2020 Mid-Year Update: Stimulus Abounds, Underlying Confidence Surfacing, Questions Still Remain

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First Half Recap

The new year started as a promising one for economic and asset growth, with the U.S. presidential election likely the largest domestic outcome "wildcard" and a relatively small, seemingly localized viral outbreak in Wuhan, China, way down on the lists of global risks. In just a few short months, a global growth engine that was modestly improving had transformed into a chaotic landscape full of question marks, unprecedented occurrences and responses by governments, consumers and investors.

The once localized illness quickly spread into one of the worst pandemics to sweep global economies and markets, dwarfing the effects of SARS and MERS before it, with social and traditional media adding to the frenzy. The confounding malady forced many federal, state and local governments to shut down or dramatically decrease activity, while this novel coronavirus took America from near half-century lows in unemployment to more than 13.3% by June (May data) — levels not seen since the Great Depression.

The S&P 500 suffered the worst first quarter since 1928, falling 19.6%. Governments around the world implemented quarantining and shelter-in-place orders to try and “flatten the curve,” and the effect on business was overwhelming as many companies shut their doors with revenues falling to zero. U.S. equity markets (S&P 500) dipped to three-year lows early in the crisis as traders and investors reassessed the potential longer-term effects of the coronavirus.

Given the abrupt shock to commerce and income across the nation, the modest advances in the U.S. economy came to an abrupt halt early in the year with advance Gross Domestic Product (GDP) estimates showing an annualized contraction of 4.8% for the first quarter of 2020. First quarter final readings are expected to show a deeper decline, while second quarter estimates range from a 25% to 40% decline, reflecting a near total shutdown of non-essential businesses.

As dismal as these data may look, the inorganic and abnormal stoppage of economic activity is increasingly likely to play out as a shorter-term anomaly as opposed to a long-term trend — at least according to some. Firms and respected wirehouses and business leaders are calling for more of a “V-shaped” or “rapid” recovery with official recession hopefully ending by the fourth quarter of 2020. There are, of course, many caveats.

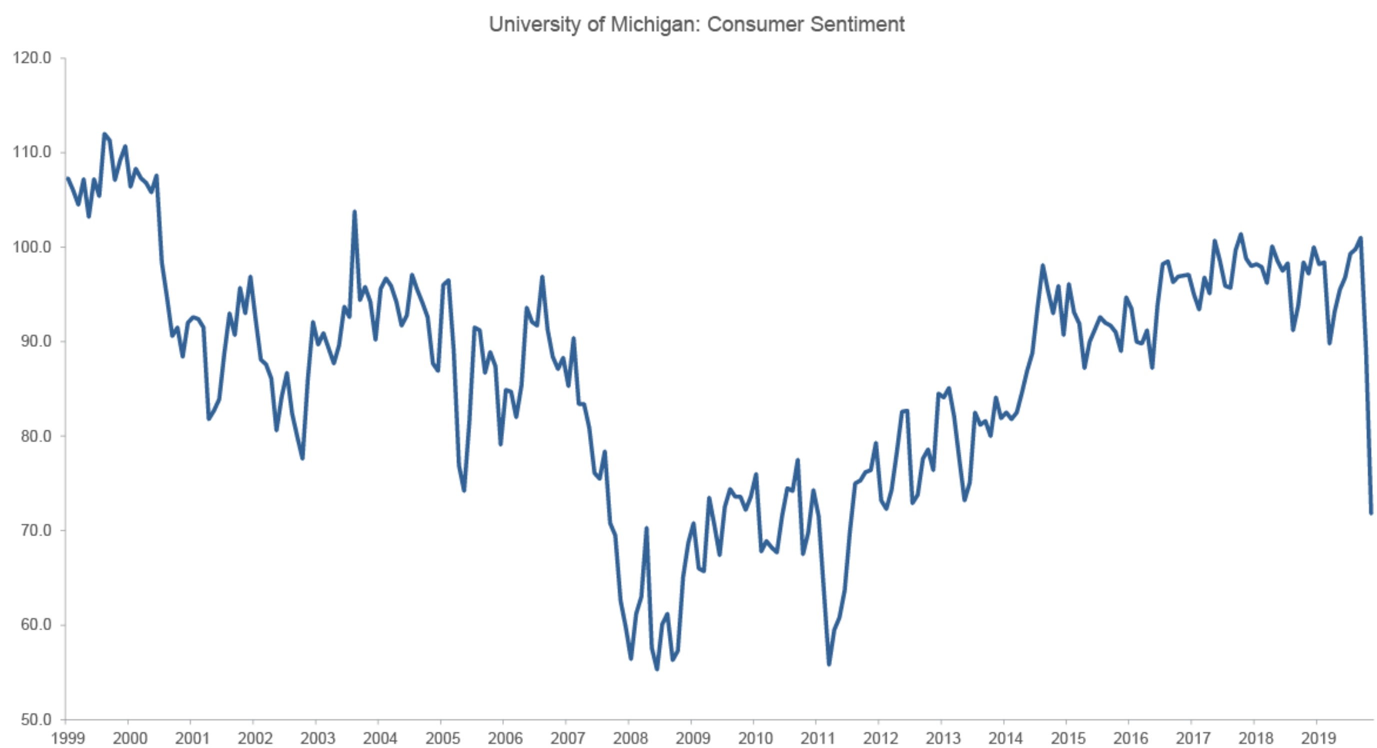
Even if the American economy recovers quickly, it’s unlikely that the rising “headline” tide will lift all boats. Some industries, such as commercial real estate, will have to drastically evolve their business models to meet new social trends and smaller average consumer budgets. Companies across many industries are already taking actions to accumulate cash and/or retool to focus on core competencies in an effort to survive and thrive in this sort of “forced evolution” of commerce.

