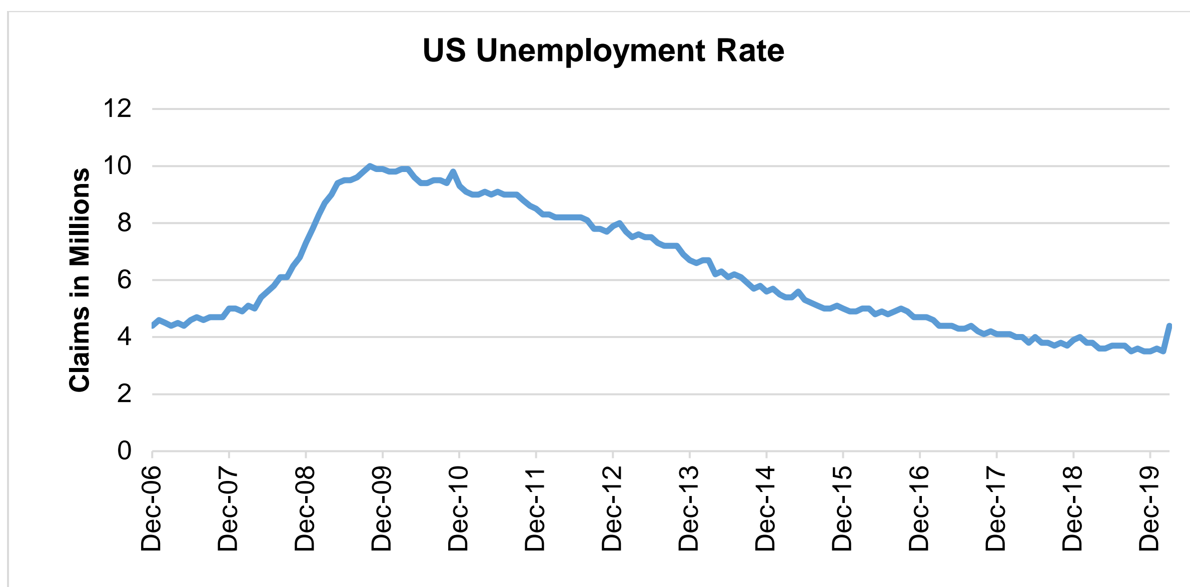
AndCo's Weekly Market Update

April 6, 2020

THE ECONOMY

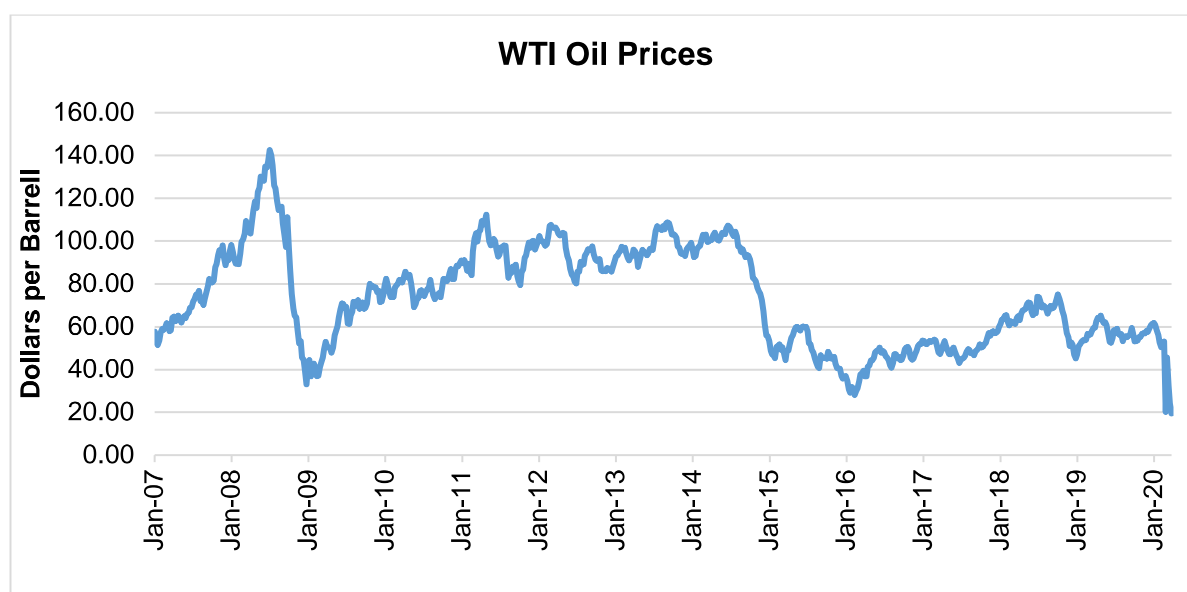
The economic fallout from the continued aggressive response to COVID-19 (Coronavirus) is becoming clearer as more economic datapoints become available. The previous spike higher in weekly unemployment claims was followed up by an additional 6.65 million people filing for unemployment benefits. Unsurprisingly, the unemployment report for March showed a deteriorating labor market with more than 700 thousand jobs lost resulting in the unemployment rate moving higher from its record low of 3.5% to 4.4%. A recent report circulated by the Federal Reserve Bank of St. Louis predicted that as many as 47 million people could be laid off during the downturn. While estimates relating to job losses can vary significantly depending on the source, it is likely we will continue to see deterioration in the labor market as the response to the Coronavirus persists.



