

COVID-19: Assessing Economic Impacts for 2020 Outlook

April 2020 | Marco Fragnito, Managing Principal | Robert R. Fragnito, Chief Operating Officer

OVERVIEW

- This month's Monthly Market Commentary aims to review the financial market, provide an analysis of the situation at hand, and our outlook for the rest of 2020 as the market faces the greater impacts of the coronavirus (COVID-19).

FINANCIAL MARKET REVIEW

In March US equity markets experienced unprecedented volatility. The CBOE Volatility Index (VIX), Wall Street's so called "fear gauge," hit an all-time high. Major US equity indices saw declines of over 10%, oil prices fell to 20-year lows and while US Treasuries yields dropped to historic lows. Investors struggled to assess the potential economic consequences from COVID-19, but even more so from the "shelter in place" or lockdown orders issued by governments across our country and most of the world.

What may have started out as a medical crisis quickly morphed into a financial crisis, with potentially severe economic consequences for both the short and long term.

This led to unprecedented actions being taken by the Federal Reserve and central banks around the world. While Washington lawmakers moved quickly to pass the [largest stimulus package](#) in US history, totaling in excess of \$2 trillion with its primary goal to help citizens and predominantly small business deal with the economic fallout from the "shelter in place" orders.

Despite all their best efforts, major US equity indices posted double digit declines for the quarter, with the Dow Jones Industrial posting its worst first quarter performance in history (-23.2%).

We as investors are all aware of what has transpired in financial markets, the question now is what does the future hold for markets.

ANALYSIS

We at MCF Capital Management, like many others, failed to foresee the extent to which government orders would panic investors and effectively lead to a stock market crash over a period of weeks. With the US economy in particularly good shape, and with growth re-accelerating on the back of two interests rate cuts by the Federal Reserve, we felt confident that equity markets would continue to set new highs.

What we failed to grasp was the extent to which in a deeply divided country politically, a crisis could be used to create so much fear and panic. While COVID-19 is without a doubt a serious medical crisis, actions taken by government at all levels have had the effect of limiting the human loss, but at what cost economically? We ask this as a starting point for analysis and not as a political statement.

What do we know in terms of our economy at this time?

- Over [26 million workers](#) have sought unemployment benefits (BLS) in the last 5 weeks,
- Retail sales [dropped 8.7%](#) for the month of March,
- Industrial production [fell 5.4% in March](#),
- West Texas Intermediate (WTI) [oil dropped below \\$20](#) per barrel,
- Most states still remain under lockdown.

Undoubtedly the economic picture is bleak, this we know, but the question is for how long? Does the economy see a V-recovery, a quick return to pre-COVID-19 levels, a U-recovery, where we re-open the economy slowly and then strongly re-accelerate back to where we were, or is it a slow grind back to economic growth over a number of years. We do hold a view on this question, but we wish to look at the data rather than work towards an outcome we perceive or what many analysts, economists and market pundits are forecasting.

Let us start by looking at corporate profits. Estimates vary, but we can say with a great deal of confidence that they will no doubt be down in 2020 versus 2019. How much is not as important as how much investors are willing to pay for those earnings, in other words what is the market P/E ratio (price earnings ratio). A general rule for financial markets is that the lower long-term interest rates are, the higher the market P/E ratio should be. At the end of 2019, the market P/E stood at [approximately 20X](#) earnings with the 10-year US Treasury yields around [1.90%](#), they are presently at [0.63%](#) almost two thirds lower. Does that mean that the market P/E should be two thirds higher at 32x earnings? This is simplistic but no doubt implies a higher market P/E is warranted.

More precisely the yield earned on an investment plays an important role in determining investors preference for a particular asset class. With 10-year US Treasury yields at 0.63% numerous asset classes provide more attractive yields. For purposes of our discussion the S&P 500 Index presently has a running yield of [2.02%](#), while that may change if the economy weakens further and corporations cut their dividends, it does provide at this time over 3X more income than US government bonds. Which in turn makes US equities an attractive alternative.