Consumer Confidence, Retail and Trade

With many brick and mortar stores closing their doors or dramatically scaling back in-person transactions during the early stages of the pandemic, retail sales data saw its worst month-to-month drop on record in April. But the overall pain in the sector was short lived as The Department of Commerce reported a record jump in sales of 17.7% in May. The big winners during the lockdown were those companies with robust and organized ecommerce offerings, such as Amazon, Walmart, Target and others. Essentials (consumer staples) and some utilities also performed well.

As the pandemic expedited work-at-home trends, we saw a rise in the technology space. Both hardware and software makers experienced a boom as workers retool for more remote, digital trends, which are likely to continue (more on that later). Motor vehicle sales absolutely collapsed by April, with some automakers reporting double-digit sales losses in May compared to the prior year. That said, the pace of auto sales picked up sharply in May going into June, averaging 12.17 million vehicles, annualized, according to Autodata. Many experts believe the automotive industry, like many others, will never be the same and will be thrust into a more digital world where virtual and flexible shopping experiences will dominate.

For consumers, the pandemic, subsequent shutdowns, layoffs and social shocks put the average citizen to the ultimate test. Officially, the two-month drop to 85.7 in U.S. consumer confidence (as reported by the Conference Board) was the steepest freefall experienced since the Great Recession. That drop ended in May and yet the index still was nowhere near its 2009 low. So as scary as the past few months felt for many, the average household still kept at least a partially positive attitude. For reference, the index was marked at 100 in 1985.



Source: Federal Reserve Bank of St. Louis (FRED)

Even though much of the trade war stress of 2019 is gone, the new challenge is how supply chains can and will be restructured to prevent the massive stoppages of components and completed goods during the pandemic, which is still ongoing. One fact is that the global supply chain is very "people dependent." Without inspectors, drivers, pilots, train operators, loaders, etc., the process can easily grind to a halt. This is why artificial intelligence and automation are likely to play a role in future plans. The focus on a more digital, automated future added support to the tech-heavy Nasdaq index, which managed to attain fresh, all-time highs in June.