Source: https://www.bls.gov/charts/employment-situation/civilian-unemployment-rate.htm# as of April 3, 2020

The US economy is often visualized as a three-legged stool with the legs represented by jobs, consumer spending and the housing market. Historically, a tight labor market (low unemployment) results in rising wages which begets positive consumer sentiment. As people feel better about their employment and income situation, they are more likely to purchase a home and all the consumer goods needed to fill the house such as electronics, furniture and home improvements. With a deteriorating jobs situation, it should come as no surprise that consumer confidence was lower in March. If the government's response to the Coronavirus persist deeper into the year, we will likely see a further erosion in confidence which would then logically cascade into other sectors of the economy.

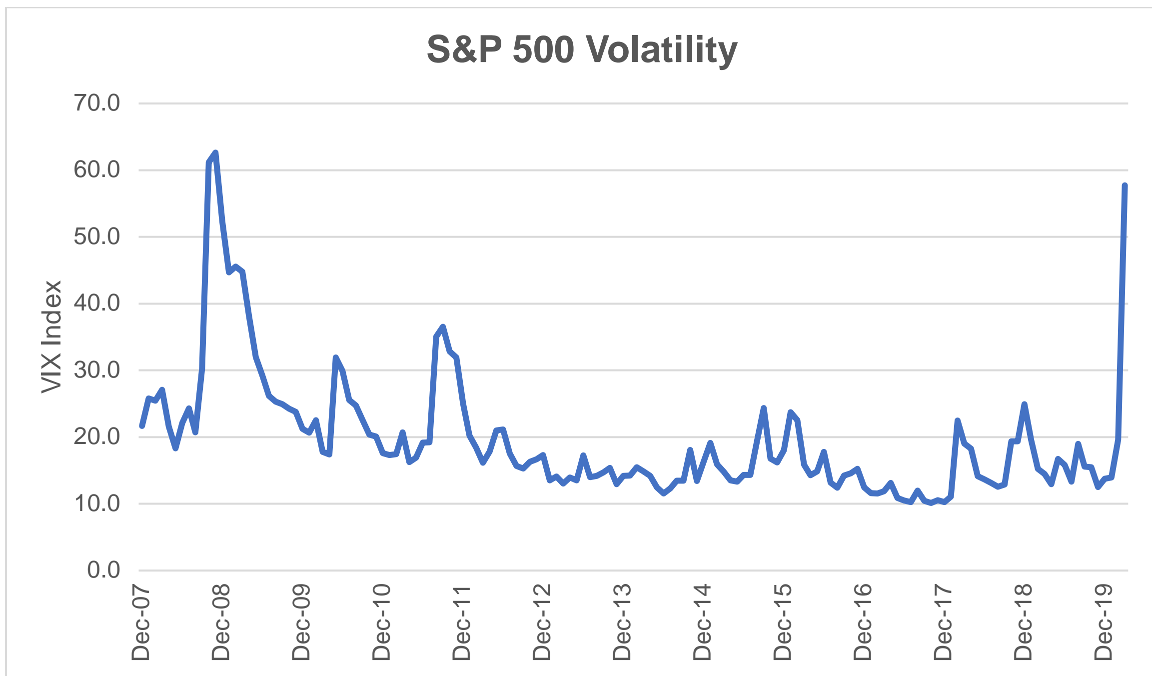
While there is much to be concerned about, there are positive signs that we can take some measure of comfort in. As a result of the drop in global demand, oil prices have declined significantly. While this drop in price will most likely result in dislocations within the energy sector of the economy, the benefits of the drop in price will be felt by consumers at the gas pump (but we're all driving less). Historically, large price drops in energy costs have acted as a tailwind to the economy and could cushion those most impacted by the Coronavirus.



