Is the Market Overreacting to the Coronavirus Crisis?

Presented by Nancy J. LaPointe

We're all aware that the market has pulled back significantly in the past couple of weeks. The volatility is like we've never seen before so, of course, concerns are mounting. But at the same time, we must ask: What's behind such volatility? I think it is worth taking a step back and assessing what's really going on.

What's Behind Collapsing Stock Prices?

There are only two things that matter for stock prices: earnings and valuations. So, any discussion of the collapse in prices has to center around what changed in one or both of these factors. Initially, the discussion has to be about valuations, as actual earnings have not changed yet. Let's start there.

Valuations. Over time, valuations depend on interest rates and the expected growth of earnings. With interest rates close to all-time lows, the drop in valuations can't be about higher interest rates, as the lower rates would, mathematically, push valuations higher. The drop, therefore, has to be about expected earnings growth.

Earnings. With a market decline of more than 25 percent, markets are telling us that, over time, earnings are expected to drop by about 25 percent—or more. That assumption might seem reasonable in the short term, but stock prices typically discount the next 10 years or so of earnings. So, that expected drop is not in the short term, but over the next decade. When we think about what the market is likely to do next, we have to ask whether that assumption is reasonable.

Is it reasonable? In the short term, absolutely. In the long term, it looks much less likely. Large sectors of the market are companies that simply are not going to drop that much. Are people going to buy 25 percent less toilet paper once they use up the stockpile they've built up? Will they buy 25 percent less food? Even for luxury items, will they buy 25 percent fewer iPhones? Will sales overall drop by one-quarter over the next 10 years? No, they will not.

There will certainly be a short-term hit, but earnings will recover over time. In the long term, earnings growth depends on population growth and wage growth. Population growth will continue. Wage growth is healthy, and although it will take a hit in the short term, it will come back in the long term. We're in a very good place economically, and any declines will be from a strong place. So, from an earnings perspective, short-term damage is certain. But over the medium to long term? The fundamentals remain fairly supportive.

More Volatility Ahead?

With valuations still supported by low interest rates (and likely to recover) and with earnings certain to take a short-term hit (but then also likely to return to trend over time), the market may end up recovering faster than expected. Certainly faster than *never*, which is largely what the market has priced in. Given reasonable assumptions, the market looks to be overreacting.

The argument above is all well and good, but in fact, we do have some actual data from other countries' experiences. We know that China brought the virus under control in a matter of a couple of months and that its stock market significantly rebounded. That's one data point showing recovery is possible.

Just because it's possible doesn't mean it will happen, though. We are not nearly as far along as China, and we have just put the necessary restrictive measures in place. We're going to see new cases continue to grow. Even though that number will be more due to expanded testing than to actual new cases, it will still affect markets. The bad news will continue for a while and so, likely, will the market volatility.

When Will We See Improvement?
After that, though, cases should start to level off in the next several weeks. It might even be better than that. One of the things that isn't brought up in the discussion is, when we look at China, Italy, and South Korea, they are all very dense urban societies. In other words, if you have a virus spreading, is it more likely to spread in a society where everybody lives in an apartment? Is it more likely to spread when everybody's on the subway together? Of course, it is.

In fact, if you look at the outbreaks we've seen in the U.S.—Seattle, New York, Boston, and San Francisco—those are the big ones in the U.S. And they're all in big cities. Most of the country isn't in big cities, and most of the country has very limited exposure. Of the places that are exposed, that is where the social limitation is going to have the most effect. So, the control might go more quickly than expected.

You can reasonably look at the current U.S. situation and say, "Fundamentally, we should do better than other countries. Fundamentally, we have most of the fundamental policies lined up or in development. Even though it's going to look worse over the next couple of weeks, fundamentally, there's no reason this should continue to grow out of control." That perspective should help limit the damage to confidence, the damage to incomes.

If we have the support from the Federal Reserve and if we get the support from Congress on fiscal policy—as we are—the actual damage may be a lot less than the market is now pricing in. At some point, the market will reflect that improved outlook.

The market right now is pricing in a lot of bad news. Valuations are at a five-year low. Most S&P stocks now have dividends above the yield on the 10-year U.S. Treasury note. We don't need to see much of an improvement in the news to support the market at current levels. It doesn't need to be good news; it just has to be less bad than expected. That will come.

The other positive factor is that there's now a financial argument for buying equities, from both a value perspective and an income perspective. When you start to see markets bottom out, that's when there is that kind of economic argument—when buying makes economic sense—and that's about where we are.

Now, that doesn't mean we have bottomed out. Again, if you look at the other countries, you typically see the bottom when the number of new cases starts to peak. We're several weeks away from that. So, we can't say we are at a bottom, or that there is no more downside. But what we can say is that at some point, and it may be sooner than people think, that downside will start to fade away and we will get a bottom. Markets are pricing in continued very bad news, and there is the likelihood that they will improve when the news does.

So, What Are the Facts?

Right now, we need to focus on the facts, not the public reaction. The facts say virus control measures are now in place in most countries, including the U.S. The facts are that despite the headlines, the situation is starting to stabilize globally even though it's still really bad in some countries. The fact is that, here and abroad, we're seeing economic risk controls being put into place. And the fact is, we're very probably past the point of maximum danger.

Unfortunately, the fact is we're not past the point of maximum fear. As testing expands, cases are going to go up. So, we're not past the point of maximum impact—but we are getting closer.

We're in a bad situation. But at least within that bad situation, we're in a pretty good place. We started from a reasonably healthy economy, and everybody here in the U.S. now knows both the problem and the solution, which has enabled policy to solve the problems. That is a better place than we were even a week ago.

The thing that matters most is the new case count. As long as cases keep expanding, people are going to perceive the situation as getting worse. Once new cases peak and start going down, we'll start to see perception matching reality. While we are not there yet, we will get there—and then things will not look nearly so dark.

Headed in the Right Direction

The ultimate takeaway here is that markets are acting like it's different this time. Of course, it's always different. But at a certain point, the virus will be brought under control, the economic damage will be done, and the markets will recognize that and will move on, as we've always done. It's not different this time; it is just another problem. Admittedly, it is a big problem, but a solvable problem and one that we're in the process of solving. We are not at the end of the market volatility, but we are headed in the right direction.

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