EDITORIAL

THE COVID-19 PANDEMIC AND THE US EQUITY MARKET

Fed Chair Powell's comment about what would happen in case of a prolonged recession has weighed heavily on equity markets. Historically, recessions are accompanied by major equity market drawdowns. The year-to-date decline is more limited, which stands in stark contrast with the plunge of activity. Massive monetary and fiscal policy support has led to a reassessment of the distribution of risks, which goes a long way in explaining the rebound of equity markets. The focus is now shifting to the outlook for corporate earnings, hence the importance of the debate on the shape of the recovery.

When the Fed Chair speaks, Wall Street tends to listen. This was again illustrated when Jerome Powell's comment on May 13 about what would happen in case of a prolonged recession weighed heavily on equity markets.[1] It is striking that his words have a bigger impact than the publication of very poor economic data or the warnings of well-known hedge fund managers about elevated valuations. Historically, recessions are accompanied by major equity market drawdowns (chart 1).[2] Against this background, the decline this year is limited[3]. This stands in stark contrast with the plunge of activity and spending data and the skyrocketing of unemployment. What might explain this apparent anomaly?

A first, straightforward factor is the massive easing of monetary policy. The Federal Reserve is in 'whatever it takes' mode and, in particular, its decision to buy corporate paper has been instrumental in reducing the risk of numerous corporate defaults, which in turn is beneficial for equity market sentiment. The decline of treasury yields works in the same direction. Moreover, QE can trigger portfolio rebalancing by investors which may support share prices.

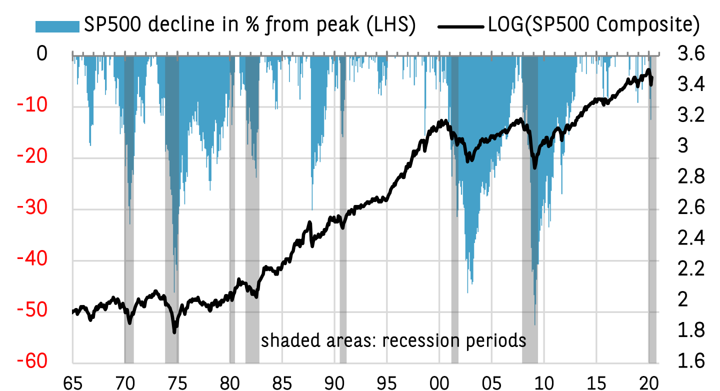
A second possible factor is fiscal policy. Congress has provided support of about 14% of GDP. To quote Jerome Powell: *"While the coronavirus economic shock appears to be the largest on record, the fiscal response has also been the fastest and largest response for any postwar downturn."* This should influence growth expectations, at a minimum by reducing the risk of extremely negative outcomes.

A third factor is specifically related to the distribution of risks. In the course of 2019 and at the start of this year, surveys showed that US CFOs considered there was a high risk of a recession in the foreseeable future. Considering the equity market declines during recessions, one can argue that risk was very much tilted to the downside: the likelihood of a big drawdown was higher than the possibility of an equivalent increase in share prices. Following the market decline due to the pandemic and given the reaction of monetary and fiscal policy, it can be argued that risk is now less asymmetric than at the start of the year.

A fourth possible factor concerns recession-related uncertainty. This concerns the depth and length of the recession as well as the pace of recovery thereafter. As shown in chart 2, recessions tend to differ quite a bit in terms of length and depth. The latter is represented by a very rough measure –the ISM manufacturing index- so as to be able to include data for the current recession[4].

1. *"A prolonged recession and weak recovery could also discourage business investment and expansion, further limiting the resurgence of jobs as well as the growth of capital stock and the pace of technological advancement. The result could be an extended period of low productivity growth and stagnant incomes."* Source: Current Economic Issues Remarks by Jerome H. Powell, Chair Board of Governors of the Federal Reserve System at Peterson Institute for International Economics, Washington, D.C., May 13, 2020
2. A drawdown is defined as the decline in % from the previous peak.
3. The chart uses monthly data. Using daily observations, the maximum drawdown was considerable though not extreme (-34% between 19 February and 23 March) but following the rebound, at present the S&P500 is trading 16% below its historical record (source: Bloomberg).
4. It was assumed that the peak of the business cycle was at the end of 2019. The NBER Business Cycle Dating Committee announces cyclical turning points with a considerable delay.

UNITED STATES: EQUITY MARKET EVOLUTION AND DRAWDOWN



SOURCE: STANDARD & POOR'S, NBER, BNP PARIBAS

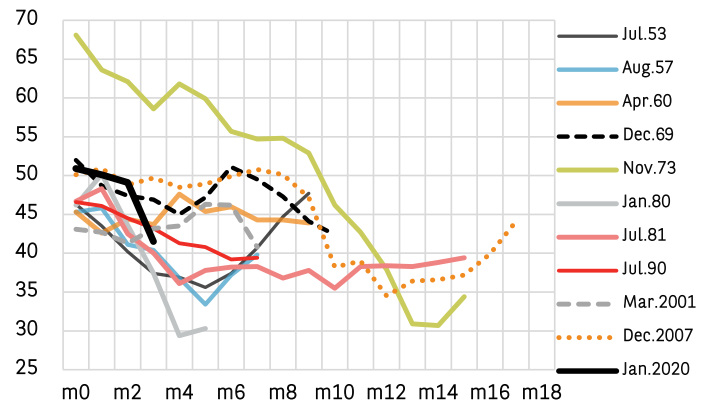
> Wall Street has rebounded on the back of massive stimulus and a reassessment of the distribution of risks. Going forward, the focus will entirely be on the outlook for corporate earnings, hence the importance of the debate on the shape of the recovery.

If we consider that the lower cyclical turning point has been reached when activity indicators start to pick up again, this would imply that the current recession should be a very short one: the contraction was triggered by the lockdown and the recovery should be initiated by the gradual easing of the lockdown. This last point implies that the usual uncertainty about the duration of a recession should be very limited, which, in addition, allows investors to look more confidently to the 'other side of the valley' and pay less attention to the depth of the recession.

These various factors help in explaining the observed behaviour of equity markets but they do not provide a forecast. Given the low level of bond yields, which are likely to increase as the economy recovers, attention of investors will focus essentially on the outlook for corporate earnings. It explains the reaction to the warning of Jerome Powell about the detrimental longer term consequences should the recovery turn out to be weak.

William De Vijlder

MANUFACTURING ISM DURING RECESSIONS (BUSINESS CYCLE PEAK = M0)



SOURCE: SISM, NBER, BNP PARIBAS