Update: The Three- Phase Greater Depression Era

Has Phase Three Already Started? Certainly, it seems so.

9.21.20

On April 13, 2020, after the Corona Crash, Stock Traders Daily issued a Special Report to all entitled subscribers that outlined a "3-Phase Greater Depression Era." This is an update to that report and addresses the third phase of this Era.

First, I have nicknamed this a 'Greater Depression Era' instead of calling for depression like conditions because stimulus was expected to support investors and mask the problems in the economy, and that is exactly what has happened. Investors do not feel any pain anymore, yet…

The three phases of the "Greater Depression Era"

- Phase 1: Stock Market and economy get hit (March).
- Phase 2: Stock Market diverges from economy because of stimulus (lasted through August).
- Phase 3: Stimulus stops supporting the stock market and the markets fall back to parity with the economy (may have already started).

Based on conditions we have already witnessed, Phase one and two of this Greater Depression Era seem to have already come. If phase three has started the market has much more room to fall.

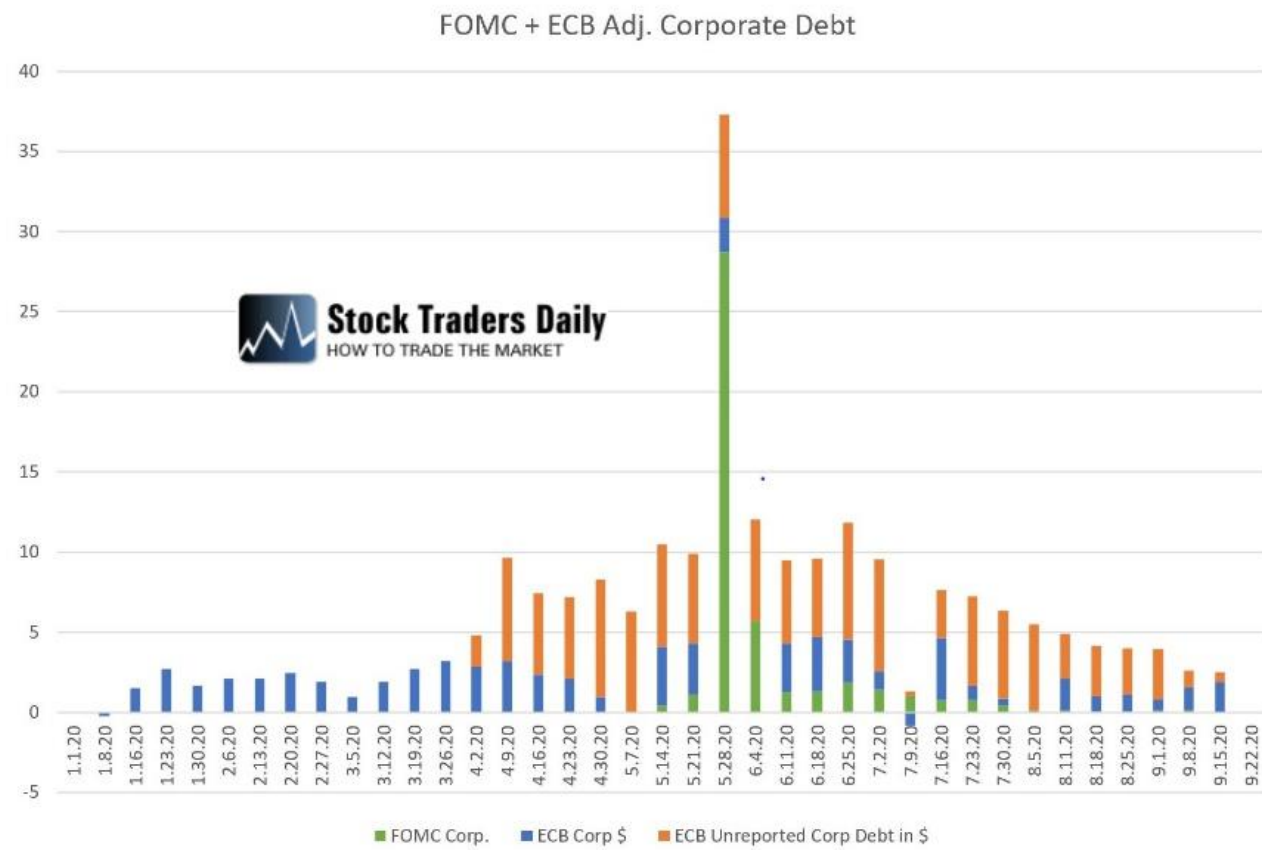
Important: Valuations do not matter until the Central Banks stop buying without regard to risk or valuation. Only after that fabricated buying stops will investors make prudent risk observations again. When prudent risk observations are being made again the third phase will begin.

