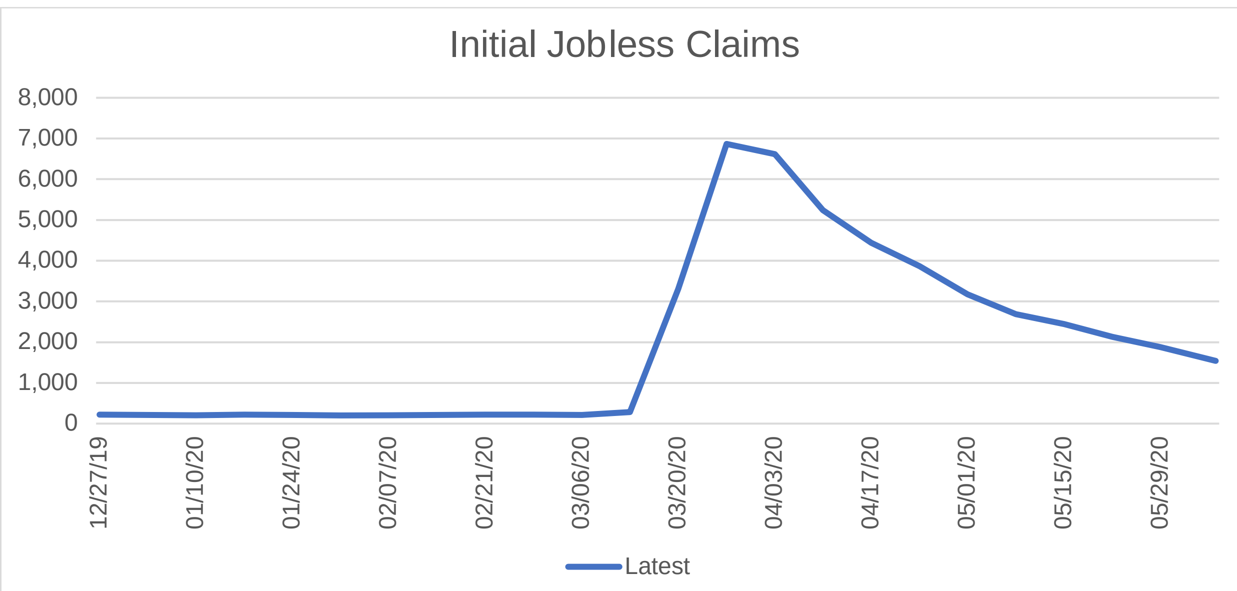
AndCo's Weekly Market Update

June 15, 2020

THE ECONOMY

In terms of US economic data points for the week ending June 12th, it was a relatively slow week. Initial jobless claims for the week ending June 6th were reported at 1.5 million, a drop of more than 350,000 from the previous week[1]. Continuing claims fell by a reported 339,000 to 20.9 million for the week ending May 30th[2]. While the trend continues to move lower, it is important to take a moment and reflect on the fact that more than 1.5 million Americans filed for unemployment last week. A truly staggering number. That said, as states continue to re-open their economies, many of these furloughed employees should begin returning to the workforce soon.



