Moving Forward On Still-Shaky Ground

In what may prove to be the ultimate “oh by the way” moment in recorded history, at 8:30 EST on July 30 the Bureau of Economic Analysis (BEA) will issue the first estimate of Q2 2020 GDP. Most analysts, us included, expect the BEA to report that real GDP contracted at an annualized rate of between 30 and 40 percent in Q2. While there is a high degree of uncertainty around these forecasts, it is all but certain that the contraction in real GDP in Q2 will easily be the largest on record. Sure, actually seeing the number in print (or flashing across a computer screen) may cause a modest stir but, by and large, the report on Q2 GDP is already old news.

Between weekly data on initial claims for Unemployment Insurance, tracking data on consumer spending, higher frequency measures of consumer and business confidence, and widespread restrictions on economic activity, it was clear by the end of March that there would be an epic contraction in real GDP in Q2. When such forecasts first began to appear, they were jolting – including to those of us making the forecasts – and markets responded in kind. Yet, thanks in large measure to extraordinarily aggressive responses from Congress and the Federal Reserve, by mid-April the focus had shifted away from the magnitude of the contraction in Q2 toward what the subsequent recovery over 2H 2020 would look like.

Expectations of how vigorously the economy would recover varied widely, but regardless of the specifics, any forecast of the economy’s path over the second half of 2020 and beyond came with one overriding caveat – that the path of the economy was contingent on the public health outcome, which itself was highly uncertain. Anyone who had lost sight of that point has been reminded, and rather rudely, over the past few weeks. Since mid-June, there has been a spike in the number of positive tests for the COVID-19 virus. That this spike came as states eased restrictions on economic activity has raised concerns that the budding economic recovery might come to an abrupt halt before ever fully taking hold.

There are three main elements that will largely shape where the budding economic recovery might go: the public policy response, the public health outcome, and business and consumer behavior. That the public health outcome remains highly uncertain, however, means that the economic outcome is highly uncertain, with meaningful and persistent downside risks. As such, there is more for policy makers to do; keeping large numbers of households afloat, but at this writing there is nothing even close to a consensus on the question of whether, or in what form, the supplemental UI benefit payments will be extended. Some argue that the size of the supplemental UI benefits being paid by the federal government are set to expire. These payments have been critical in keeping many households afloat, but at this writing there is nothing even close to a consensus on the question of whether, or in what form, the supplemental UI benefit payments will be extended. Some argue that the size of the supplemental UI benefits has created a disincentive to work, while others point to the recent improvement in labor market conditions as evidence that no extension of the supplemental UI benefits is warranted.

To their credit, Congress acted quickly and aggressively at the outset of the pandemic. That the public health outcome remains highly uncertain, however, means that the economic outcome remains highly uncertain, with meaningful and persistent downside risks. As such, there is more for policy makers to do; keeping large numbers of households from plunging over an income cliff later this month is a good place to start.

The second element is the public policy response, and while still in specific manners, such as closing bars and either closing or further limiting eat-in establishments. Should there be need for additional policy responses, we assume this early pattern will be the template, which will be much less disruptive for the economy than blanket shutdowns. The third main element is how consumers and businesses respond, and at present it is too soon to know. For instance, if the spike in positive COVID-19 tests persist, the recent improvements in consumer and business confidence could easily be reversed, which would have implications for consumer spending, business investment, and the labor market.

So, while it is clear the economy had begun to turn, the progress that has been made to date still seems somewhat fragile, and the economic data continue to send mixed messages. For instance, after declining by a total of 21.191 million jobs over March and April, private sector nonfarm employment increased by a total of 7.999 million jobs over May and June. With the exception of mining/natural resources, each of the broad industry groups added jobs, but in most industry groups hiring has been somewhat restrained, with job gains highly concentrated in three industry groups – leisure and hospitality services, retail trade, and education and health services. These three industry groups accounted for 60.9 percent of all nonfarm job losses in March and April but accounted for 74.3 percent of all nonfarm job gains in May and June. Within leisure and hospitality services, restaurants and bars have accounted for the vast majority of job gains, and these are the establishments most at risk from the recent spike in positive COVID-19 tests.

In the absence of a much more geographically and demographically dispersed incidence of COVID-19 cases, the economy should continue to recover over 2H 2020, though perhaps at a slower pace than we expected before the recent spike. There are other obstacles in the economy’s path, however. Most immediately, many households are facing a steep “income cliff” by the end of July, as the $600 per week in supplemental Unemployment Insurance (UI) benefits being paid by the federal government are set to expire. These payments have been critical in keeping many households afloat, but at this writing there is nothing even close to a consensus on the question of whether, or in what form, the supplemental UI benefit payments will be extended. Some argue that the size of the supplemental UI benefits has created a disincentive to work, while others point to the recent improvement in labor market conditions as evidence that no extension of the supplemental UI benefits is warranted.

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The S&P 500 Growth index outpaced the S&P 500 Value index by 5.7% during the month, with growth’s outperformance more muted farther down the market-cap spectrum as the Russell 2000 Growth surpassed the Russell 2000 Value by just 1.1%. With economic growth uncertain or scarce, many investors remain willing to pay a premium for exposure to long-term secular growth leaders. However, economically sensitive sectors will continue to garner interest as ebbing and flowing continue amid progress, real or perceived, toward a COVID-19 vaccine and news tied to the U.S. economy re-opening. A barbell approach between growth and value continues to make sense to us and remains our preferred positioning.