Has Phase – 3 already Started?

Given the importance of the Central Banks to the level of the stock market, Stock Traders Daily monitors changes to stimulus programs weekly, and recently the pace of purchases of the asset class that is most closely correlated with the equity market has declined to pre-pandemic levels. If it stays that way the return to parity with the economy is likely to continue.

Based on experience in 2015-2016, and again in November 2019, Stock Traders Daily defines the most influential asset class as Corporate Debt. Treasury and Agency purchases help stabilize the financial system, but the money flows from those parts of the stimulus regimes do not have direct follow through to the equity market like the purchases of Corporate Debt.

The chart below shows the pace of the combined corporate debt purchases of the ECB + FOMC. The data shows that the FOMC has already stopped all corporate debt purchases, but the ECB continues. In addition, the ECB has unreported purchases, but we have extracted that in this observation and accounted for both reported and unreported corporate debt accordingly.



Importantly, the FOMC has the ability to buy much more aggressively, as we can see from the May 2020 data above, but they stopped buying in July, and on September 16, 2020 the FOMC made it clear that they would not be buying corporate debt unless conditions become dire. The FOMC will continue to buy Treasuries and agencies, but not corporate debt via SMCCF.

Therefore, we can conclude that the pace of corporate debt purchases is likely to remain at pre-pandemic levels unless conditions get worse.

Will that slower pace be enough to support the stock market from here?

Looking back to November 2019, when the ECB began buying corporate debt again after stopping at the end of 2017, the similar pace was sufficient enough late in 2019 and in early 2020 to not only support the market but to give it a material jolt. However, this was also when market and economic conditions were good, and investors who remembered what happened in 2017 (a one-sided up market because of corporate debt purchases) also began piggybacking the ECB actions, but that has changed.

Today the pace of corporate debt purchases is similar to what it was when the ECB started last November, but market conditions are much different, and the economy has cratered. In addition, the stock market has already rallied hard and it has diverged materially from the economy, largely because the pace of corporate debt purchases was so strong right after the crash, but now the pace has retracted. The pace has retracted but the divergence still exists.

By Thomas H. Kee Jr., President and CEO, Stock Traders Daily. 9.21.20

This is a material difference. The conditions now are not like the conditions that existed when the ECB began their program last year, and ever since the pace slowed to pre-pandemic levels, which happened in the beginning of September, the market has begun to fall.

Therefore, our conclusion is that the pre-pandemic pace of corporate debt purchases is not enough to bolster the stock market, which opens the door to retracements, and possibly a return to parity with economic conditions.

A complete return to parity may be unlikely, that would require a much more aggressive decline and the FOMC probably would step in to prevent that if it started, but a retracement to longer term support levels as we have defined those for Stock Traders Daily entitled subscribers is reasonable given these conditions. Defined resistance has already been tested and a retracement has begun.

The longer term chart of the S&P 500 above suggests that the S&P 500 tested longer term resistance and tried to break above longer term resistance in August, when the pace of corporate debt purchases was still strong, but then it fell back. The reversal has opened the door for an additional retracement based on this chart, and 2820 is the downside target so long as 3438 remains intact.

