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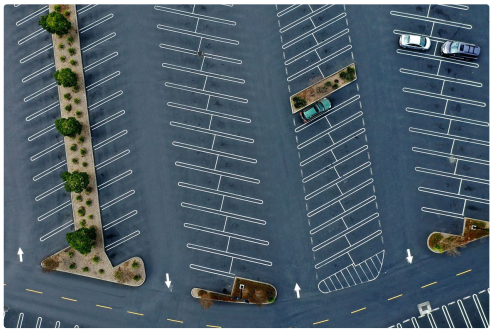
CORONAVIRUS

Why the Stock Market Hasn't Hit Bottom and Could Fall Another 35%

By Reshma Kapadia March 25, 2020 4:47 pm ET



Efforts to stop the coronavirus from spreadin have been tough for many retailers.
Photograph by Justin Sullivan/Getty Images

Don't get too excited about the second consecutive day of stock-market gains.

Charles Dumas, chief economist at TS Lombard, doesn't think the S&P 500 has hit bottom. He says the U.S. will be in a recession at least through the summer as the economy feels the second- and third-order ramifications of the coronavirus pandemic, and efforts to control it.

In a note to clients on Wednesday, TS Lombard strategists said the market has more room to fall, citing expectations that earnings for companies in the S&P 500 could fall roughly 30%. That decline, and the effects of the economic slump they see, put the fair value of the S&P 500 closer to 1600 to 1800, down as much as 35% from the closing level of 2475.56 on Wednesday.

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Although policy makers have responded better than they did during the 2008 financial crisis, Dumas says, the second round of fallout from countries around the world shutting down or slowing their economies to curb the spread of the coronavirus will include a slump in consumer and capital spending. Another likely effect is a rationing of credit—increased difficulty in borrowing—that will slow the economy.

"P/E ratios can no longer be sent ever skyward by an ever-expanding Fed balance sheet," Dumas wrote in a note to clients. "Just like every recovery before, something different will drive the next upturn."

For the second quarter, Dumas estimates the U.S. economy could contract 18%, shrinking by 7% in the third quarter. So far, social- distancing measures in the U.S. have closed industries that contribute 30%—or 35 million—of private-sector jobs. TS Lombard expects 12 million people will lose their jobs in the first round of cuts in April, and that may not be the high mark.

The severe downturn isn't likely to feed into an immediate recovery once social-distancing measures are eased, in part because central bankers don't have the same amount of ammunition, or room to cut interest rates, as they did at the start of the last financial crisis. At the same time, years of interest rates near record lows have obscured problems on balance sheets.

The fiscal measures the U.S. takes will shape the size and scope of the recovery, but Dumas expects the consumer rebound to be relatively mild. He says it will be hampered by an only gradual recovery in social interactions, recessionary-level unemployment, and the loss in equity- market wealth.

Capital spending tends to follow earnings with at least a six-month lag, so the initial hit to profits from efforts to control the virus may hamper growth later in the year, Dumas adds.

And while central bankers have taken aggressive measures to ease a credit crunch, Dumas sees possible trouble ahead among smaller banks, whose customers have been among the most affected by the closures in the U.S. As income losses pile up at banks, that could create longer- lasting scars for the economy.

"Small banks have been the more aggressive lender and borrower of liabilities than large banks through this cycle," Dumas writes. "If borrowings become too expensive, or banks decide to borrow less to shrink their balance sheet, the Main Street credit squeeze accelerates."

The second- and third-round of ramifications of the economic fallout from the coronavirus outbreak expose major financial weaknesses in the global economy created by years of ultralow interest rates, Dumas cautions. Add in the significant amount of money and deficit financing needed for a recovery, plus the likelihood of major bankruptcies and debt write-offs, and Dumas sees stock-market returns below their long-term trend, possibly for years.

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