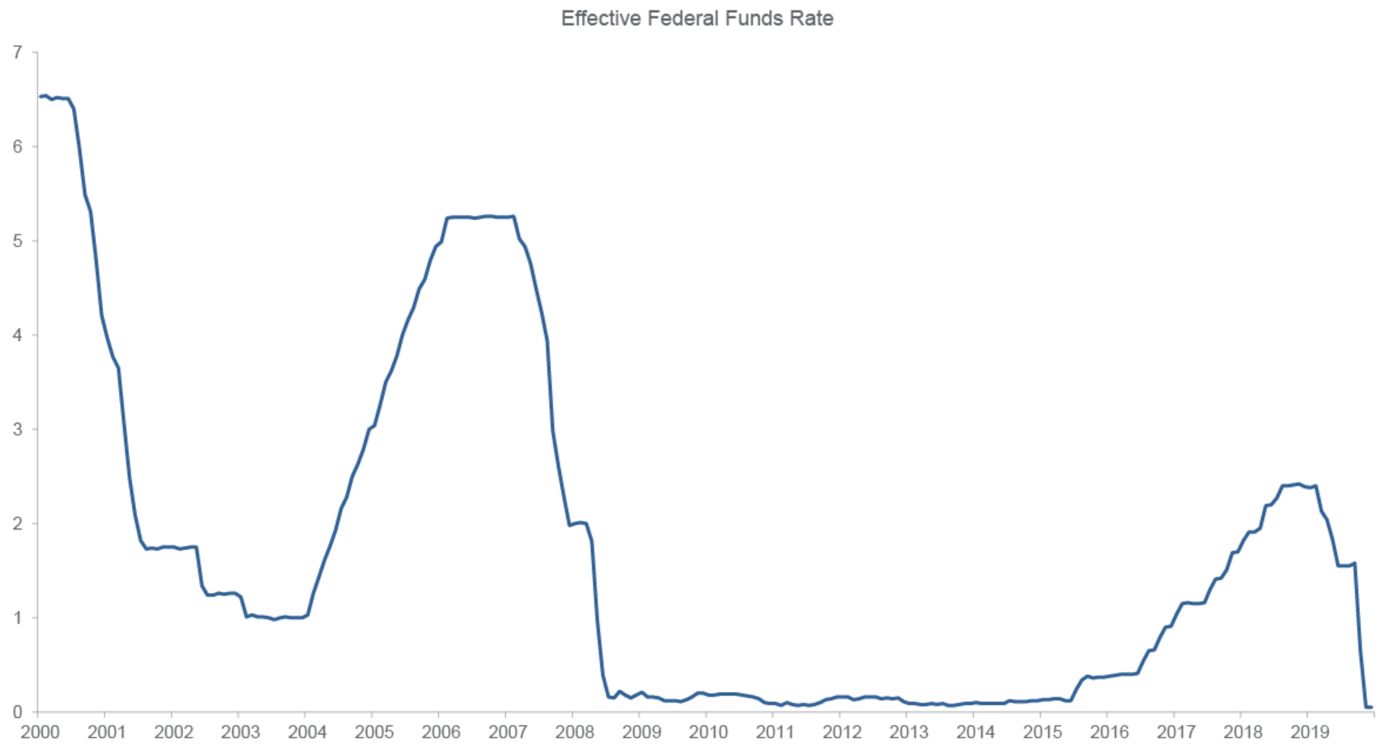
And while higher volatility in capital markets and sentiment is certainly factored into most forward models, there does seem to be a sense of hope, at least by and large. Equity and credit markets are now functioning well and valuation anomalies seem to have been soaked up. That said, the U.S. and global economies are on somewhat shaky ground as a recovery will be predicated on controlling the spread of the virus without shutting economies down again.

Governments' Very Aggressive and Fast Response

If the Federal Reserve was called "accommodative" in 2019, the central bank can now be classified as fully supportive, encouraging and outright aggressive in maintaining orderly credit markets, supporting equity prices above their standard mandates when it comes to employment and economic stability. The central bank is more communicative and predictive than in the past, adding to its effectiveness.

In unison with quick, highly stimulative legislation and policy from Washington, the Fed had also enacted several emergency initiatives to bolster markets, from aggressive rate cuts to lending programs and credit facilities to keep liquid flowing.

Fed chair Jerome Powell continues to be extremely vocal about current and future plans for stimulus and rate trajectory. Just recently, the Fed indicated that interest rates were likely to remain near zero until 2022. In addition, the central bank will continue to keep its quantitative easing pace steady by increasing holdings of Treasury and mortgage-backed securities over the coming months, while still supporting its extensive bond buying programs. The Fed is a little less optimistic about the recovery, but sees unemployment dropping back to 9.3% by the end of 2020, and to 6.5% by the end of 2021. The Fed sees the economy contracting 6.5% this year, before rebounding somewhat and growing 5% in 2021.



Source: Federal Reserve Bank of St. Louis (FRED)

First Half Highlights

- Global pandemic interrupts most economies and trade. The emergency triggers aggressive monetary, fiscal and legislative policy changes around the world.
- Federal Reserve moves to a highly accommodative policy, drops rates to near zero and introduces a multitude of programs to stimulate economic activity.
- The U.S. slips into a recession, but many experts believe the negative GDP growth will be short lived, with a recovery coming as soon as the last quarter of 2020.
- Corporate earnings estimates fell into deep negative territory, with full-year 2020 earnings estimates dropping from roughly +8% growth in early January to a decline of -24.1% by early June. Traders do expect an earnings rebound in 2021.
- Expect a remake of the economic and corporate landscape. Many corporations will have to alter the way they conduct business; look for a surge in remote workers and contraction in large corporate office parks.
- China records first economic contraction since official record keeping began in 1992.

