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WHY THERE IS NO V

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Table of Contents

EXECUTIVE SUMMARY

The market has been getting excited by the prospect of a V-shaped recovery. It points to data such as the ISM Manufacturing PMI, which rose from 43.1 in May to 52.6 in June, indicating expansion.

While the ISM M-PMI print is positive developments, it is not indicative of a V-shaped rebound. PMIs are designed to measure month-to-month changes. The economy is still in a big hole that it's trying to dig out of, and there are signs the recovery is stalling.

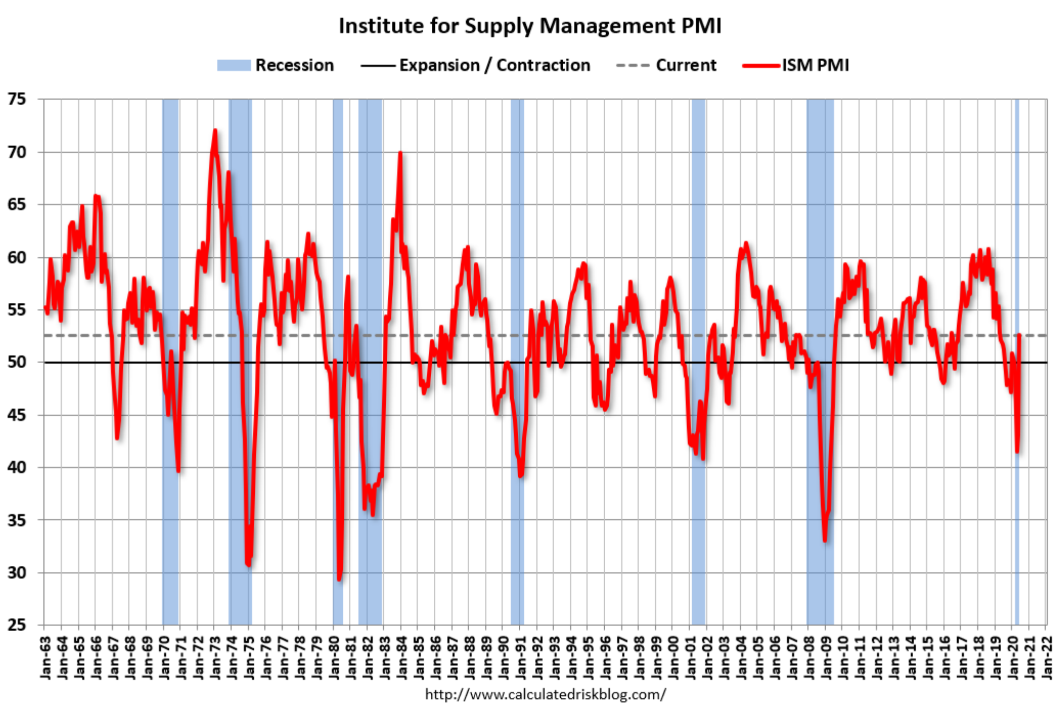
As an example, the June Employment Report shows a strong economic recovery on the surface, but high wage job growth is stalling, and the outlook for government jobs is an overhang. As well, high-frequency data since then has shown a stalling in consumer activity, which is probably attributable to the recent surge in COVID-19 cases.

Looking ahead, we believe the trajectory of stock prices will depend mainly on investor reactor to Q2 earnings season and the official policy response.

A False Hope

The market has been getting excited by the prospect of a V-shaped recovery. It points to data such as the ISM Manufacturing PMI, which rose from 43.1 in May to 52.6 in June, indicating expansion. The employment index improved from 32.1 to 42.1, and the new orders index increased from 31.8 to 56.4.

