08/04/20

Quarter in Review

The Markets

Q2's rebound in equity security prices was one of the fastest on record, and even more surprising given the economic backdrop. With S&P 500 up over 20% for the quarter it almost reversed its entire loss for Q1. Value stocks across the capitalization spectrum were up but didn't recover as much as the broad indexes or growth tilts. And value stocks had fallen much farther to begin with, over 30% for mid and small cap names in Q1. Developed nations' equity was down 28% in Q1 and clawed back about 13%, while EM was down 22% in Q1 and up 17% in Q2. Growth equity along with fixed income were the definitive winners of Q2 though, with long bonds up over 6% in both Q1 and Q2. Medium term bonds were up close to 3% while short term bonds were up 2% in both Q1 and Q2. Like developed market equities, real estate and commodities were up close to 12% for the quarter but still deeply in the red for the year, down over 18% and 23% YTD respectively.

National

Although I will attempt to enumerate other important events during the quarter, there is really only one topic, Covid-19, from either a national or international standpoint, that mattered to headlines. China US tensions, albeit a secondary or even tertiary topic to the November US elections, may in fact turn out to be the much broader and deeper issues facing the world over the next decade, but for now it is Covid-19, a viable non-side effect vaccine, and the ability to cope economically from measures taken. The quarter started with new unemployment claims posting a 6.6mm number, down from March's highest ever 6.8mm, dating back to January of 1967. In mid-April the president temporarily halted funding to the WHO, while Gilead Sciences' drug Remdesivir showed promising results in helping patients with Covid. Toward the end of April, the President signed an executive order suspending immigration while a $484 billion stimulus bill passed the Senate. The next day the President also suspended issuing Green Cards for two months. In the end of April, NY announces a phased reopening could start May 15th, along with Georgia pushing ahead with their reopening plans. By the end of April, US Covid cases topped 1 million with 58k deaths. In early May the Secretary of State stated COVID-19 began in a laboratory in Wuhan China, while California (the first state to shut down), started to loosen its lockdown along with most countries in Europe. J. Crew Group filed for Chapter 11 on May 4th, followed by Neiman Marcus on May 7th, and then J.C. Penny on May 15th. In the middle of May, Dr. Anthony Fauci testified to the Senate that opening too quickly could risk new coronavirus outbreaks. On May 21st AstraZeneca received 1 billion in U.S. government funding of development of an experimental coronavirus vaccine.

A day later, Nissan announces 20k in job cuts and IBM said it would be cutting an unspecified number as well. By the end of May the US had 1.7mm (up 700k in one month) and 98k deaths (up 40k from April) from Covid-19. During the first week of June the S&P 500 went green for the year, having recovered to its January 1st levels, but quickly retraced to end the month lower. The Federal Reserve's meeting projections show interest rates will be kept at or near the zero-lower bond through 2022, while asset purchases would continue. In mid-June the first signs of a second wave of infections were showing up and by the third week cases were rising dramatically in Texas, Florida, Arizona and California. With the Chinese US relationship starting to fray, a meeting in Hawaii resulted in China agreeing to ask state owned agriculture buyers to help meet the terms of the phase one deal, which was to increase purchases of U.S. goods and services by $200 billion over 2020 and 2021, and commitment to buy $40 to $50 billion of agriculture product in both years. In the final weeks of June, the IMF projected that the US would see its GDP fall by 8% in 2020, while gaining 4.5% in 2021. In June, GNC Holdings, Lucky Brand Dungarees, Brooks Brothers, RTW Retailwinds (New York & Co.), and Ascena Retail Group (Ann Taylor, Lane Bryant, and Catherine's) all filed for Chapter 11. By the end of June, with daily increase of Covid cases topping 38k, governors halted opening plans in Texas, North Carolina, Louisiana and Kansas. The Fed capped bank dividends and banned share buybacks through September, and capital plans will have to be resubmitted later in the year. Finally, in the end of June, companies from Unilever, Coca-Cola Co., Starbucks Corp to Diageo PLC said they would halt or reduce advertising with Facebook for its inability to police hateful and misleading content.

