Now Comes the Hard Part

The S&P 500 soared 12.0% last week which was the largest one week gain since October 10, 1974 when it was up 14%. The rally in 1974 developed after the S&P 500 had just bottomed on October 3, whereas the rally last week occurred 9 days after the low on March 23, 2020. In 1974 the S&P 500 rebounded 20.8% off the low on a closing basis compared to a gain of 24.7% so far in 2020. After peaking at 75.21 on November 7, 1974, the S&P 500 fell -13.6% and posted a secondary low 4.4% above the low on October 3, 1974. Although the S&P 500 didn’t fully retest the original low it did retrace 65.7% of the initial rally before embarking on a new bull market.

As discussed in the April 6 WTR, the S&P 500 was expected to rally to 2792 and potentially up to 2896. “From the low of 2192 the S&P 500 rallied to a high of 2641 on March 31 a gain of 449 points, which appears to be Wave A. The quick sharp drop to 2447 on April 1 was likely Wave B. The rally since the low of 2447 is the beginning of what should be Wave C. If Wave C is equal to Wave A, the S&P 500 would move up to 2896. The other two primary targets are the 50% retracement of the plunge from 3393 to 2192 which is 2792 and the 61.8% retracement target of 2934. Wave A lasted about 6 trading days which suggests Wave C could rally until April 9 if it is equal in time, and potentially to April 14 – 15 if it lasts 1.618 times as long.” The S&P 500 spiked higher on April 9 reaching 2813 before pulling back to 2721 on April 13.

The first real batch of earnings will come out this week and could provide an important clue as to the short term trend in the S&P 500. My assumption is that everyone knows earnings are going to horrendous and will give most companies a pass. No one expects any company to provide forward guidance since no one knows what is going to happen with any degree of certainty. If I’m wrong and stocks sell off as bad earnings are reported, the S&P 500 has rallied too far relative to expectations. If investors are willing to give companies a pass on Q1 earnings and forward guidance, the S&P 500 can rally back to the high on April 9 of 2818, and possibly make a run at 2896.
The Federal Reserve has acted forcibly to restore liquidity and reduce volatility in the Treasury bond market, foreign exchange market, and mortgage backed securities market. On April 9 the Fed announced programs to buy municipal bonds and corporate bonds, including those whose rating had been lowered from investment grade to junk. The central bank will extend its financing to include the following: -Small and mid-size business loans (Main Street Lending Program, up to $600 billion) -Municipal debt (Municipal Liquidity Facility, up to $500 billion) -Corporate debt, including high-yield bonds that were recently downgraded from investment-grade ("fallen angels") The program will even include corporate bond ETFs that are "mostly" investment-grade, collateralized loan obligations (CLOs), and commercial mortgage-backed securities (CMBS) Pretty amazing! It was no coincidence that the Fed’s announcement was timed within seconds of the third awful unemployment claims report showing another 6.6 million newly unemployed workers had filed for Unemployment Insurance.

Congress passed the CARES Act which creates a safety net for unemployed workers and small and medium sized business. The extra unemployment benefit of $600 a week will last 10 weeks, and Small Businesses can receive money equal to 250% of their average monthly payroll, or about 10 weeks. Congress has put into place a cushion that can support the economy for 10 weeks or so. This safety net could effectively last until May 31, if a mid March start date is used or mid June if March 31 is used. The implication is that the national shelter in place order is very likely to be extended beyond April 30 without doing significant additional damage to the economy or requiring Congress to come up with more money.

The stark reality is that COVID-19 is highly contagious and there is nothing that can prevent more infections or effectively treat those who become seriously ill. The only medical tool that has succeeded in bringing down the number of infections and deaths has been social distancing at the expense of shutting down the U.S. and global economy. One major problem is epidemiologists don’t have the data they need to accurately assess the fatality rate, since most of the testing to date has only been on sick people showing up at a hospital. It is possible that there are millions of people who have contracted COVID-19 but either experienced no symptoms or didn’t require medical attention. Based on the current number of cases and deaths, the fatality rate in the U.S. is almost 4%. (23,463 deaths, total cases 583,444) However, this figure may be inflated significantly since less than 1% of the total population has been tested. As more people are tested in coming weeks and months, the fatality rate is going to come down, as those who have recovered are included. The number of tests performed each day has increased but has only reached about 140,000 per day. Even if this rate is ramped up to 200,000 a day, the U.S. will only test another 2% of its population in the next month.
President Trump has said the decision to reopen the U.S. economy will be the toughest decision in his life. The only comparison that comes to mind is President Truman’s decision to drop the atomic bomb on Japan. Although it would save thousands of U.S. soldier’s lives, it would kill many times the number of U.S. lives saved, and change the trajectory of mankind. There is no vaccine and no known treatment for COVID-19 so the number of infections and deaths will increase whenever the economy is reopened. The moral dilemma is balancing the cost and damage from keeping much of the economy closed, and the fatality rate from COVID-19. If half of the population could be tested (165 million tests), and the fatality rate was determined to be less than 0.7% (7 times the average flu rate of 0.1%), one could make an educated guess as to the number of fatalities that would result from opening up the economy. This estimate could be compared to the number of increased deaths from keeping the economy shutdown. There isn’t however enough time to conduct the number of tests needed to truly assess the fatality rate from COVID-19. Until there is more testing, and way more than what will be done in the next 30 days, President Trump will be forced to make the toughest decision of his life without all the data needed to make a true assessment.