Exhibit 1: ISM Manufacturing PMI



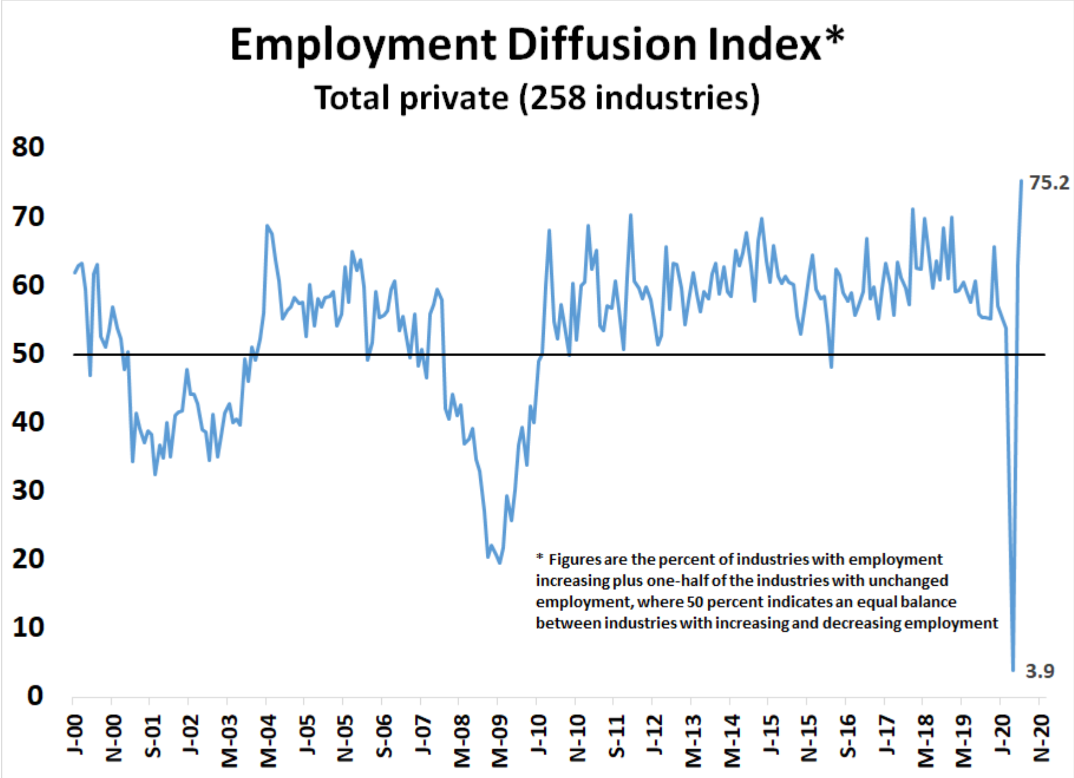
Source: Calculated Risk

While those are positive developments, this is not indicative of a V-shaped rebound. PMIs are designed to measure month-to-month changes. The economy is still in a big hole that it's trying to dig out of, and there are signs the recovery is stalling.

The June Employment Report

Let's begin by analyzing the June Employment Report. The economy added 4.8-million jobs, which was well ahead of expectations. In addition, the diffusion index spiked, indicating a broad rebound. That's good news.

Exhibit 2: Employment Diffusion Index

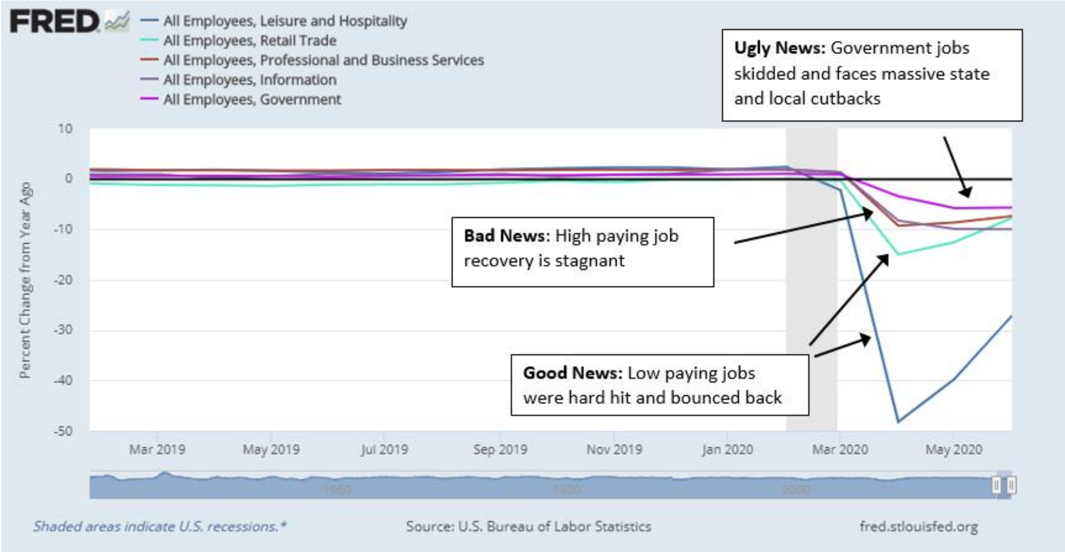


Source: BLS, Pennock Idea Hub

The picture looks far less rosy beneath the surface. Here are the good, the bad and the ugly parts of the report.

- **Good:** Low-wage positions like retail and leisure and hospitality were devastated by the shutdown, and they have bounced back strongly.
- **Bad:** The high-wage white collar job recovery is stagnant.
- **Ugly:** Government job growth skidded during the pandemic, and state and local governments are facing urgent budget pressures. Without federal aid, there will be another wave of layoffs in that sector.