International

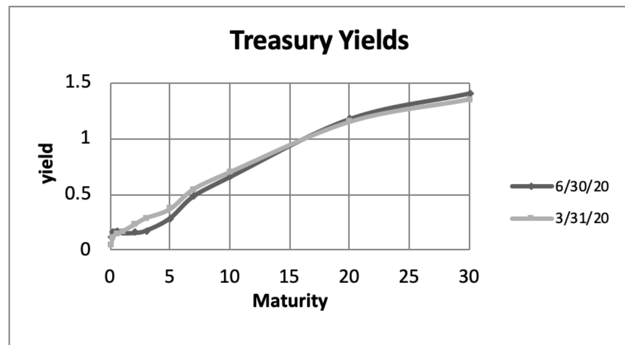
In the beginning of April, the global death toll was 42k on 860k reported cases, and by the end of the quarter there was 507k deaths and 10.45mm cases reported. On the banking front HSBC, Standard Chartered Plc, Royal Bank of Scotland Group Plc, Barclays Plc and Lloyds Banking Group Plc all cancelled outstanding payments and said there would be no dividends in 2020. After OPEC said it would curtail production by 10 million barrels or more a day, WTI closed up $26 from $20 in the beginning of the month. The PM of the UK was hospitalized for Covid-19, and Japan announced a $1 trillion-dollar stimulus package. By the middle of April, European countries began to show signs that they were slowly lifting restrictions. The international energy agency said that there is a risk of running out of places to store oil, as global demand was said to fall by 9% this year. **On April 20th WTI went to negative $36 a barrel spot price**, and then slowly climbed through the quarter finishing at close to $40, well short of the $60 a barrel in the beginning of the year. This was caused by a drastic 30 percent cut in the demand for fuel that made companies pay others to store their oil. In fiscal news, the Group of Seven countries had purchased $1.4 trillion of financial assets in March while they estimate that central banks' balance sheets will have increased $6.8 trillion when it is all over. Service PMIs dropped in Germany to 15.9 and France to 10.4, both were above 50 in February. Most PMI data are considered "soft" economic data points gleaned from surveys, where expansion is anything higher than 50 while anything less is contractionary. The composite for Europe dropped to 13.5, while European leaders endorsed a 540-billion-euro fiscal plan. At the end of April Italy's PM said Italy will start to reopen but schools will stay closed until September. BOJ announced further corporate bond buying and scrapped the previous limit for it. Spain and France saw their economies contract 5% in Q1 2020. Deutsche Bank surprised the markets announcing a €66 million in net income in Q1. In early May the ECB was told by Germany's top court it had

three months to fix their asset purchase program after the judges ruled it was unconstitutional. In early July the Bundestag with broad political alliance voted to accept the ECB explanation for the program. This fulfilled the Constitutional Court's demand that the Bundestag (the lower house) review the program as "proportionate." But this still leaves open other countries and future political groups to challenge measures like these in the future. By the 15th of May data showed that Germany's GDP fell 2.2% in Q1 compared to the US 5%, but that estimates were that Germany's GDP would fall by 6.5% for the year. In the latter half of May, Brazil reported a record day for infections turning the country into the world's fastest growing hotspot, while Latam Airlines Group SA filed for bankruptcy. Germany bailed out Lufthansa for close to 10 billion, while the ECB gave its 2020 outlook of a decline of 8% to 12% for the Union. In late May, China implemented a national security law that bypassed Hong Kong's legislature, to which the US responded negatively with sanctions and the removal of Hong Kong's special economic status. Moving into June, OPEC+ agreed to a one-month extension to the production cuts, and stricter approach to monitoring. In the UK economic growth fell by 20.4% in April, which, when added to the 5.8% decrease in March, wiped out the growth of the economy for the UK of the past decade. In the middle of June, while China reported largest daily increase in coronavirus cases since mid-April, North Korea blew up an inter-Korean liaison office on its side of the border, and Brazil hit a new daily record of close to 35k new Covid cases. On 06/18 the ECB conducted its largest ever liquidity operation with banks drawing 1.3 trillion euros, and four days later Wirecard AG, said $2.1 billion was missing from its balance sheet, while 1,300 workers in a slaughterhouse contracted Covid-19 in Germany. Interestingly, companies in Europe took up less than 15% of the funds made available as loan guarantees by law makers, meaning more than 2 trillion remained untouched. Loan guarantees from banks are different than the ECB allowing banks to borrow. Corporations are often reluctant join programs that could have a stigma, either real or perceived, from the investing community. In the end of June, the IMF projected global growth would fall -4.9% for the world, almost 2% worse than the April estimate. In the UK a survey of employers showed that a quarter of furloughed workers are likely to lose their jobs permanently when Government support runs out. Finally, the Global Covid-19 cases passed 10 million with deaths topping 500k. It took three months to go from 0 to 5 mm, and five weeks to go from 5mm to 10mm cases.