President Trump has been criticized for not acting sooner to shut down the economy in late February rather than in mid March. Some of these critics enjoy being a Monday morning quarterback since it allows them to always be right and some of the criticism is warranted. This criticism though may make President Trump more closely listen to Dr. Fauci and other experts since it will provide him cover when infections go up and people start dying. No matter what President Trump decides you can count on CNN dwelling on the negative side of any decision even if he follows Dr. Fauci’s advice to the letter.

President Trump will decide to open the economy when Dr. Fauci tells him we have enough testing equipment and lab capability to turn around tests within 24 hours, and the capacity to do contact tracing to quickly identify those who were in contact with an infected person. This capability is the only way to quickly damp down any localized increase in infections so they don’t spread. It will be mandatory for everyone to wear a mask when they are in public since numerous studies in the wake of the SARS epidemic in 2003 and 2009 epidemic in 2009 found that wearing a face mask lowered the infection rate up to 50% depending on the percent of the population wearing a mask. Older workers (60+) may be told to wait for a period of time until their area has been open for some length of time. The number of people allowed to get together will also be limited to a small number i.e. 25 or fewer. Contact tracing will be crucial in reopening the country and there is good news on this front.
Apple and Google announced they are working together to produce software that can assist in contacting anyone who was with an infected person within the past two weeks. This technology will make contact tracing far more effective than conducting interviews with the infected person who can only identify those they know. The Apple and Google collaboration may duplicate what Singapore has been doing. On March 20, Singapore rolled out a smart phone app called Trace Together. The app enables Phones within two meters of each other to exchange Bluetooth signals, allowing the app to make a record of the encounter. When a patient doesn’t have the contact details of a person they came into contact with, or simply can’t remember an encounter from the two weeks prior to their infection, the app is expected to provide medical personnel more complete data doing contact tracing.

Irrespective of how careful the economy is allowed to get back to ‘normal’, it will take longer than expected and there will be setbacks as localized outbreaks erupt.

**Stocks**
The actions by the Federal Reserve and Congress has eliminated and certainly postponed the prospect of a depression, which was a widespread fear as the S&P 500 was plunging to its low of 2192 on March 23. This deep seated fear has been replaced by a surprising level of optimism as Wall Street strategists have performed a 180 degree pirouette. In late March the expectation was that after a bounce the S&P 500 would retest the low. On April 13 a number of strategists have declared the bottom in and are raising their targets for the end of 2020, with some expecting a new all time high above 3500. The shift in psychology is extraordinary and worth noting. Three weeks ago nearly everyone was expecting a retest of the low, and now the notion of a retest is considered passé given the actions of the Federal Reserve. As a contrarian, the possibility of a correction, if not a full retest, is higher now since it is not expected. One thing is certain, the market is no longer oversold and is actually over bought as measured by the 21 day average of Advances minus Declines (red horizontal line). At the high of 2818 on April 9 the S&P 500 approached the lows of last August just above 2820 before reversing.
The expectation is that the S&P 500 will experience a pullback once the glow of Federal Reserve intervention is replaced by the hard work of reopening the economy and the challenges that endeavor will present. The pattern and depth of any pullback will provide valuable insight as to whether the bottom is in or whether a retest is still on the table. The key is whether the economy can be opened up in most cities without a serious secondary infection and how prepared the U.S. is going into the fall.

**Treasury Bonds**
The pattern suggests the 10-year Treasury yield will drift higher to 0.90% - 1.05%.

The 30-year Treasury yield is likely to rise to 1.50% - 1.60%.
Gold
In the April Macro Tides I discussed how a narrative can take hold and drive a market, even if the logic underlying the narrative is faulty. “Sometimes a narrative can prove to be such a strong elixir that it can overwhelm what should be obvious. After the Federal Reserve expanded its balance sheet from $900 billion in 2007 to $2.5 trillion in 2011, a narrative developed that the increase in the Fed’s balance sheet would ignite hyper inflation. On the surface this was easy to embrace and investors believed it, which is why Gold rallied from $1,045 in February 2010 to $1920 by September 2011. At that point bullish sentiment exceeded 90% bulls even though inflation wasn’t really picking up as expected for one simple reason. Although the Fed had almost tripled the size of its balance sheet, most of the money was sitting in the banking system in the form of free reserves. Free reserves held at the Federal Reserve totaled $1.62 trillion in July 2011, so almost 65% of the increase in the Fed’s balance sheet was sitting at the Fed doing nothing. The simplest definition of inflation is too much money chasing too few goods which causes the price of goods to rise. The premise behind the hyper inflation narrative was not supported by the real world, but that didn’t keep investors from jumping on the Gold bandwagon.”

