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MACROCOSM

Covid-2019 and Bernie-2020

Wednesday, February 26, 2020

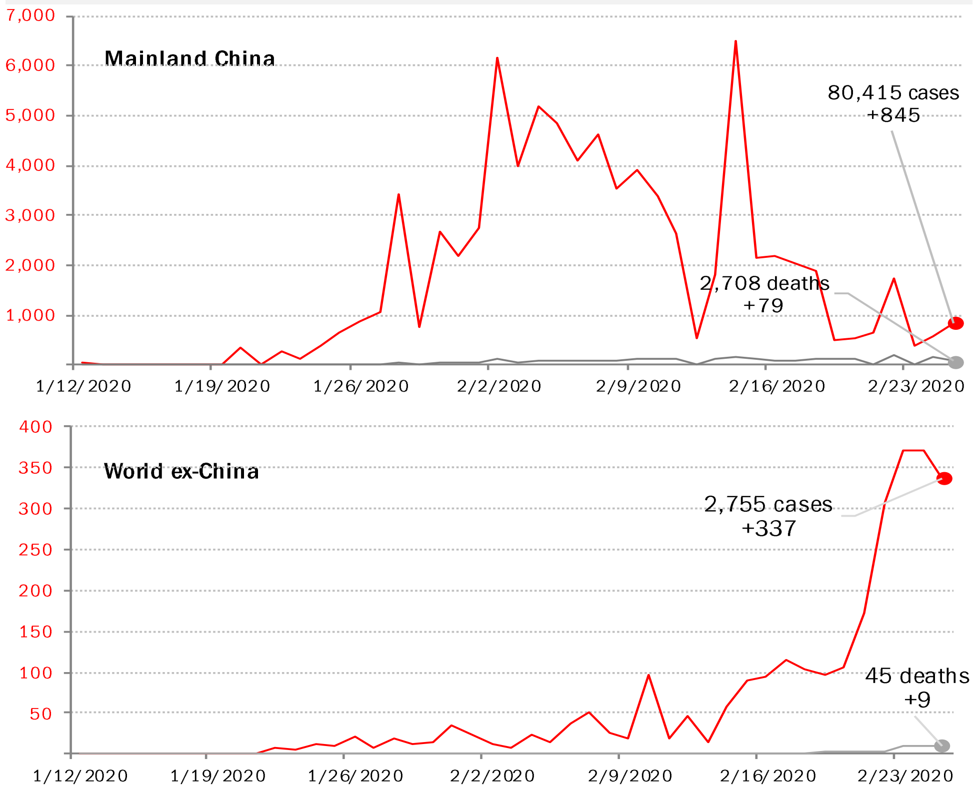
Donald Luskin

CDC alarms aside, the virus is rolling over, and Sanders remains an improbable nominee.

We've been talking to clients non-stop these last two tumultuous days, and we can report a consensus among them that *markets are reacting to two separate risk-factors that both emerged over the weekend: the breakout of coronavirus Covid-2019 cases in countries outside China, and the breakout of Bernie Sanders (D-VT) in the Nevada caucuses as the front-runner for the Democratic presidential nomination*.

FIRST, THE VIRUS Three weeks ago we said we expected to see more of a correction in asset markets – something in line with the 6% correction in equities we saw in the 2003 SARS incident, or the 10% we saw in the 2014 Ebola scare (see "Is Coronavirus a Chinese Bio-Weapon?" February 3, 2020). *First we were wrong*, as stocks made new all-time highs just 5

Covid-2019 daily confirmed cases and deaths



Source: John Hopkins, TrendMacro calculations

Update to strategic view

US MACRO, ASIA MACRO, US STOCKS, US BONDS, US FED, US ELECTION MODEL: As we predicted, asset markets are correcting commensurately to past reactions during pandemic crises, just as the coronavirus crisis is probably cresting. But it's more: they are reacting both to breakouts ex-China, and to Sanders' big win in Nevada. Covid-2019 daily new cases in China have been consistently under 1,000, and the outbreak ex-China has not topped 400, and has not grown for 3 days. There are only 45 deaths ex-China, implying a fatality rate of about 1.5%. The alarming statement by the CDC is typical for public health officials seeking to raise awareness and enhance preparedness, similar to the false-alarm about Ebola in 2014. Stocks have corrected similarly to prior pandemic panics, and the equity risk premium is now attractive. The Fed will likely cut rates in March or April to dis-invert the yield curve. Forward earnings have been remarkably resilient, seeming to look across…