Source: Bloomberg as of June 11, 2020

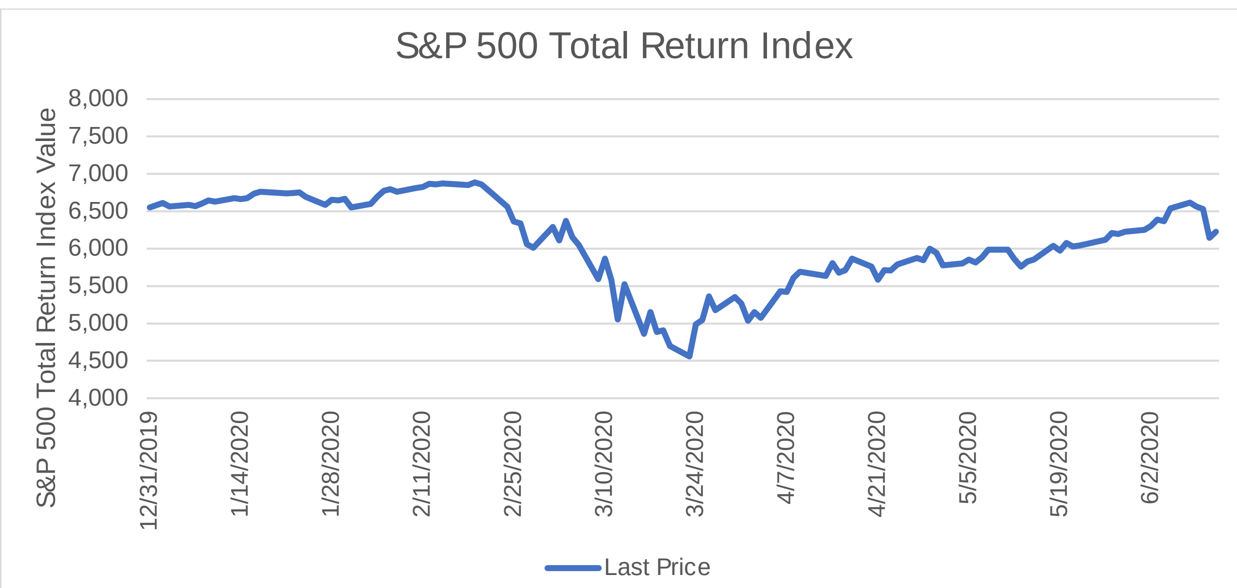
The National Bureau of Labor Research's (NBER) Business Cycle Dating Committee announced that the US economy peaked in February. This announcement marked the end of a 128-month expansion, the longest in the history of US business cycles dating back to 1854, and the beginning of a recession. Despite the contraction, we are hopeful the economy will see positive quarter-over-quarter economic growth beginning in the third quarter as the economy continues to re-open and that the recession will be short-lived despite the lingering effects from the COVID-19 pandemic.

The Federal Open Market Committee (FOMC) met this week and Chairman Powell announced no changes to the Fed Funds rate. Importantly, Powell signaled that US interest rates could remain low well into 2022 in an effort to provide liquidity to the market and thereby promoting an economic recovery. Some of this decision to keep interest rates low most likely can be attributed to the recent Consumer Price Index (CPI) reading that showed a decline of -0.1% month-over-month in May as the US economy was hit by a deflationary wave as a result of the pandemic. The Federal Reserve Bank (Fed) has a stated inflation target of 2.0% annually. Given the lack of measured inflation, this gives the Fed room to remain accommodative for longer.

Finally, the low interest rate environment continues to provide a catalyst for the real estate market as evidenced by the mortgage applications reading. The index increased 9.3% for the week ending June 5th3. Low interest rates, combined with an improving labor market, also contributed to an increase in the Michigan Consumer Sentiment Index which rose 6.6 points to 78.94 for the June preliminary reading. Both the current conditions and expectations sub-components of the reading were higher which suggest that consumers are beginning to move past the pandemic and focus on the recovery.

EQUITIES

US equity markets closed sharply lower on the week with the S&P 500 down -4.7% while the Russell 2000 Index dropped by -7.9%. With no real news to start the week, stocks traded in a narrow range on Monday and Tuesday. However, beginning on Wednesday, market volatility began to increase as Chairman Powell's statements concerning the Fed's intention to hold interest rates lower began to sink in. The implication being that if the Fed holds interest rates lower for longer, underlying economic conditions may not be as good as investors first thought. Thursday saw a significant downdraft in the market following reports that a second wave of COVID-19 infections may be on the horizon as many states recorded record increases in cases. As a result, the S&P 500 Index declined by more than -5.9% on Thursday5. While the concern related to potential for another wave of COVID-19 infections is real, investors may also have been examining the significant retracement the market has made since the low on March 23rd and determined the market may be overvalued. As possible evidence, the S&P 500 traded with a P/E of roughly 21.8x as of the close on Friday, well above the long-term average of roughly 16x6. Given the uncertainty regarding future corporate earnings, investors may have simply used the opportunity to take profits and reallocate portfolios into asset classes with better valuations. As we near the end of the quarter, future corporate earnings guidance will most likely shape how the markets proceed from this point forward.

