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The Opposite: The Market Takes A Cue From Seinfeld

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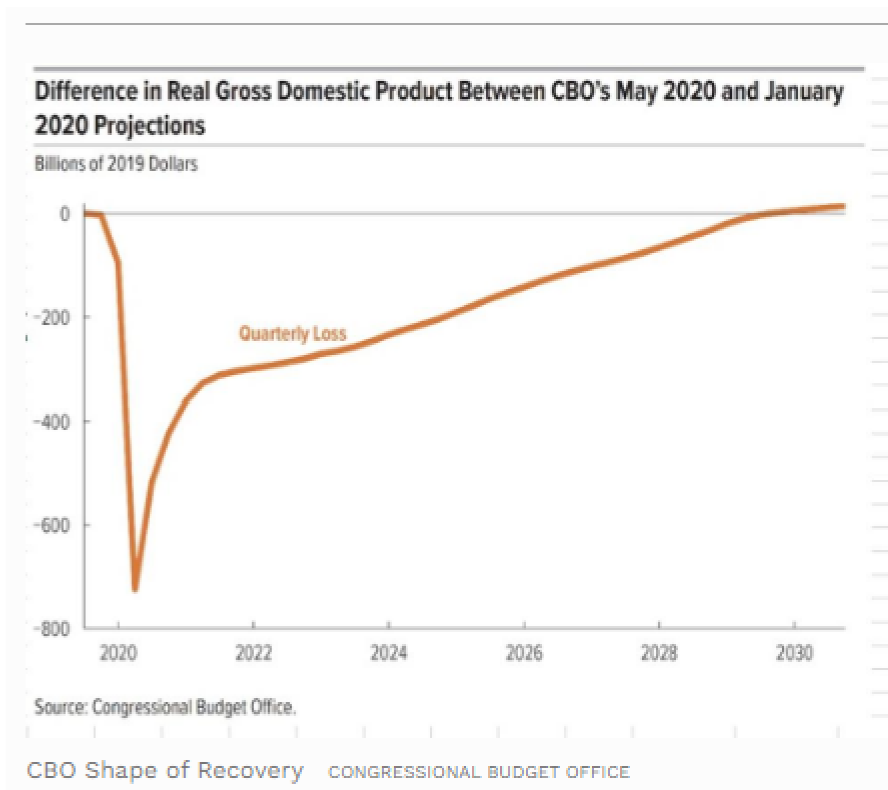

CBO Shape of Recovery CONGRESSIONAL BUDGET OFFICE

The Opposite

In one of the 1990s Seinfeld episodes known as "The Opposite," George Costanza decides to make decisions opposite of what his "normal" instincts would tell him to do. The results of his "opposite" actions were a beautiful girlfriend, a standing ovation, and a job with the N.Y. Yankees! Today's equity market seems to be behaving similar to George, choosing to do the "opposite" of what one would normally expect from the condition of the economy, political/social events, the labor market, and corporate revenues and profits. The table chronicles some of these:

Event	------Equity Normal	Markets---- Opposite
Civil Unrest and Violence	Fall	Rise
U.S-China Relationship Deteriorating	Fall	Rise
Q2 Real GDP -50% (similar for world GDP)	Fall	Rise
Warnings about a second virus wave	Fall	Rise
40% of S&P 500 Companies pull guidance	Fall	Rise
Latest Unemployment Claims data +2.5 million (5/30/20)	Fall	Rise
State & Local Gov't layoffs (+1.5 million) & fiscal cliffs	Fall	Rise
ISM PMIs significantly below 50	Fall	Rise
New auto sales < 12 million annual rate	Fall	Rise

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The rise in equity prices appear to be based on the mistaken view that we are in a "V"-shaped Recovery and if that proves not to be the case, the Fed has the markets' back. In addition, the market is looking at the 2nd derivative, i.e., 1.9 million Initial Claims week of 5/30 is better than 2.1 million the prior week. While true, the economy is still contracting, just not as fast. With this kind of thinking, "The Opposite" may continue a while longer. The problem is that when rationality returns, and it will, the bottom could be a significant double-digit percentage lower. Meanwhile, Enjoy!

Employment – A Pleasant Surprise, But Still Dire

The big news of the week occurred on Friday, June 5th. The U-3 unemployment rate fell to 13.3% (16.3%) from 14.7% (19.7%). (The numbers in parentheses are from BLS footnotes which correct the misclassification errors in the numbers.) The +2.5 million net increase in jobs was a surprise to just about everyone. Of the 78 forecasters polled by Bloomberg, the most optimistic forecast was -800k, the most pessimistic -12 million. No one was close. It is really hard to come close when everyone was just guessing, as these are unprecedented times. In the scheme of things, positive employment numbers were not supposed to happen until June's report, so, the re-openings pulled this expected event forward one month. Like the equity market's response to the data shown in the table above (i.e., "The Opposite"), this unemployment announcement added 829 Dow and 82 S&P 500 points on Friday, June 5th. Seems like a strange reaction for a market near its all-time highs to be so joyous about a 13.3% (16.3%) U-3 rate!

