AndCo's Weekly Market Update

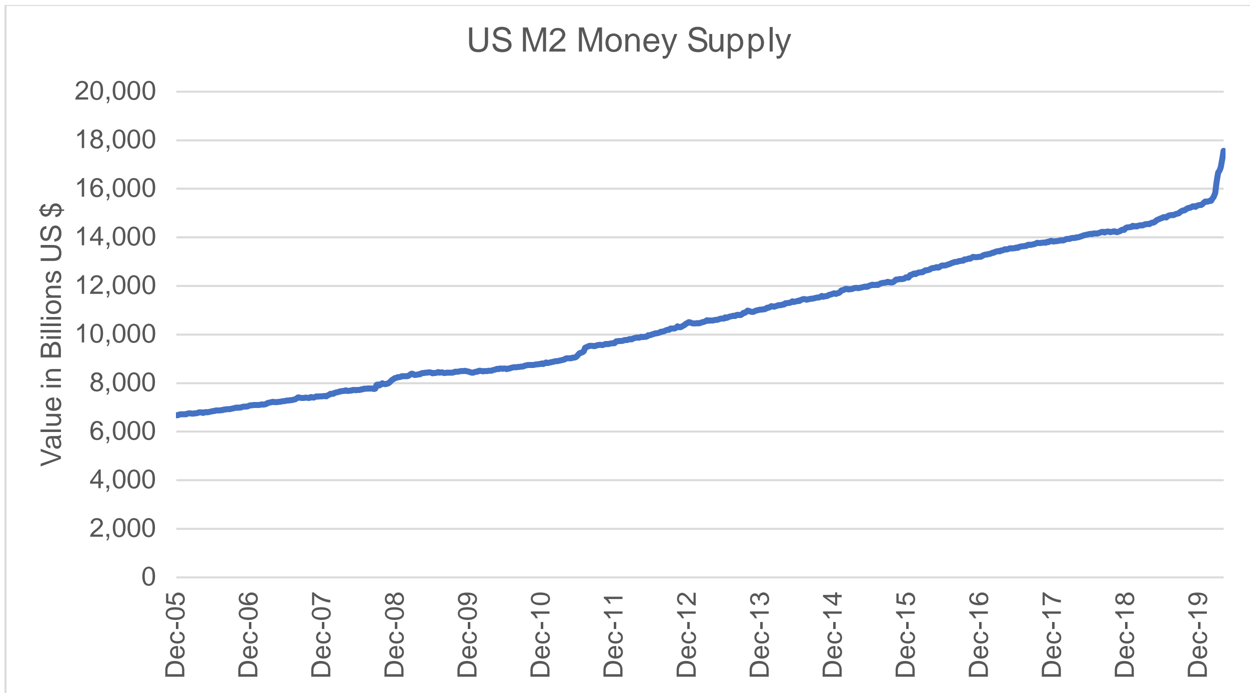
May 11, 2020

THE ECONOMY

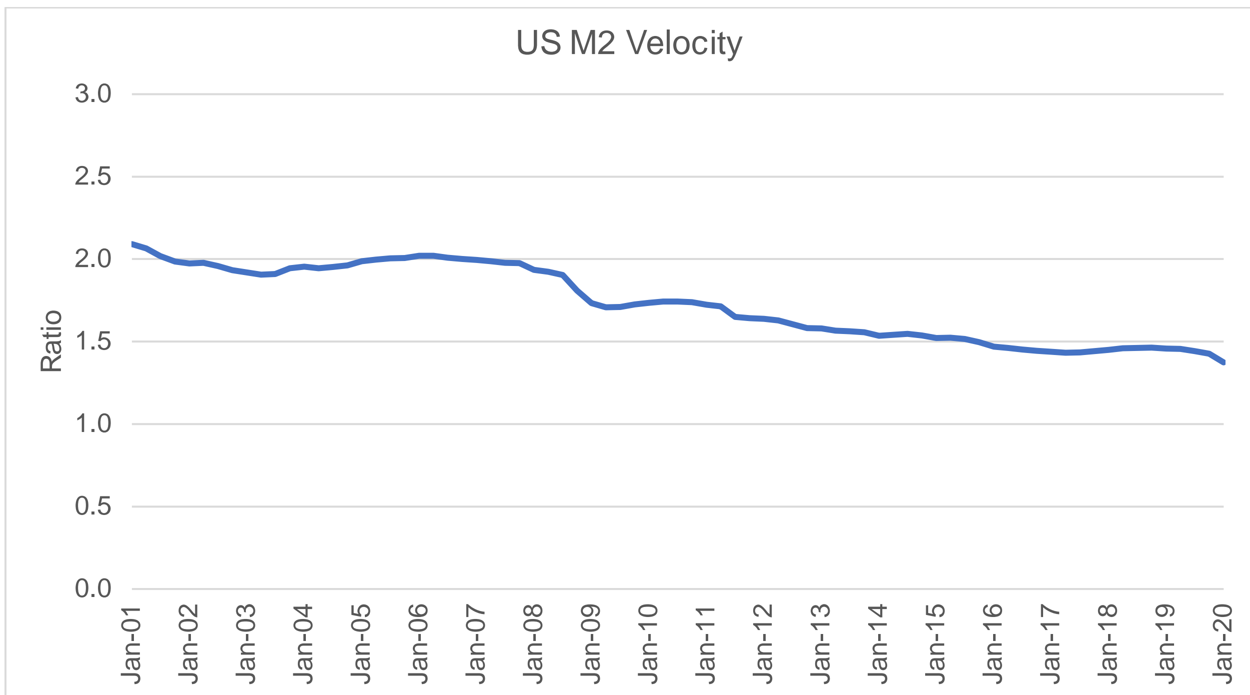
Outside of Friday's highly anticipated unemployment report, it was a relatively light week in terms of US economic data. As expected, the ISM Non-Manufacturing Index and the US Services PMI declined significantly in April as businesses remained shuttered. One point that could be considered a positive was that US consumer borrowing declined significantly in March. Credit card balances shrank by $28.2 billion during the month, the largest single monthly drop since recordkeeping began in 1968[1]. The drop in the use of credit, in conjunction with increased savings rates, suggests that the US consumer could emerge from the COVID-19 (Coronavirus) pandemic in a stronger position[2]. This of course is dependent on the condition of the US labor market and the speed of its eventual recovery.

On Friday, we received the US non-farm payroll number for the month of April. In previous updates we have chronicled the weakness in weekly initial unemployment claims, and as such, the terrible jobs report comes as little surprise. For the month, the US lost a record 20.5 million jobs, the largest loss in the history of the report[3]. As a result, the US unemployment rate increased by 10.3%, up from 4.4% to 14.7%. While the magnitude of the increase in unemployment is staggering, it is important that we look towards the future. Many states are beginning the process of reopening their economies. While there most likely will be persistent structural unemployment resulting from businesses having to reorganize and adapt to the new environment, the overall unemployment level should begin to level off and eventually decline as employers across the country reopen for business.

As we have discussed in recent updates, the Federal Reserve Bank (Fed) has been highly aggressive in its response to the pandemic, injecting trillions of dollars into the economic system in order to provide liquidity and support to the economy. While we believe the policy response is justified, we are keen to understand the potential longer-term implications. One such concern is the potential for inflation resulting from the increase in the US monetary base. Looking back to the policy response following the Financial Crisis in 2008, despite the Fed's actions, the growth of money supply declined year-over-year in 2009 to roughly 3%, compared with a 10% increase in 2008[4]. According to Bloomberg, US M2 (cash in circulation, savings, time deposits and money market funds) has increased roughly 14.5% year-to-date as of April 27th. Despite the significant increase in money supply, the velocity of money changing hands in the economy has continued to decline which has contributed to the relatively benign inflationary environment in recent years. Broadly speaking, financial markets are underpricing the potential for rising inflation as evidenced by the fact that the US 10-Year Treasury bond is trading between 0.6% and 0.7% and US 10-Year TIPS breakeven rates are 1.1%[5]. The TIPS breakeven rate is often used as a reliable measure of inflation expectations. Should some of the liquidity the Fed has been providing start to leak into the broader economy resulting in an increase in the velocity of money, financial assets such as bonds may underperform.



