AndCo's Weekly Market Update

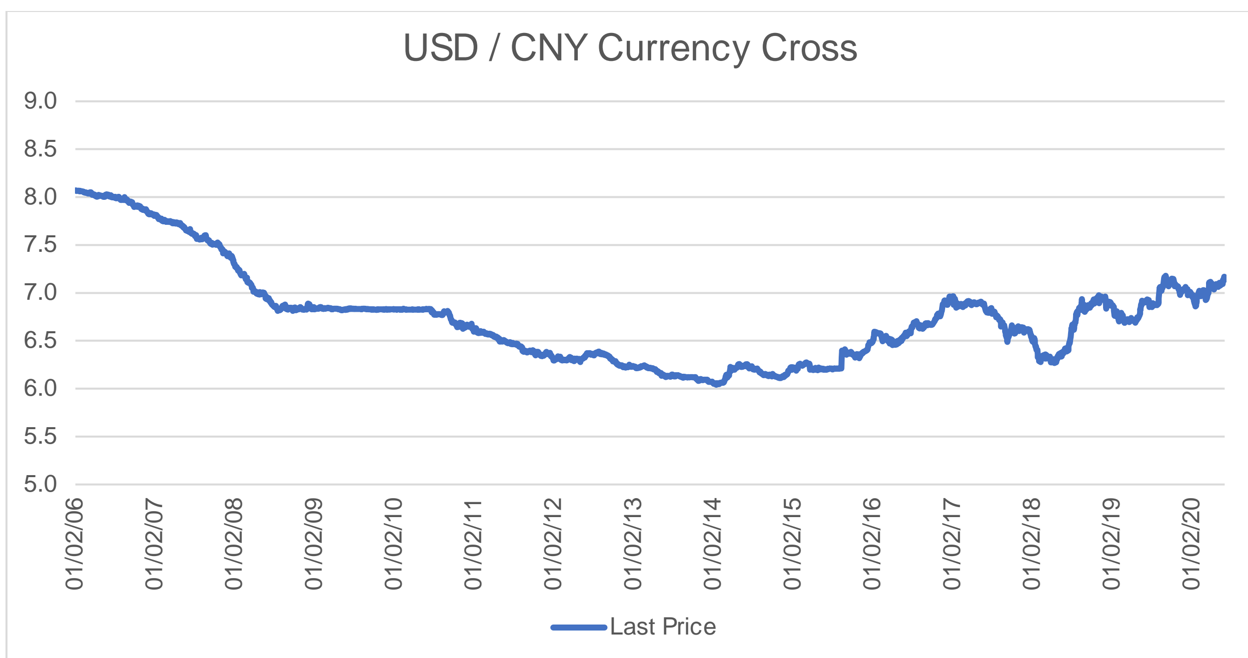
June 1, 2020

THE ECONOMY

We continue to look for signs that the economy has weathered the worst of the pandemic and has begun the process of recovery. There were a number of datapoints this week that offer both a glimpse into how difficult the recent past has been, but also reasons for optimism. The labor market continues to shed workers. For the week ending May 23rd, roughly 2.1 million Americans filed for benefits, bringing the total number of jobs lost since the onset of the pandemic to more than 40 million[1]. Despite this, continuing claims, or the number of individuals receiving benefits, fell 3.9 million during the week of May 16th. The implication here is that some of those who temporarily lost their jobs have begun the process of returning to work. Durable goods orders declined by 17.2% in April, one of the largest month-over-month declines on record[2]. Not surprisingly, personal spending also declined 13.6% during the month. Finally, we saw the second revision for the first quarter's GDP come in slightly lower at -5.0% compared to the advanced estimate of -4.8%[3].

While these data points are troubling, we saw several reasons to remain optimistic about the resiliency of the US economy. The May consumer confidence report was released on Tuesday showing a 0.9 point increase to 86.6 in May, up slightly from 85.7 in April[4]. Looking at recent months, it appears the rate of decline in the confidence reading may have bottomed following significant declines in both March and April. Personal income rose 10.5% in May, though much of the increase can be attributed to the stimulus payments from the government. While for many, the payments fill the gap resulting from lost wages, it is reasonable to conclude that some of those payments will be used to pay down debt such as credit cards and auto loans. While a snap back in consumer spending is not likely in the near-term, consumers may be in a better position later in the year assuming the labor market recovers.