The week ended April 18th, which was the BLS's survey week (the surveys always occurs the week that has the 12th) showed 18.0 million Continuing (unemployment) Claims. The week ended May 16th, the May survey week, showed 20.8 million Continuing Claims. That's 2.8 million more than April. If we add the Initial Claims, the April total unemployment number (those collecting unemployment insurance) was 22.4 million, and that rose to 23.2 million in the May survey week. The latest data we have for these two data releases (week of May 23rd) shows even higher unemployment at 23.6 million. Now you know why everyone was so surprised by the BLS announcement. Not discussed by the BLS, by the media, or by most economists are the people who have just stopped looking for work and are not being counted. In February, the size of the labor force was 104.2 million. That fell by -10.0 million to 94.2 million in April's survey week which theoretically should add 10 points to April's U-3 rate if you assume that most stopped looking because the economy was shutdown. In May, the labor

force grew by +2 million to 96.2 million, a small positive, but still -8.0 million less than the February labor force.

There were a number of commentators that speculated that businesses that received PPP money were required to rehire staff in order for the "loan" to turn into a "grant." This, they believe, had a large impact on the +2.5 million net increase in May's employment data. They also opined that, once the PPP money becomes "free," many of those recalled employees will be furloughed again (kind of a "second wave, but in the labor market) as consumer demand is not expected to rebound to February's levels anytime soon.

Going forward, the two key readings continue to be Initial Claims (IC) and Continuing Claims (CC) which appear to be the most accurate and reliable indicators of labor market health. In the table and chart below, I show IC and the Change in CC. Together, these two are weekly indicators of the net change in unemployment (with negative numbers being 'good').

	IC	CC	Chg CC	Net New UE
3/14/2020	282,000	1,784,000	82,000	364,000
3/21/2020	3,307,000	3,059,000	1,275,000	4,582,000
3/28/2020	6,867,000	7,446,000	4,387,000	11,254,000
4/4/2020	6,615,000	11,914,000	4,468,000	11,083,000
4/11/2020	5,237,000	15,819,000	3,905,000	9,142,000
4/18/2020	4,442,000	18,011,000	2,192,000	6,634,000
4/25/2020	3,867,000	22,377,000	4,366,000	8,233,000
5/2/2020	3,176,000	22,548,000	171,000	3,347,000
5/9/2020	2,687,000	24,912,000	2,364,000	5,051,000
5/16/2020	2,446,000	20,838,000	(4,074,000)	(1,628,000)
5/23/2020	2,126,000	21,487,000	649,000	2,775,000
5/30/2020	1,877,000			

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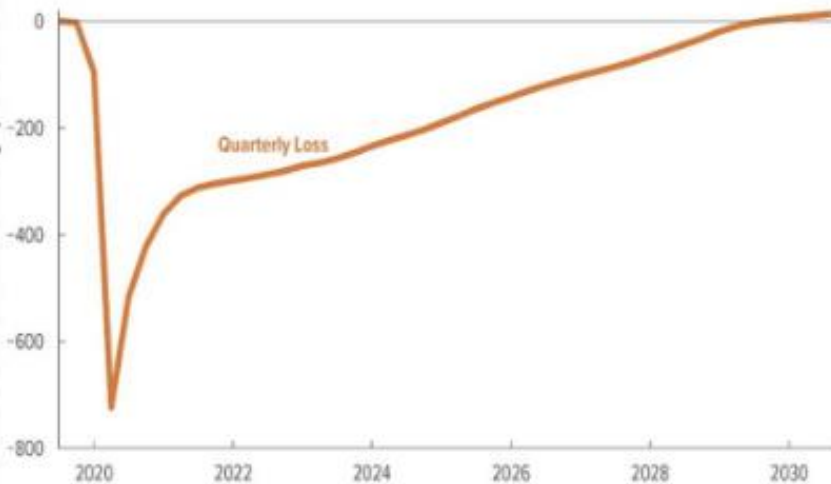
The Shape of the Recovery- the Flattening

For the past month, I have written several times about my view of the likely shape of the Recovery, and I provided a chart, which has appeared in several of the latest blogs. I have gone over the reasons for the early "v"-like upswing (re-openings) and then the flattening (small business failures, large business bankruptcies, higher production costs, lower productivity, consumer reluctance…). Now, the highly paid economists at the Congressional Budget Office (CBO) have given us a graph of their official view of the path of the Recovery. I have included

both my graph and the CBO's below; they are nearly identical. The biggest difference is that my graph didn't cost the taxpayers anything!

With Friday's unemployment report, the equity market now seems more convinced than ever that the Recovery will be a capital "V." So much for the CBO!!