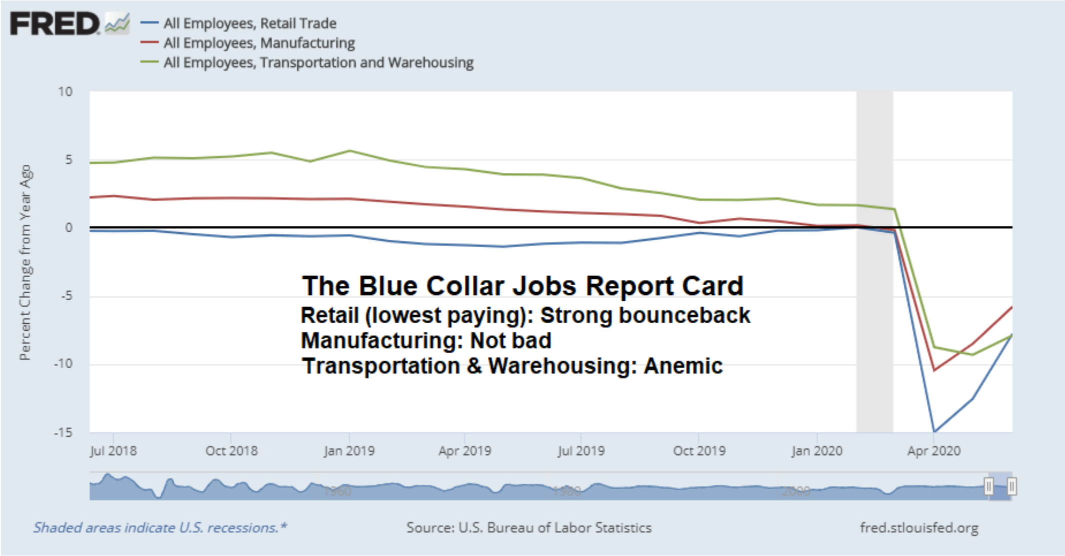
Exhibit 3: The Good, The Bad and The Ugly



Source: FRED, Federal Reserve Bank of St. Louis

The story is the same within the blue and pink collar job sector. Low paying retail jobs have bounced back nicely. The rebound in high-paying manufacturing jobs has been less strong, and transportation and warehousing job growth is stagnant.

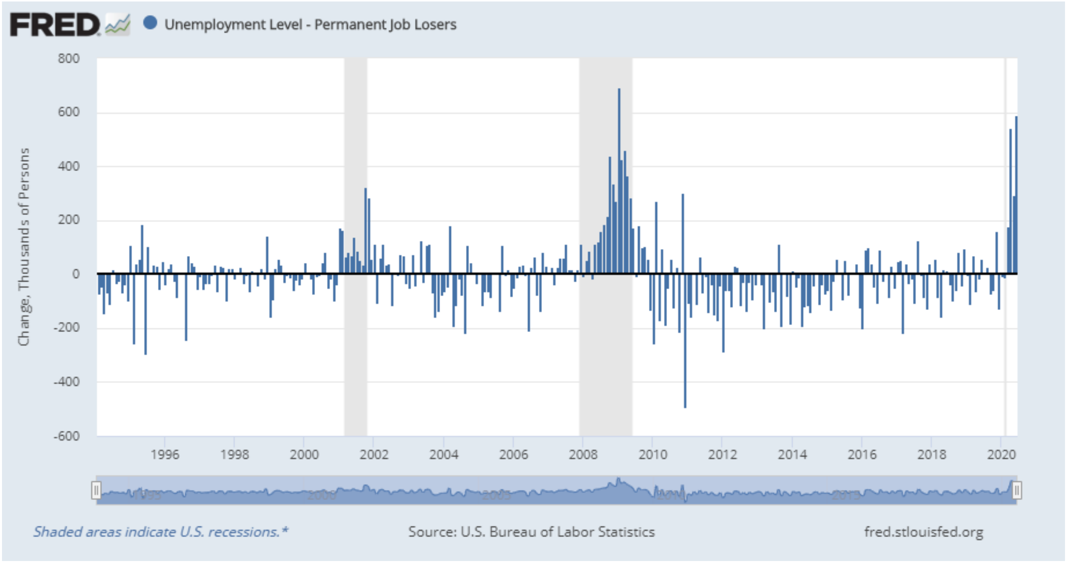
Exhibit 4: An Uneven Recovery in Blue and Pink Collar Jobs



Source: FRED, Federal Reserve Bank of St. Louis

So far, the jobs recovery can be seen in the reversal of temporary furloughs. The unfortunate news is the number of permanent jobs lost.