Reasonably, given what we know about economic conditions associated with the Coronavirus, including the much slower pace of expected normal growth in a post pandemic world, a decline to 2820 in the S&P 500 would NOT be a return to parity with current economic conditions, a much more material decline would be required for that, but the FOMC is locked and loaded and ECB purchases still exist. Those should help pad the declines, and therefore a complete return to parity is unlikely, but moderate additional retracements do look likely.

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The excessive divergence between the stock market and the economy that reached a peak late in August is already starting to reverse, and there seems to be room for more declines, but in order to reach conclusions we also must take a closer look at valuations.

Valuations:

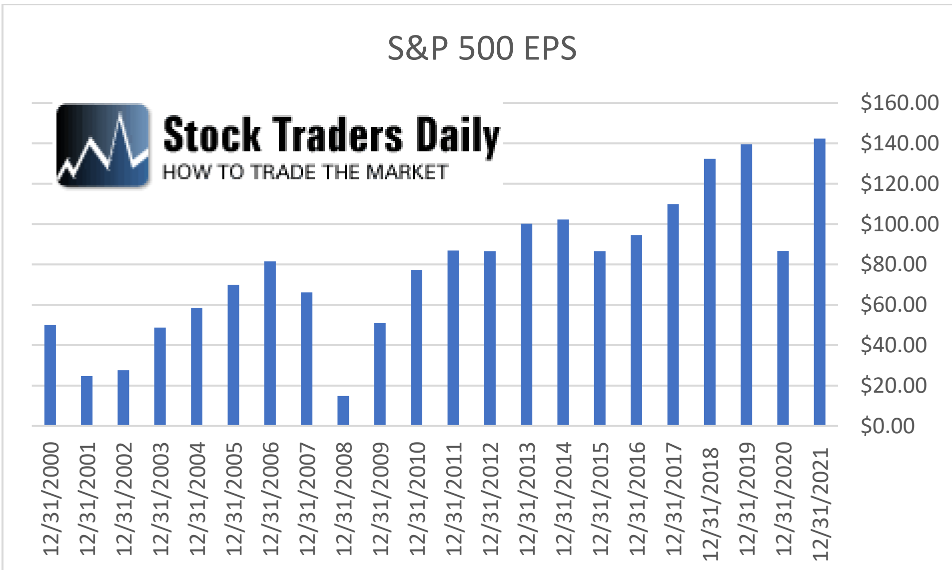
In order to assess valuation and valuation risk we need to look at the PE multiple as that relates to growth rates, historical observations of risk matters too, and then we need to understand how stimulus has changed the definition of risk as well.

The charts below compare earnings growth and the PE multiple for the S&P 500 since the turn of the century. Below that an additional observation is offered for the DJIA.

The chart above shows us that the PE multiple for the S&P 500 has hovered around 20x since 2000, except for periods of recession, when PE multiples spiked. This is a material difference from the historical average, which is slightly above 15x, and in recent years multiple expansion can be identified.

The chart below helps make the multiple expansion that existed during the post Credit Crisis stimulus phase clearer. EPS for the Market was $86.95 at the end of 2011, just before stimulus was inaugurated, and it was at 86.53 in 2015 too. There was hardly any EPS growth during this time span, but the PE ratio increased from 14.46x to 23.62x. That is a 63% expansion that was not supported by earnings growth.

This observation first helps us quantify the influence of stimulus, and it also helps us understand why the PE multiple is so much higher today than the historical average. Stimulus influenced the definition of fair value to be higher than normal, natural levels.



Importantly, the chart above also shows us that sustained earnings growth after the credit crisis was not realized until 2017, eight years after the recovery began (will it take that long this time too). During that time the FOMC and the ECB were fully engaged in stimulus, and in 2017 there was a golden scenario.

