There are No Shortcuts!

May 18, 2020

by Jeff Miller

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The economic calendar is light with a focus on housing reports. These are becoming interesting again since we are getting a look at data that reflects the crisis effects.

The reopening of the economy will continue as the leading story. What will be the safeguards in reopening businesses and the precautions taken by those venturing out? Many will worry about a rebound in COVID19 cases. Others want to see improvement, and they want it right now!

Dr. Anthony Fauci: “…(Y)ou’ve got to understand that you don’t make the timeline, the virus makes the timeline.”

The virus timeline ripples through the pace of reopening, the economic impact, the need for government action, corporate earnings. And finally, of course, financial markets.

There are no shortcuts.

Last Week Recap

In my last installment of WTWA, I analyzed the rebound in stocks and summarized the various roadblocks faced by the long-term investor. There were many stories on this theme, but no one else is really pulling them all together.

The Story in One Chart

I always start my personal review of the week by looking at a great chart. This week I am featuring Jill Mislinski’s version, an excellent combination of the most important information.

The market lost 2.3% on the week. The trading range was 6.5%, up from the last several weeks. You can monitor these along with historical comparisons in my weekly Indicator Snapshot (below).

Here is Jill’s chart showing drawdowns. For those expecting a return to the March low, it suggests an interesting wager. With the market actually closer to the record high, which is more likely?
Personal Note

Rather than taking off completely this weekend, I am providing a “short form” version of WTWA. I am hitting the most important highlights and reporting progress on my continuing research efforts, available to readers at no charge.

The News

Each week I break down events into good and bad. For our purposes, “good” has two components. The news must be market friendly and better than expectations. I avoid using my personal preferences in evaluating news – and you should, too!

New Deal Democrat’s high frequency indicators have always been a valuable part of my economic review. The overall picture remains terrible in the nowcast and short indicators and mildly positive on long indicators. The one spot of encouragement is in housing. NDD writes:

What’s noteworthy this week is the all time low in mortgage rates, and the big improvement (from an awful bottom) in purchase mortgage applications, back to the low end of their 2019 range. Also, there were no new “most awful” readings this week among any of the indicators, suggesting that, while there are some second order spreading losses – particularly in employment-related measures – many of the other indicators appear to be stabilizing or slightly rebounding, albeit from dreadful levels.

The Good

Until we have more relevant data, I will just hit the highlights and provide some interpretation. Some of the “good” news fits the less bad description, especially if beating expectations. I do not intend this to sugar coat the terrible economic situation. It is simply a technique for taking note of changes.

- The House has agreed to remote voting permitting it to act without members returning to Washington. This is important for the passage of any crucial legislation.
- Michigan consumer sentiment for May was 73.7, an upturn from April’s 73.2 and the expected 64.0.
- Mortgage applications increased by 0.1%, better than last week’s decline of 3.3%. 

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The Bad

- **Small business optimism** at 90.9 was a decline from March’s 96.4, but better than many expected.

- **Inflation data**, negative on both the CPI and PPI, sparked worries about deflation. This is difficult to correct once it comes.

- **Industrial production** declined 11.5% in April slightly better than the forecast of -12.1% but much worse than March’s -4.5%.

- **Retail sales** plunged by 16.4% in April. This was much worse than the expected decline of 11.9% and March’s -8.3%.

The Ugly

As I feared, the Coronavirus finger-pointing and lack of cooperation is going to make a recovery much more difficult.
The Week Ahead

We would all like to know the direction of the market in advance. Good luck with that! Second best is planning what to look for and how to react.

The Calendar

The economic calendar is light with a focus on housing data. The reports now include April, so the data are more meaningful. I am particularly interested in housing starts and building permits. The weekly data on initial and continuing jobless claims continue to command attention.

The pandemic story and the economic reopening will continue to lead the news.

Briefing.com has a good U.S. economic calendar for the week. Here are the main U.S. releases.