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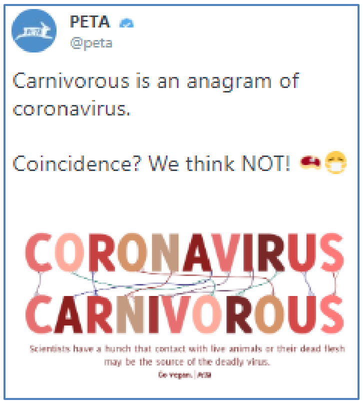

sessions ago. *<u>Sadly, now we are right</u>*, with the cash S&P 500 as of this writing off as much as 8.1% from last week's high – splitting the difference between the two prior incidents. From the day in mid-January when the coronavirus first burst upon the markets' consciousness, the correction has been 4.0%. Actually, you can another 1.3% damage in last night's panic in equity futures markets.

All that said, the epidemiological data isn't entirely consistent with this risk-off reaction. In China, new confirmed cases have been under 1,000 for 4 of the last 5 days (please see the top chart on the previous page). Outside China, at the same time there has been a surge in new cases over the last 10 days (please see the bottom chart on the previous page). *<u>But new cases outside China – in total, worldwide – have never hit 400, and have been stable for the last 3 days. Of the countries ex-China where cases are still on the rise, they've rolled over everywhere but Italy. There are still only 45 deaths outside of China – in total, worldwide – implying a fatality rate of about 1.5%</u>*.

- Say what you will about the reliability of the data coming out of China (see "If Coronavirus Were a Public Company…" February 14, 2020). Presumably the data coming from countries like Japan, South Korea and Italy, where so much alarm has been focused the last several days, is more reliable. And for the moment, it is generally not getting any worse.
- *<u>We hate to say it – because we don't want to accuse "Mr. Market" of being provincial or xenophobic</u>*. But it strikes us that some important part of the concern the last couple days has been that Covid-2019 isn't confined to a nation as exotic as China. With the rise of cases in northern Italy, especially, *<u>we think there is a kind of shock of recognition that this disease can strike Western civilizations, too</u>*.
- *<u>At the same time, the US Centers for Disease Control made alarming public statements yesterday, and this undoubtedly materially contributed to a sense of dread</u>*. Nancy Messonnier, MD, Director of CDC's National Center for Immunization and Respiratory Diseases, said yesterday, that with Covid-2019's spread to so many countries,

  "Successful containment at our borders becomes harder and harder. Ultimately we expect we will see 'community spread' in this country. It's not so much a question of if this will happen anymore, but of exactly when this will happen in this country, and how many people will have to bear illness."

- In a rather maudlin moment in her telephonic press briefing yesterday, she said she is telling her children, "We…need to be prepared for significant disruptions to our lives."
- First, considering the volume of business, tourist and educational

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…the valley. Sanders' bigger than expected win in Nevada is alarming to markets. But that doesn't mean he can win in November, or even that he can win the Democratic nomination……In a crowded field in primaries that award delegates proportionally, he likely won't have a majority at the convention, and would be unlikely to be nominated on the second ballot. If he is in first position yet is denied the nomination, it could tear the Democrats apart. Our quantitative model still strongly predicts Trump, with the most salient risk being a recession created by a worse than expected pandemic.

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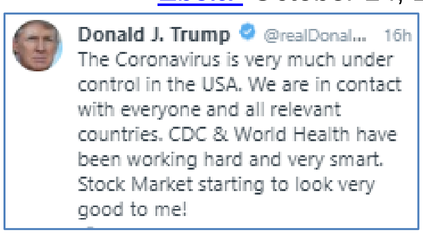
[About us]