Not only was the ECB fully engaged in corporate debt purchases in 2017, but the S&P 500 began to realize a breakout in EPS growth too. This combination helped push the PE multiple to 24.33x, that did not seem too far out of line because EPS grew at 16.21% that year too, but then stimulus stopped.

In 2018 stimulus came to an end, and that gave us a chance to see how investors would assess risk without the fabricated support of Central Banks.

The chart below shows the percentage change in EPS for the S&P 500…

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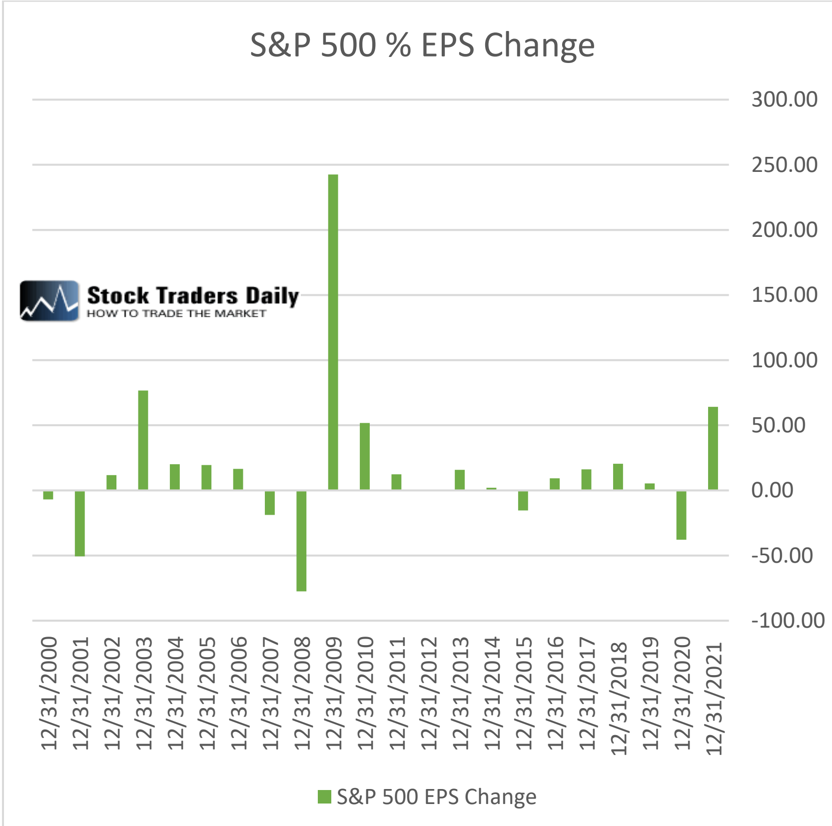