Source: https://fred.stlouisfed.org/series/M2



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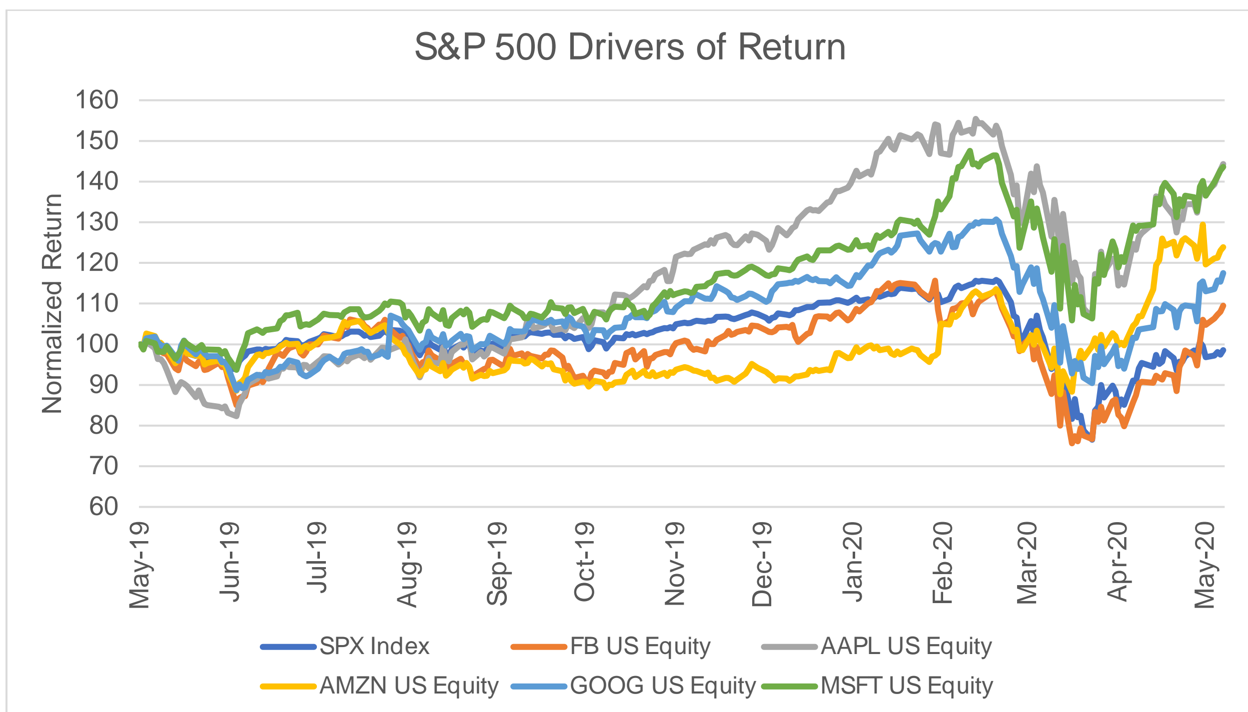
EQUITIES

US equity markets were broadly higher this week as investors continue to look past poor recent economic data and towards the global economy re-opening. For the week, the S&P 500 Index rose roughly 3.6% while the Russell 2000 Index rose 5.5%. Looking a bit deeper, while the broader equity market has moved higher in recent weeks, there are a few large cap technology stocks such as Microsoft (MSFT), Facebook (FB), Apple (APPL), Amazon (AMZN) and Google (GOOG) that have contributed significantly to the S&P 500's recovery. These companies make up a combined 19% of the S&P 500 Index[6]. If we index their returns relative to the full index over the past year, we can see that each of these companies made a positive contribution while the full index has been essentially unchanged over the period. Part of this visual can be attributed to the composition of the index. Sectors such as energy (3%) and financials (10.3%) have contributed -34.7% and -16.5%, respectively, over the last year while the information technology sector has surged 26.1%. Given the collapse in energy prices and the decline in interest rates, these returns are not surprising. During periods of market distress, investors typically seek out those companies with competitive advantages and the ability to grow revenues and earnings. These large technology companies, while still negatively impacted by the pandemic, are generally better positioned to weather the storm given the strength of their balance sheets. Importantly, these companies could become even more vital to the economy as businesses adapt to work-from-home restrictions. While the recent recovery in oil prices has been welcomed by the energy sector (up 32.3% quarter-to-date), we believe it is likely that the dispersion within the index will remain as investors gravitate to companies with more predictable earnings patterns.



