AndCo's Weekly Market Update

May 18, 2020

THE ECONOMY

The economic calendar was relatively light this past week. Both the CPI and PPI ex-food and energy readings showed continued declines month-over-month suggesting that the economy continues to experience deflation as consumption and production of goods and services remains muted as a result of the COVID-19 (Coronavirus) pandemic[1]. Further confirmation of the impact of reduced consumer activity was received on Friday when it was reported that retail sales declined by roughly -16.4% month-over-month in April[2], which was the steepest drop going back to the reading's 1992 inception. In addition, industrial production fell -11.2% for the month, marking the largest drop on record in the index's 101-year history[3].

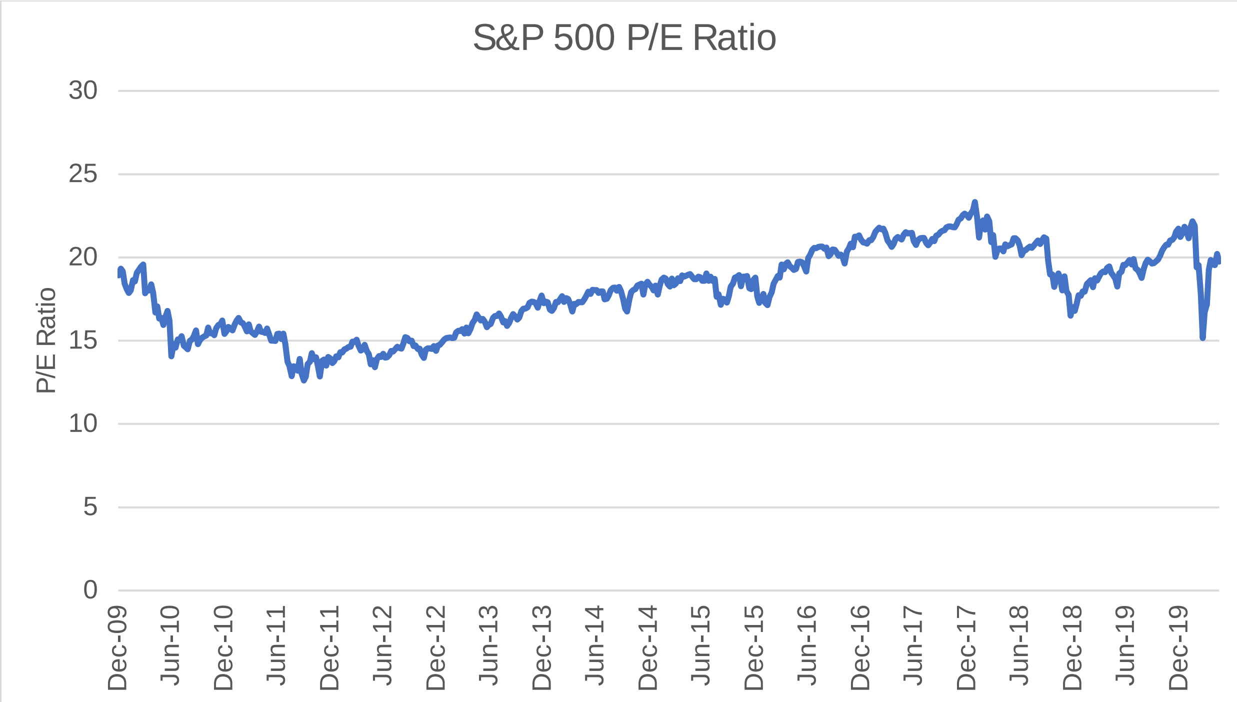
Despite the barrage of continued bad news, there were some positive signs that the worst may be behind us. First, initial jobless claims reported for the week ending May 9th were 2.98 million, down from the prior week's 3.18 million claims[4]. Overall, the total number of claims filed since the pandemic started stands at more than 36 million[5]. While it is likely that the US unemployment rate will increase from the reported 14.7% in April, the pace of the deterioration of the US labor market seems to have slowed. Consumer sentiment, as measured by the University of Michigan Index, rose to 73.7 in May, up from 71.8 in April[6]. While still low by historic measures, consumers may be turning their attention toward future prospects as the pandemic's peak hopefully recedes. Finally, we saw oil prices climb steadily during the week. The June WTI contract closed at $29.43, up nearly 19% on the week[7]. While still down more than 50% on the year, the combination of production cuts and increasing expectations that the worst of the economic shutdown may be behind us proved to be catalysts for higher prices. Rising oil prices may help alleviate some of the pressure on US oil and gas companies which have been suffering under price declines.

