May 2020

**THE ECONOMY**

**Temporary, But For How Long?**

According to the initial estimate from the Bureau of Economic Analysis (BEA), real GDP contracted at an annualized rate of 4.8 percent in Q1 2020. In more normal times, this would likely merit much more attention than it has gotten, as there are only seven quarters on record with larger contractions in real GDP. In these decidedly not so normal times, however, the contraction in real GDP in Q1 has more or less been relegated to the “oh, by the way” category, given the far more severe contraction on tap for Q2.

There are, however, a few elements of the Q1 GDP data that merit mention. For instance, real private domestic demand, or, combined household and business spending, contracted at an annualized rate of 6.6 percent in Q1, easily outdistancing the contraction in top-line real GDP. Real consumer spending contracted at a 7.6 percent rate, the largest contraction since Q2 1980, with real spending on services contracting at a 10.2 percent rate, the largest contraction on record. Real business spending on equipment, machinery, and structures fell sharply in Q1, which reflects the pullback in economic activity and a sharp decline in business confidence, but also reflects the early phases of what will be a much larger decline in capital spending in the energy sector triggered by the plunge in crude oil prices.

The one segment of private domestic demand that held up in Q1 was fixed residential investment, fueled by unseasonably strong single family construction. The difference between the contraction in real private domestic demand and top-line real GDP in Q1 is mainly accounted for by rising federal government spending. What makes the decline in private sector spending in Q1 so noteworthy isn’t so much the magnitude of the decline but the speed with which it took place. Keep in mind that, prior to the sudden stop in a wide swath of economic activity in mid-March, growth in Q1 was accelerating in Q1. Such was the speed and the depth of the decline in private sector spending over the back half of March that it dragged Q1 real GDP down with it.

If one-half of one month of diminished private sector spending can have that much of an impact on a full quarter of GDP, imagine what an entire month of an even more widespread pullback can do, hence the even larger contraction in real GDP we and most others expect for Q2. Rather than looking at it from a demand-side perspective, however, we can look at it from a supply-side perspective. The Bureau of Labor Statistics (BLS) reported that total nonfarm employment fell by 20.5 million jobs in April, with private sector payrolls down by 19.5 million jobs and public sector payrolls down by 980,000 jobs.

The unemployment rate rose to 14.7 percent in April, but BLS notes that had all of those who lost a job in April correctly reported their status – many reported being absent from work rather than being unemployed – the unemployment rate would have been roughly five percentage points higher. The broader U6 measure, which also accounts for underemployment and those marginally attached to the labor force, rose to 22.8 percent in April.

We know from the data on initial claims for unemployment insurance that the May data will show additional job losses, though not of the same magnitude as April’s job losses. As it is, aggregate private sector hours worked fell at an annualized rate of 47.55 percent in April. The annualized rate is the basis on which changes in aggregate hours map into annualized changes in real GDP from a supply-side perspective, with labor productivity growth being the other component of total labor input. As such, the severe contraction in aggregate hours worked in April along with the further decline coming in May set up a contraction in Q2 real GDP of close to 40 percent on an annualized basis, even allowing for some improvement in labor market conditions in June as economic activity begins to come back on line.

It is interesting to note that, of those who lost their jobs in April, the vast majority (87.57 percent) reported they were on temporary layoff, the first time temporary layoffs have ever topped permanent job losses in a given month. Going forward, the question is the extent to which these temporary layoffs are just that, as opposed to turning into permanent job losses. While lending programs aimed at small and mid-sized businesses are intended to keep this from becoming the case, it is too soon to assess their effectiveness, especially since the recovery in the broader economy is likely to be slow and uneven. But, the longer it takes to fully open the economy back up, increased numbers of what started out as temporary layoffs will become permanent job losses and thus act as a drag on the recovery.

There are signs – modest growth in air travel, restaurant reservations, hotel stays, and same-store retail sales – of a budding increase in economic activity. To be sure, any such increases are coming off of an extremely depressed base, and the absolute levels of activity remain strikingly low. And, if we are correct that May will bring further job losses and a further increase in the unemployment rate, consumers are likely to remain somewhat restrained, even as more states take steps, albeit small and cautious steps, to relax restrictions on movement and activity. Moreover, in any discussion of an economic recovery, the obvious caveat is that progress on the health front is contingent upon further progress on the health front. At present, the outlook on the health front remains highly uncertain, with a “second wave” of the COVID-19 virus a nontrivial downside risk. So, while the equity markets may not seem to agree with our assessment, we expect the rebound in the U.S. economy to proceed at a slow and uneven pace.
STOCKS
It's All Relative

A pril provided equity investors with a much-needed confidence boost as global markets rallied, the S&P 500 turning out its best monthly return since 1987. Riskier and more volatile sectors and segments of the equity market, namely domestic small-cap stocks, fared even better. This bullishness led to major indices reaching new highs. As this bullishness continued, market participants began to question the sustainability of this rally. The debate over whether this rally is driven by fundamentals or is a continuation of the recovery from the COVID-19 pandemic weighs on investor sentiment.