Exhibit 5: Permanent Job Loss at Recessionary Levels



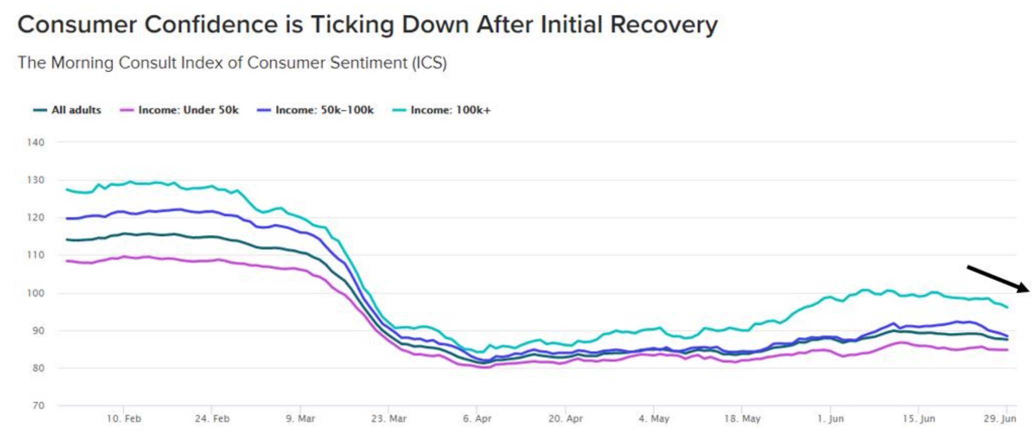
Source: FRED, Federal Reserve Bank of St. Louis

The V-shaped recovery can only be found in low-wage positions. The rest of the jobs market faces a far cloudier outlook.

The Consumer Pulls Back

The June Employment Report is a snapshot of the economy in mid-June. High-frequency data since then has shown a stalling in consumer activity. Morning Consult reported that consumer confidence is starting to roll over. The weakness began just after mid-June, which was after the data date of the Employment Report.

Exhibit 6: High Frequency Consumer Confidence Turns Down



Source: Morning Consult

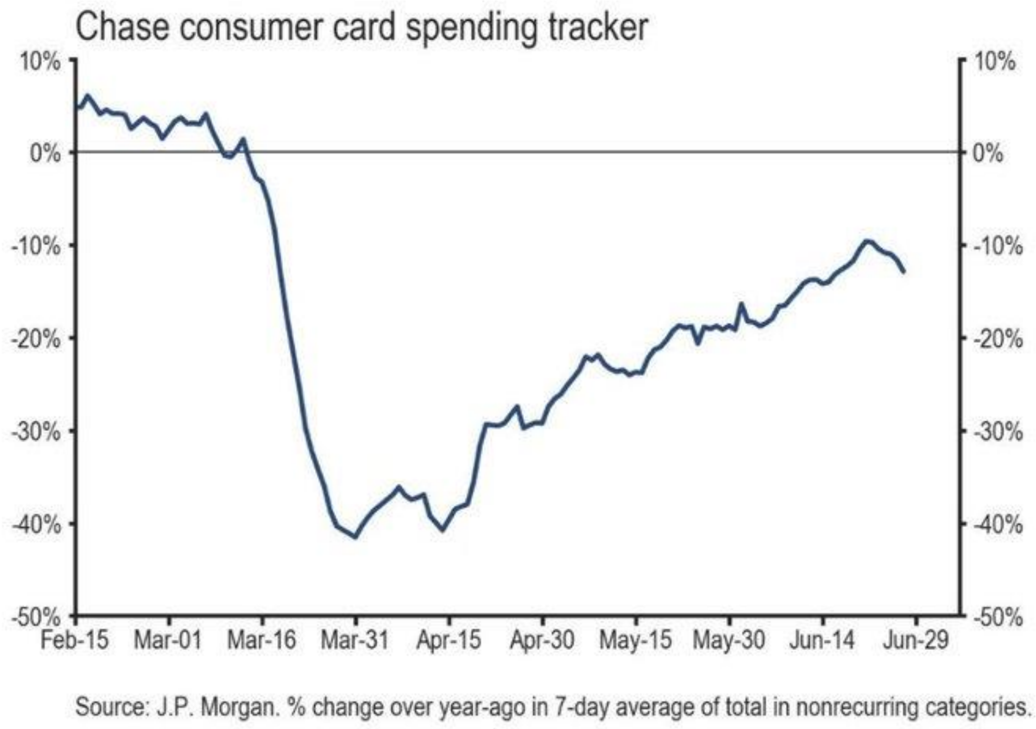
The ECRI Weekly Leading Index has flattened out in the last two weeks.

