Why Stocks Are Surging During COVID Crisis/Recession

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by Gary Halbert

of Halbert Wealth Management

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Overview

I want to begin today by sharing with you the latest question I am getting over and over from colleagues and friends. That question is: *How have the stock markets rallied to record or near-record highs in light of the terrible economic news due to the coronavirus crisis?* While I don't claim to have the definitive answer, I do have some thoughts on this question which I will share with you just below.

Following that discussion, we'll look at US consumer spending which plunged by a record 6.9% in March. Then it plummeted by almost double that record amount, -13.6%, in April. We won't know how much more it dropped in May until late this month. The plunge in consumer spending, while not totally unexpected given the economic lockdown, is very troubling since it accounts for over two-thirds of growth in the economy. The question is, what can we do about it? That's what we'll focus on as we go along today.

Why Are Stocks Surging During the COVID-19/Economic Crisis?

To answer this question, let's start with the bad news. Over 43 million Americans have lost their jobs in the last three months, and even more if we include the self-employed and those who have given up trying to find a job. While many have reportedly gone back to work as the economy has partially reopened, estimates are that at least 25 million remain out of work.

We are now in an official economic recession which began in February, and second-quarter GDP is expected to plunge by 25%-40%, which we won't know until late July. Anything in that range will mean the worst quarterly economic decline in US history.

We remain in the midst of an unprecedented coronavirus pandemic that has already taken the lives of more than 117,000 Americans. It remains to be seen if there will be a second wave of the outbreak this fall and winter – assuming the first wave ends sometime soon. The pandemic is wrecking the economy across most of the country with no end in sight.

If that weren't bad enough, in many cities across the country, we have nearly nonstop protests in the wake of the brutal killing of George Floyd by a Minneapolis police officer. I don't know about your city, but the protests in Austin, Texas show few signs of lightening up.

The bottom line is this country is in the worst recession since the Great Depression, and some argue it's even worse than that. While the much better than expected unemployment report for May offered hope that the economy may have hit bottom, most forecasters agree it will take several years for the economy to get back to where it was before the coronavirus pandemic.

Sadly, I still believe the worst may not be over, especially if business bankruptcies soared in May as is widely believed and continue to surge again this month. If so, there is still plenty of bad news ahead of us.

And yet, the Nasdaq Composite Index hit a new record high last week, and the Dow Jones Industrial Average and the S&P 500 indexes were within striking distance of their record February highs before the downward correction that occurred last Thursday.

So, what gives? How can stocks be so strong in the face of this enormous amount of bad news? How can this be happening? How can so much bad news in the real-world result in such surprisingly good news in the stock markets?

Aside from the obvious answer that no one knows for sure why this is happening – or if they say they do, they don't – there are any number of possible explanations. First and foremost, one has to attribute much of the amazing stock market recovery after its mid-March collapse to the extraordinary actions the Federal Reserve Board has taken since the economy went into lockdown around March 10.

Initially, the Fed returned its short-term interest rate to near zero, as it had been for years after the 2008 financial crisis. Then, on March 23 and again on April 9, the Fed signaled it would do pretty much whatever it could to pump huge amounts of liquidity into the capital markets. Chairman Powell implied that the Fed would be willing to buy nearly any financial instrument that was not tied down, including risky high-yielding junk bonds – something the central bank had never done before.

In other words, the Fed made clear it was willing to essentially back-stop the capital markets by once again becoming the buyer of last resort. The Fed news caused an immediate and significant shift in investor sentiment both in the equity and in debt markets. After reaching an all-time high of 29,551 on February 12, the DJIA collapsed to 18,591 on March 23, a 37% plunge in a little more than five weeks. Since March 23 – the day the Fed announced its first massive intervention—the DJIA has climbed back to above 27,300, prior to last Thursday's sharp selloff.

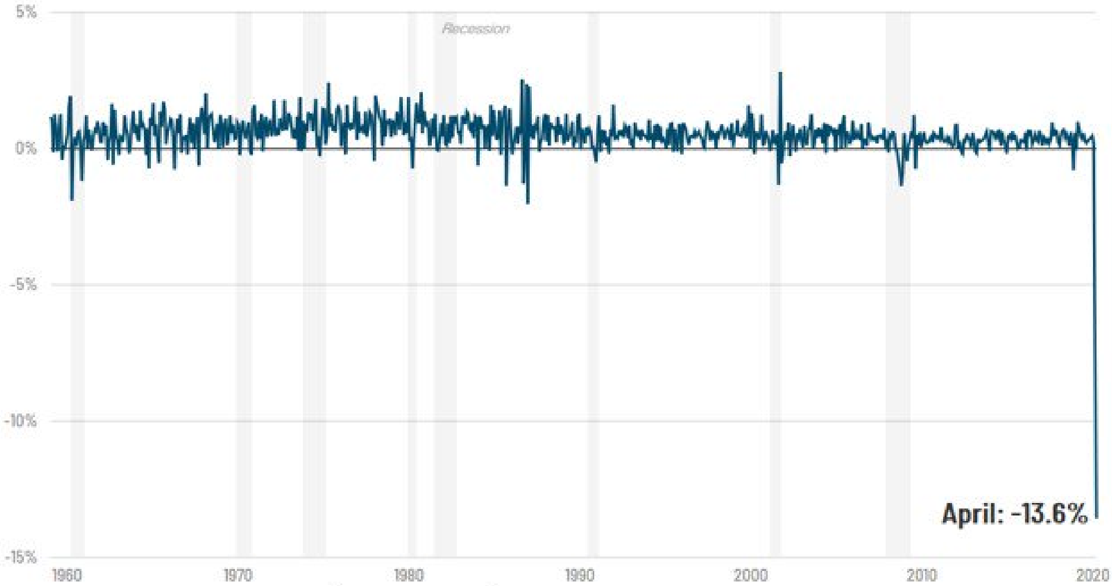
It remains to be seen, of course, whether the Dow and the S&P 500 will succeed in making new highs just ahead, but Fed Chairman Powell made it clear in his press conference last Wednesday that the central bank will continue to do everything in its power to turn the economy around.