<table>
<thead>
<tr>
<th>Week of May 18 - May 22</th>
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<tbody>
<tr>
<td>Date</td>
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<td>May 21 10:30</td>
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Next Week’s Theme

The economic data is gradually becoming interesting again. This week’s housing reports will be useful, especially for those of us invested in the homebuilders. None of the reports will mean much until we have a timeline for the pandemic, reopening the economy, and the reactions of consumers and businesses.

Only then can we appreciate changes in economic indicators and adjust our corporate earnings estimates. And only then will we know what to expect from financial markets. Many are skipping over the needed steps, but it is a mistake.

Figure 1: Probability of recovery beginning within 3 months

There are no shortcuts.

Dr. Anthony Fauci: “…(Y)ou’ve got to understand that you don’t make the timeline, the virus makes the timeline.”
Background

In the April 4th Edition of WTWA, I wrote about *Navigating the Maze of Models*. I argued that there were models for each stage of a complex process. Each depended on the result from a different stage.

- The Pandemic effect required five different types of information. The model design and the assumptions also had a great effect.
- Government action, for better or worse, was an important influence on the pandemic effects.

On my resource pages I am fleshing out each of these models. I begin each with my own current conclusion, which is archived and updated as facts change. I cite the best articles I have found so that readers can consider the evidence. Here is a section of my current Pandemic/Government page. It is becoming obvious to others that studying the intersection of the different stages is important. It is all a work in progress, so stay tuned.

**Pandemic Government actions**

My current conclusion:
Testing Issues

Some tests yield many “false positives” giving an inaccurate feeling of security.

The speedy Abbott test, which is supposed to determine in five to 13 minutes whether a person has the virus, missed a third of the positive samples found by the diagnostic company Cepheid when both tests used nasopharyngeal swabs, according to the study done by a group from New York University. It missed more than 48 percent of cases when dry nasal swabs were run on Abbott machines, compared to nasopharyngeal swabs run on the Cepheid testing platform. Nasopharyngeal swabs penetrate deeply into the nasal passages, while dry nasal swabs are less invasive.

The False Positive leads to common decision-making error, the base rate fallacy.

But the predictive value of an antibody test with 90 percent accuracy could be as low as 32 percent if the base rate of infection in the population is 5 percent. Put another way, there is an almost 70 percent probability in that case that the test will falsely indicate a person has antibodies.

The reason for this is a simple matter of statistics. The lower prevalence there is of a trait in a studied population — here, coronavirus infection — the more likely that a test will return a false positive. While a more accurate test will help, it can’t change the statistical reality when the base rate of infection is very low.

Pace of reopening

To investigate the consequences of different approaches, we return to a survey of infectious disease experts organized by Thomas McAndrew and Nicholas Reich, both biostatisticians from the University of Massachusetts Amherst. For many questions, respondents are asked to provide their best estimate, as well as a best-case and worst-case possibility. Structuring the survey in this way lets the organizers generate probabilistic consensus forecasts, a tool that can answer questions about how likely various scenarios are.

Even as it extended its stay-at-home orders through the end of the month, Washington state has begun four-phase
reopening plan that Gov. Jay Inslee’s administration is calling “Safe Start.” The state plans to remain in each phase for a minimum of three weeks. The first phase of Safe Start allows for some recreation and construction activity, along with auto sales and commercial pet walking. At the time of the survey, five counties with fewer than 75,000 residents and no new reported cases in the past three weeks were allowed to begin Phase 2, which allows the resumption of activity in restaurants, house cleaning services and hair and nail salons, among other businesses.


I hope to update the remaining pages on economic impacts and valuation. Stock themes and ideas are covered in the Great Reset project. I will summarize the most recent conclusions for each section in the regular WTWA posts.

Quant Corner and Risk Analysis

I have a rule for my investment clients. *Think first about your risk. Only then should you consider possible rewards* I monitor many quantitative reports and highlight the best methods in this weekly update, featuring the Indicator Snapshot.