The macro backdrop and variables impacting equity sub-asset classes are often out of the investor's control, but forecasting future earnings with confidence remains challenging due to the duration and depth of the downturn as well as the ultimate path to recovery remain uncertain. As the gulf between ‘haves’ and ‘have nots’ widens as the U.S. economy recovers in an uneven fashion, the biggest companies will likely take market share from smaller peers. The same can be said for sectors and industries that are expected to benefit from the uneven recovery. The increased importance of getting ‘in the weeds’ to identify long-term winners as opposed to ‘buying beta’ or index-linked exposure. Industries that stand to undergo shake-ups and are fertile ground for stock pickers include retail, energy/oilfield services, and real estate investment trusts (REITs), among others, in financial distress poised to benefit most from liquidity provided by the Fed and U.S. Treasury via newly announced lending facilities. With month-end approaching, investors tilted portfolios in a pro-cyclical way, buying materials, financial services, and energy laggards in advance of a staggering 283.30% return of the S&P 500 in April. The market proved to be resilient, setting up a more constructive long-term backdrop as survivors will have improved pricing power as we exit the current environment. Given cash constraints, consolidation in the oil patch will take time as companies and their balance sheets need to expand their capital bases.

Lastly, falling yields from the COVID-19 pandemic will greatly impact REITs as operators will reevaluate portfolio holdings and adjust as consumers shop differently and ‘business as usual’ evolves. Data centers and cell towers are positioned to benefit from the work from home/telecommuting trend, while owners of central business district office space and shopping malls may need to be more flexible and aggressive on price when leasing space and/or increasing rents as corporations and consumers are increasingly price-sensitive. Industry upheaval and turmoil, while painful for some, presents opportunities for companies with strong management teams, cash, and fortress balance sheets to take market share.

BONDS
Mixed Messages

The yield curve steepened as May kicked off, the spread between 2-year and 10-year U.S. Treasury yields (2/10 spread) rising to 0.50% in the first week of the month – a potentially positive indicator that economic growth and inflation expectations have at least bottomed. The yield curve is often used as a barometer for the economy. The yield curve can seem to make up its mind as it experienced both a ‘bear steepener,’ the 10-year yield rising faster than the 2-year yield, and a ‘bull steepener,’ the 2-year yield falling faster than the 10-year yield, in the same week no less. Fixed income investors are compiling, distilling, and digesting headlines daily to inform their yield curve positioning and asset allocation decisions. A sharp rise in U.S. Treasury issuance over coming months, U.S./China trade-related uncertainty, and aSpiderweb of possible paths forward for the U.S. economy are just a few considerations impacting positioning as new information becomes available or headlines cross. Amid such a fluid backdrop, it’s little wonder why Treasury yields have experienced fits and starts.

In mid-May and persisting into the summer months, the U.S. Treasury will issue more than $3 trillion of securities at various maturities to replenish funds used in lending and credit facilities announced in late March and early April to provide liquidity and relief to consumers and corporations. Yields on long bonds could be increasingly volatile throughout the balance of May as details are auction sizes and maturities are released. On the short-end of the yield curve, the economic recovery currently implied by the 2-year Treasury yield at 0.16% is at odds with the a far more impressive one discounted by the S&P 500, and we suspect the 2-year yield will be proven ‘right’ as the economic recovery is gradual and uneven.

The Bloomberg Barclays U.S. Corporate and U.S. Corporate High Yield indices rallied 5.2% and 4.5%, respectively, in April, recapturing some of the 7% and 11.4% each lost in March. Corporate bond issuance has picked up as the Fed continues to support the market. We are monitoring the formation of special purpose vehicles (SPVs) allowing for the purchase of investment-grade and some ‘fallen angel’ corporate bonds via credit facilities. These facilities provided investors with confidence to take credit risk with the knowledge that the U.S. government would be there to step in as a backstop/liquidity provider should the profits or cash arise. It’s not lost on us that investment-grade corporate bonds outpaced high yield during the March downturn and again during the subsequent April rally. We remain overweight core, investment-grade bonds at the expense of foreign bonds and are constructive on higher quality corporate bonds and agency mortgage-backed securities specifically. We expect an uptick in defaults over the balance of 2020 but maintain a neutral allocation to high yield credit due to significantly higher carry than can be found in other segments of the fixed income market.