The same narrative has recurred as the Federal Reserve has taken steps to combat the economic fallout from COVID-19 and the Fed’s balance sheet has increased from $3.8 trillion to over $6 trillion in a matter of weeks. The Fed is expanding its balance sheet to ward off deflation and to prevent an economic depression. The expansion of the Fed’s balance sheet is not increasing the amount of money in the economy that will be used to drive the prices of goods and service higher. As long as Gold’s upward momentum remains in place the narrative will attract money and momentum traders.

Last week I thought the short term pattern suggested that Gold could push above the March 26 high of $1638.60 before a more protracted decline set in. Gold spiked up to $1666 on April 6. The closing high was $1678.60 on March 9. I thought if Gold did close above $1678.60 its RSI may register another lower high reinforcing the loss of upside momentum. From its closing price on April 8 of $1644.80, Gold rocketed higher after the Fed announced its program to support the municipal bond market and its intention to buy junk bonds. Gold closed at $1711.00 on April 13 and its RSI did not confirm the new
price high. Gold is also approaching the trend line connecting the high in August, February, and March which should provide some resistance.

**Gold Stocks**
Last week I thought GDX might test $30.00 before another decline took hold. GDX broke out above $27.21 on April 9 after the Fed’s announcement and traded up to $31.07 on April 13. It seems a foregone conclusion that GDX will test $31.84 and probably make a modest new high.

**Dollar**
The Federal Reserve extended $500 billion in repo’s to other central banks to lower the volatility in the foreign currency market, and it appears to be working. The volatility in the Dollar has fallen and the Dollar continues to trade under 101.00 which is an important technical level. A drop below the recent low of 98.32 would be another positive sign. Conversely, should the Dollar rebound and close above 101.00, it would be a big negative. Short term the Dollar looks more likely to fall further.
Emerging Market
EEM was expected to rally a bit more if the S&P 500 rallied above 2800. It is interesting the EEM was not able to make a higher high after the Fed’s announcement on April 9. (36.07 vs. 36.09) EEM is expected to trade down to $30.10, which was the intra-day low on March 23. This would complete its Wave 5 decline from the high of 46.32, and set up a great buying opportunity.

Tactical U.S. Sector Rotation Model Portfolio
Relative Strength Ranking
Once the S&P 500 closed beneath 3214 (the intra-day low on January 31 and February 24), an intermediate peak was confirmed, which was the expectation discussed in the February 24 WTR. The unrelenting decline caused the MTI to drop sharply. The MTI fell below the blue horizontal line on March 11, confirming the onset of a bear market.

A cross above the red moving average would generate a bear market rally buy signal. A bear market rally buy signal could occur before April 17. If the past is any guide it may prove to be a whip saw trade as the table below illustrates. It is common for the first crossover buy signal after a large decline to be followed by a retracement that is deep enough to cause the MTI to cross back below the moving average. A crossover below the moving average is considered a sell signal. Since 1962 the smallest whip saw loss was -4.0% and the average was -7.9%. In 1987 there was only a single crossover, but there was also a full retest of the initial low prior to the bear market rally buy signal.

<table>
<thead>
<tr>
<th>Low Date</th>
<th>S&amp;P Low</th>
<th>1st Buy Date</th>
<th>S&amp;P High</th>
<th>1st Sell Date</th>
<th>S&amp;P Sell</th>
<th>Trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/26/62</td>
<td>52.32</td>
<td>07/11/62</td>
<td>57.73</td>
<td>08/22/62</td>
<td>59.78</td>
<td>10/01/62</td>
</tr>
<tr>
<td>5/26/70</td>
<td>69.29</td>
<td>06/18/70</td>
<td>76.52</td>
<td>06/18/70</td>
<td>76.52</td>
<td>06/26/70</td>
</tr>
<tr>
<td>10/3/74</td>
<td>62.28</td>
<td>10/10/74</td>
<td>69.79</td>
<td>11/07/74</td>
<td>75.21</td>
<td>12/05/74</td>
</tr>
<tr>
<td>7/23/02</td>
<td>797.7</td>
<td>08/14/02</td>
<td>919.62</td>
<td>08/22/02</td>
<td>962.7</td>
<td>09/17/02</td>
</tr>
<tr>
<td>11/22/08</td>
<td>752.44</td>
<td>12/08/08</td>
<td>909.7</td>
<td>01/06/09</td>
<td>934.7</td>
<td>02/19/09</td>
</tr>
</tbody>
</table>

The risk of another whip saw is high given how overbought the market has become. It is also difficult to imagine another program the Fed would feel compelled to launch after doing so much already. With the push from policy moves by the Fed and Congress in the rear view mirror, the stock market will need to overcome lousy earnings and the potential the shutdown will persist well into May for most of the country.

Jim Welsh

jwelsh@smartportfolios.com
760-710-1956

Disclosure - The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index. The Nasdaq 100 is composed of the 100 largest, most actively traded U.S. companies listed on the Nasdaq stock exchange. All indices, S&P 500, Russell 2000, and Nasdaq 100, are unmanaged and investors cannot invest directly into an index.