Broadleaf Partners, LLC

What's Next? April 15, 2020

The markets have enjoyed a record setting bear market rally of nearly 30% from the intraday lows reached on March 23rd, nearly a month ago. Bear market rallies, defined as short term, powerful upside moves within a bear market environment are commonplace, but this one has been so strong that in the absence of general news, one might wonder if anything unusual was occurring in the world.

With earnings season kicking in big time in the coming week and lasting the next four, we wanted to share our thoughts about what might be next before we go into radio silent mode, digesting the quarterly reports and insights from corporate executives.

A week ago, we gave the following answer to a client's question about the negative economic data being reported by the media and what might soon be coming down the pike from the same department. He appreciated our answer so much that he encouraged us to share it on social media, which we did, and now a week later, we share it with you solely for educational purposes.

> *"All true. However, most of these statistics are what those of us in the business call lagging indicators. In other words, they don't lead the performance of the market but lag it. Even recessions are lagging indicators in the sense that by the time the Economic Board calls it one, the market has long moved past it. There are also coincident indicators and then leading indicators. A coincident indicator tends to move with stocks – like sentiment and confidence. It isn't predictive, but coincident. A leading indicator is one which moves in advance of changes in the market. Stimulus measures are often leading indicators of varying effect – 6 months to two years.*
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> *In my opinion, this is a very different demand driven crisis. As such, I suspect COVID cases will play a major first role in market performance. When it plateaus and begins to improve, the markets will likely move up violently, perhaps as they are doing now. At the same time, however, I don't think we will immediately get to all- time highs in a V shaped recovery, partly because of the caution many will continue to exercise, but also because of the stimulus itself and the bureaucratic times/questions that come of getting it to the right people at the right time.*
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> *Hope that helps, but that is how I take things like lagging and sometimes coincident indicators. It makes for great media and news, but is often of little value for the stock market. Stocks tend to look forward."*

The market's response has continued to be quite positive in the past week, anticipating perhaps that new COVID cases are beginning to flatten and that at this stage of the game, watching the economic data from China, which both entered and exited the pandemic earlier than the rest of the world, might offer a good reference point for what may happen next on the economic front.

I won't get into the details, but Nike, Apple, Starbucks and Lululemon all highlighted slow and steady progress in their reopening efforts in China. In general, we believe these observations are fluid and still bear watching.

JP Morgan and Wells Fargo both reported results this morning and both banks took huge new loan loss reserves against potential defaults associated with COVID 19. The financial sector and both of these bank stocks were down today, but it would appear that the market did, in fact, do a decent, albeit imperfect job of anticipating the negative news ahead of the ultimate reports.

In accounting for one-time events like natural disasters, companies often report results on a pro-forma basis, which quantifies such impacts and then removes them from the financial statements to offer more reasonable comparability with other periods, "all things being equal". Unless you have to buy or sell at the moment of such crisis, Wall Street analysts and the markets tend to look through these periods of time as one-offs as long as bankruptcy is not a probability. Such a framework may not be a similar outcome for today's pandemic, but it is worth considering the possibility that it could be.

While we are under no illusions that the costs of battling COVID are absolutely immense and historically unprecedented, we suspect that in rallying hard off the lows, Wall Street is trying to discern what the pro-forma numbers might look like, assuming they are "one-time and unusual in nature."

Clearly, it remains an unknown whether or not this COVID pandemic is one time in nature, how long the quarantine period might last, or how long a recovery to a reasonable level of normalcy in the economy might take. But we suspect that in rallying, the market is trying to find an equilibrium point or price at which buyers and sellers can transact in reasonable good faith, given the unknowns. Our approach is not only to assume that "this too shall pass", but to also be thinking a great deal about how different a new normal might look.

Despite opinions and reports to the contrary, the government has done a reasonably good job of launching an historic economic stimulus program and Fed monetary policy accommodation. While there will no doubt be a great deal of kinks to work out in these programs and already are, the measures likely have kept things from getting far worse for the economy and the markets than they otherwise might have. At the same time, as the dust begins to settle, the cost of these programs will start to become clearer and a cost benefit analysis will become more productive and useful.

A great number of common stock shares have transferred between owners of the economy in the past month of this epic crisis. Hopefully, these shares are now in the hands of those who can afford to take a longer term view.

While we suspect that we did see the lows of the crisis on an intraday trading basis back on March 23rd, we are under no illusions that those lows are dependent on the COVID crisis fading from here. The real work will lie ahead in rebuilding what has been broken and in more fully understanding and appreciating how the "things" of our future might look different from the past.

There is no doubt that we will still eat, we will still travel, and that we will still communicate, among the many other facets of this thing we call life. But how we do those things will change, as it always does, in a more permanent manner. We will see the evidence of such permanence in the months ahead and they may be every bit as model breaking as the move from the horse and buggy to the automobile. Therein lies the opportunity for investors, to discern the path forward and to not only help in the rebuilding process, but to potentially gain from having done so.

As always, we look forward, with optimism, in being a part of the healing process that lies ahead.

Kindest Regards,

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