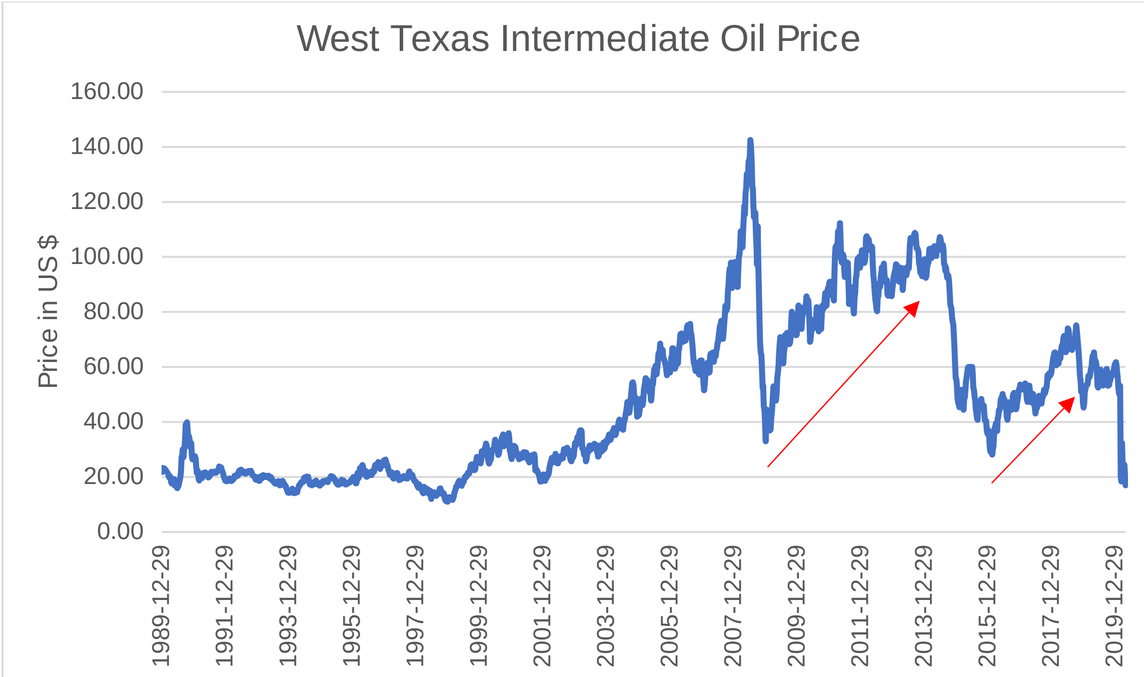
AndCo's Weekly Market Update

April 27, 2020

THE ECONOMY

Attempting to call a market bottom has proven to be a losing bet for many industry veterans. Despite the strong rally in stocks since the recent low on March 23rd, many investment managers we have spoken with have shared divergent views on what to expect going forward. We continue to observe data points showing the global economy came to a virtual standstill in March. As evidence, US durable goods orders, reflecting those products designed to last more than three-years such as cars and washing machines, declined -14.4% month-over-month, marking the largest decline since 2014[1]. Given that most Americans were observing shelter-in-place orders, the lack of sales for big ticket items is understandable. Unfortunately, an additional 4.4 million Americans filed for unemployment benefits for the week ending April 18th, bringing the total number of filers to more than 26 million over the past five weeks[2]. Continued weakness in the labor market most likely contributed significantly to the drop in consumer sentiment which posted its lowest reading since December 2011[3]. While the news cycle will likely remain negative in the interim as we continue to grapple with COVID-19 (Coronavirus), it is important to consider that markets have historically bottomed prior to the news cycle turning positive.

One market that may have already bottomed is oil. The combination of demand erosion, oversupply and lack of physical storage has resulted in oil prices trading at their lowest levels in more than two decades[4]. As evidence of the recent unpredictability of the market, prices for May oil futures contracts traded at negative prices, meaning that producers were paying buyers to take delivery of the physical commodity. A key contributor to this dislocation was the amount of remaining capacity in the US's largest oil storage facility located in Cushing, Oklahoma. There are several factors besides supply and demand that can influence the price of oil such as geopolitical risk, inflation risk and political risk. News this week that President Trump ordered the US Navy to shoot at Iranian attack boats if provoked immediately sent oil prices higher and served as a reminder that oil markets do not necessarily trade on market fundamentals. Importantly, with global economic growth stalled and the USD's continued strength relative to other foreign currencies, the likelihood of a price shock in the near-term is relatively small. That said, similar to equities, oil markets have displayed the tendency to rebound quickly following drawdowns as evidenced by the rebound in prices in 2009 and 2016 (see chart and red arrows on the next page).