Source: https://fred.stlouisfed.org/series/DCOILWTICO as of March 30, 2020

EQUITIES

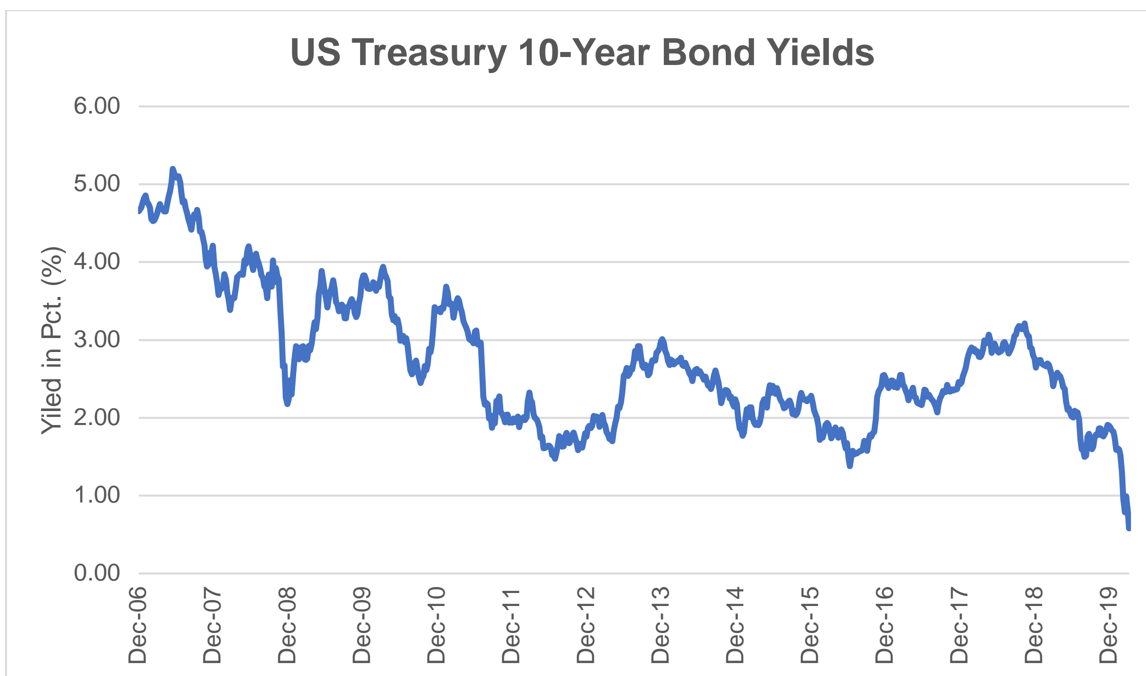
Equity markets were slightly lower on the week from last Friday's market close. That said, the intra-week volatility was high as measured by the VIX index (VIX). For context, the VIX is often referred to as the "fear-index" since it estimates the implied (future) volatility of the S&P 500 using index options 30 days into the future. Given the magnitude of the recent market drawdown, it should come as no surprise that the VIX is trading near the highs reached during the height of the Great Financial Crisis (GFC) in 2008. So, what does an elevated VIX mean? A persistently elevated VIX would suggest that investors can expect to see choppy markets over the near-term until some clarity around the economic impact of the Coronavirus is determined.



