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Around the Markets

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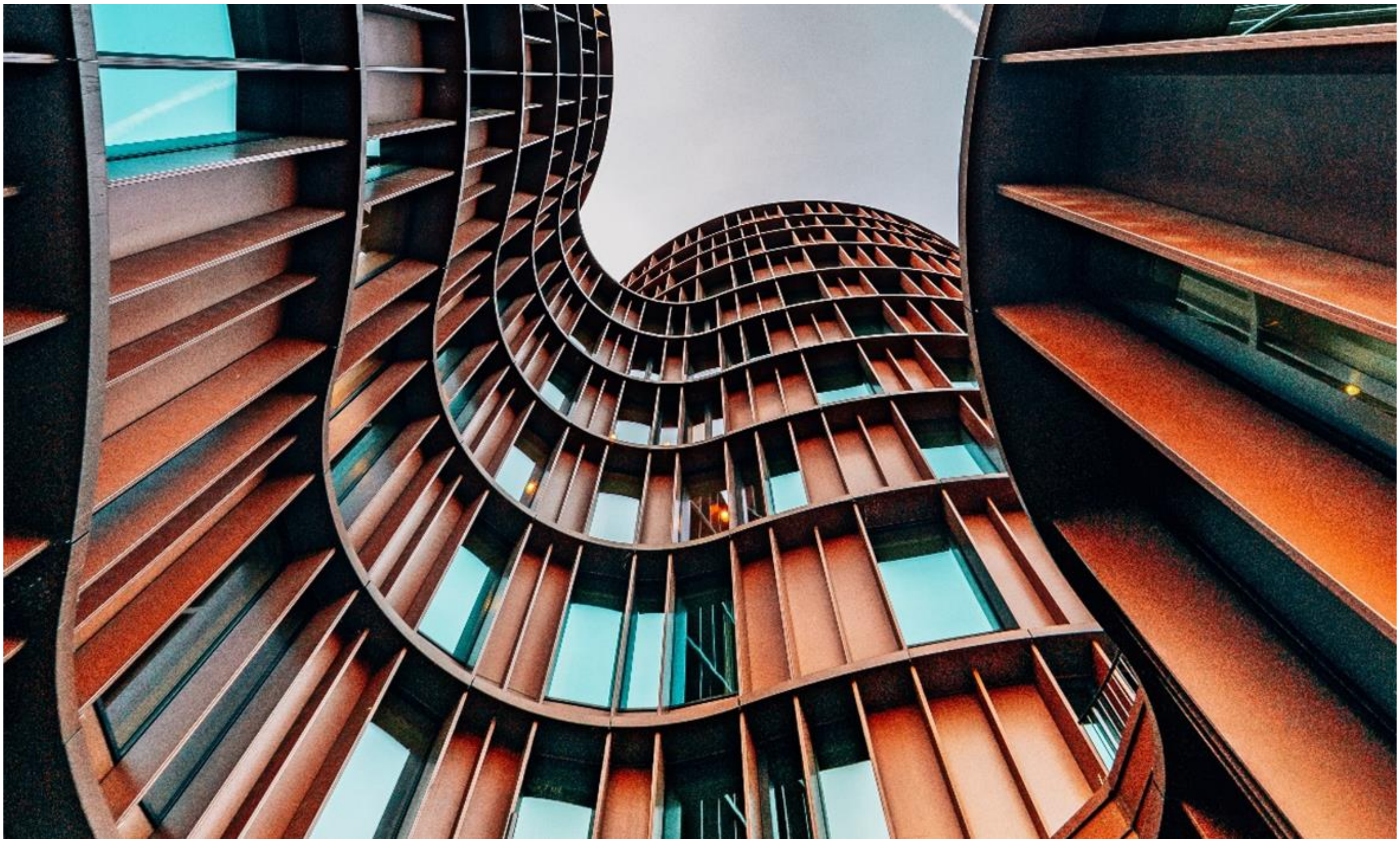

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Congress Throws a Lifeline with CARES Act

In our previous *Around the Markets*[1], we discussed that the potential passage of the Phase 3 stimulus bill could go a long way toward strengthening investor confidence.