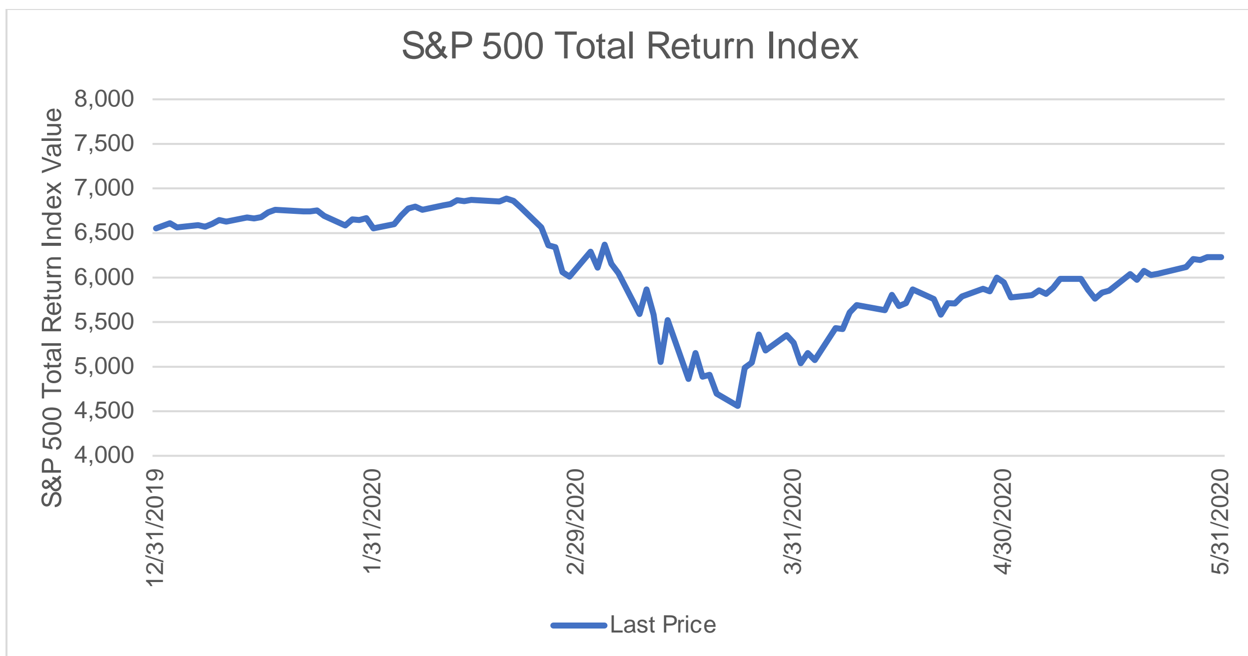
Globally, relations between the US and China continue to deteriorate following the recent decision by China to enforce strict security laws over Hong Kong. On Friday, President Trump endorsed legislation that could potentially bar Chinese companies from registering on US stock exchanges. While the tone of the rhetoric has continued to deteriorate in recent weeks, there has not yet been any economic retaliation between the two countries. However, it is interesting to note that the Chinese currency (yuan) continues to weaken relative to the US dollar. Why is this important? The currency exchange rate is set by the Chinese government and has historically been used as both a policy tool and as a signal to markets and foreign governments. One point of contention for President Trump has been the continued trade deficit with China. While the Phase 1 trade deal was supposed to help alleviate this problem, a weakening yuan may present an additional challenge as Chinese companies maintain their price advantage relative to US counterparts via a weakened currency.