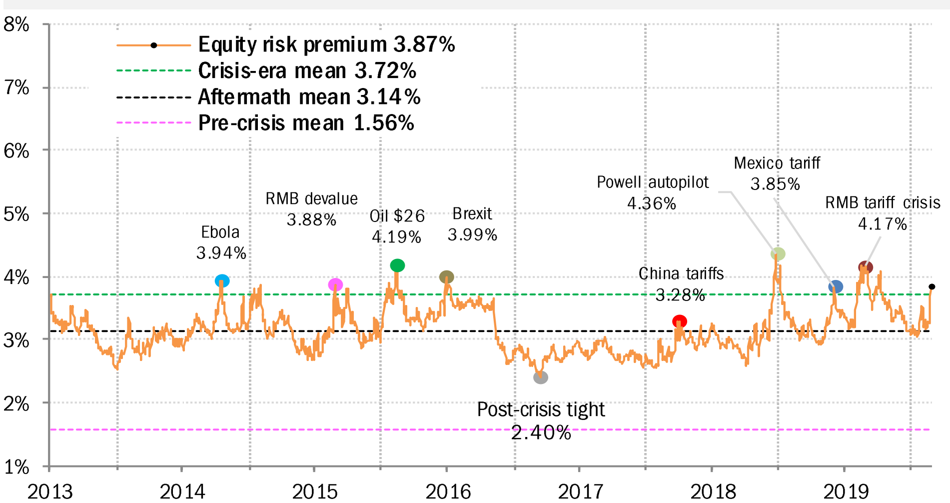
travel between the US and China, it is miraculous – or perhaps just meritorious – that there are only 53 confirmed cases here. There has been no "community spread" – the large majority of US cases are evacuees from China, or passengers on [the stricken cruise ship *Diamond Princess*] (which has been isolated in the Port of Yokohama in Japan, after an on-board breakout triggered by a passenger from Hong Kong). And there have been no US deaths.

- But second, yes, we need to be prepared. Indeed, *public health officials like Messonnier make statements like this precisely to alarm you into being prepared* – with the hope that such preparations will thwart the very risk they are warning about. In other words, *it is their mission to scare you into acting so as to make their dire predictions wrong*.
- We saw the very same thing in October 2014 at the peak of the Ebola panic. World Health Organization officials were warning that the epidemic in three African nations would soon go global, and that there would be 10,000 new cases every day world-wide. With the US stock market down more than 10% in the ensuing panic, and a 20 bp flash-crash within a few minutes in the 10-year Treasury yield, we pointed out to clients that this statement was absurd considering that the number of Ebola cases and deaths in the three African nations had actually peaked several weeks earlier. That data was publicly available, but recognized nowhere else at that time (see "Something You Probably Didn't Know about Ebola" October 14, 2014). *The worst of the market's panic was driven by the statements of public officials, not by the epidemiological data.*



- *That was an opportunity. We're more cautious this time, considering what is already the global scope of the Covid-2019 breakout (and remember, it hasn't hit vulnerable Africa at all, yet). But there are encouraging signs in the data, and in the atmosphere of panic, and this is probably the time to at least start buying the dip*.
- *The S&P 500 equity risk premium* (please see the chart below) *is*

S&P 500 equity risk premium (forward earnings yield minus 30-year Treasury yield)



Source: Various, TrendMacro calculations

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Financial Times
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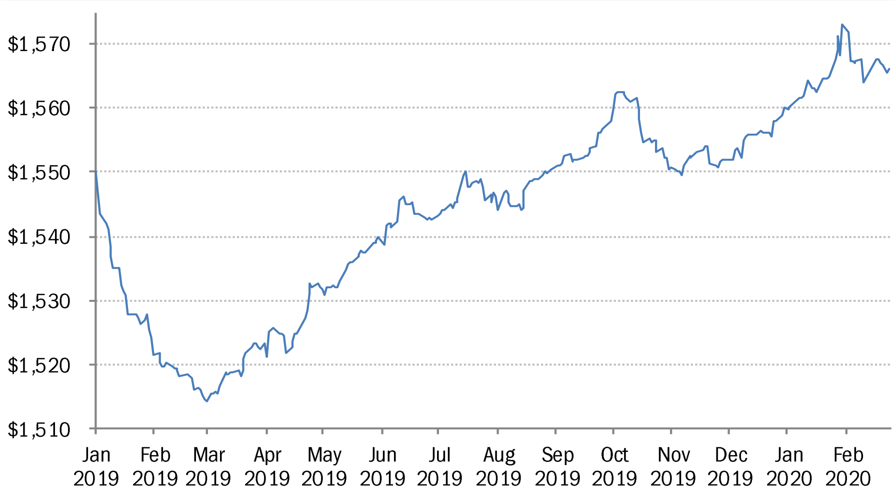
almost as wide now – in part, thanks to new all-time lows for long-term Treasury bonds – as it was at the worst of the 2014 Ebola panic (again, see "Something You Probably Didn't Know about Ebola"). It's wider than it was last June in the Mexico tariff crisis (see "Video: What you're not hearing about Trump's tariff gambit with Mexico" June 9, 2019). But the ERP was much wider in the December 2018 Jerome Powell "automatic pilot" fiasco (see "Did Powell Just Cut a Deal?" December 23, 2018), and last August in China's currency-crisis (see "Never Let a Good Currency Crisis Go to Waste" August 14, 2019). *So stocks are cheap, but we've seen them cheaper.*

- *The ERP is supported not just by rich Treasuries, but by the remarkable resilience of forward earnings despite lower guidance in the face of the Covid-2019 lock-downs, and the related damage to both consumer markets and supply-chains* (please see the chart below, and "Video: What you're not hearing about Apple's revenue warning" February 18, 2020). Since the recent high on January 31, they are only off $6.75 billion, one-third of which is explained by the energy sector. We have respect for what might be implied by Mr. Market's recent turn toward the pessimistic, but *year-ahead forward earnings are another form of consensus, and for the moment they are very much looking across the valley*.

