INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

Which Way Is Up?

In their long-awaited, though not necessarily eagerly anticipated, report on Q2 GDP, the Bureau of Economic Analysis (BEA) estimates that real GDP contracted at an annualized rate of 32.9 percent in Q2. While the contraction in real GDP in Q2 was record breaking, as it is the largest quarterly contraction on record, the report on Q2 GDP broke no new ground, as it was clear by the end of March that there would be an epic contraction in Q2. Indeed, perhaps the most surprising thing about the Q2 GDP data is that there were no real surprises in the Q2 GDP data – by the middle of April, forecasts of the contraction in real GDP in Q2 had gravitated toward an annualized contraction of better than 30 percent. But, given the extent to which the pandemic has wreaked havoc on the monthly economic data, which more often than not have been far out of line with expectations, it is interesting that Q2 GDP came in so close to expectations.

With the magnitude of the contraction in real GDP in Q2 now having been settled, the more relevant question at this point is where the economy goes from here. Given that by the end of April the contraction in economic activity had run its course, it might seem that, in early-August, there would be a fairly straightforward answer to that question, which is decidedly not the case. Even in the calmest of times, the economic data can be quite jumpy, prone to noise and exhibiting volatility from one month to the next. Those traits have been even more pronounced of late, thus complicating the task of interpreting what the data are trying to tell us.

Take for instance the monthly surveys of the manufacturing and services sectors conducted by the Institute for Supply Management (ISM). The ISM Manufacturing Index rose to 54.2 percent in July, while the ISM Non-Manufacturing Index rose to 58.1 percent, both stronger than expected (any reading above 50.0 percent indicates expansion). The gauges of new orders, often a leading indicator of employment and production, were notably strong, with the index of manufacturing orders hitting its highest level since November 2018 and the index of non-manufacturing orders rising to an all-time high. Those numbers, however, are in stark contrast to the measures of employment; the index of employment stood at 44.3 percent in the manufacturing survey and at 42.1 percent in the non-manufacturing survey, indicating declining employment.

The key to interpreting these mixed messages is to recall that the ISM survey results are presented in the form of diffusion indexes, which tell us the direction of change while telling us nothing about the intensity of that change, while at turning points in the economy, diffusion indexes are prone to sharp swings. Think about it this way – if each industry group in the ISM’s surveys reports higher new orders in one month relative to the prior month, the diffusion index does no distinction between a one percent increase and, say, a 50 percent increase. One way to interpret the ISM’s July surveys is that production and new orders were rising off of very low levels, but firms were not yet feeling confident enough to ramp up employment to any meaningful degree.

While comments from survey respondents relayed by ISM support that interpretation, the July employment report seems to tell a different story. Total nonfarm employment rose by 1.763 million jobs in July, with private sector payrolls up by 1.462 million jobs and public sector payrolls up by 0.301 million jobs, while the unemployment rate fell to 10.2 percent. Those July job growth numbers, however, are flattered by seasonal adjustment, and thus overstate the strength of job growth. For instance, though manufacturing payrolls are reported to have risen by 26,000 jobs in July, that increase is more than accounted for by seasonal adjustment noise tied to employment amongst motor vehicle manufacturers, without which factory sector payrolls would have posted a decline – in keeping with the ISM survey. The seasonal adjustment issue is even more pronounced in the data on public sector payrolls, with almost the entire increase reflecting nothing more than seasonal adjustment noise.

Another oddity in the July employment data is that restaurants and bars are reported to have hired 502,000 workers last month, accounting for one-third of all private sector job gains. This is odd in the context of the upturn in COVID-19 cases that led many states to impose new restrictions on bars and restaurants. Our hunch is that a nontrivial portion of the strong hiring reported for bars and restaurants – 3,440 million jobs over the past three months – reflects the effects of the Paycheck Protection Program (PPP), meaning that once the PPP funds have been exhausted, a good many of these jobs may be cut. It will be several months, however, before we’re able to assess this.

If you’re feeling confused at this point, that’s quite understandable. After all, we do this for a living – analyze data, not confuse people – and more and more often these days we find ourselves asking which way is up. Allowing for all of the noise and all of the seemingly mixed messages in the data, our sense is that the economy is recovering from the brief but violent recession brought on by the COVID-19 virus and the efforts to stem its spread. That recovery, however, is both uneven and uncertain. While the housing market is outperforming the broader economy, many of the services industries continue to struggle to regain traction, and it is far too soon to know how many business closings and job losses that started out as temporary will become permanent. Moreover, with the aid to households provided under the CARES Act having run its course and Congress seemingly deeply divided on what an additional aid bill should look like, consumer confidence has backtracked and significant numbers of households face an increasing degree of financial stress in the months ahead. About the only thing that seems clear at this point is that, with the COVID-19 virus still in the driver’s seat, the path ahead for the U.S. economy is anything but clear.