Exhibit 7: ECRI U.S. Weekly Leading Index Flattens Out

Source: ECRI

As well, Chase reported that consumer card spending is also rolling over.

Exhibit 8: Chase Consumer Card Spending Rolls Over

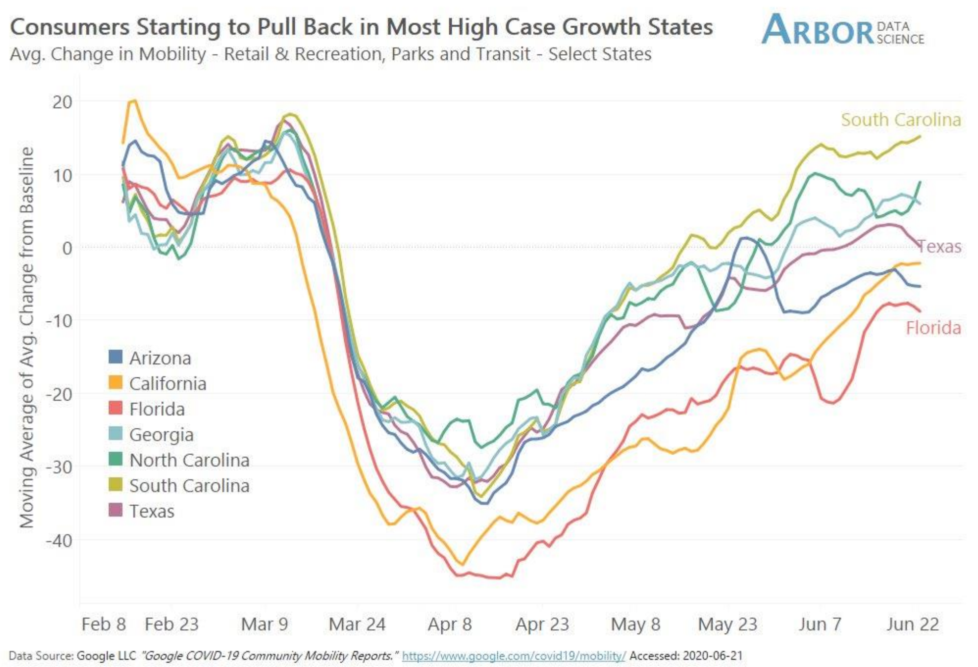


Source: JP Morgan

Blame the Pandemic

The slowdown is probably related to a rise in COVID-19 cases in the U.S. south and southwest. Mobility is slowing in the states, showing high-case growth rates.

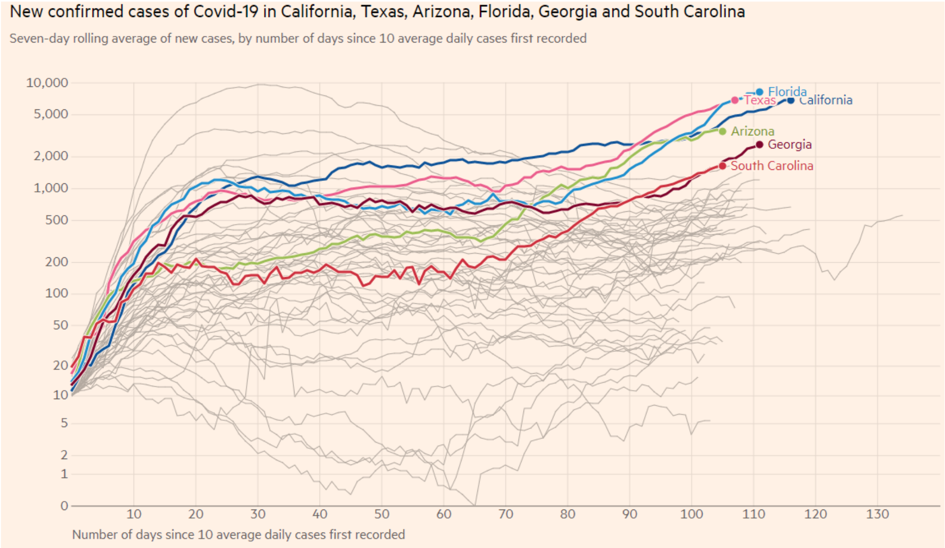
Exhibit 9: Mobility Slowing in High Case Growth States



Source: Arbor Data Science

The surge in case counts in a number of states is well known.

