then, it has moved lower for nearly all the sectors. Utilities is the only sector with its forward profit margin at a record high. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (22.3%, down from 23.0%), Financials (18.1, down from 19.2), Real Estate (15.5, down from 17.0), Communication Services (14.9, down from 15.4), Utilities (13.6, record high), S&P 500 (12.0, down from 12.4), Health Care (10.5, down from 11.2), Industrials (10.1, down from its record high of 10.5% in mid-December), Materials (10.0, down from 11.6), Consumer Staples (7.4, down from 7.7), Consumer Discretionary (7.3, down from 8.3), and Energy (5.7, down from 8.0).

US ECONOMIC INDICATORS

CPI ([link](#)): February's core CPI rate was back at its recent peak rate of 2.4% y/y, posted last August and September, after four months at 2.3%. (It first reached 2.4% during July 2018—which was the highest since September 2008.) Before accelerating to 2.4% last August, the core rate had fluctuated in a narrow band from 2.0% to 2.2% for 12 months. Core prices rose 0.2% for the second month in February, up from 0.1% during the final month of 2019; the three-month rate accelerated for the second month, to 2.4% (saar), after slowing the previous four months from 3.0% to 14-month low of 1.7%. Here's a ranking of the 12-month core rates

on a February-over-February basis, from lowest to highest for goods: used cars & trucks (-1.3% y/y), apparel (-0.9), new vehicles (0.4), alcoholic beverages (0.9), medical care commodities (1.8), and tobacco & smoking products (5.6). Of those, only the rate for medical care commodities has been on an accelerating trend, though it did ease a bit. Here's the same drill for the core services rates: motor vehicle insurance (0.3), physicians' services (0.8), airfares (2.4), owners' equivalent rent (3.3), motor vehicle maintenance & repair (3.5), rent of primary residence (3.8), and hospital services (4.3). Only the hospital services rate remains on an accelerating trend. The headline CPI rate moved above 2.0% last November for the first time since November 2018 and accelerated through January—rising steadily from 1.7% in September to a 15-month high of 2.5% y/y; it ticked down to 2.3% in February.

GLOBAL ECONOMIC INDICATORS

UK GDP ([link](#)): Real GDP growth was flat in January, after a 0.3% gain and a 0.3% loss the previous two months—with the rate for the three months though January also flatlining, on a three-month average basis. (In January, the outbreak of the coronavirus was in the early stages, so the data don't reflect the impact of the virus.) The service sector (which accounts for roughly 80% of the UK economy) ticked up 0.1% in January and was flat on a rolling three-month basis, while production industries—which includes manufacturing—fell 1.0% over the comparable three-month period, with manufacturing contracting 1.2%. Meanwhile, construction expanded 1.4% over the three-month period, offsetting declines in other industries. Yesterday, the UK government announced a series of emergency measures (worth £30 billion) to shield the economy from the growing negative impact of the coronavirus outbreak.

Contact us by [email](#) or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823

Copyright (c) Yardeni Research, Inc. Please read complete [copyright and hedge clause](#).