STOCKS

Emerging Strength Abroad

After taking a breather in June, global equity markets were in full-on rally mode in July. Reflective of the risk-on rally was a 7% monthly return in the MSCI Emerging Market Index, which captured the strength of markets in Taiwan, China, and India. Domestic large-cap stocks generated a 5% return during the month, which pushed the S&P 500’s year-to-date price return positive. Persistent strength out of prior market leadership sectors, specifically consumer discretionary, information technology, and communication services, pushed the index higher. Mid-month capital inflows into developed foreign markets reflected investor optimism surrounding the economic recovery in the Eurozone, but these expectations were tempered as GDP data out of Germany near month-end pointed toward a less rosy outlook. For the month, the MSCI EAFE Index, which tracks 21 developed market countries around the globe excluding the U.S. and Canada, generated a 1.5% return as a 4.2% rally in Germany (9.2% of EAFE) was offset by weakness in the U.K. and Japan (39.5% of EAFE combined).

Continuing its recent three-month trend, the U.S. Dollar (USD) Index, or DXY declined 4.7% in July. The dollar’s collapse has provided a powerful tailwind for not only precious metals such as gold and silver but also for equity sub-asset classes such as emerging markets, which have historically benefited from a weaker greenback. As the USD weakens, raw materials such as copper and crude oil, which are priced in dollars and are the lifeblood of economic growth for many developing nations which are net importers, become more affordable. Another benefit is lower debt service costs for corporations and governments that tapped credit markets by issuing bonds denominated in USD over the past decade.

Source: BEA; BLS; ISM
There was $22.1 trillion of emerging market debt outstanding at year-end, of which, $2.4 trillion of corporates and $1.2 trillion of sovereigns had been issued in U.S. dollars. As developing countries experience COVID-19 flare-ups and tensions between the U.S. and China simmer, a persistently weaker U.S. dollar would be a welcome increment by which it may spur improved sentiment surrounding emerging market assets.

Currently, we remain comfortable with a neutral allocation to emerging market stocks versus our strategic long-term target. Because domestic large-cap equities are a less volatile and higher quality way to position portfolios, we will continue to hold our neutral EM position with an overweight allocation to domestic large-cap stocks via the S&P 500. This is because as the greenback weakens, U.S. goods and services become more affordable for foreign buyers, which is a tailwind for emerging assets. In 2019 almost 40% of S&P 500 revenue came from outside the U.S.

Toward the end of July and into August, deal-making experienced a renaissance reflected in three transactions – two of which have been announced, while one remains a subject of speculation. In the first week of August, two notable deals in the health care space came to fruition as a division of German conglomerate Siemens purchased Varian Medical Systems for $16.4B and Teladoc Health and Livongo Health joined forces in an $18.5B merger that will create a formidable player in the flourishing and evolving telemedicine space. Lastly, while activity is lackluster in the technology sector, media giant WarnerMedia announced a deal with Discovery to combine their media assets.

Employees of Regions Asset Management may have positions in securities or their derivatives that may be mentioned in this report or in their personal accounts. Additionally, the trademarks of their owners and are used only to identify such companies or their services or products and not to indicate endorsement or sponsorship of Regions or its services or products.

While a KSU buyout hasn’t been announced as of this writing, it’s encouraging that those with deep pockets are again circling, looking to deploy capital despite the uncertain economic backdrop.

Merger and acquisition (M&A) activity has understandably dropped sharply year over year, but investors should appreciate the confidence that it takes, especially with the current lack of economic visibility, to engage in transactions such as those outlined above given the messaging implied by such moves. Transactions such as these can result in improved investor sentiment and positively affect market appetite, two variables which have contributed to the performance of the S&P 500. It remains rally back to within 2% of its all-time high.

To engage in these types of deals, management teams must focus on the long-term and tune out ‘noise’ while keeping their eyes and ears open to opportunities. These traits are also what is required for, among other things, a tailwind for emerging assets. Over the past four-plus months have been an outstanding reminder that the only constant is change, making resiliency and adaptability crucial.

From an asset allocation perspective, our thinking is little changed. We maintain a preference for ‘quality,’ i.e. the S&P 500, and are using international-developed markets as a source of funds. Emerging markets and domestic small/mid-cap stocks hold some appeal and should remain a component of any broadly diversified equity portfolio as these areas will benefit in an outsized way from a durable global economic recovery. But given the heightened volatility and uncertainty, we maintain a neutral allocation for fixed income portfolios, but appropriate sizing remains paramount.

Demand for riskier bonds has been insatiable over the past four-plus months, leading to heightened issuance of corporate credit at ever-lower yields. At the same time, economic growth and inflation expectations remain anchored, leading to a series of record low closing yields on both the 2- and 10-year U.S. Treasury bonds. We continue to focus on the importance of diversification within fixed income portfolios as even relative value is difficult to find. Treasuries should remain a core holding, supplemented with investment-grade corporate bonds which can help offset the negative price impact of rising Treasury yields should economic growth and inflation expectations rise with the development of a COVID-19 therapeutic or vaccine. As the YTW approaches 5%, high yield corporate bonds hold less appeal, but relative to what can be found in other pockets of the fixed income market that yield remains difficult to forego. This leaves us comfortable with our neutral high yield allocation at present.