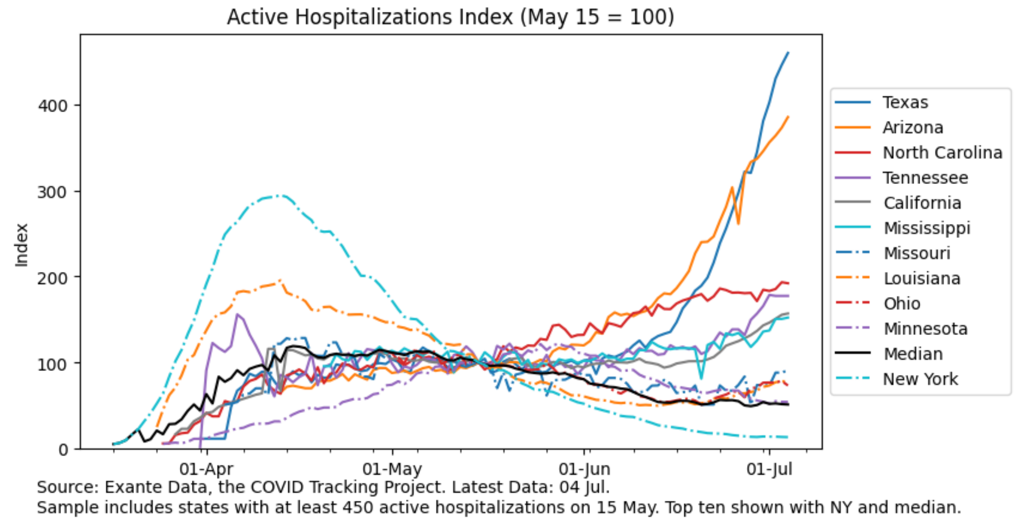
Exhibit 10: Case Counts Surging in U.S. South and Southwest



Source: Financial Times

Deaths have not risen so far, which is attributable to a number of things. First, young people are being infected, and they tend not to be as vulnerable as the older population, which was the group that was the most affected initially. There is also a lag in the data. The sequence of reports is case count, followed by hospitalization and deaths. The lag between case count and death is roughly four weeks. Hospitalizations exacerbate the fatality rate, because hospitalization is a signal that a case is serious and at risk of death or serious complications. However, there is no national database of hospitalizations, and some states, like Florida, do not report hospitalization. Nevertheless, hospitalization rates are rising, with Texas and Arizona being the most seriously affected states.

Exhibit 11: Hospitalizations Are Rising



Source: Exante Data

So far, the death rate has not risen. If the lagged sequence of case count, hospitalization and death were to hold, the daily fatality rate in the key states is expected to rise to 1,000 per day or more by late July.

Exhibit 12: Projected Fatalities, Selected States

Scenario Analysis: Daily Fatalities in Four Weeks Time

		Current Case Trend	Current Fatality Rate	Projected Fatalities
1	Florida	8000	5%	400
2	Arizona	3000	5%	150
3	South Carolina	1500	5%	75
4	Nevada	800	5%	40
5	Texas	7000	5%	350
6	Alabama	1000	5%	50
7	Georgia	2500	2%	50
8	California	7000	2%	140
	Total 6 states			1065
	Total 8 states			1255

Source: Exante Data

Regardless of what happens with the virus, the high-frequency data shows that the consumer is already reacting with greater caution. State and local authorities are also reacting to the rising infection rates with new edicts. Texas is the first state to re-impose a lockdown after re-opening its economy. The mayor of Jacksonville, Florida, began requiring face masks to be worn in public last week, and the measure could jeopardize the Republican National Convention, which is scheduled for August 24–27 in that city.

Forget about the V. Business Insider reported that Christophe Barraud, who was ranked by Bloomberg as the most accurate forecaster of U.S. economic data eight years in a row, said the U.S. won't return to its fourth quarter 2019 real GDP level until at least 2022. For some European countries, a recovery won't happen until 2023.