International-developed markets (MSCI EAFE) and emerging markets (MSCI EM) outpaced the S&P 500 and Russell 2000 during June. European equities experienced a renaissance of sorts as the European Central Bank (ECB) increased the size of its bond buying program, and additional support via credit facilities, while Germany surprised markets by finally announcing fiscal stimulus measures, with the package exceeding estimates, totaling €130B. Indices tracking market exposure in France, Germany, and Italy rose 2% or more during the month, while the U.K. and Japan lagged after a period of strong relative performance. The U.K.’s FTSE 250 and Japan’s Nikkei 225 lower or higher by less than 1% in June.

On the emerging markets front, leadership was broad, with India, China, South Korea, and Taiwan – the four largest individual country weights in the index – gaining on eight contiguous months of outperformance. The MSCI Emerging Markets Index rose 6.8% in June, up on value more than at the expense of growth. Europe and much of emerging Asia has weathered the worst of the COVID-19 storm and may be poised to experience sharper economic recoveries as a result, and with less demanding valuations versus U.S. stocks the recent rally abroad may be on firmer footing with upside

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BONDS

Clipping Coupons As Price Gains Harder To Come By

June was, broadly speaking, a non-event month in fixed income land. Treasury yields remained range-bound, particularly on the short-end of the yield curve. The 2-year U.S. Treasury yield was unchanged month over month at 0.16%, while the 10-year yield, after attempting to break out above 0.90% early in June, closed the month at 0.66%, just one basis point above its May 29 close. The 50-basis point spread between the 2-year and 10-year is working monitoring and at a minimum needs to be maintained in our view as this is a level that has been defended on numerous occasions and a sustained break below might signal longer-term expectations for higher short-term interest rates.

Investment-grade (IG) corporate bonds continued to perform well in June, backstopped by Fed and Treasury purchases of IG and fallen angel ETFs, a program expanded last month to include purchases of individual corporate issues. The Bloomberg Barclays U.S. Corporate index was higher by 5% year-to-date through June and carried a yield-to-worst of 2.15% at month-end, 0.65% above the benchmark 10-year U.S. Treasury yield. The option adjusted spread (OAS), or yield compensation for taking on credit risk, for the index over the 10-year U.S. Treasury sat at just 1.50% at the end of June, just below the index’s 20-year average OAS of 3.65%. The Fed and Treasury created a rising tide lifts all ships backdoor in late March with the announcement of the creation of the Secondary Market

Driven by unprecedented fiscal support.

With each passing day we inch closer to November, and market participants will at some point shift their attention away from the benefits of monetary and fiscal stimulus and the rising tide of liquidity that has propelled equities during a period of higher market valuations, which can lead to more extreme outcomes. While it’s too early to handicap with any degree of confidence, we would be remiss to not at least consider potential ramifications.

Were Joe Biden to win the presidency and the Democratic party take over the Senate, the corporate tax rate may be set to rise to 28% from 21% at present. An increase of this magnitude could chop around 10% off projected 2021 S&P 500 earnings. Biden would also likely push for the tax rate on capital gains to increase as well, up to around 39% from 15% or 20% at present has been speculated. Should the Senate remain under Republican control, potential changes to the tax code outlined above become far less likely. Conversely, with Donald Trump becoming president and the Democratic party gaining control of the Senate climb higher as we approach November, investors sitting on substantial long-term capital gains desiring to lower their tax bill in future years may sell, putting downward pressure on stock prices in the process.

While the first half of 2020 was far from dull, the back-half is setting up to be just as intriguing with the U.S. economy experiencing an uneven recovery, U.S./China trade and diplomatic relations on rocky terrain, and the outcome of November’s election looming large for investors. We remain neutral on our target allocation to stocks and bonds, but within equities, we overweight U.S. stocks relative to our long-term neutral allocation entering July, favoring large-cap (S&P 500) at the expense of domestic-developed markets (MSCI EAFE). We are more constructive on our target allocation to bonds and bond-like instruments and programs in place and cheaper valuations relative to history and U.S. large-caps, the time to get closer to neutral on international-developed markets may be near.

Despite low yields relative to historical norms, IG corporates continue to hold some appeal as the SMCCF remains in place, allowing market participants to buy these bonds with the knowledge that they will find a buyer with deep pockets willing to take it off their hands, likely at a higher price, should they choose to sell. High yield corporates, as expected, have been more sensitive to economic ebbs and flows over the past month, with the Bloomberg Barclays Corporate High Yield index generating a 1% return during June. The incentive to correct an outperformance of interest is high, with the 2-year U.S. Treasury yield falling 2% on average for the year through June, even as we anticipate an uptick in defaults from here through year-end.

Corporate Credit Facility (SMCCF), but as noted above, the program was expanded in June to include purchases of individual corporate bonds. Through buying individual corporate issues while shunning bonds from other investment-grade issuers as it constructs its own ‘index,’ the Fed risks creating a dual-class structure of sorts among IG issuers. While remain neutral exposure to IG corporates has worked well up to this point, security selection and active management should play a larger role as performance dispersion at the issuer level increases.

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Source: Bloomberg, Factset

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