Interest Rates

The Federal Reserve's balance sheet expanded by $1.2 Trillion dollars to $7 Trillion during the second quarter of 2020. The Fed made it well known through their statements that the fed funds rate will be at the zero-lower bond for some time, if not to the end of 2022, and will continue with their assets purchasing program. Their balance sheet actually shrank from the peak of $7.16 Trillion during Q2 with a reduction in currency swaps from other foreign central banks due to a drop in demand for emergency credit facilities, but their asset purchases continued. This led to asset prices further raising despite continued deterioration in underlying fundamentals. There is simply no price discovery anymore thanks to the Fed put. The yield curve did not move much during the quarter. I guess you can simply hint at yield curve control to make it happen.

Years	6/30/20	3/31/20	Difference
0.08	0.13	0.05	0.08
0.24	0.16	0.11	0.05
0.5	0.18	0.15	0.03
1	0.16	0.17	-0.01
2	0.16	0.23	-0.07
3	0.18	0.29	-0.11
5	0.29	0.37	-0.08
7	0.49	0.55	-0.06
10	0.66	0.7	-0.04
20	1.18	1.15	0.03
30	1.41	1.35	0.06



The Primary Mortgage Market Survey from FHLMC showed the 30-year conforming balance fixed rate mortgage fell to 3.13% at the end of June from 3.5% in December. As of the time of this report it continued to decline to 3.01%. 15-year-Conforming balance loans also fell from 2.92% in March to 2.59% in June, and 2.51% as of the time of this write up.

The Mortgage Bankers Association information as of 07/29/20 showed 30-Year conforming balance FRM down from 3.45% with .28 points in April to 3.20% with .37 points in June. Jumbo loans were down from 3.81% with 0.34 in points to 3.52% with 0.30 points. 15-year conforming balance FRMs were also down from 3.03% with 0.33 in points, to 2.76% with 0.36 points.

Leading Economic Indicators

The Conference Board's leading economic indicators (LEI) stood at 102.0 for June, rebounding from April's low of 96.9 but still far away from December's 111.4. The increase was mainly caused by falling unemployment insurance (which in July has started to increase again as a rise in Covid-19 cases in the south and west.) To a lesser extent, increased workweek hours and stock prices also helped to boost the LEI. The detractors were the leading credit index, consumer expectations for business (both Conference and Michigan confidence indicators fell again in July). Going forward workweek production might increase, but with Covid-19 upticks and more furloughed employees getting permanently let go, I don't know if that truly will be the case. UI claims have leveled off and are now increasing, which will drag the index down, new orders for consumer goods and materials may surprise to the upside, as the ISM new order index recovered above 50 (but this is still a soft stat, and recently prone to lagging the actual deterioration in manufacturing). New orders for nondefense capital goods improved dramatically for June so

this might help replace some of the loss from the change in claims data. With that said it is still down 18.5% year over year. As the S&P returned 5.51% for July, this will help boost the LEI. Interest rates spreads won't be going anywhere so this will be a positive contributor, but consumer expectations for business will probably reduce the LEI going forward as the second wave hurts expectations. There is really a mixed bag here, but I think the claims numbers will probably hold LEI steady or push it slightly down going forward.

Jobs

At the time of this write up, **nonfarm payrolls** posted an **increase of 4.8 million jobs for June.** This is up from May's 2.7mm but wasn't enough to make up for **April and March's loss of 20.8 and 1.3 million jobs.** The official unemployment rate was fraught with issues this past quarter as it differed dramatically with unemployment claims data. Although claims data had backlogs, some duplication and lags, the estimates from BLS were self admittedly off by multiple percentage points from month to month. For example, nonfarm payrolls from the end of 2019 to June showed total job losses of around 14 million while people claiming UI benefits in all programs ending July 4th was 31.8 million. Using the BLS U-6 number, a more inclusive look at those unemployed, showed 18 million unemployed, but that is still far off from the claims data. Although data collection with the Payroll report (nonfarm) was reported as being within their tolerance, the other survey, Household, was not. And this survey is the basis from which the unemployment number is calculated. **Temporary services** are down about 24% through June from December. **Median duration of unemployment** round tripped from 7 months in March to 2 months in April (a huge amount of newly unemployed people will skew this number) and back to 13.6 in June. For some perspective since the last recession that number maxed out at 25 months. This number will grow, and my feeling is it might surpass the previous high. The **civilian labor force participation rate** clawed back to 61.5 from an April low of 60.2, a level not seen since the mid 1970s. Now some additional perspective here, participation wasn't above 60 until the late 1960s, dating back from the inception of the data point being 1948. My assumption of that number dropping into the 50s last quarter may have been premature, but with recent Covid-19 flare ups in the south, and more furloughed employees being put on notice that job cuts might turn permanent by the end of August it might just drop more.