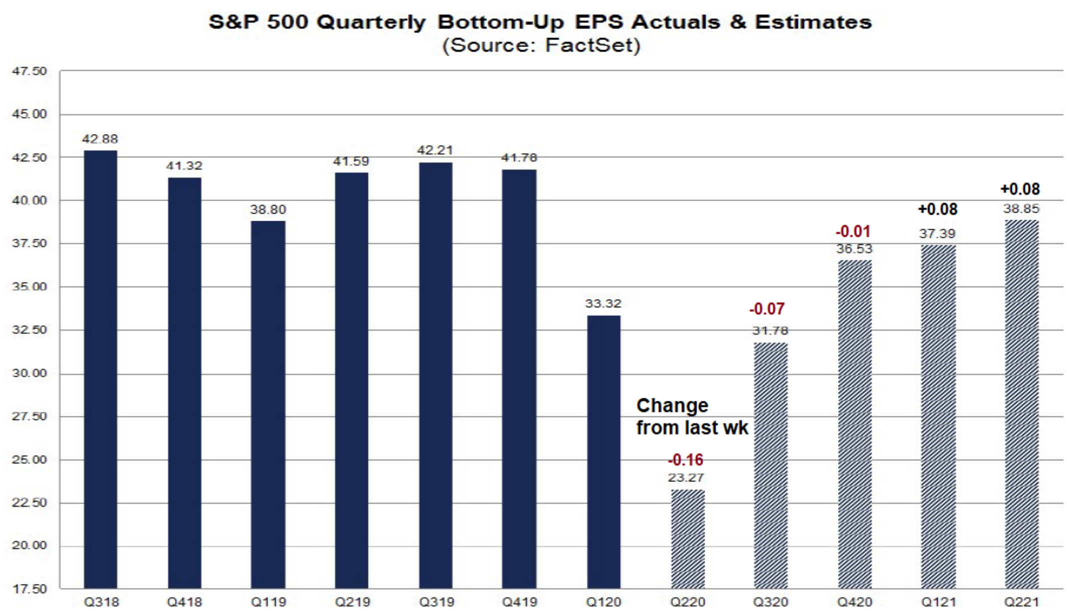
Investment Implications

Looking ahead, the trajectory of stock prices will depend mainly on investor reaction to the Q2 earnings season and the official policy response.

As we enter the Q2 earnings season, companies will undoubtedly discuss their near-term outlook. The latest update from FactSet shows that the Street is lowering near-term 2020 estimates, while raising longer-term 2021 estimates. Much will depend on the companies' body language this earnings season, though an extraordinary number have withdrawn guidance for the remainder of this year owing to high levels of uncertainty.

The Transcript, which monitors earnings calls, gives us an early glimpse of the tone of Q2 earnings reports. The latest update shows reports of a rebounding economy combined with nervousness from executives about rising virus cases in some states and countries.

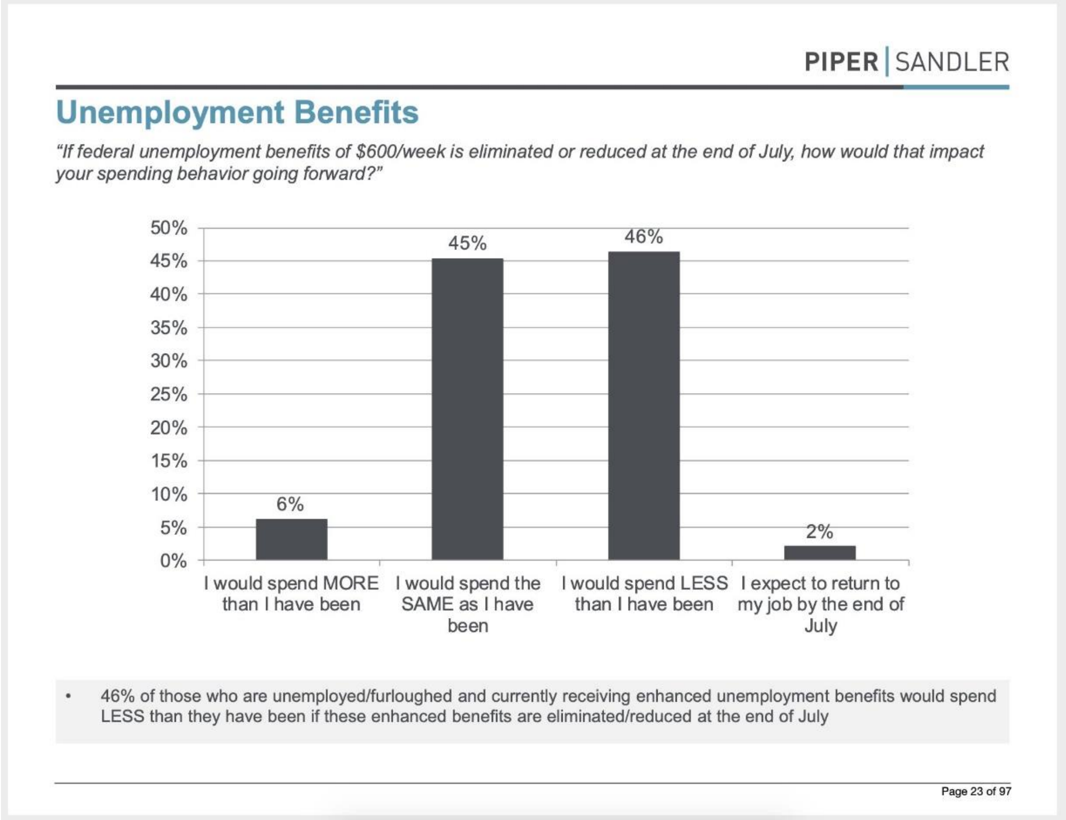
Exhibit 13: The Street Is Lowering 2020 Estimates while Raising 2021 Estimates



Source: FactSet Information Systems

Policy response has several elements: fiscal policy, monetary policy, and health care policy. The economy has been supported by what amounts to "battlefield surgery" fiscal support, which runs out at the end of July. It is clear the economy needs further support beyond July, but it is unclear whether the Republicans and Democrats can agree on a second rescue package so close to an election.