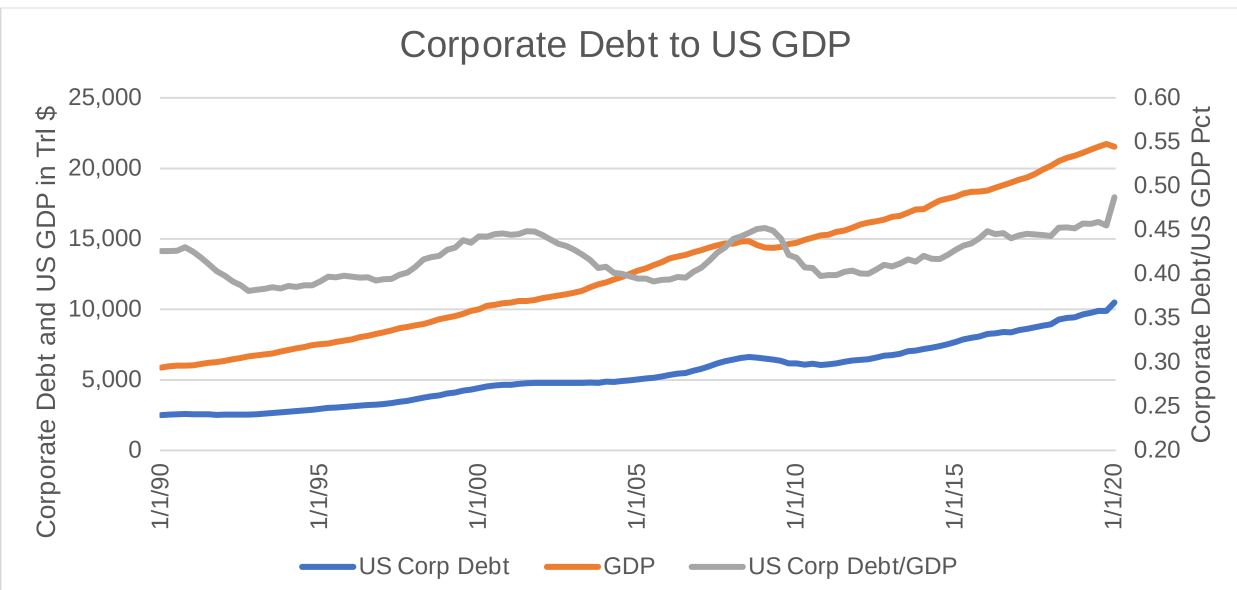


Source: Bloomberg as of June 12, 2020

FIXED INCOME

For the week, US interest rates, as measured by the US 10-Year Treasury yield, were lower. The combination of the Fed's economic outlook and forward guidance on interest rates, in conjunction with the prospect of a second wave of COVID-19 cases, pushed yields lower. While the recent decline in yields is noteworthy, the likelihood is that US interest rates will slowly move higher over time as the US economy shows signs of recovering and the significant new supply of Treasury bonds is digested by the market. The economic calendar should provide some clarity on the speed of the recovery as we will see May's retail sales figures, industrial production and housing data in the coming days. In April, all three gauges of the economy showed large declines as a result of the pandemic.

For the week, investment grade and high yield US corporate credit spreads increased 13 and 75 basis points, respectively, as investors demanded more yield to compensate for perceived risks in the market7. While spreads have declined dramatically from their highs during the height of the pandemic, there remains a healthy amount of risk in corporate credit. As we discussed in last week's Market Update, lower interest rates have provided companies the ability to refinance outstanding debt at lower costs while also increasing leverage by issuing new debt. As long as interest rates remain low, this environment provides the needed time for the economy to restart which should improve business conditions. However, as noted by Fitch, high yield defaults are expected to increase to more than 5% annualized in June, the highest since 2016. Most of the defaults have been confined to the energy sector as a result of the sell off in commodity prices resulting from the pandemic. However, we have also seen recent defaults in several large companies, most notably Hertz, which are not related to the energy sector. Interestingly, US corporate non-financial debt has now risen to nearly 50% of US GDP, a truly staggering number. While we continue to believe that the broad US economy will continue to show signs of improvement in the near future, we remain cautious that a sharp rise in interest rates may result in an increase in corporate defaults.



Source: https://fred.stlouisfed.org/series/BCNSDODNS#0 as of June 12, 2020

Appendix

1. Bloomberg as of June 11th, 2020
2. Bloomberg as of June 11th, 2020
3. Bloomberg as of June 10th, 2020
4. Bloomberg as of June 12th, 2020
5. Bloomberg as of June 11th, 2020
6. Bloomberg as of June 12th, 2020
7. Bloomberg as of June 12th, 2020
8. https://www.fitchratings.com/research/corporate-finance/us-high-yield-default-rate-to-hit-5-with-imminent-energy-bankruptcies-11-06-2020

Important Disclosure Information