AndCo's Weekly Market Update

May 4, 2020

THE ECONOMY

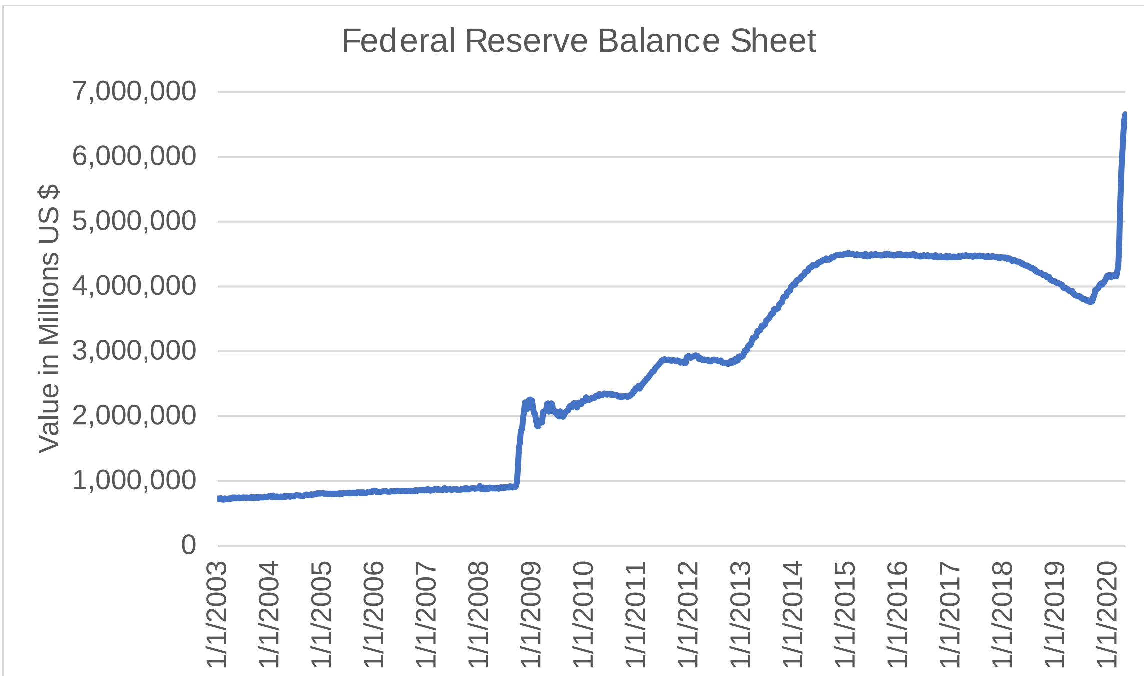
It feels a bit like deja vu when looking at the economic data released this week which showed the US economy slowing in April. The advance estimate of US GDP for the first quarter came in at -4.8%, below Wall Street's consensus estimates. For the week ending April 25th, initial jobless claims came in at 3.8 million, a modest improvement over the previous week's number of 4.4 million. To date, more than 30 million Americans have filed for unemployment benefits since the beginning of the pandemic[1]. While it's no real surprise with shelter-in-place orders in effect across the country, the US housing market took a hit in April with pending home sales down more than 20%. Broadly speaking, as we close out the month of April, there was not much in the way of positive economic data to get excited about despite some advances in treatment for COVID-19 (Coronavirus).

Despite the deluge of negative data and the likelihood of continued economic weakness into the second quarter, there are a few bright spots that are worth exploring. First, the US Government has spent more than $2.6 trillion to fight Coronavirus[2]. A significant amount of that expenditure was directed to small businesses in the form of forgivable loans and directly to individuals in the form of additional unemployment benefits and stimulus checks. While this may be a case of too-little-too-late for some, the magnitude of the stimulus should help buffer the economy in the interim. Second, the Federal Reserve Bank (Fed) has been aggressive in both its policy response (cutting short-term interest rates) and direct support of markets as evidenced by their stated intent to begin purchasing corporate bonds. Finally, many states have already begun the process of slowly re-opening their respective economies by lifting some of the restrictions placed on businesses. While the pace of opening will likely vary from state-to-state depending on the number of new Coronavirus cases and the potential development of effective treatments and/or vaccines, any freedoms regained that allow the populace to begin resuming life should be considered a net-positive for the economy and peoples' psyche.