Source: Bloomberg as of May 7, 2020

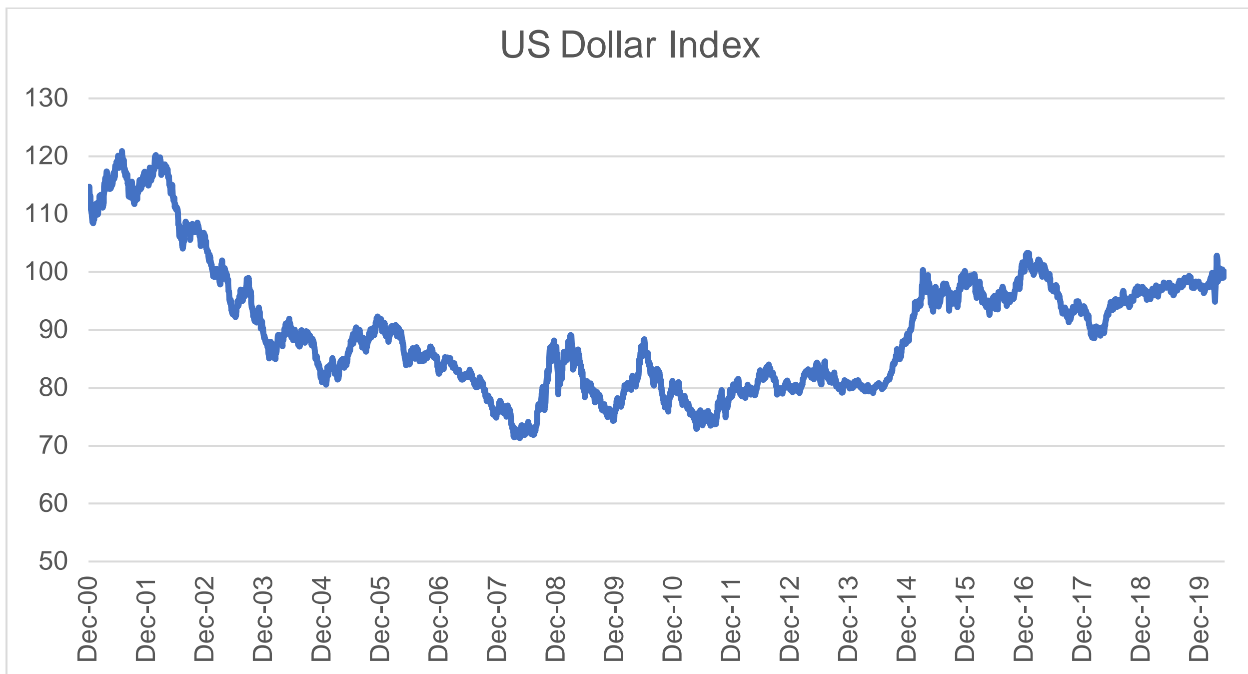
FIXED INCOME

For the week, long-term US interest rates as measured by the 10-Year US Treasury bond were flat. However, rates for the shorter-term US Treasury 2-Year bond moved lower from roughly 0.18% to 0.12% on concerns over economic growth[7]. Importantly, Fed Funds futures are now pricing in negative rates in the US beginning in June.

Meeting Date	#Hikes/Cut	%Hike/Cut	Implied Rate Change	Implied Rate
06/10/2020	-0.028	-2.8%	-0.007	0.044
07/29/2020	-0.055	-2.7%	-0.014	0.038
09/16/2020	-0.138	-8.3%	-0.034	0.017
11/05/2020	-0.171	-3.3%	-0.043	0.009
12/16/2020	-0.317	-14.6%	-0.079	**-0.028**
01/27/2021	-0.335	-1.8%	-0.084	**-0.032**

Source: Bloomberg as of May 7, 2020

Why does this matter? Despite the trillions in stimulus supplied by the Fed, markets are pricing in negative rates which suggests that even more needs to be done. Importantly, the US dollar, as measured by the US Dollar Index (DXY), is actually stronger now than prior to the pandemic. Chairman Powell is on record as stating that he is not in favor of negative rates. However, this dynamic bears watching as pressure builds for the Fed to take additional action in support of the economy.



Source: Bloomberg as of May 7, 2020

Appendix

1. Bloomberg as of May 7th, 2020
2. https://fred.stlouisfed.org/series/PSAVERT
3. https://www.bls.gov/news.release/empsit.nr0.htm
4. https://fred.stlouisfed.org/series/M2
5. Bloomberg as of May 7th, 2020
6. Bloomberg as of May 7th, 2020
7. Bloomberg as of May 7th, 2020

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