On March 27th, the US Congress approved the Coronavirus Aid, Relief and Economic Security (CARES) Act to support individuals, businesses and governments most affected by the virus-induced economic shutdown. The S&P 500 Index rallied 20% last week as it became increasingly clear that the bill was going to pass.[2]

The CARES Act will deliver over $2 trillion in economic relief, or more than 10% of US annual GDP. It is the largest single year piece of legislation since FDR's New Deal.[3]

From an economic recovery perspective, we believe that the most important aspect of the CARES Act is that nearly 50% of the package consists of direct funds for households and small businesses. That includes $300 billion in direct cash handouts and nearly $400 billion in small business assistance in the form of loan forgiveness.[4] Specifically, for keeping workers on their payrolls during the current COVID-19 emergency, small businesses (<500 employees) receive forgiveness for loans used towards payroll costs, mortgage interest, rent and utilities.[5]

As small businesses employ one-half of the private sector workforce, the passage of the CARES Act is important in ensuring that critical economic relationships are not disrupted by months of low activity and therefore may recover relatively quickly when the pandemic is over. The CARES Act has provided a lifeline to small businesses, and subsequently many US workers, so they can stay afloat financially through the current crisis.

It's important to note that the economic relief provided to households and small businesses is intended to *replace* lost wages and profits and will be used to fund essential spending that would be captured in GDP regardless (in the absence of delinquencies and defaults). As a result, we do not expect the CARES Act to boost US GDP in the near term. Consumer spending is not simply a function of wages, but also confidence and expectations.

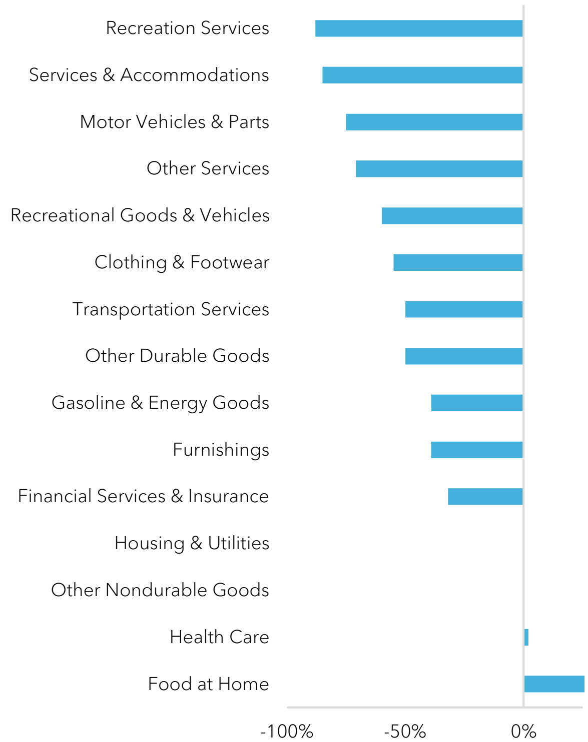
The Waiting is the Hardest Part

Given the extreme uncertainty in the duration of the economic shutdown, consumers are likely to limit their near-term spending to the essentials until there is more visibility on the extent of the economic damage from the pandemic.

We expect a sharp pullback in consumer spending, particularly in discretionary categories such as travel and restaurant dining. Investment firm Morgan Stanley expects an average 40% decline in real consumer spending between February and April.[6] As consumer spending accounts for over two-thirds of US GDP, such an abrupt shift in behavior is expected to translate into a sharp decline in GDP, particularly in Q2.