EQUITIES

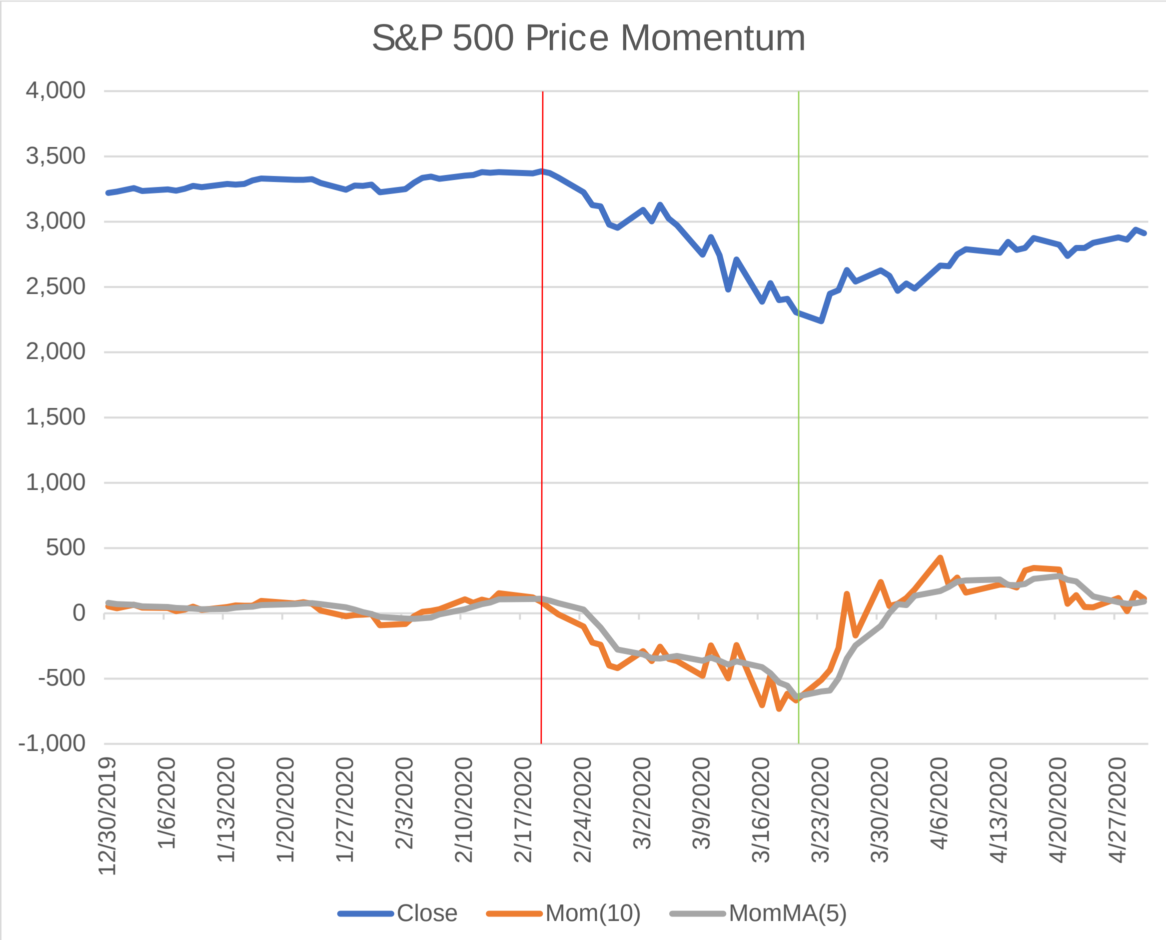
It is perfectly reasonable for equity investors to feel disoriented after the past two months where we saw one of the fastest drawdowns in history only to be followed up by the stock market's best month in three decades. From its peak on February 19th, the S&P 500 Index fell nearly 34% until the trough on March 23rd. From there, the market rallied more than 26% to recover roughly half of the value lost. Despite the negative economic data and poor earnings announcements, the index rallied more than 12.8% during the month of April. While investors are likely feeling a bit better following the strong showing during the month, we asked ourselves what the catalysts of these returns were and if they can be counted on to continue driving the market higher.