From the perspective of additional fiscal or monetary policies, Congress passed a $3 trillion stimulus package aimed at providing additional relief in the form of aid to local governments, expanded Coronavirus testing, and support for rent and mortgage payments. While the package faces significant political headwinds, the prospect for additional fiscal stimulus is likely on the horizon. The Federal Reserve (Fed) Bank's Chairman Powell made several comments this week concerning the potential for negative interest rates. While the Fed prefers not to follow the paths of other developed market central banks at this time, pressure continues to mount on the Fed to provide additional monetary stimulus in the form of quantitative easing (QE) or lower interest rates.

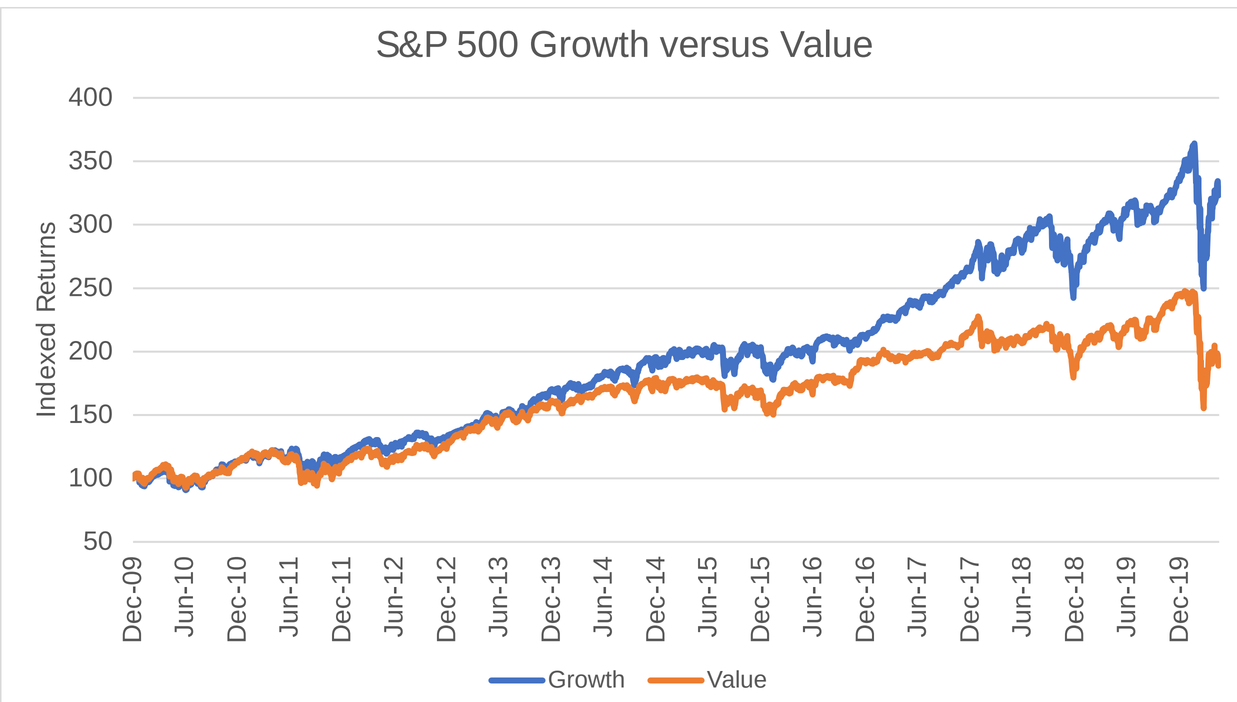
EQUITIES

US equity markets cooled this week in mostly choppy trading as investors focused on comments made by Fed Chairman Powell regarding the state of the economy, the potential for increased Coronavirus cases as states begin to reopen, and the rise in rhetoric regarding potential trade issues with China and the US. For the week, the S&P 500 Index declined by roughly 2.2%. On Wednesday, Powell stated that the US economy faces further risks and that the pace of recovery may be slowed without further action by Congress[8]. While it is likely that some action will be taken to pass additional stimulus, the proposed $3 trillion package faces significant headwinds as the debt incurred to fight the pandemic becomes a drag on future growth. During the week, President Trump expressed his frustration with China to adhere to phase one of the recent trade deal and the country's