Exhibit 14: Consumer Spending Will Go over a Cliff without Further Fiscal Support



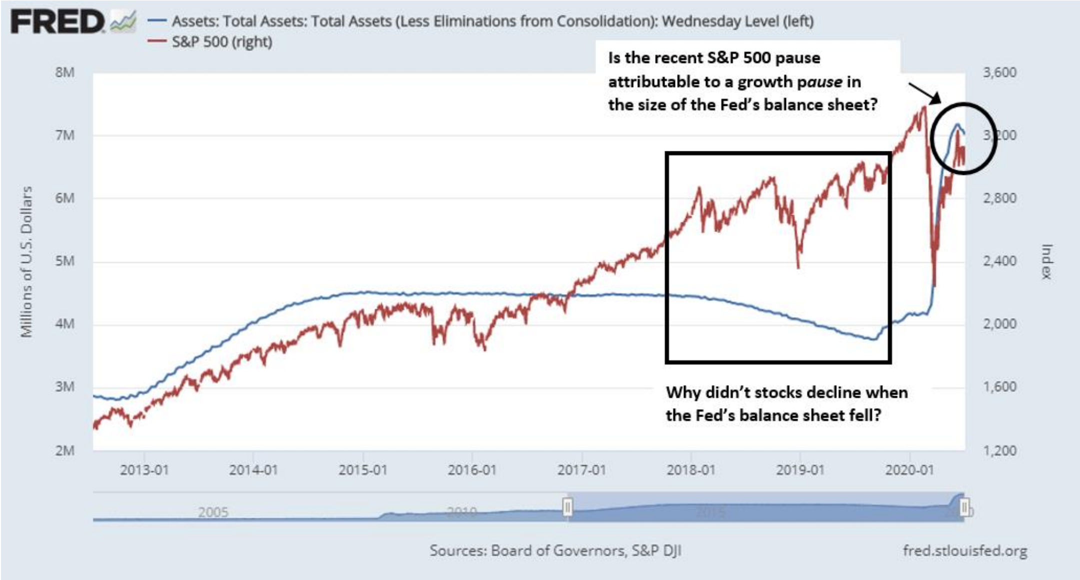
Source: Piper Sandler

The June FOMC minutes gave the market some direction on the path of monetary policy. The Fed is clearly concerned about the pandemic response, and it stands ready to act.

> *Participants all agreed that the effects of the pandemic would weigh on economic activity in the near term and that the duration of this period of weakness was uncertain. They further concurred that the unpredictable effects of the coronavirus outbreak were a source of major downside risks to the economic outlook...Participants stressed that measures taken in the areas of health care policy and fiscal policy, together with actions by the private sector, would be important in shaping the timing and speed of the U.S. economy's return to normal conditions. Participants agreed that the Federal Reserve's efforts to relieve stress in financial markets would help limit downside near-term outcomes by supporting credit flows to households and businesses, and that a more accommodative monetary policy stance would provide support to economic activity beyond the near term.*

The effectiveness of the Fed's response is in the eyes of the beholder. The Fed's balance sheet shrank for a third week in a row. The reduction in the first two weeks was mainly attributable to the unwind of USD swap lines with foreign central banks, and the latest decline can be traced to a reduction of bank repos that injected liquidity into the banking system. The repo unwind should continue for a few more weeks. The Fed is continuing its purchase of Treasuries and other fixed income instruments during this time.

Exhibit 15: How Much Does QE Matter?



Source: FRED, Federal Reserve Bank of St. Louis

As for health care policy, NBC News reported that the White House is pivoting to a "learn to live with it" message in battling the virus:

> *At the crux of the message, officials said, is a recognition by the White House that the virus is not going away any time soon — and will be around through the November election.*
>
> *As a result, President Donald Trump's top advisers plan to argue, the country must figure out how to press forward despite it. Therapeutic drugs will be showcased as a key component for doing that and the White House will increasingly emphasize the relatively low risk most Americans have of dying from the virus, officials said.*

However, there is some hope on the therapeutics front.

> *Next week administration officials plan to promote a new study they say shows promising results on therapeutics, the officials said. They wouldn't describe the study in any further detail because, they said, its disclosure would be "market-moving."*

Stay tuned for the new "market moving" announcement. Will it be any more than a one-day wonder or will it have a sustained effect on the outlook?

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