Industrial production

Q2 IP was down -6.71% (-12.7% in April, 1.38% in May, and 5.41% in June). Q1 IP was revised, down -4.73%, making the YTD reduction -11.12%. Motor vehicles manufacturing were responsible for the bulk of the increase in May. Consumer durables, business equipment and durable materials were up 36.6%, 11.8%, and 7.4% respectively. **Factory output fell 47% on an annual rate in the second quarter**. Even though motor vehicles came back strong in May and June, they are still down 25% from the February level. **Capacity utilization currently stands at 68.6%** a level not seen since September 2009. The main concern going forwards is whether the pent-up demand for

durables will wane over the next quarter, making continual gains in IP at this pace difficult. With continued bankruptcies and economic starts and stops, I don't believe IP will have a positive year.

Housing

New home sales for June were up to 776k per year, the highest number for the year after previous adjustments. New home sales do have a wide statistical variation and numbers get revised often. With that said, this looks like a bright spot for the economy, and outperformed **Existing Home Sales** at 4720k per year on a percentage basis. Year over year new homes sales are up 6.89% whereas existing homes sales are down -11.28%. Median new and existing home sales prices both rose to 329k and 295k respectively, up 5.58% and 3.5% respectively from June 2019. Arguments were made price increase were caused by low inventory estimates with 307k new homes or a 4.7 month's supply vs 1.57 million existing homes or a 4-month supply. I think a combination of supply, declining mortgage rates and people reconsidering (for the time being) city life, are contributing to the prices increases.

The Consumer

The Conference Board's consumer confidence index stood at 98.3 in June, up from May's 85.9 and April's 85.7, the two lowest readings since 2014. The **University of Michigan's consumer sentiment June number of 78.1,** up from May's 72.3 and April's 71.8. As of the time of this write-up, July's numbers for both of the index fell again on a resurgence in Covid-19 cases. CB's index stands at 92.6 and Michigan's at 82.8 (revised lower again during the month). With a resurgence in cases in California, Arizona, Texas and Florida, coupled with companies starting to give permanent notices to furloughed employees, the damage to the consumer without the ability to find work will be substantial. The savings rates rocketed in Q2 up 33.5% in March, 24.2% in May and 19% in June. These are based on annualized income and expenditure numbers the Bureau of Economic Analysis puts out monthly. A staggering 1.3 Trillion dollars was saved over Q2 which coincided with inflow amounts banks saw into checking and savings accounts over the same time period. However the money supply (https://fred.stlouisfed.org/series/MZM) went from 17 trillion to 21 trillion over the same time period. In 12-months the money supply has increased by close to 30%, eclipsing even the 18 months it took from 2008 to 2009 to increase by 18.5%. Consumers did not pay back much debt compared to the amounts they squirreled away in savings accounts. For the three months ended May total consumer credit declined around 100 billion, or about 2.4% of all debt outstanding. **According to the mortgage bankers association forbearance and call volume survey, mortgage forbearance grew from 0.25% as of March 8th to 8.55% as of June 7th**. So, the consumer is socking cash away, not paying down a lot of debt, and millions of homeowners aren't paying their mortgages, or renters their rent. But several million people have opened retail trading accounts and are buying stocks of bankrupt companies like Hertz which after bottoming at

$0.40 rose to $5.53 or over 1200% in early June, because they are home on the couch getting paid, bored and have no idea if they will get to go back to work again (insert 30mm people collecting UI benefits here).