inability to contain the Coronavirus. While the likelihood that the administration would begin another round of sanctions on China in the midst of a global recession is low, companies with significant international exposure came under pressure, nonetheless.

From a valuation perspective, the S&P 500 Index's price-earnings (P/E) ratio stood at roughly 19.7 as of Friday May 15th. While below the peak of 23.3 in January 2018, the ratio remains above the longer-term historical average of approximately 15.0[9]. Importantly, given the uncertainty of future corporate earnings, the ratio could be considered lofty, and as such, any recent pullbacks in the equity market may be justified. As we discussed in last week's Market Update, technology stocks have been the strongest contributor to the index's return while sectors like industrials, energy and consumer discretionary have underperformed the broad market by a significant margin during the pandemic. From a valuation perspective, the S&P 500 Information Technology Index currently trades at a P/E of 25.9 while the S&P 500 Industrials Index trades at a P/E of roughly 15.0[10]. This means that investors are willing to pay significantly more for each dollar of future earnings of technology-related companies compared to industrial-related companies. Why does this matter? In general, historically value stocks have significantly underperformed growth-oriented stocks for more than a decade. Given the current economic climate, investors appear willing to pay more for companies that have the ability to continue to grow earnings despite economic headwinds. That said, we remain on guard for any signs of a reversal to this trend.