[1] As of 3/19/2020
[2] Bloomberg
[3] CRFB (Committee for a Responsible Federal Budget)
[4] CRFB (Committee for a Responsible Federal Budget)
[5] SBE (Small Business & Entrepreneurship Council)
[6] Morgan Stanley, 3/22/2020

Expected Decline in the Level of Real Consumer Spending Between February and April[7]



The median of economists' forecasts reported on Bloomberg from March 19th to March 31st now estimate annualized growth of -2.1% in Q1 versus the previous quarter, owing to a particularly sharp drop off in March activity. The estimated QoQ growth in Q2 is -24.0%, a historically sharp contraction. With two consecutive quarters of negative economic growth, the US is now widely expected to enter into a recession beginning in Q2.[8]

With daily new virus cases in Italy continuing to decline[9], a survey conducted by Cornerstone Macro between March 27th and March 30th indicates that most investors expect the number of cases in the US to peak in late April or early May.[10] As lockdowns may start to loosen in the summer, economic activities will likely begin to resume thereafter. The median economists' forecasts of GDP growth rates for Q3 and Q4 are 12.0% and 6.7%, respectively, resulting in YoY GDP growth of -3.1% for 2020.[11]

Given the nature of the crisis, there's still a lot of uncertainty at this stage. Infections in poorer countries, where social distancing measures are more difficult to implement, may spread back into the US. There is always the chance that we will see a rebound in cases later this year if the lockdowns are lifted too early. These are all left-tail scenarios that we simply cannot assess accurately, thus the potential path of recovery remains within a wide range.

The Economic Cost of Lingering Psychological Impact

Imagine a post-COVID world. Lockdowns are lifted. Restaurants are re-opened. Traffic congestion is up. Classrooms are filled with students. Millions of people are back in their offices.

However, not all things will return to normal, not right away, at least.

In China, where the COVID-19 outbreak is reported to be largely under control, many are still hesitant to return to their old lives. As fears about safety linger, many are still nervous about leaving their homes and going to public places, such as restaurants and theaters. Aside from this, many have become more cautious with their discretionary purchases, after having experienced the financial pressure caused by the country's economy effectively being frozen for two months.

Investors and businesses have been banking on pent up demand, which they hoped would be unleashed once restrictions were eased, so much so

[7] Morgan Stanley, 3/22/2020
[8] Bloomberg, 4/1/2020
[9] Johns Hopkins University & Medicine, 4/1/2020
[10] Cornerstone Macro, 3/30/2020
[11] Bloomberg, 4/1/2020

that "revenge spending" on luxury goods has become a buzzword on social media.[12]

The challenge that Chinese policymakers are facing to jump-start consumption will serve as a cautionary roadmap for governments around the world that hope for a quick recovery once lockdowns are lifted.

The global scale of the impact of the COVID-19 pandemic is unprecedented. The September 11th terrorist attacks and the 2008-2009 global financial crisis were somewhat limited by geography and business sector. In this case, the virus has no boundaries.

Furthermore, the psychological impact of the COVID-19 crisis is unique and likely much more profound than prior crises, and it has triggered both health anxiety and financial anxiety at elevated levels. The pandemic has left millions without jobs, sent billions into isolation, and forced nearly everyone on earth to grapple with the feeling that they or those they love are suddenly physically vulnerable. The sense of insecurity and uncertainty will likely have a lasting impact on consumer confidence and spending habits.

The economic rebound in Q3 may not be as swift as some economists have forecasted. Models of GDP projection should take into account the potential lasting impact of the pandemic on consumer psychology. Policymakers may need to continue to inject fiscal stimulus long after the pandemic is over, to ensure a U-shaped economic recovery.

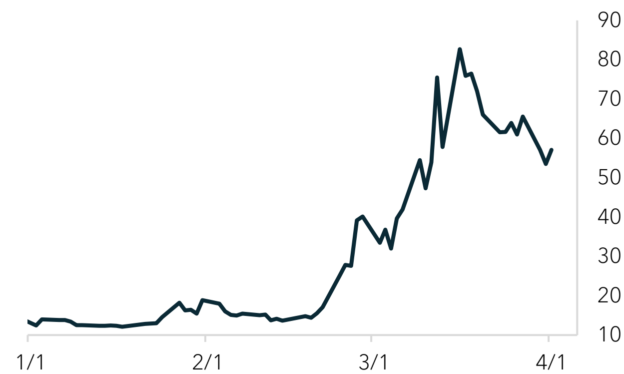
What Does the Market Expect?