Inflation

As of June, **CPI was up 0.71% and PCE was 0.75% year over year.** Although these numbers are positive, CPI has been negative for the past two quarters. Along with negative GDP, and large unemployment, this is why we shouldn't expect the Fed to turn off the firehouse anytime soon. Core inflation (less food and energy) was up 1.2% year over year ending June. It was up 0.2% in June **the first monthly increase since February.** Energy's 5.1% monthly rebound in June helped drive headline CPI but is still down 12.6% year over year. Apparel also was up 1.7% in June, but still off 7.3% year over year. Food, both at and away from home saw a positive June and are up 5.6% and 3.1%. Shelter has been very muted, but still up 2.4% year over year. The underlying story here is that rent increased 3.2%, while owner's equivalent rent was up 2.8%, while **lodging away from home fell 14%.** The real news came this week from the Fed's chairman, as they are considering abandoning pre-emptive rate moves to curb inflation. Although not surprising, I believe this starts us down a dangerous path. Inflation reduces the value of fixed income securities, by reducing the value of the future payment stream. It is also a very convenient way for governments to reduce the value of their outstanding debt to GDP levels. The Fed has even toyed with the idea of interest rate controls, essentially buying and selling debt to hold the levels of Treasuries at points it deems necessary to expand the economy. For Q2 the dollar index (the dollar's value compared to a basket of other currencies) was very volatile, but down only around 0.75%. Since the end of June though, it has fallen 4%. Currency markets, like other commodity markets, are supply/demand based, and from an export perspective, lower dollar valuations help. Not many people fear the dollar losing its global reserve currency, but we are doing things that haven't been done since the end of WWII and are starting to look like certain emerging markets countries.

In Closing

We entered into a recession in February of this year and it is currently 5 months old with the longest recession being 65 months long, with the average lasting 17.5 months. I am still very concerned about the price level of both equity and fixed income securities. There are a lot of factors that will provide increased volatility to securities in the coming months. **Interest rates** are fixed, and whether the Fed is explicitly using yield curve control or not, rates aren't going anywhere anytime soon, unless people lose faith in the dollar. The Leading Economic indicators will slip in Q3, as claims data has plateaued and in fact gone back up, expectations will fall, and workweek production could be cut, as more states reinstitute closures. Schools that are operating on a 2-day on and 3-day off schedule will not allow for a large part of the workforce to return. This leads me to the **job market**, where I think claims data along with BLS survey are now not as effective as in the past. Look for July to be flat, if not lower, in the non-farm payroll numbers. We will get a clue on **Industrial Production** when the ISM survey and jobs numbers come out this

week. Combing manufacturing employment and average weekly hours of production workers (also used in the LEI) give a rough indication of the IP number not released until the middle of the month. I think the increases we have seen in IP the past couple of months are going to fade, and Q3 GDP will not see the 25% gains anticipated by Wall Street firms, and that is obviously off a lower base. New single-family homes sales have recovered quicker than existing, and inventory levels remained lower than during the initial stages of the last recession. But if evictions and foreclosures start to happen on the high levels of loans in forbearance, this will definitely hurt valuations. People will then begin to grieve their real estate taxes, but municipalities that are already tax strapped will just adjust their residential assessment ratios to maintain or increase their tax amounts on those homeowners that can still afford to pay. **The consumer** had the worst contribution to GDP ever in Q2, and the Q3 rebound will hinge on their ability and willingness to purchase goods and services over the next three months. Consumers saved 1.3 trillion Dollars over the past quarter and only paid down $100 billion in credit card debt. They also stopped paying rent and their mortgages without recourse. When should this reverse, and if so, who pays for it, the landlord, the taxpayer? Surprisingly personal consumption expenditures on durable goods increased dramatically in June. I don't think this growth can hold, and it, along with government unemployment benefits will fade over the quarter. **Inflation** was up about 70 bps year over year ending June, where energy and apparel rebounded somewhat. Temporary measures from the last recession where never withdrawn, will the ones enacted in March be permanent as well. I am worried about the long-term effects of expanding debt burdens, expanding Fed balance sheets, and expanding money supply has on real economic growth, as Fitch has recently lowered the outlook for its US government credit rating to "negative" from "stable.

As of this write up my model is calling for a 79% probability of the recession continuing. Markets are completely disconnected from economic reality and only supported by government and Fed interventions, and forecasted growth rates for Q3 and forward look irrational at best. Thus, I have remained in cash, as markets have rallied back to pre-March levels. I will fully admit it has been painful to watch, and I struggle with it daily. This is probably the only time I will paraphrase Keynes but I feel these markets can remain irrational longer than I can keep client's fear of missing out at bay.