Equities

Following a strong showing for 2019, stocks were choppy in early January as investors locked in some of their exceptional multi-year gains. By mid-January, equity momentum was back on, with equities peaking in February. By the end of February, fears of the spread of coronavirus had taken hold, triggering a turbulent selloff, exacerbated by algorithms and previously placed stop losses set to protect years of gains. By late March, bearish investors seem to have capitulated and equities began a recovery higher, recovering a fair amount of what was lost by early June. But since it's still difficult to fully model the economic effects of the coronavirus and the timeliness of an anticipated vaccine and/or effective treatment, equity volatility is likely to remain elevated and driven by headlines and events.

As of June 30, the S&P 500 and Dow Jones Industrial Average both registered negative year-to-date returns of -4.04% and -9.55%, respectively. Despite increased volatility across all indexes, the tech-heavy NASDAQ Composite logged a 12.1% gain since Dec. 31, 2019. All major equity indices experienced sharp corrections beginning in late February and into March, followed by a fairly significant bounce in all. This behavior implies the initial shock to stocks may have been overdone as investors simply couldn't model all the potential effects of the COVID-19 pandemic. The NASDAQ's outperformance is due to the heavy weighting of tech and ecommerce names, which seem less negatively affected by the virus' economic strain.

While still changing on almost a daily basis, full-year 2020 earnings estimates dropped from roughly +8% growth in early January to a decline of -24.1% by mid-June. The good news is that the negative revision trajectory has slowed and even reversed in many cases with analysts becoming more optimistic that the country's reopening will drive a jump in revenues and subsequent earnings results, although increased costs (shrinking margins) are likely to be a concern. At the time of writing, Q2 earnings season was just underway, so we were unable to analyze management teams' commentary and perspective on current and future climate.

Big tech, including digital, social and networking companies continue to shine, but not all tech is on fire. Energy-related companies are seeing some of the worst downgrades and outlook given the shock in the oil markets. Overall, we see S&P 500 operating earnings down (-5%) for full-year 2020, but that projection is likely to have a larger standard deviation than normal due to a myriad of highly impactful variables.

Credit Markets/Fixed Income

The Federal Reserve's aggressive cut of short-term interest rates by 1.50%, combined with its expansion of the size and scope of its purchasing program of Treasury and Agency Mortgage-Backed Securities and inclusion of corporate and municipal bonds, seems to be working well. These, and additional new programs aimed at restoring liquidity in the fixed income markets, have restored a more normal yield curve and added confidence to the bond market in general, with prices stabilizing. The U.S. Treasury Yield Curve steepened as the yield differential between 10-year and 2-year Treasuries widened modestly during the first quarter. Inflation expectations fell during the period.

The yield on the 10-year Treasury fell from 1.92% down to 0.67% during the most recent quarter, while investment grade credit spreads widened by roughly 175bps during the quarter, causing duration matched Treasuries to substantially outperform corporate bonds.

Within corporates, Utility sector bonds outperformed while Industrial sector bonds underperformed. Triple AAA rated bonds were the best performer while BBB rated bonds underperformed. Short-duration yield convertibles came under pressure during the first quarter as credit spreads widened out across fixed income asset classes. Additional dislocation in prices was seen during the second half of March, as convertible investors seeking liquidity were forced to unload positions, selling what was sellable, and artificially suppressing prices in short-dated yield convertibles.

Source: Federal Reserve Bank of St. Louis (FRED)