Finally, the amount of record stimulus injected into the economy and financial markets has historically worked over the long term if not the short term. Market pundits will always claim that this will be the time it fails; history and the data have proven otherwise. Do we as investors want to believe that this time is different, and markets will not recover. Over the last 200 years, the US economy has seen great times and some extremely difficult times, yet one thing has endured—the great spirit of the American people to overcome and raise themselves to new heights.

MARKET OUTLOOK

While it may be difficult at this time to forecast the future course of financial markets, as it always is, we can let the data guide us to take some calculated risks going forward. We at MCF feel very strongly that while earnings will no doubt fall, the value of companies with a proven record of longer term growth in earnings will prove more valuable as measured by the market or individual companies price earnings ratio (P/E). This will entail making some adjustment to our portfolios, as we have already made some for our clients, and will no doubt be more active in the short term.

We will also be assessing portfolio holdings as to their financial strength and ability to adapt to a potentially different operating environment. Although we must say we feel that contrary to popular opinion, we do not feel Americans will want to change their way of life.

One area where we are directing a lot of overtime in resources to is looking at what are the implications of major overhauls in global supply chains on our economy and financial markets. This remains a work in progress, but at this time we feel strongly that a return to a less globalized economy appears in the future. The ramifications at this time are not clear although we feel at least for the next few years it could provide a boost to the US economy and more specifically North America as a whole. The signing of the USMCA could prove quite beneficial to all three parties' economies as manufacturing is repatriated from overseas.

We find ourselves feeling optimistic about financial markets, due to several factors. Without doubt, the super low interest rate environment makes equities attractive over the near and long term. Historically they have proven to be at least for markets if not necessarily for the economies they impact. We also believe that the restructuring of global supply chains over the near term should provide the US economy with a boost to growth over the next few years. Finally, the record fiscal stimulus which now stands well in excess of \$2 trillion dollars will have the effect of jump starting the economy once the economy across the country re-opens whether that be slowly or more rapidly. The amount of economic stimulus is unprecedented and should work, yet the consequences of such a large package remain to be seen.

In conclusion, what we have experienced in the last three months has never occurred in history. Never have we witnessed our country along with many other countries completely attempt to shut down their economies. The actual long-term consequences remain unknown. We at MCF feel for all those impacted economically to a far greater extent than we have been, and we mourn for all the lives lost.

As portfolio managers our job remains focused on the future and not the present. While we cannot change what has happened, we remain positive on US equity markets and would not be surprised to see new highs sometime next year around this time.

Thank you for your trust and for the confidence you continue to show in us during these unprecedented times.

Resources from The Fragreport:

- [Timeline: US Action Countering the Economic Impact of the Coronavirus](#)
- [Coronavirus Aid, Relief, and Economic Security \(CARES\) Act](#)
- [Key IRA Impacts of the 2020 CARES Act](#)
- [Key Qualified Retirement Plans Impacts of the 2020 CARES Act](#)

If you enjoyed this article and have any questions please contact us directly at 949.472.4579, and feel free to forward this article and our contact information to anyone who might be interested.

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CONTACT INFORMATION

MCF Capital Management, LLC | 23010 Lake Forest Dr. Ste E | Laguna Hills, CA 92653 | Tel: 949 472 4579 | Fax: 949 472 8195
www.mcfcapitalmanagement.com

Marco Fragnito | Managing Principal | CA Insurance License #0E07490 | marco.fragnito@mcfcapitalmanagement.com

Robert R. Fragnito | Chief Operating Officer | Financial Advisor | CA Insurance License #0G97306 | robert.fragnito@mcfcapitalmanagement.com

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SOURCES

Wells Fargo Advisors, Angela Shin and Jack Kraft, "Monthly Market Commentary," April 2, 2020.