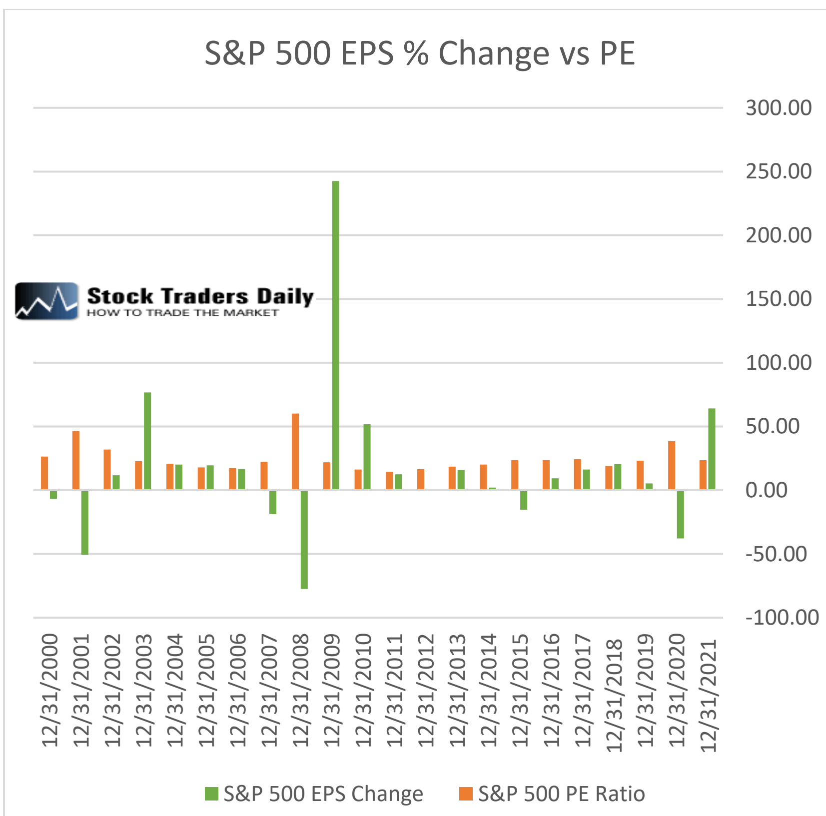

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The chart above offers many insights, but our focus is on how the market acted without stimulus. In 2018 stimulus had stopped, and the PE ratio on the market fell.

The assessment of risk by investors in the market changed when stimulus stopped, and the PE ratio dipped to 18.94x in 2018. This happened even though EPS grew by 20.49% that year. The multiple expansion phase that was tied to stimulus had come to an end, and this rolled over to 2019.

However, in late October 2019 that changed. The ECB began a new stimulus regime then, and the S&P 500 increased by about 10% in the final two months of 2019. The PE ratio at the end of 2019 was 23.16x, but EPS growth in 2019 was only 5.35%. EPS growth declined, but the Market remained steady thanks in part to the actions of the ECB.

Smart Money Investors do care about stimulus, and Smart Money watches these actions closely.

Using the chart above to look ahead, the expected PE for the S&P 500 at the end of 2020 is 38.49x, even though EPS is expected to decline by 37.81%. This is not an immediate surprise because past recession eras have seen similar disparities. On the other hand, in 2021 the PE is expected to be 23.45x, while EPS growth is expected to rebound by 63.15% in 2021 vs 2020. Again, this is not a surprise, but real EPS growth vs 2019 will only be 2% if that happens. Any recovery would be welcome, but does that growth rate and future growth expectations in the post pandemic economy warrant a 25x PE Multiple?

Investors always look ahead, and expectations are robust for next year so that is enticing, but multiples near 25x seemed to mark a cap the last time stimulus stopped, and we cannot forget that.

25x has been an upper threshold to natural investor risk tolerances in the S&P 500, and the Market is already near 25x using 2021 expectations. If the pace of ECB corporate debt purchases are being nullified by selling tied to economic weakness, a drawdown from 25x would also be reasonable.

Corroborating our observations for the S&P 500, analysts are also expecting the earnings for the DJIA to increase by 40.5% in 2021 after declining by 26.5% this year. However, the DJIA suffered EPS contractions in 2019 too; DJIA earnings peaked in Q4 2018 and have been declining ever since. This obviously is not true in tech, we cannot forget that, and that helps us differentiate the S&P 500.

Please review our DJIA Fair Value Analysis.

With exposure to tech as well as the bellwether stocks in the DJIA, the broader S&P 500 has already begun a retracement, and our Phase 3 update tells us that a decline to longer term support is likely. Valuation observations support the same, and the current role of stimulus remains a catalyst in both directions. These metrics combined to support additional retracement and a fulfillment of the return to parity suggested by phase 3 of our Greater Depression Era Report, originally dated April 13, 2020.

Target 2820 in the S&P 500 as a longer term retracement target based on this update.

The S&P 500 was at 3260 when this was published, and immediately the next leg of direction will most likely be up instead of down, the market recently fell from midterm resistance, but lower highs and lower lows are evident. We are expecting a modest increase from the lower low that was recently tested, and then a progression down towards 2820 as the return to parity continues.

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