Just as in 2009, it's likely that markets will rebound before the economy turns the corner. But should investors brace for more downside from here before that occurs?

We do not believe that earnings-based valuation metrics are helpful here. Companies will begin reporting Q1 earnings a few weeks, but even company managements have offered little or no guidance for the remainder of the year; we cannot expect analysts to have accurate forecasting models.

Credit spreads in fixed income tell us the market expects further downgrades to credit ratings. As the number of Americans infected with COVID-19 continues to rise, markets are likely to be rattled. We expect volatility to be high for a while; the CBOE volatility index, or VIX, remains high despite passage of the CARES Act.

CBOE Volatility Index (VIX)[13]



Bear markets rarely end without retesting the low, so in our view, lower equity prices are possible in the near-term. After the Q4 2008 market selloff, the stimulus efforts mentioned above jump-started the markets; between late November and the first week of January 2009, the S&P 500 Index rose over 24%. But as job losses mounted and the reality of the earnings decline set in, the Index lost all of its recent gains and then some, finally putting in the low in early March 2009.

The cause of this bear market may offer some solace for investors, however. As devastating as the virus has become, its effect on financial markets may be less than if the distress was caused by internal

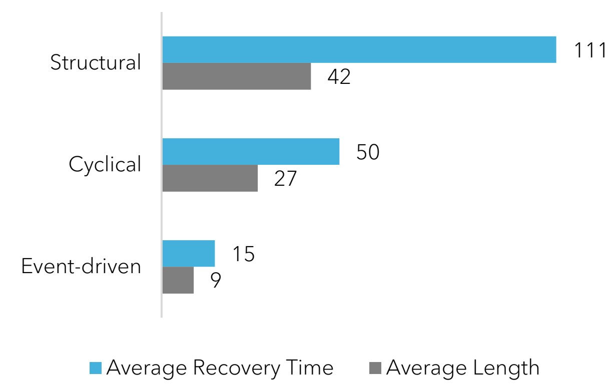
[12] Bloomberg, 3/12/2020

[13] Bloomberg, 4/1/2020

market dynamics. Investment firm Goldman Sachs notes that event-driven bear markets are typically shorter in duration (9 months on average) and recover more quickly (15 months on average) than bear markets caused by either structural or cyclical circumstances.[14]

Bear Markets Recover Faster After Adverse Events[15]

Average Length and Recovery Time of US Bear Markets Since 1800, by Type of Trigger (in months)



Can Banks Take All This "Stress"?

Financials are the second worst performing market sector so far this year – the S&P 500 Financials Index have a total return of -32%[16] – with only the Energy sector down more. It's an eerie reminder of 2008 woes and investors are right to ask if bank securities are attractive at these levels.

Much has been written about the difference in banks today vs. 2008. Balance sheets are stronger now; Barclays' banks analyst notes that loan/deposit ratios (a measure of liquidity) is the strongest since the early 1980s and credit quality is at its highest level since 2006.[17] The Federal Reserve also made a point to highlight banks' strength recently, commenting that, because banks hold so many low-risk, liquid assets like cash and government securities, traditional capital ratios understate their strength.[18] The Fed also puts the largest US banks through an annual "stress test." The latest one, in which the banks all emerged with adequate capital, simulated a 25% drop in house prices, a 10% unemployment rate and a 50% decline in stock prices.[19]

Nonetheless, as the CARES Act provisions allow for credit extensions and loan forgiveness, banks are likely going to shoulder some of that burden, even with looser rules around allowable leverage ratios. If economic weakness lingers, demand for loans could erode. And banks are already dealing with the malaise of exceedingly low interest rates that limit fee-based income. Some relief has come from regulators relaxing accounting standards that should make it easier for banks to help borrowers. Larger banks may be in a better position to deal with upcoming challenges than their smaller community bank peers that have less flexibility to diversify.