Shape of the Recovery UNIVERSAL VALUE ADVISORS



CBO Shape of Recovery CONGRESSIONAL BUDGE

Bankruptcies and Credit Destruction

Despite the significant backup in Treasury yields this week (ended 6/6), corporate bonds played well, as spreads to Treasuries tightened dramatically. For example, early in the week, Southwest Airlines LUV came to market with a $1.3 billion 5.125% seven-year maturity (6/15/27) at par (100). (Rating Baa1 Moody's, BBB- S&P). This is an airline highly impacted by the pandemic, so, on Monday, 5.125% seemed like the right price for the risk. On 5/29, LUV's equity price was $32.10. But it began to rise throughout the week, and, especially after the

"gangbuster" labor market report on Friday 6/5. It closed the week up 19% at $38.18. And this occurred as no one, including the airline executives themselves, has any visibility into future demand or the costs that will be imposed by "social distancing" rules. Also, by Friday, June 5th, the price of the 5.125% newly issued bond (issue date: June 8th) was trading at a 4.19% yield, up a huge 5 points to more than 105 in less than a week and during the when-issued period of trading. Highly unusual, especially during a week when Treasury yields were backing up.

I continue to be very concerned that the next emerging issue that will impact markets is bankruptcy, credit destruction, and the havoc they will play on financial markets and institutions. This past week, the market for highly leveraged CLOs (Collateralized Loan Obligations) came under significant duress.

	Cumulative Bankruptcies	Annualized
6/3/2020	102	241
5/31/2020	99	238
5/15/2020	85	229
4/30/2020	71	215
3/31/2020	52	209
2/29/2020	36	220
1/31/2020	17	201
2019		139
2018		118

Trend in bankruptcies for 2020 as compared to 2019 and 2018 UNIVERSAL VALUE ADVISORS

The table to the left shows the trend in bankruptcies for 2020 as compared to 2019 and 2018. As you can see, as the year has progressed, the trend has accelerated. Note, though, that even prior to the business shutdowns, the trends in January and February were significantly higher than the results of the prior two years. I suspect that we will see continued acceleration here as the year progresses.

Gold

Gold has been an out of favor asset for nearly a decade, with the SGOL ETF peaking at $17.53 on July 1, 2012. Because there is no cash dividend, when inflation and economic chaos are not present, it goes out of favor. SGOL bottomed at $10.35 on October 1, 2015. But, today we have not only economic chaos, but social unrest. Of significant importance, the Fed has grown its balance sheet by $3 trillion since February. And I thought that the growth from $1 trillion to $4 trillion was excessive over the '08-'12 period of financial crisis. Over the last three months, M1 and M2 have ballooned. The Fed has supported almost every conceivable financial market (not CLOs yet, or equities – but just wait!) including High Yield Bonds. At the same time, corporations, already bloated on cheap debt, managed to float record new debt financings in May, and June is also starting out hot (e.g., Southwest Airlines). If the business isn't making it, more debt just postpones the inevitable and makes the clean up even harder to bear. And Fed support of zombie companies also misprices and clouds the market's price discovery mechanisms.

Date	Price SGOL	% Chg from 12/31
12/31/19	14.62	
01/31/20	15.27	4.4%
02/29/20	15.18	3.8%
03/31/20	15.15	3.6%
04/30/20	16.25	11.1%
5/31/20	16.68	14.1%
06/05/20	16.17	10.6%
		% Chg from 6/5/19
06/05/19	12.81	
06/05/20	16.17	26.2%

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While today we are dealing with deflation, future inflation appears inevitable given all of the above, the Fed's largesse and record Federal deficits as far as the eye can see. But inflation isn't the only reason to own gold. Economic chaos, economic uncertainty, and social strife are also good reasons., as is falling confidence in the dollar as the world's reserve currency. So, it is no surprise that the price of gold has risen handsomely over the past year and significantly since government imposition of business shutdowns, economic chaos, and uncertainty. The table to the left shows the returns on SGOL over the past year and since 2019's year end.

Conclusions

Equities continue to price in a "V"-shaped Recovery despite the view of most economists and now the CBO that the Recession will be long-lived. Instead of looking at levels of economic activity, the equity market seems to be focused on and reacting to 2nd derivative changes, or to data "beats" when forecasters are clueless and are merely guessing. If last year I told you that the Dow would rally 829 points because the U-3 unemployment rate was only 13.3% (16.3%), you would have laughed and called me a kook economist.

In today's world, the equity markets appear to be behaving "The Opposite" of rational and appear to be way over extended. But, as we have seen over the past month, it doesn't mean they won't go higher. We just can't figure out why. When I was a kid, there was a saying in the neighborhood about the bullies: "The bigger they are, the harder they fall!" I think that is apropos here.

About the Contributor

Robert Barone, Ph.D. is a Georgetown educated economist. He is a financial advisor at Four Star Wealth Advisors: www.fourstarwealth.com. He is nationally known for his writings and Robert's storied career includes his having served as a Professor of Finance, a community bank CEO, and a Director and Chairman of the Federal Home Loan Bank of San Francisco. Robert is currently a Director of CSAA Insurance Company (the AAA brand) where he chairs the Finance and Investment Committee. Robert is the co-portfolio manager of the UVA Unconstrained Medium-Term Fixed Income ETF (FFIU).