An old Wall Street adage is, "Don't fight the Fed!" As we have discussed previously, both the Federal Government and the Fed have committed to providing near-unlimited support to both the market and the economy as part of their response to the pandemic. As seen below, after brief tapering beginning in 2018, the Fed's balance sheet has grown by more than 75% since late 2019. While much of these proceeds have gone to the repurchasing of US Treasury bonds in order to keep interest rates low, it is reasonable to expect that some of this stimulus has leaked into risk assets, such as equities and high yield bonds, which likely contributed to higher prices. The Fed recently announced that it has begun tapering its purchases of US Treasury bonds. Given the amount of stimulus in the system, this action would seem reasonable. However, should markets take another leg down, it is likely the Fed could begin ramping back up the size of its purchases to put a floor under the market.



Source: https://fred.stlouisfed.org/series/WALCL

Much like sports, momentum in markets is sometimes hard to find and even harder to keep. We often look at momentum indicators (MI) which are designed to measure the net difference in price between two points in time. The Momentum line (ML), the orange line seen in the graph below, is the difference between the closing price today and the closing price 10 days ago. A simple five-period moving average (MA) is shown as a second gray line. A sell signal was generated when the ML fell below the MA, marked by the vertical red line. Conversely, a buy signal was generated when the ML crossed above the MA, marked by the vertical green line. Why is this important? Trend following strategies employed by managers such as Commodity Trading Advisors (CTAs), which deal in systematic futures or options strategies ("black-box"), program such indicators indiscriminately in their models rather than assessing underlying market fundamentals. When changes in momentum are identified, these strategies can quickly swing their exposures, resulting in periods of elevated volatility and fast-moving markets. Because momentum can work for and against investors, in the event that the market was to move lower, it is likely that momentum could be a headwind going forward, just as it was a tailwind during April.



Source: Bloomberg as of April 29, 2020

FIXED INCOME

US interest rates were down slightly on the week as poor economic data weighed on the market. The benchmark US Treasury 10-Year note declined from 0.66% to 0.63%. In credit, both investment grade and high yield option adjusted spreads (OAS) declined (tightened) as credit markets firmed up, supported by investors seeking higher yields at more attractive prices and explicit support from the Fed. Despite the Coronavirus, investment-grade (IG) issuance set a record in the first quarter with more than $245 billion in new bonds[3]. One area of concern for investors was the number of issuer downgrades from IG to high yield status during the first quarter. IG bonds (BBB-/Baa3 or higher) downgraded to high yield are commonly referred to as “fallen angels.” This action also results in the formerly IG bonds falling out of IG benchmarks and into their high yield counterparts. Importantly, the sectors that these downgraded bonds reside in are those under the most pressure – energy and consumer-related sectors which include gaming, lodging and hospitality. These sectors have already come under intense pressure as a result of the Coronavirus. As indices are reconstituted, additional selling may occur which can result in lower prices over the interim as managers rebalance to benchmark weights. However, short-term price volatility has historically provided active managers with opportunities to purchase solid companies at discount prices.

Appendix

1. https://www.bloomberg.com/news/articles/2020-04-30/another-3-8-million-in-u-s-filed-for-jobless-benefits-last-week
2. Bloomberg as of April 30, 2020
3. https://www.fitchratings.com/research/corporate-finance/us-investment-grade-issuance-hits-record-245b-volume-for-1q20-29-04-2020

Important Disclosure Information