INVESTMENT STRATEGY OUTLOOK

J

uly was an outstanding month for investors in riskier segments of the fixed income market as both yields and credit spreads for investment-grade (IG) and high yield corporate bonds trended lower throughout the month. In July, the Bloomberg Barclays U.S. Corporate index generated a 3.25% total return and is now higher by 8.44% year-to-date. For the month, the Bloomberg Barclays High Yield index rose 4.69%, moving it into positive territory on a total return basis for the calendar year. Reflective of robust returns in corporates, the yield-to-worst (YTW) on the Bloomberg Barclays U.S. Corporate index fell from 2.15% on June 30 down to 1.86% on July 31, while the YTW on the Bloomberg Barclays High Yield index dropped an incredible 150 basis points, or 1.50%, down to 5.37% at month-end.

Compensation for taking on credit risk has moved sharply lower month after month since unprecedented Fed and Treasury lending and credit facilities were announced in late March. These backstops, many of which have been expanded and/or extended into late 2020, have emboldened traders and investors to buy at already elevated prices/low yields in the belief that the U.S. government at an even higher price/lower yield should a ‘hotter’ trade present itself. Corporate bonds are ‘rich’ relative to historical norms, but so long as Fed and Treasury facilities remain in place, sell-offs should be contained and ‘rich’ may yet become ‘richer.’

Piggybacking on this emerging market equity discussion, emerging market debt has also experienced sizable inflows over recent months. The J.P. Morgan Emerging Market Bond Index, or EMBI, which tracks an index of U.S. dollar denominated emerging market corporates and sovereigns, rallied 13.2% from the end of March through July and was up another 3.1% in the first week of August. Over the prior 20 years, the credit quality of issuers in the emerging world has improved significantly, evidenced by the percentage of sovereigns held within the EMBI rated investment-grade rising to 54% at year-end 2019 from 26% in 1999. Our sole dedicated

exposure to international fixed income over recent years has been a play on U.S. dollar denominated emerging market debt, and while it’s been a rollercoaster ride at times, EM debt remains an appealing asset class on both an absolute basis and relative to other spread sectors within the fixed income market. From a credit quality perspective, EMBI falls between the investment-grade Bloomberg Barclays U.S. Corporates Index and the Bloomberg Barclays High Yield Index, and carried a yield-to-worst (YTW) of 4.23% at month-end, more than double the U.S. Corporates YTW of 1.86% and much closer to the High Yield Index YTW of 5.37%. In our view, emerging market debt remains an appealing asset class for fixed income portfolios, but appropriate sizing remains paramount.

© Regions Bank, Member FDIC. This publication has been prepared by the staff of Regions Asset Management for distribution to, among others, Regions Wealth Management clients, Regions Asset Management is a business group within Regions Bank that provides investment management services to customers of Regions Bank. The information and material contained herein is provided solely for general information purposes. This material is not intended to be investment advice nor is this information intended as an offer or solicitation for the purchase or sale of any security or other financial instrument. Any opinions expressed herein are given in good faith, are subject to change without notice, and are only current as of the stated date of their issue. Certain sections of this publication may contain forward-looking statements that are based on the reasonable expectations, estimates, projections and assumptions of the authors, but forward-looking statements are not guarantees of future performance and involve risks and uncertainties, which are difficult to predict. Investment ideas and strategies presented may not be suitable for all investors. No responsibility or liability is assumed by Regions Bank, its parent company, its subsidiaries or its affiliates for any loss that may directly or indirectly result from use of information, commentary or opinions in this publication by you or any other person. The content and any portion of this newsletter is for personal use only and may not be reprinted, sold or redistributed without the written consent of Regions Bank. Regions, the Regions logo and other Regions marks are trademarks of Regions Bank. The names and marks of other companies or their services or products may be the trademarks or service marks of third parties and are used only to identify such parties or their products. Employees of Regions Asset Management may have positions in securities or their derivatives that may be mentioned in this report or in their personal accounts. Additionally, affiliated companies of Regions may hold positions in the securities mentioned specifically are sample companies, noted for illustrative purposes only. The mention of the companies should not be construed as a recommendation to buy, hold or sell positions in your investment portfolio. Neither Regions nor Regions Asset Management (collectively, “Regions”) are registered municipal advisors nor provide advice to municipal entities or obligated persons with respect to the offering or sale of any municipal securities or the issuance of municipal securities (including regarding the structuring, timing, terms and similar matters concerning municipal financial products or municipal securities issuances) or engage in the solicitation of municipal entities or obligated persons for such services. With respect to this presentation and any other information, materials or communications provided by Regions, (a) Regions is not recommending an action to any municipal entity or obligated person, and Regions or any of its affiliates or subsidiaries is not acting as an advisor to any municipal entity or obligated person and does not have a fiduciary duty pursuant to Section 18B of the Securities Exchange Act of 1934 to any municipal entity or obligated person with respect to such presentation, information, materials or communications, (c) Regions is acting for its own interests, and (d) you should consult your own legal, accounting, tax or other advisors before acting on any presentation or any such other information, materials or communications. As of the date of publication, Regions Bank, Regions Asset Management, Regions and their respective affiliates are not involved in the ownership, management or operation of the companies described herein except as described above.