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Only a V-shaped economic recovery will do now

The Nasdaq's 45% surge from its March 23 low is the epitome of a V-shaped rebound (Figure 1). Overly optimistic investors who are banking on a similar economic recovery may be in for a disappointment.

There are a growing number of signs that risk appetite is back in a big way, judging by the ease with which negative news is being dismissed. On June 1, for instance, stocks rose despite a weekend of frenzied rioting in the U.S. and news that Gilead Science's remdesivir – currently the only FDA-approved treatment for severe cases of Covid-19 – showed only a limited benefit in a large trial involving patients with moderate forms of the disease.

This week also witnessed the reopening of the U.S. initial public offering (IPO) market, with two IPOs off to a solid start. Warner Music gained 20% in its first day of trading, after the company sold shares in the biggest U.S. IPO this year, while technology company ZoomInfo (no relation to Zoom Video Communications) had a first day pop of 62%.

Investors are also snapping up securities that had endured the biggest plunges in the "Covid Correction," as they pin their hopes on a rapid return to normalcy. A Bloomberg report highlighted recent gains in the iShares MSCI Brazil ETF and the US Global Jets ETF as proof of this phenomenon. Note that Brazil currently has the dubious distinction of being the most recent epicenter of the global pandemic, while air travel around the world has been decimated by the coronavirus.

An interesting Bloomberg article points out that assets in the US Global Jets ETF are up almost 30-fold from $33 million in early March to more than $1 billion presently. The ETF's top holdings are the four major U.S. airlines, with a collective weight of 45%. The ETF's CEO attributes the tremendous growth in the fund's assets to novice day traders lured by the prospect of a strong rebound in airlines[1], as was the case after the 9/11 terrorist attacks and the 2008 financial crisis.

The Jets ETF had plunged 64% from mid-February to mid-March and is still down 40% for the year despite a 70% surge off its lows. Likewise, the Brazil ETF had slumped close to 60% for the year at its March 19 low, and even after a 50% bounce, is still down 36% for the year. These levels might yet prove to be decent entry points if the global economy rebounds as anticipated.

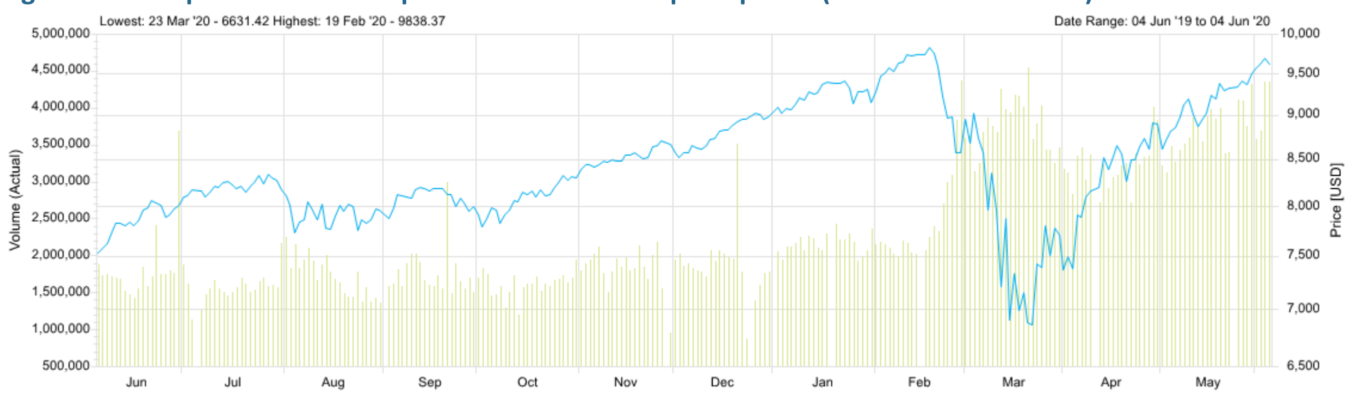
Estimated earnings for the TSX Composite and S&P 500 offer more evidence that investors are wagering on a V-shaped economic recovery. Based on estimates collated by FactSet, earnings for the TSX are forecast to plunge 40% this year to $632, before soaring 60% in 2021 to $1,010. For the S&P 500, earnings are forecast to tumble 22% to about $126, before rebounding 29% to just over $162 in 2021.

The TSX and S&P 500 are both trading at a multiple of 24.6x this year's earnings, which is the richest valuation in decades. Investors are willing to look past these rich valuations primarily because of the expected rebound in next year's corporate earnings, which would bring valuations down to relatively reasonable levels. But with such unbridled optimism having already driven the TSX and S&P 500 up 40% from their lows, there is a significant risk of much of these gains dissipating if this optimism proves to be unfounded in the upcoming months.

Patient investors who are in for the long haul may do well even in the absence of a V-shaped recovery. But for traders with a more finite time horizon, only a V-shaped economic recovery will do.

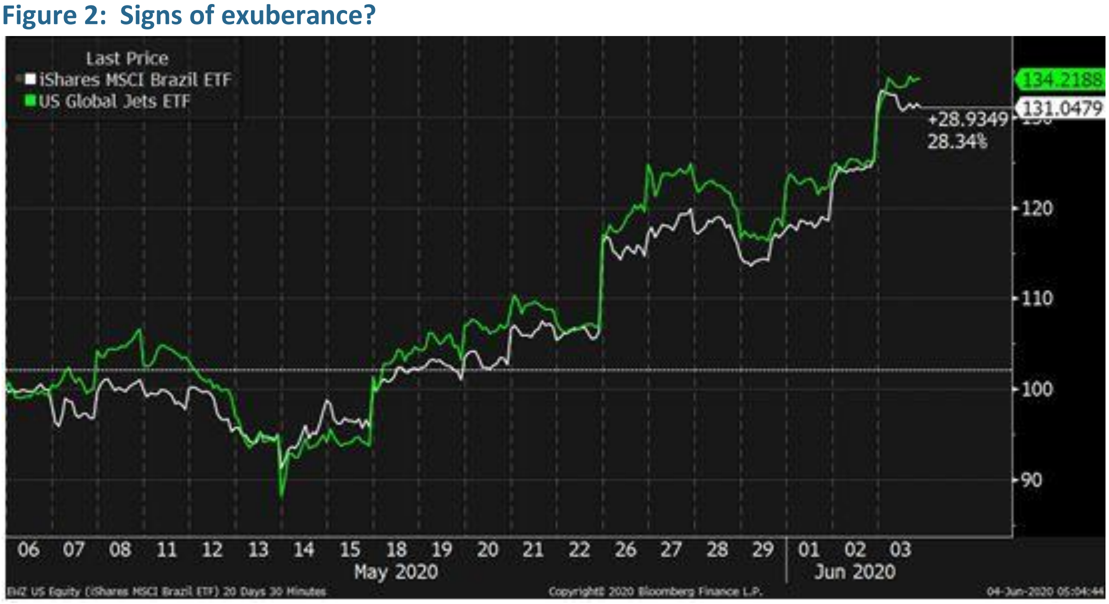
[1] https://www.bloomberg.com/news/articles/2020-06-03/-bored-millennials-boost-airline-etf-to-1-billion-in-assets

Figure 1: The epitome of a V-shaped rebound – Nasdaq Composite (June 2018 to Present)



Source: FactSet

Figure 2: Signs of exuberance?



Source: Bloomberg