Investors interested in banks should feel comfortable holding a moderate percentage of higher quality bank stocks in their portfolios. And we expect their dividends to be generally secure; most of the larger banks have relatively low payout ratios (dividends/earnings) and have already stopped share buybacks to preserve cash that may be used for dividend payments.[20]

All the Gems May Not Be Hidden

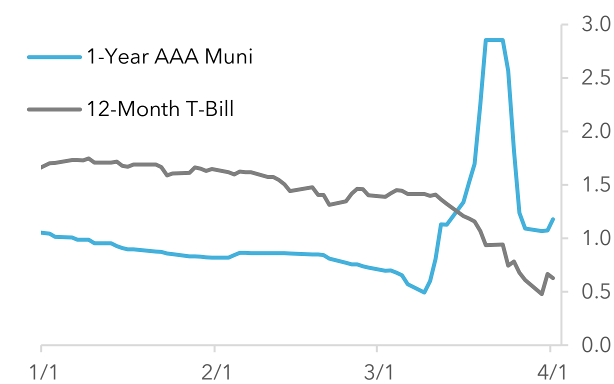
Income-seeking investors may be discouraged that recent news stories highlight companies that have announced cuts to, or suspension of, stock dividends. That is clearly a risk as the economy

[14] The Wall Street Journal, 3/27/2020
[15] Goldman Sachs
[16] Bloomberg, 3/31/2020
[17] Barron's, 3/23/2020
[18] Barron's, 3/23/2020
[19] CreditSights, 3/27/2020
[20] Barron's 3/23/2020

struggles and company managements shift capital allocations to preserve balance sheets. But we expect most of those actions to be limited to stocks within the Energy sector and those most exposed to a drop in discretionary consumer spending. We encourage investors to review their exposure to these areas. We also expect many companies to suspend their share buyback policy while maintaining their dividends.

Yield-oriented investors may want to shift their emphasis to the fixed income markets. Price dislocations have made municipal bonds quite attractive relative to taxable instruments; muni yields are almost double those of US Treasury bonds. This does not happen very often.

1-Year AAA Muni vs. 12-Month Treasury Yield[21]



While tax revenues are likely to be lower due to the economic shut-down, state and local governments are recipients of some relief in the CARES Act. Also, the Federal Reserve may now purchase municipal bonds, adding liquidity to that market.[22]

Preferred stocks are another source of yield that we find attractive. They have participated in the market's selloff to the point that yields are in the 5-6% range. True, most of the issuers of preferred stock are banks. But the real issue for preferreds, since they are senior to common stock dividends in capital distributions, is whether banks will have limitations imposed on them to maintain required capital. According to CreditSights, even if banks were to suffer huge losses, it is highly unlikely that Common Equity Tier 1 ratios (solvency gauge) would erode to the point that preferred dividends would be restricted.[23]

For investors who are not necessarily seeking income, we look to two of the largest sectors in the market: Technology and Health Care. Both have a large representation of growth stocks and both should benefit favorably from changes that are likely to occur as our nation returns to normal.

Technology is already benefitting from stay-at-home requirements of greater bandwidth and increased video game and downloaded content usage. But some behavioral patterns are likely to remain after the crisis passes. The demand for person-less transactions, increased use of the cloud for data access and storage, and an upgrade cycle in laptops and tablets are all potential longer-term benefits to the sector.

Benefits to segments of the Health Care sector as a result of the pandemic are numerous. We expect that the diagnostic testing and equipment of life sciences companies will be in demand for long beyond this crisis. Biotechnology and pharmaceutical companies, criticized in recent years for their pricing policies, are now seen as lifelines in the search for a cure. Investors seeking longer term appreciation should be able to find investment opportunities here.

[21] Bloomberg, 4/1/2020
[22] Barron's, 3/30/20
[23] CreditSights, 3/23/20

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