Economic Strategy

A third quarter correction for the S&P500?

- Second quarter earnings will likely disappoint.

After peaking at 3386 points on 19th February 2020 the S&P500 then plunged to 2237 points on 23rd March. Since that time the recovery in US equity prices has been almost as rapid as the prior decline. By 8th June 2020 the S&P500 had recovered to 3232 points.

The popular explanation for the rapid recovery in US stock prices is liquidity. One possible measure of an increase in liquidity is the fall in the Fed Funds rate. The effective Fed funds rate, quoted by the Federal Reserve Economic Database tells us that Fed funds fell from an effective interest rate of 2.4% in July 2019 to 1.58% in February 2020. The most dramatic decline then began. By April 2020 the effective Fed funds rate had fallen to 0.05%. This means that in a 9-month period the Fed funds rate had fallen by 2.35%.

The increase in the Fed Funds rate that had taken place between January 2014 and April 2019 was in total an increase of 2.35%. This total increase in the Fed funds rate of over a period of 4 years and 8 months had been wiped out in only 9 months. Then in March 2020 the Federal Reserve decided that it was going to reintroduce quantitative easing. Is this the reason for a rise in the stock prices?

Try as I might, I am unable to find any direct statistical relationship between the decline in the Fed funds or the size of the Fed balance sheet and equities prices. Both of those variables exert their power not on equities but on the market for bonds. Both the decline in the Fed funds rate and an increase in purchases of bonds by the Federal Reserve put downward pressure on US bond yields. It is those falling bond yields in-turn which put upward pressure on equities. The question is how much upward pressure does the decline in US treasury yields result in terms of points gained by the S&P500. How do we know when the effect of this liquidity is exhausted?

Back on the 5th of May, I used a longer-term version of our model of the S&P500 to suggest that earnings announcements in the 3rd quarter of 2020 would not be enough to support equities at very high prices. The S&P500 is higher now than when I wrote those words. When is the rise in the S&P500 too much?

There are periods over the long-term in which there has been very low liquidity. The Financial Crisis of 2008 was one such period. During this time the statistical response of US equities to charges in US Bond yields entirely disappeared. What mattered during this period was not the investment demand for money but the problem of finding a supply of money to invest. This is what we call a credit crunch.

Since the passage of the Volker rule in early 2014, the liquidity available through the Federal Reserve system to both the US bond market and the US equities market has dramatically increased. It is the investment demand for money not the limited supply of money which now has an enhanced relationship with equities prices.

This means that US equities since the beginning of 2014 have become far more sensitive to changes in US bond yields than they were before. The first question is by how much? The second question is, what does this mean for the equilibrium level of the S&P500?

Our model of US equities for the period is based on US earnings per share and variation in long bond yields. The highest level of US 10-year bonds yields in the past 5 years was the level of 3.22% in November 2018. This is also the highest level of bond yield observed since the beginning of the data period in our model in January 2014.

A multi-year fall in US treasury yields took them down to a low on 21st April 2020 of 0.57%. Since that time, US bond yields have risen very slightly to 0.84% on 8th June. These very low yields on 10-year bonds put upward pressure on the equilibrium value for US equities.

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The other variable in our model naturally is earnings. Our numbers for US earnings and their forecasts are drawn from surveys available from Standard and Poor's. Movements in US earnings during the period have been as dramatic as the movements in bond yields. Some of the movements have been even more sudden. The peak in quarterly operating earnings for the S&P500 was in the third quarter of 2019. Quarterly operating earnings per share in that quarter stood at $41.38. This has declined in the earnings season for the first quarter of 2020 to a level of $19.70 a share. The first quarter saw a decline in US GDP currently estimated at 1.4%.

In the second quarter of 2020 the current forecast is for operating earnings per share to rise to $23.08 per share. In this same second quarter of 2020, GDP is expected to fall by the Congressional Budget Office by a level of 12%. This is a fall 8 times as great than the decline in the 1st quarter. Yet earnings are forecast to rise in that same quarter.

We think it incredibly likely that this second quarter, when it begins to be reported in the middle of July, will provide rather dramatic earnings disappointment. We note that the worst quarterly earnings in the recession of 2008 was quarterly earnings of 0 in the fourth quarter of 2008. The slump in GDP in that quarter was less severe than the slump forecast for the second quarter of 2020.

We put our time series of earnings together with our time series of bond yields and we restrict the period to that since the beginning of 2014. Our model peaks at 3178 points in August 2019. It then moves sideways to 3060 points in November 2019 and 3007 points in February 2020. Then weaker earnings result in a fall. On 8 June our fair value had fallen to 2625 points or 607 points lower than the actual level of the S&P500 of 3232 points on the same day.

Our model tells us that the S&P500 in early June is significantly overpriced. We think the Us equities market on current fundamentals has risen to a level in excess of what can be justified even if we take into account all of the effect of the Federal Reserve action in lowering US ten-yield bond yields and all of the effect of those lower bond yields in pushing up the fair value of US equities.

Conclusion

The US equities market has already run to a level in excess of that justified by the stimulus of the Federal Reserve. We think it highly likely that forecasts of US earnings for the second quarter of 2020 will dramatically disappoint. The S&P500 is increasingly vulnerable to a correction.

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06.09.19