S&P 500 year-ahead bottom-up consensus forward earnings (USD billions)



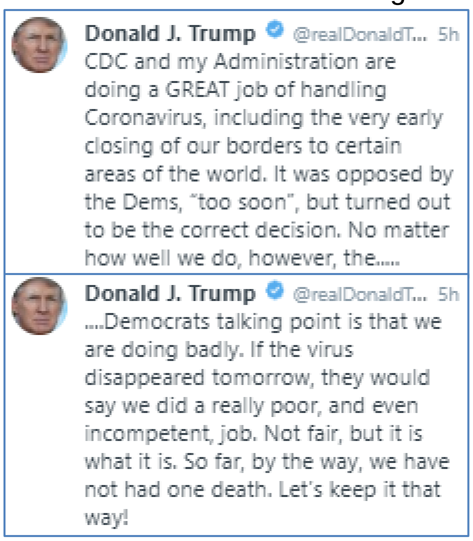
Source: Bloomberg, TrendMacro calculations

- *Another element in a bull case is that long-term Treasuries are forcing the Fed to act, with a March rate cut now very much a possibility.* The Fed flattened the yield curve (between the effective funds rate and the 10-year Treasury yield) at the last FOMC when it hiked the interest rate on reserves by 5 bp (see "On the January FOMC" January 29, 2019). *Now the curve is inverted by 23 bp – it would take a rate cut just to get it flat again. We wouldn't call that a panic response to Covid-2019, but rather deferred maintenance that had to be done in any case. We think it's inevitable, if not in March, then in April*.

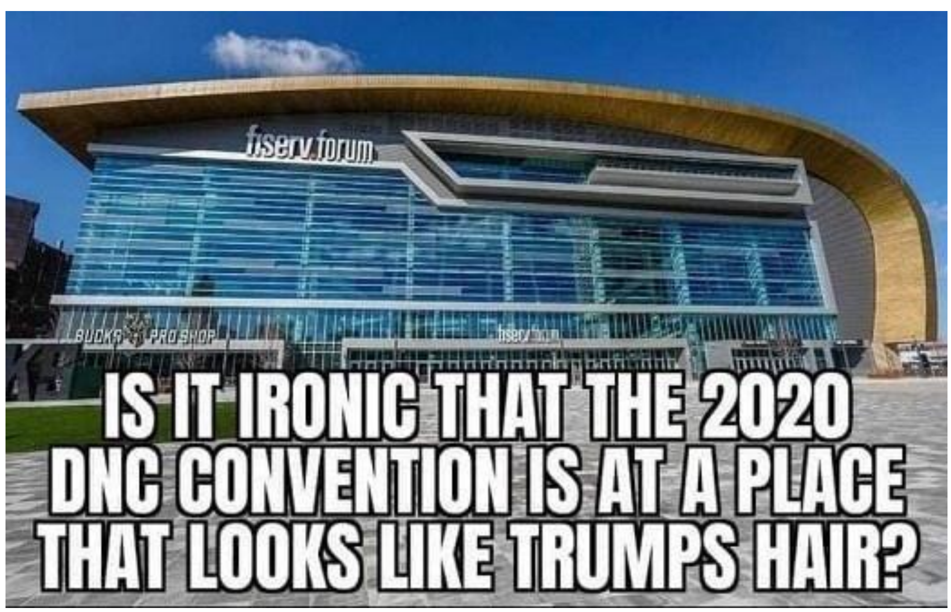
BERNIE We said at the beginning of the year, before anyone had heard of the coronavirus (other than Xi Jinping and a health care worker in Wuhan, now deceased) that the US presidential election would be the most consequential event for markets in 2020 (see "2020 Outlook: After a Near-Miss Recession, It's the Election" January 2, 2020). We have explained the bull run in US stocks in February – at least until the train-wreck of the last several sessions – as a response to the coalescence of the Democratic primary process around Sanders and Michael R. Bloomberg (see "Video: What you're not hearing about why stocks are making new highs (hint: it's the election!)" February 10, 2020).