Source: Bloomberg as of May 31, 2020

EQUITIES

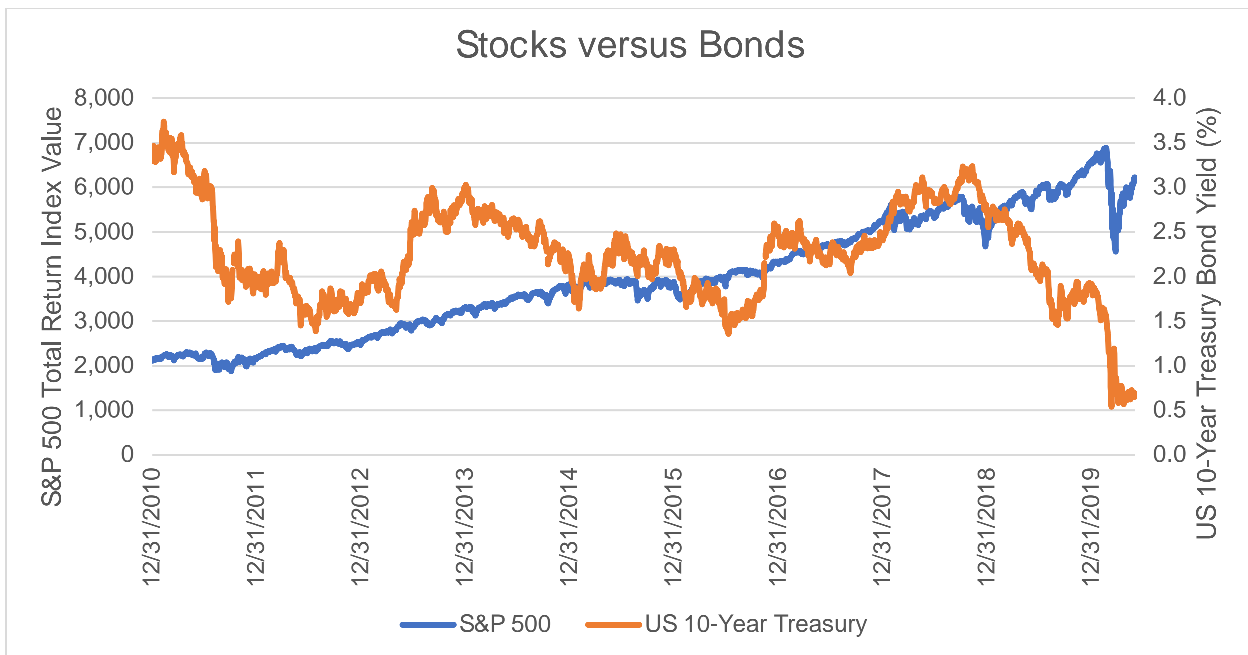
The old adage is to "sell the market in May and go away." If investors had decided to leave the market based on the expectation that bad economic data would lead to a declining market, they would have missed out on a great month. For the week, the S&P 500 Index returned 3.0%, and was up 4.8% for the full month[5]. While the recent advance is impressive, the market remains down roughly -5.0% year-to-date[6]. From a valuation perspective, the recent rise in equity prices has diminished some of the perceived value compared to when the market was trading at lower levels. As of the end of May, the S&P 500 Index price-to-earnings (P/E) ratio was 21.18[7]. The concern going forward will surround the ability of companies to grow earnings enough to justify their stocks trading at elevated values. Given the current economic environment, that could be a challenge. While all 50 states have begun the process of re-opening, given the magnitude of the decline in US GDP, it would be reasonable to expect that the recovery could begin to take hold later this year or early next year. That said, the Federal Reserve has committed itself to supply the market with liquidity. Importantly, with US interest rates effectively at 0%, the trailing 12-month dividend yield of roughly 2.0% on the S&P 500 Index looks attractive relative to bonds.



Source: Bloomberg as of May 31, 2020

FIXED INCOME

For the week, the benchmark US 10-Year Treasury bond yield was roughly unchanged at 0.65%[8]. With US equity prices continuing to grind higher, it is somewhat surprising that interest rates have remained subdued. That said, with the Fed continuing to purchase Treasury bonds in the open market, new supply has been diminished in recent weeks which has had a dampening effect on yields.



Source: Bloomberg as of May 31, 2020

While US interest rates have remained low, corporate issuers have taken advantage of the opportunity and issued a staggering amount of bonds in recent weeks. According to Bloomberg, year-to-date issuance of corporate bonds has exceeded $1 trillion as of May 28th [9]. According to the article, this amount of issuance is not normally reached until the fourth quarter of a typical year. While the ability of companies to raise capital at this time is crucial to their survival, it is important to note that there were more corporate bankruptcies in May than in any other month since the Great Financial Crisis in 2008[10]. The issue going forward will concern the ability of these companies to service a higher debt burden. In the event that the economy recovers more slowly, many of these highly levered companies will likely have to restructure their debt. Equally as important will be the reaction in the corporate bond market if, and when, interest rates do begin to rise. However, for now, these risks remain muted as the Fed continues to be supportive and investors do not require additional risk premia to hold corporate debt.

Appendix

1. Bloomberg as of May 28th, 2020
2. Bloomberg as of May 28th, 2020
3. Bloomberg as of May 28th, 2020
4. Bloomberg as of May 28th, 2020
5. Bloomberg as of May 29th, 2020
6. Bloomberg as of May 31st, 2020
7. Bloomberg as of May 31st, 2020
8. Bloomberg as of May 29th, 2020
9. Bloomberg as of May 28th, 2020
10. Bloomberg as of May 31st, 2020

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