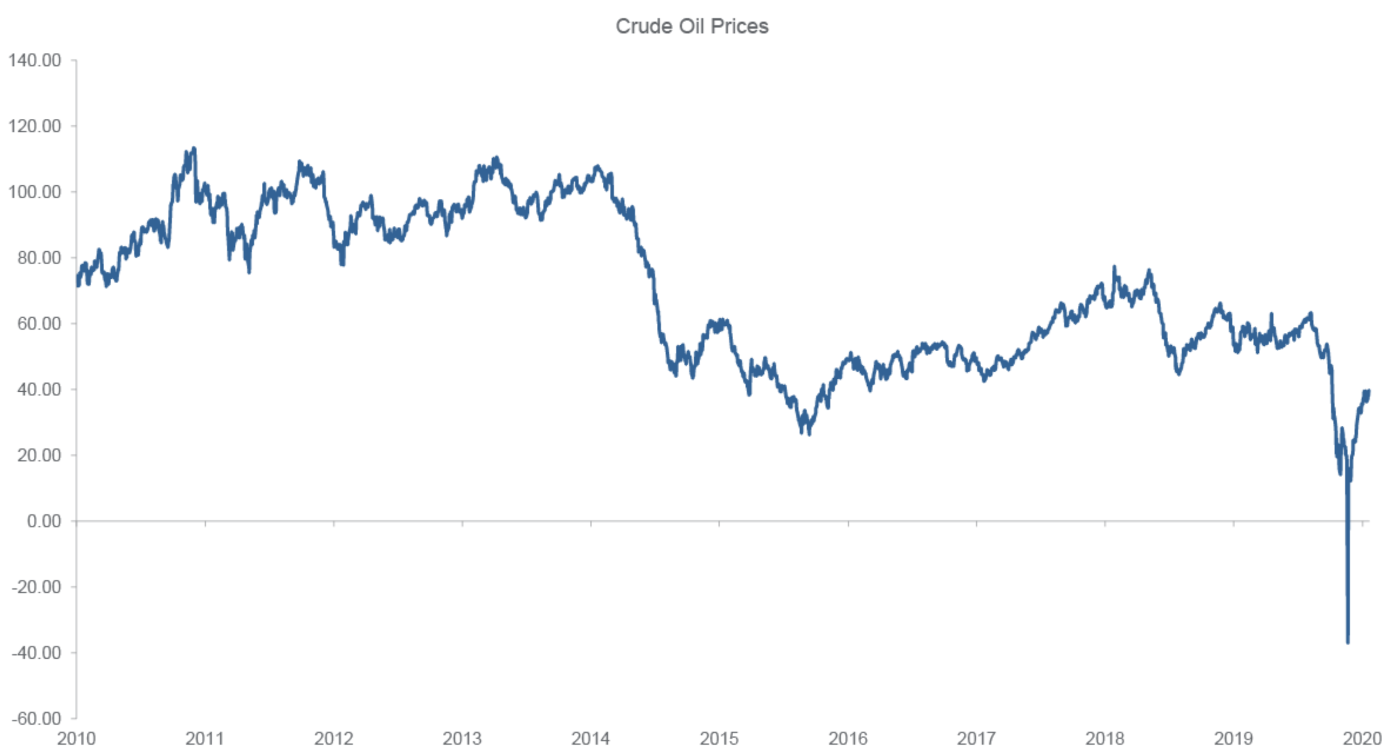
Commodities

With global consumption and supply chains interrupted, most soft commodities (grains, milk, etc.) were hit hard early in the first half of the year. On the other hand, some "hard" commodities like gold are benefiting from a drop in the U.S. dollar, along with their safe-haven attributes. Goldman Sachs and HSBC both increased their 12-month gold price forecasts to around $2,000 per troy ounce given the longer-term tailwinds.

Other precious metals with more of an industrial usage have experience heightened volatility and disconnects. Platinum and palladium, both used as auto catalysts, saw a huge divergence as palladium leapt to a record high of around $2,880 an ounce, making it roughly three times more expensive than platinum, which tends to be more highly correlated with the health of the auto industry.

Crude oil experienced a dramatic drop of more than 66% as a perfect storm of oversupply, OPEC politics and slashed demand drove May futures contracts negative for a brief period. Lower economic activity amid the COVID-19 pandemic coupled with the Russia-Saudi Arabia disagreement triggered the anomaly. Prices have since stabilized around the $43 mark as demand returns.

The midstream energy infrastructure asset class declined dramatically during the quarter due to the decline in global economic activity driven by the spread of COVID-19, the subsequent decline in commodity prices and technical selling pressure from levered closed-end funds. On the commodity pricing front, crude oil prices decreased -66.5% while natural gas prices declined -4.6% during the quarter.



Source: Federal Reserve Bank of St. Louis (FRED)

Market Outlook

It was extremely hard to predict the worldwide gravity and depth of the novel coronavirus pandemic. Even more difficult would be to assign a highly probable trajectory to capital outlooks. In other words, the back half of 2020 has a myriad of caveats that could dramatically alter market stability and performance as well as global GDP growth.