Consumer Spending Plummeted by Record 13.6% in April

The Commerce Department reported at the end of May that US consumer spending plunged by a record-shattering 13.6% in April as the COVID-19 pandemic shuttered businesses, forced tens of millions of layoffs and sent the economy into a deep recession. This, of course, is very troubling since consumer spending accounts for apprx. 70% of Gross Domestic Product.

April's spending decline was almost double the revised **6.9%** drop in March, which itself had set a record for the steepest one-month fall. The Commerce Department figures reinforced evidence that the economy is gripped by the worst downturn in decades, with consumers unable or too anxious to spend much.

US Consumer Spending Plunged by Record in March & April



Source: Commerce Department, chart courtesy of CNN

Even with employers cutting millions of jobs, though, incomes soared 10.5% in April, reflecting billions of dollars in government payments in the form of unemployment aid and stimulus checks. Wages and salaries, normally the key component of overall income, sank by an annualized $740 billion in April. By contrast, income in the form of government support jumped by an annualized $3 trillion. However, that form of income will likely fade by the end of July when certain government stimulus programs expire – unless Congress extends them.

The latest report showed sharp declines in consumer spending across the board – from durable goods like cars to non-durable items such as clothing to services ranging from doctor visits to haircuts. Spending tumbled 17.3% for durable goods, 16.2% for non-durables and 12.2% for services.

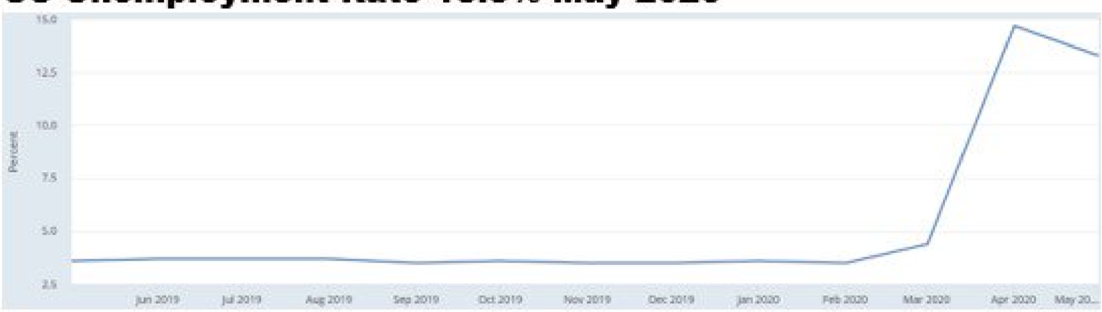
The depth of the spending drop is particularly damaging because consumer spending is the primary driver of the economy. Last month’s figure signaled that the April-June quarter will be especially grim, with the economy thought to be shrinking at an annual rate as high as 30%-40%. That would be, by far, the worst quarterly contraction on record.

With spending plunging and incomes surging on the strength of government support payments, Americans’ personal savings rate hit a record high of 33% of after-tax income in April. Economists said this underscored how anxiety and uncertainty about the economy are making consumers reluctant to spend.

The latest spending report showed that an inflation gauge preferred by the Federal Reserve fell 0.5% after a 0.2% drop in March. Fed officials have cited the absence of inflation pressures as one reason they can be so aggressive in supporting the economy by cutting their benchmark interest rate to near zero and pumping billions of dollars into credit markets to keep them flowing smoothly.

In April, the nation’s jobless rate was 14.7%, the highest since the Great Depression, although it did dip to 13.3% in May to the surprise of forecasters. States are gradually restarting their economies by letting some businesses reopen with certain restrictions, and some laid-off employees are being recalled to their former jobs. Still, the job market remains severely depressed, and the outlook for the rest of the year remains bleak.

US Unemployment Rate 13.3% May 2020



Source: US Labor Department, chart courtesy of Federal Reserve Bank of St. Louis

Some financial support for the tens of millions of consumers who have been laid off over the past three months is coming from weekly unemployment benefits. Besides whatever unemployment aid states are providing to laid-off workers, the federal government is providing $600 a week in additional benefits to those who qualify.

A debate in Congress over whether to extend the $600 a week in federal unemployment aid looks sure to intensify, with the number of people receiving that aid now topping 30 million – one in five workers. The program is set to expire July 31. Yet with the unemployment rate widely expected to still be in the mid-teens by then, lawmakers will face pressure to compromise on some form of renewed benefits. We'll see what happens.

Best regards,
Gary D. Halbert