Volatility: The new normal
A sharp drop in oil prices on top of the coronavirus is likely to increase uncertainty.

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Key takeaways

✔ Expect continued volatility as investors struggle to price in the coronavirus’s twin shocks to supply and demand.

✔ Sharply falling oil prices are adding to the uncertainty.

✔ Whether the recovery is U-, V-, or L-shaped will depend on earnings, interest rates, and valuations. It will likely be several weeks before we know the market’s path forward.

✔ Make sure you have a long-term, diversified investment plan you can live with, even during market pullbacks.

The markets remain in what I would describe as "chaotic price discovery mode," as investors struggle to gain a sense of how long the twin shocks to both demand and supply chains will last, how deep it will be, and how quickly (or slowly) things will rebound once the growth rate of new COVID-19 cases peaks in the
US and globally. At this point, nobody knows these answers yet, which is why the markets remain so volatile.

I suspect this volatility will continue for at least several more weeks as the number of confirmed cases in the US leaps higher as more people get tested, and as more conferences get canceled and more companies tell their employees to work from home.

The market’s moment of truth will likely arrive in a few weeks as we enter preannouncement season leading up to what will likely be a challenging Q1 earnings season.

**Recession ahead?**

The "R" word is likely going to get thrown around a lot more in the coming weeks, and with it fears that we are all going to relive the scary days of the financial crisis in 2008. The US has only had 2 recessions during the past 2 decades (2001 and 2008), and each of them produced declines of at least 50% for the S&P 500.

So investors, especially younger ones, can be forgiven for assuming the worst—even if it turns out that COVID-19 only produces a technical recession (i.e., a temporary decline in GDP growth not accompanied by an inventory cycle or a financial crisis).

**Stress in energy markets could speed up**

Making things worse for earnings and especially for the credit markets, news just hit over the weekend that OPEC not only failed to come up with production cuts, but now Saudi Arabia has entered a price war against Russia. The US shale industry is directly affected by this. With price levels no longer being propped up, the price of American oil is falling too and it may take some time to cut production.

So instead of OPEC mitigating the decline in oil prices and widening of credit spreads, we could now see an acceleration of stress in the energy markets, as we did in 2014–2015. It's not what the markets need right now.

**3 potential earnings scenarios**

Nobody knows exactly what the coming weeks will bring, including whether we will see a bear market or a recession.

A simple way to try to gauge the effect from COVID-19 is to bring it all down to the common denominator of earnings, interest rates, and valuation. We know that rates have plummeted to record lows (investors now get 40 basis points on the 10-year Treasury). Also, we know that valuations have come down (from 19.1x to 16.3x at the low), and that earnings appear likely to contract in the coming few quarters before they bounce back.

What we don't yet know is how deep the contraction will be, how long it will last, and how swift the rebound will be (V, U or L). And we also don't know what the proper valuation multiple is for a market faced with this much uncertainty.
So, let’s do a simple back-of-the-envelope exercise mapping out 3 earnings scenarios and 2 valuation scenarios. Our starting point is 2019 earnings per share (EPS) of $163 and 3,379 for the S&P 500 Index (SPX), the ending point is the high in January 2020.

- The first scenario (U) assumes a modest 5% hit to EPS over the coming 2 quarters, followed by a trend-line growth rate of 8% (the expected growth rate prior to COVID-19). This scenario would see EPS bottom at $156 in Q2 and then rebound to $161 in 2020 and $172 in 2021—a recovery delayed but not canceled.

- The second scenario (V) is a one-time hit of 10% over 2 quarters (down to $147 in Q2) followed by a V-shaped recovery to $159 in 2020 and $186 in 2021. Think of it as the earthquake scenario where demand gets hit hard and then comes roaring back.

- The third scenario (L) is a one-time hit of 10% over 2 quarters followed by the same moderate trend-like 8% growth rate that was expected. In this scenario, EPS falls to $147 as before, but only rebounds to $152 by the end of 2020 and $163 in 2021 (so, it ends up where it is now).

Best-case scenarios

From here it becomes a matter of applying the appropriate valuation multiple. Let’s optimistically assume for now that the market should be valued at 19x trailing earnings, below the recent peak of 20.7x but in line with where interest rates and inflation are. This is a best-case scenario in my view.

In the U-shaped scenario, the S&P 500 should decline 13% from the highs, to 2,956. Compared to the low of 2,857 that we saw 2 Fridays ago, the market has already corrected more than it needed to. That suggests that the bottom is in place and the market can build its base before it moves back up (to 3,058 in 2020 and 3,271 in 2021).

In the V-scenario, the S&P 500 would fall to 2,795 from the highs for a total decline of 17% from the highs. That means that the S&P 500 has corrected almost as much as it should have (to the low of 2,857) and has upside to 3,023 in 2020 and 3,537 in 2021.

In the L-scenario, we would also see a decline of 17% from the peak, followed by a slower rebound to 2,891 in 2020 and 3,093 in 2021.

Worse-case scenarios

Now let’s take a lower multiple of say 17x, and see where we come out. At a 17x multiple and using the above 3 earnings scenarios, we would get the double-whammy of both an EPS decline and a valuation haircut.

In the U-scenario, we get to a bottom of 2,645 for a decline of 22% from the high (crossing slightly into bear market range), and in the L-scenario, we would get a decline to 2,501. That would be a 26% decline and would put us firmly in bear market territory.

From there we would recover slowly or swiftly, based on the earnings recovery and more importantly the magnitude of multiple-expansion off the lows.
These are just simplistic scenarios, but what I'm trying to do here is map out some scenarios for downside risk as we approach earnings season. What makes this difficult is that all 3 variables are in a state of rapid flux right now.

The week ahead

If we see new correction lows this week, the question will become where we bottom and how quickly we reverse. That will depend on the growth rate of new coronavirus cases, oil prices, credit spreads, and the policy responses from Washington and elsewhere. A chaotic price discovery indeed.

For long-term investors with a well-diversified plan, there is really nothing to do. Just stay the course. If you don’t have a long-term investment plan, or if the market pullback has you questioning if it’s still right for you, consider meeting with a financial professional.

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