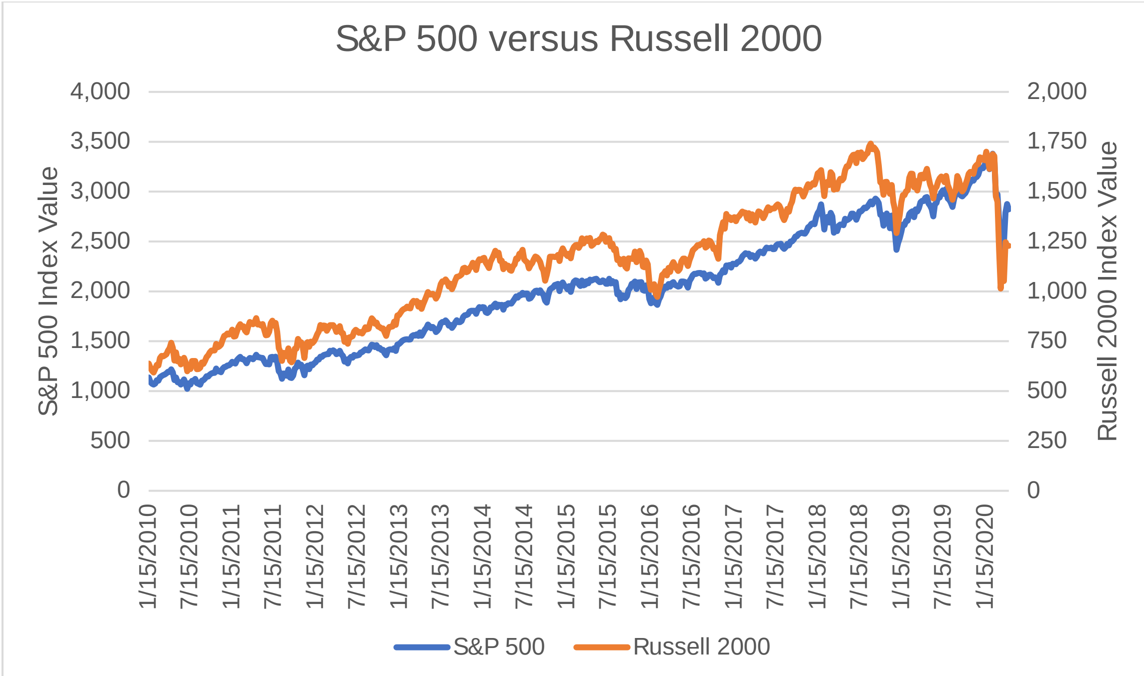


Source: https://fred.stlouisfed.org/series/DCOILWTICO as of April 24, 2020

EQUITIES

Global equity markets were broadly lower on the week as continued negative economic news weighed on investors. Despite the negative news, there were a few bright spots here in the US as technology related stocks posted gains on strong earnings announcements from both Intel (INTC) and Verizon (VZ) and energy stocks shored-up some of their recent losses with a rebound in oil prices. As of April 23rd, roughly 23% of S&P 500 companies have reported earnings. It is estimated that earnings contracted by more than 14% during the quarter with most of the underperformance coming from energy and financial-related companies[5]. In Europe, stocks traded lower on the week due, in part, to continued concerns related to the ECB's stimulus package. Earlier in the week, the ECB approved a 500 billion euro stimulus package but paused without providing additional details regarding the larger 1 trillion euro package due later in the year. International developed and emerging market stocks continue to lag the US as concerns related to Coronavirus, slowing economic growth and the resulting strong US dollar act as headwinds.

As allocators, we seek out patterns to understand behaviors and potentially exploit inefficiencies. One pattern that has historically held is that during drawdowns, small cap stocks underperform large cap stocks only to recover and outperform as markets rebound. While we are hesitant to make the claim that it is different this time, small cap stocks are currently underperforming their large cap brethren since the trough on March 23rd by more than 370 basis points[6]. Concerns related to Coronavirus and the ability of small businesses to sustain themselves during the quarantine are most likely the primary cause for the relative underperformance. As US states begin to re-open for business and more clarity is gained about the trajectory of the pandemic, we will be watching closely to see if this divergence mean-reverts as economic growth improves.



Source: Bloomberg as of April 24, 2020

FIXED INCOME

Interest rates in the US declined slightly during the week with the US Treasury 10-Year bond declining from 0.64% to 0.59% on concerns about the poor economic environment. The New York Fed "NowCast" model is predicting that the US economy contracted by -0.40% during the first quarter and is forecasting a contraction of -7.79% during the second quarter[7]. The Federal Reserve Bank announced during the week that it would slow its pace of US Treasury bond purchases from $15 billion to $10 billion per day. Investment grade and high yield bond spreads were largely flat on the week aided by the rally in oil prices. While prices for both investment grade and high yield bonds have recovered in recent weeks, we are continuing to watch for signs of potential cracks in the credit markets. As of April 20th, 15 companies in the leveraged credit market have filed for bankruptcy or missed a coupon payment, representing over $33 billion in bonds and loans in aggregate. The number of issuers in technical default is the most since April 2009, and the $33 billion in defaulted principal value represents the third largest monthly total on record. While we remain optimistic about the timing of the decision to begin re-opening the US economy, there is a high probability that there could be more defaults, especially in commodity-sensitive, travel and hospitality-related, issues in the near future.

Appendix

1. https://tradingeconomics.com/united-states/durable-goods-orders
2. https://www.axios.com/coronavirus-unemployment-rate-great-depression-af170c25-bf19-4f0d-9de8-c4dd515d6a91.html
3. https://tradingeconomics.com/united-states/consumer-confidence
4. https://oilprice.com/Energy/Oil-Prices/Oil-Prices-Hit-15-For-The-First-Time-In-21-Years.html
5. https://www.raymondjames.com/pdfs/share/weekly_market_guide.pdf
6. Bloomberg as of April 24, 2020 (SPX Index compared to RTY Index)
7. https://www.newyorkfed.org/research/policy/nowcast

Important Disclosure Information