Source: https://fred.stlouisfed.org/series/VIXCLS#0 as of March 31, 2020

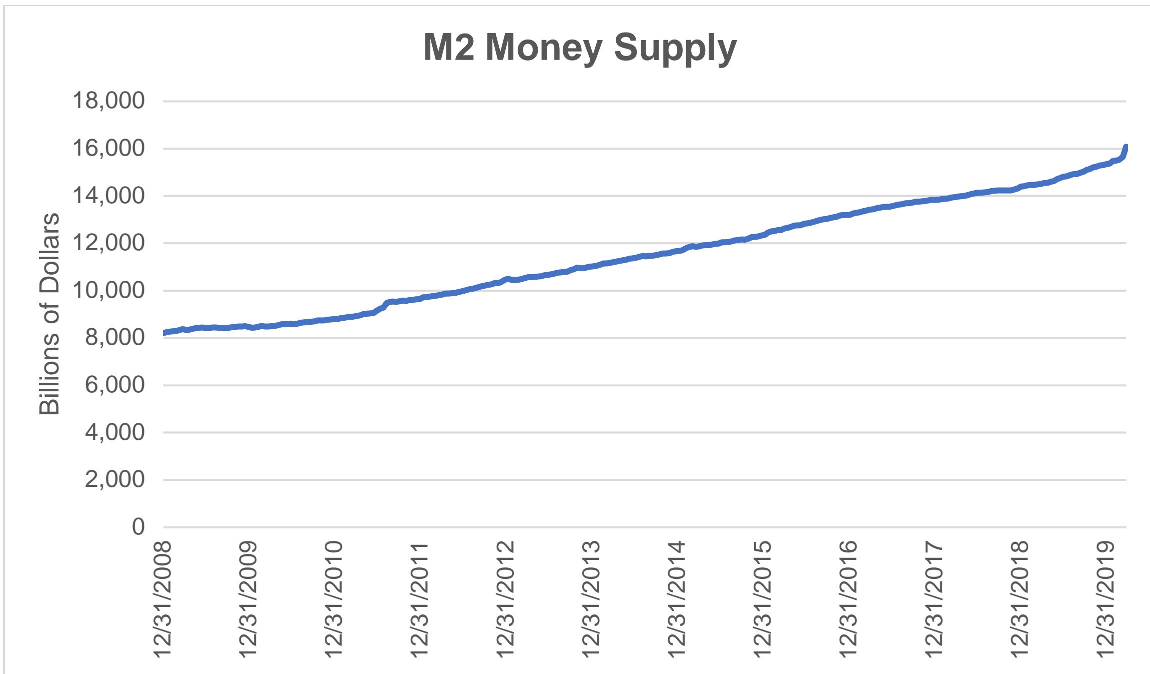
FIXED INCOME

US interest rates, as measured by the 10-Year US Treasury bond, were moving lower during the week prior to the release of last Friday's (4/3) US unemployment report. Since the end of February, the US 10-Year Treasury bond has moved lower from 1.29% to 0.58% as investors' concerns over future economic growth increased. During this time, the Federal Reserve Bank (Fed) cut the Federal funds rate to 0% and announced that it would begin purchasing at least $500 billion in US Treasury securities and $200 billion in mortgage-backed securities (MBS). This program was expected to last only a few months. However, on March 23rd, a statement was released that the program is now open-ended. What does this mean? Essentially, the Fed is fully committed to supporting the US economy by monetizing assets without limitation. This should provide support to the bond market while also indirectly supporting risky assets such as high yield bonds and equities as liquidity makes its way into the economy.



Source: https://fred.stlouisfed.org/series/DGS10#0 April 3, 2020

While headline inflation remains subdued, mostly due to depressed energy prices, one data point we are watching closely is the central bank measure M2, or the supply of money that includes cash, checking deposits, certificates of deposit (CDs) and money market funds. As seen below, M2 had grown modestly prior to the GFC in 2008. Following the crisis, and the Fed's first quantitative easing (QE) program, the growth of money in the system exploded higher. The most recent (February) reading of M2 shows annual growth of 7.4%. What does this mean? Under normal economic conditions, we would expect significant growth in the money supply to result in inflation. However, given the Coronavirus's downward pressure on current economic conditions, we do not expect inflation to pick up significantly from its 2.3% annual level in the near-term. If and when inflation begins to take hold, interest rates could begin to move higher which may result in the Fed reversing its current course and begin raising short-term interest rates to dampen inflation. Until then, we believe US interest rates are likely to remain low and the US dollar should remain the safe haven currency.



Source: https://fred.stlouisfed.org/series/M2#0 March 23, 2020

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