<table>
<thead>
<tr>
<th>Risk Indicator</th>
<th>This Week</th>
<th>Last Week</th>
<th>Last Month</th>
<th>Last Quarter</th>
<th>Interpretation</th>
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<td><strong>Valuation</strong></td>
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<td>Ten-year note yield</td>
<td>0.64%</td>
<td>0.65%</td>
<td>0.64%</td>
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<td>S&amp;P 500</td>
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<td>S&amp;P Forward Earnings</td>
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<td>189.5</td>
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<td>S&amp;P Earnings yield</td>
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<td>4.70%</td>
<td>5.07%</td>
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<tr>
<td>Equity Risk Premium</td>
<td>4.14%</td>
<td>4.05%</td>
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<td>3.62%</td>
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<td><strong>Economy</strong></td>
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<td>C-Score</td>
<td>3210</td>
<td>2861</td>
<td>767</td>
<td>286</td>
<td>Uncharted territory</td>
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<tr>
<td>BC1p</td>
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<td>NA</td>
<td>-281.1</td>
<td>100.0</td>
<td>Reporting paused because of extreme readings</td>
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<tr>
<td>SLSI</td>
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<td>0.9</td>
<td>1.0</td>
<td>-1.517</td>
<td>High Risk</td>
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<td><strong>Anticipated inflation</strong></td>
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<td>1.01%</td>
<td>1.66%</td>
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<td><strong>VIX</strong></td>
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<td>38.15%</td>
<td>13.68%</td>
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<td><strong>Historical S&amp;P Volatility</strong></td>
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<tr>
<td>Last Five Days</td>
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<td>3</td>
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<td>9</td>
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<td><strong>Overall Outlook</strong></td>
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<td>Bearish</td>
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For a description of these sources, check [here](https://fivethirtyeight.com/features/infectious-disease-experts-think-washington-states-slow-reopening-will-mean-fewer-cases/).

The C-Score spiked again. It is a dramatic change in underlying factors which normally provide important indications. This level is an extreme outlier that cannot readily be interpreted. Georg Vrba has paused the BC1p signal because of the extreme readings. It has done its job for now.

I continue with a rating of “Bearish” in the overall outlook for long-term investors. My concerns relate to the trading range, overall market valuation, and my expectation for a more challenging battle with COVID19. I did some selling again last week. I expect to replace positions with stocks that will do extremely well in an economic rebound.

**The Featured Sources:**

Bob Dieli: Business cycle analysis via the “C Score”.

Brian Gilmartin: All things earnings, for the overall market as well as many individual companies.

Georg Vrba: Business cycle indicator and market timing tools. Georg’s business cycle index continues its steep decline.
David Moenning: Developer and “keeper” of the Indicator Wall. His most recent update summarizes the key elements.

Doug Short and Jill Mislinski: Regular updating of an array of indicators, including the very helpful Big Four.

Insight for Investors

If I had to suggest a single best source for investors this week, it would be a video! It will show you how a model can be useful in guiding policy. If you try the interactive features you can see how a good model permits you to vary assumptions, observing the sensitivity of the result to each.

Watch this tutorial video and then play with this masksim simulator yourself — we’re making an interactive version of this agent-based model available here for you to try experimenting with our new individual agent-based model, and see what different masking policies do. You’ll see how much small accidents can affect the spread of infections as we’ve made each run completely randomized. Try many runs if you want to see the statistical tendencies under different masking policies.

Final Thought

Please consider what we have learned about aerosol transmission. The current conclusions are dramatically different from what was supposed only a few weeks ago. Scientific American surveys the findings in How Coronavirus Spreads through the Air: What We Know So Far.

Jeremy Howard is a data scientist who began the study of mask use without a preconception. His analysis combines data analysis and the results of a laser light-scattering experiment. For those who trust their own eyes more than data, check out the cited video.

Mrs. OldProf is sitting in my office with me, enjoying my background music. After looking over my shoulder at today’s subject, she reminded me about the time I followed a car with the right license plate on a route that I thought was a shortcut. It wouldn’t happen in these days of the GPS, but on that occasion, I wound up in a farmer’s driveway.

Be wary of investing shortcuts.

And do not get stuck at a farm at the end of a road.

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