Source: Bloomberg as of May 15, 2020

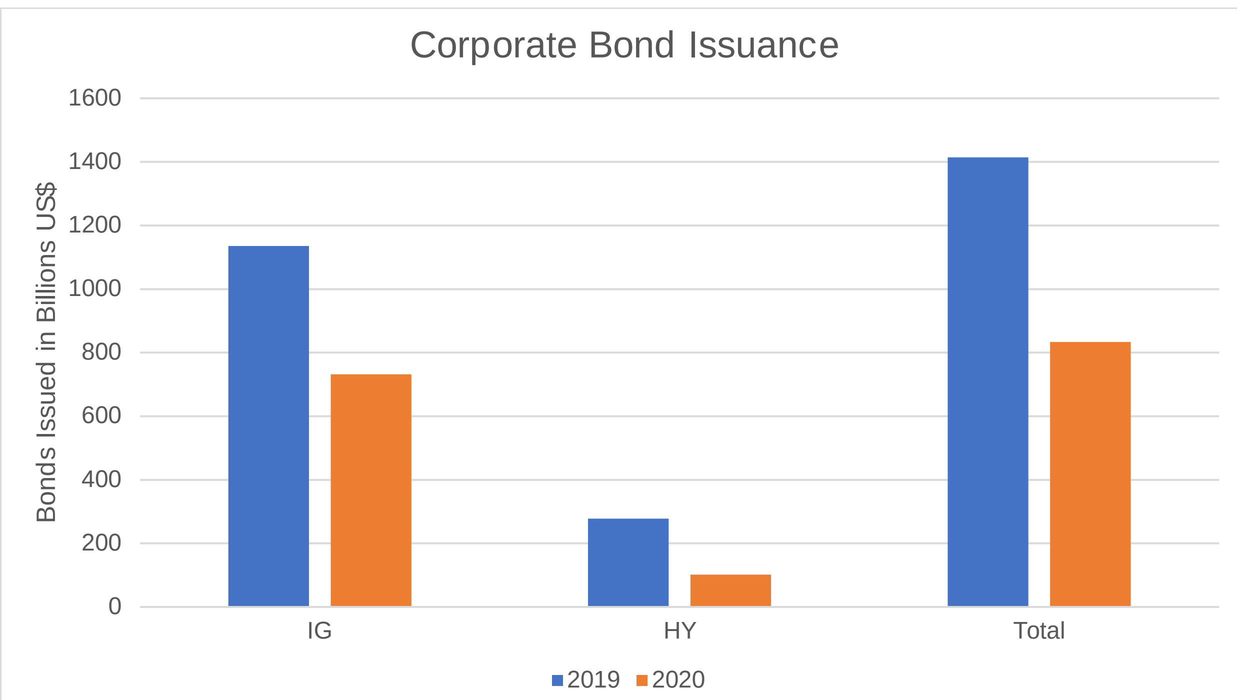


Source: Bloomberg as of May 15, 2020

FIXED INCOME

For the week, long-term US interest rates, as measured by the 10-Year US Treasury bond, fell modestly from 0.71% to roughly 0.64%[11]. On the heels of last week's announcement by Secretary Mnuchin that the US Treasury would need to issue more than $3 trillion in new bonds, it was announced this week that the Treasury would begin issuing 20-year bonds with the first auction set for next week. Most of the recent Treasury issuance has been in the form of short-dated Treasury Bills and bonds within five-years of maturity. Longer-dated bonds may be helpful to those investors seeking to match liabilities with assets such as insurance companies and pension funds.

Credit markets were a mixed bag for the week with investment grade credit spreads moving slightly lower while high yield bond spreads expanded[12]. One area we are watching closely is the amount of new corporate issuance hitting the market as companies take advantage of low borrowing costs to refinance their balance sheets. Year-to-date as of May 1st, investment grade bond issuance stood at roughly $732.1 billion while high yield issuance was $102.2 billion. This represents a year-over-year increase of roughly 78.1% and 23.1%, respectively[13]. Why does this matter? As seen in the chart below, at this breakneck pace, it is reasonable to expect total issuance to surpass last year's record level. Our ongoing concern relates to the potential for downgrades in the coming quarters should companies' earnings remain low and/or below expectations. The potential for downgrades and bankruptcies suggests that investors should be demanding higher spread premiums to compensate for these risks. Additionally, with the potential for investment grade companies to be downgraded into high yield, index reconstitution may present additional challenges as passive investment grade managers are forced to sell these issues and high yield indices are rebalanced.



Source: https://www.sifma.org/resources/research/us-corporate-bond-issuance/

Appendix

1. Bloomberg as of May 15th, 2020
2. Bloomberg as of May 15th, 2020
3. https://tradingeconomics.com/united-states/industrial-production-mom
4. Bloomberg as of May 15th, 2020
5. Bloomberg as of May 15th, 2020
6. https://tradingeconomics.com/united-states/consumer-confidence
7. Bloomberg as of May 15th, 2020
8. https://www.bloomberg.com/news/articles/2020-05-13/powell-says-virus-poses-lasting-harm-more-may-need-to-be-done
9. https://www.multpl.com/s-p-500-pe-ratio
10. Bloomberg as of May 15th, 2020
11. Bloomberg as of May 15th, 2020
12. Bloomberg as of May 15th, 2020
13. https://www.sifma.org/resources/research/us-corporate-bond-issuance/