- Our idea was that either way, this enhances the probability of Trump being re-elected (which we are assuming would be a pro-growth and risk-reducing outcome, if for no other reason than it would preserve today's low corporate tax rate, regardless of whatever else you may think personally about the president). We pointed out that *while Sanders has much higher net approval than Trump* – or any other Democratic contestant, as he himself pointed out in last night's debate (though we assure you he is not a TrendMacro client) – *his stridently radical policies make him unelectable. Bloomberg's policies are more moderate, but he is unelectable because his negative net approval is even worse than Trump's has been throughout his controversial presidency*.
- *That said, we agree with clients who think Sanders' surprisingly large win in the Nevada caucuses was a shock to markets. It's not unlike the effect of Covid-2019 proliferating in Italy – it makes the possibility of a black-swan worst-case scenario suddenly very, very palpable.*
- You can think of the distinction between Sanders and Bloomberg in game-theoretic terms. Bloomberg is the cautious "minimax" play – he's probably not electable, but he's more electable than Sanders, and just in case he wins it won't be so bad because his policies are far less anti-growth. Sanders is the go-for-broke "maximax" play – he's much less electable, but if somehow he *does* get elected, his anti-growth policies would be disastrous.
- After Nevada, Mr. Market's nose is being rubbed in the reality of actually making the "maximax" play, for better or worse. *One can't help but ask, if he can win the nomination, why can't he win the presidency – especially after a decisive win like Nevada, in which he punched through what had been seen as a "ceiling" in terms of vote-share, and support by older and ethnic voters.*
- *We're getting asked now by clients how we can be so sure that Sanders can't win – especially since we were early and accurate in predicting Trump's win in 2016, and his candidacy was even more seemingly improbable* (we even said he'd be "the best pro-growth president in decades" – see "Sympathy for the Donald" March 2, 2016).
- *For one thing, improbable Sanders isn't going to be elected just because the last improbable candidate was. And as to busting through that "ceiling," it's one thing to do that among Democratic primary voters in a weak and divided field, and another to do it in November against Trump.*

- *For another, our quantitative election prediction model predicted Trump in 2016, and it's predicting him again in 2020* (see "Video: TrendMacro's 2020 election model" March 15, 2019). This is bolstered by a recent strong improvement in what had been a potential vulnerability for Trump – his net approval (which is not an input to the model), which has swung over the last month from negative 10 to positive 5 (again, see "Video: What you're not hearing about why stocks are making new highs (hint: it's the election!)".
- All bets are off if we are wrong about the coronavirus, and it evolves into a true global pandemic that produces economic conditions that look like a conventional recession. Our model assumes that the US economy will be in good shape in November. The Democratic candidates are already preparing for it not to be – a "blame Trump" narrative was piloted last night on the debate stage in South Carolina.