Here's what we do know:

- We are experiencing a sharp pandemic-driven contraction in economic activity from a consumption void that should (hopefully) be followed by a dramatic rebound in economic activity once fears abate to a level where consumers, small business owners and executive boards feel confident enough to resume "new normal" behaviors.
- We believe global central banks will continue to provide extraordinary monetary economic and market support. Their very low policy rates, asset purchases and lending programs will reduce volatility and help smooth out price and function irregularities across credit markets.
- Fiscal spending will support some, but not all, of the gap. After confidence restarts (with virus control), consumer spending is likely to be lower as global consumption style trends evolve. From a sector perspective, areas of outperformance in the back half of 2020 may include digital solutions (cloud, security, remote networking), properly positioned traditional and disruptive ecommerce, utilities and consumer staples. The latter may be the most interesting to watch as the U.S. grocery industry lacks a large, organized ecommerce solution. There are obvious leaders, like Amazon, in the space, but it will be interesting to see how solutions evolve given recent social changes.

There is resilience

The expeditious (albeit more volatile) rebound in equity markets was a sign that investors still see value across many industries. And while unlikely that the S&P 500 will back up through its previous highs, it seems (anecdotally) that a fair amount of retail and professional investors are using the large dips to enter positions in quality companies whose valuations had become a bit stretched during the peak.

General consumer confidence is also stabilizing. The University of Michigan's consumer sentiment jumped to 78.9 in June 2020 from 72.3 in May. But Americans do remain cautious, as data show most do not expect the reestablishment of favorable economic conditions anytime soon. The gauge for current economic conditions increased to 87.8 from 82.3 in May, while the index of consumer expectations rose to 73.1 from 65.9, both relatively modest readings. Ironically, tempered attitudes toward growth can help minimize disappointment, and in turn lead to a more positive response if, and when, economic landscapes improve.

We also expect the Federal Reserve to remain extremely accommodative and timely with its responses. To date, some of its lending programs have not been utilized by borrowers at all, as they simply don't see the need. The central bank still has arrows in its quiver and is reportedly discussing yield-curve control (YCC) or interest rate caps for the first time since the 1940s to clamp down on rising Treasury rates/yields in order to keep borrowing costs low for businesses and consumers.

There is, of course, the chance of a second global wave, that could backtrack much of the country's forward progress. Seoul, Korea, is currently seeing a resurgence of infections and is taking necessary precautions. Actual and headline risks surrounding the virus' effects must be considered in forward-looking models. We are hopeful that the trend of lower mortality and research brings forth a vaccine, but most experts don't see that widespread solution occurring until 2021. Treatments should continue to improve.

Unemployment is likely to remain elevated and could even worsen slightly over the next couple months before beginning its decline. The unemployment rate is projected to average 15% during the second and third quarters of 2020. Inflation should remain well under control (1%+-), below the Fed's target.

Outlook Positives

- Fed remains supportive of markets – The Fed has acted quickly and aggressively to address market disconnects, liquidity concerns and even equity market volatility. We believe they will continue their very supportive role and react quickly to quell disruptions.
- Inflation – Remains low and is likely to stay that way. Cheap fuel and energy for much of the country should remain for Q3 and Q4, softening the blow for consumers.
- Government stimulus – Washington has already enacted several bipartisan stimulus packages that continue to benefit consumers and businesses. And while we don't expect a myriad of additional bills becoming law, there is a chance of additional stimulus if data doesn't improve.
- Race for vaccine/treatment/cure – The medical community's response to the novel coronavirus has been unprecedented. Scientists, researchers and medical companies around the world are making small breakthroughs on a weekly basis. Treatment options should continue to improve, adding confidence and stability.
- Data supports expedited recovery – From increased travel and petroleum consumption to payroll improvements and continued housing market stability, consumer activity does appear to be exponentially increasing.

Outlook Risks

- China – China saw its economy contract for the first time in its history in Q1 and is now reportedly in technical recession. Economists are hoping for a “V-shaped” recovery there as well, but a continued decline in consumption and overall health could slow global recoveries and have deflationary effects on materials.
- Substantial second wave of COVID-19 – A severe resurgence could trigger local, state and even federal closures, deepening already stressed resources, budgets and consumer confidence. While current data is mixed, it does appear that increases in cases and/or mortality are limited to a select number of areas.
- Increased volatility – Expect volatility to remain elevated and for market participants to be more sensitive to events and headlines. Volatility is likely across most asset classes but may be more pronounced in equities. Investment selection will continue to require increased precision as indexes may include less desirable names that mute overall performance.
- Unexpected policy/regime shift – The current administration could abruptly shift its policies in a way that adversely affects the economic recovery. The November election could potentially bring about a complete regime change that could alter trajectories of many asset classes. Volatility centered around election results will likely intensify as we approach Nov. 3.