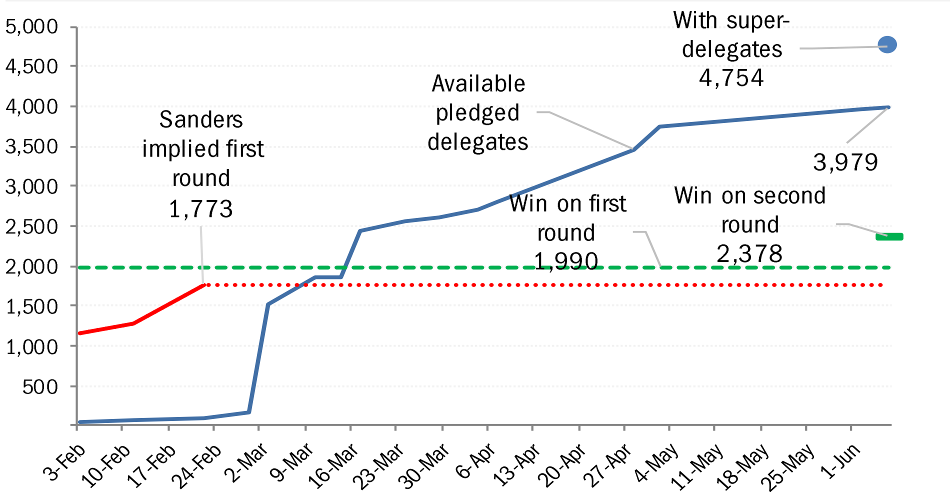


- *Finally, the structure of the Democratic primary process that Sanders faces is very different than the one Trump faced in 2016. Because every primary election will award its delegates proportionally, in a crowded field, it is difficult for any candidate to amass the majority of delegates to win the Democratic nomination at the convention in Milwaukee on the first ballot*
- In 2016, many of the GOP primaries were "winner-take-all" or "winner-take-most," so in a crowded field, all Trump had to do was come in first – even with a small plurality – and he would still get all or most of the delegates. Trump only won clear majorities toward the end when the field had narrowed to just two or three candidates.
- In 2020's proportional Democratic primaries, it is difficult for any candidate to amass a majority – and that difficulty compounds itself because it leaves incentives for many candidates to stay in the race, hoping they can prevail at a contested convention.



- Even with Sanders' big win in Nevada, he has won only 45% of the delegates available so far (please see the chart below). Polling for Saturday's South Carolina primary indicates that Sanders will come in second to Biden, so that will likely bring his percentage down. If he breaks even on Super Tuesday next week – that is, if he preserves his relative delegate position – *he'd still have to win more than 60% of delegates, on average, in all the remaining primaries in order to come to Milwaukee with the 1990 he needs for a clean majority. Unless the field narrows considerably, that strikes us as a very big ask*.

Delegates in the Democratic presidential nominating process 2020



Source: Various, TrendMacro calculations

- *Lacking that majority, even if he comes in with a commanding plurality – say, today's 45% – it's not at all clear Sanders could win on the second ballot when the "super-delegates" made up of Democratic party elders become eligible to vote. To be sure, they may conclude that whoever got the most delegates is, on the face of it, the one with the most support and the best chance for the general election. On the other hand, they may well decide that Sanders is nevertheless fundamentally unelectable, and a less radical candidate – and one with hundreds of billions of his own dollars to fund his campaign, that is, Bloomberg – would be the wiser choice.*
- "Fairness" won't be part of their thinking, nor should it. Sanders will argue that it is "unfair" not to give him the nomination, since he came in first with, say, 45%. But the super-delegates can reasonably argue that it would be *more* "unfair" to not honor the wishes of the 55% who wanted anyone *but* Sanders. Besides, it is not the duty of the delegates to be "fair," anyway. Their duty, on the second ballot at least, is to try to pick the candidate who can win in the general election.
- The choice will be complicated by the ferocity of support that Sanders enjoys among his base. If he is the plurality winner, but doesn't get the nomination, we wouldn't rule out riots at the convention and ongoing disruptions throughout the campaign of, say, Bloomberg. We were in the arena in Chicago in 2016, at a

Trump rally, when Sanders' supporters rioted on the floor and prevented Trump from even entering the building (see "DisTrumption: What I Saw In Chicago" March 14, 2016). *This is another dimension through which both Sanders and Bloomberg are unelectable – Sanders because he is so radical, and Bloomberg because the "Bernie bro's" will shatter his campaign.*

- *The delegates at the convention will be aware of this risk to Bloomberg, but we doubt that they will bow to it. Bloomberg's more moderate positions – and his money – despite his lackluster debate performance in both Nevada and South Carolina – make him the more likely nominee. If Mr. Market prefers "minimax" in the form of Mini Mike, it looks to us like that's what it will get.*

Bottom line

As we predicted, asset markets are correcting commensurately to past reactions during pandemic crises, just as the coronavirus crisis is probably cresting. But it's more: they are reacting both to breakouts ex-China, and to Sanders' big win in Nevada. Covid-2019 daily new cases in China have been consistently under 1,000, and the outbreak ex-China has not topped 400, and has not grown for 3 days. There are only 45 deaths ex-China, implying a fatality rate of about 1.5%. The alarming statement by the CDC is typical for public health officials seeking to raise awareness and enhance preparedness, similar to the false-alarm about Ebola in 2014. Stocks have corrected similarly to prior pandemic panics, and the equity risk premium is now attractive. The Fed will likely cut rates in March or April to dis-invert the yield curve. Forward earnings have been remarkably resilient, seeming to look across the valley. Sanders' bigger than expected win in Nevada is alarming to markets. But that doesn't mean he can win in November, or even that he can win the Democratic nomination. In a crowded field in primaries that award delegates proportionally, he likely won't have a majority at the convention, and would be unlikely to be nominated on the second ballot. If he is in first position yet is denied the nomination, it could tear the Democrats apart. Our quantitative model still strongly predicts Trump, with the most salient risk being a recession created by a worse than expected pandemic.