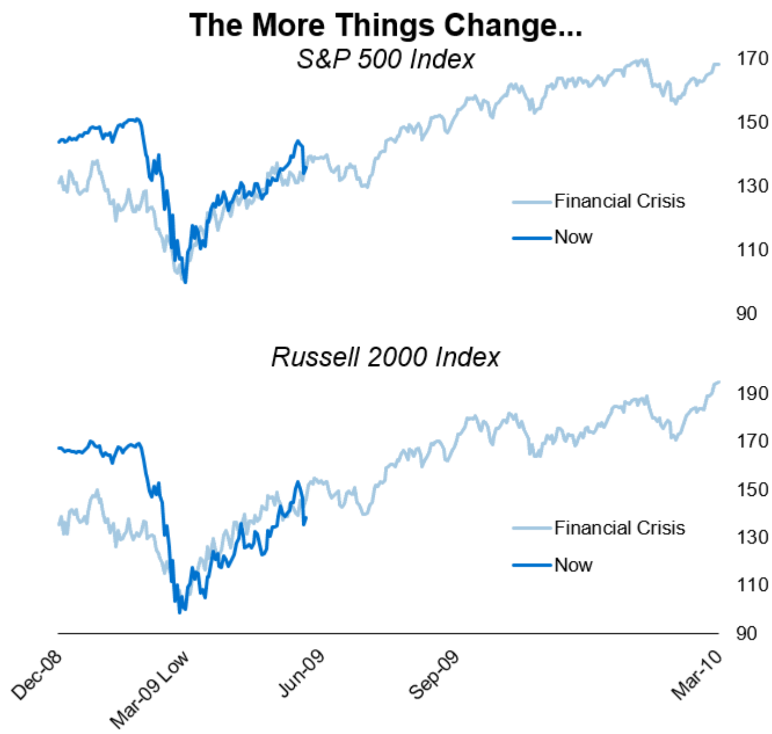
FIRST WORD ON THE MARKET

July 8, 2020

We hope everyone enjoyed their 4th of July weekend, no matter how different it seemed this year. In our community north of Cincinnati, the annual fireworks displays were canceled. Swimming pools required reservations. And the traditional Independence Day parade was completely upended – instead of being stationary and the parade passing by us, we had to drive through a maze of stationary floats parked at the local high school.

While most everything seems a little different these days, the stock market's rebound off the March 23 low looks remarkably like its initial recovery in 2009. The chart at right illustrates this similarity. Each time period is synced so that the low is indexed to 100 on the chart. The light blue line is how the market behaved in 2009 and the dark blue line is what's happened this year.

Not only has the pattern been remarkably similar, but the magnitude of the changes have been incredibly close as well. The reasons for the rallies, however, have been significantly different. In 2009, the financial system was on the brink of a complete meltdown and regulators, central bankers and legislators were attempting to limit the fallout and shore up company balance sheets to avoid a global economic collapse. Their efforts were focused on correcting the economic damage caused by irresponsible actions.



Source: Yahoo! Finance, FFWM Research. Values indexed to 100 at market lows (3/9/09, 3/23/20)

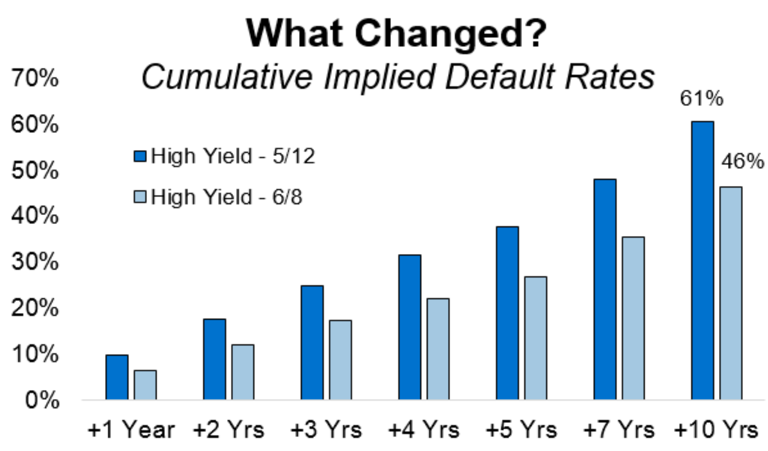
This time around, central bankers and legislators have blasted economies with a bazooka-like policy response. Unlike in the Financial Crisis when blame could be pinned on overleveraged financial companies and overburdened borrowers, there is no "bad actor" to point the finger at this time around. The pandemic has spread everywhere, impacting nearly every economic corner of the world. Thus, politicians don't have to worry about being viewed as sympathetic to the "bad guy" in this case. The coronavirus shut down most everything, so there was very little opposition to passing stimulus measures in order to help folks through this Great Lockdown.

What's interesting is that, given the lessons learned from the Financial Crisis and the lack of a "bad actor", the stimulus measures that have been passed far exceed anything else in modern history. Consider this: in 2008 and 2009, US fiscal policy measures combined to equal 8.0% of total gross domestic product (GDP). As a result of purchasing fixed income securities on the open market, the Federal Reserve's balance sheet grew by an amount equal to 8.6% of GDP. Fast forward to today and the policy measures that have already been announced total 12.3% of GDP and the Fed has already expanded its balance sheet by 12.8% of GDP! While a few percentage points might not sound like much, keep in mind that US GDP exceeded $20 TRILLION in 2019.

What's also interesting about the stimulus this time around is that the Federal Reserve has expanded the types of securities it is holding on its balance sheet. Until recently, the Fed primarily held mortgage-backed securities. Then, on May 11, the Fed announced that it was going to begin buying corporate bond exchange traded funds. Why? Here's an explanation from Matt Wirz of the *Wall Street Journal ("Fed Backstop Fueled Corporate Bond Surge", 6/30/20)*:

> *"Corporate bond markets seized up in March. Fears of an economic depression sparked panic selling as investors dumped their safest bonds to raise cash and caused a spike in yields, which rise when prices fall. The Fed turned the tide when it announced a program to buy Treasuries and investment-grade bonds… Within days, fund managers of all types started buying investment-grade corporate bonds, betting prices would bounce as the Fed began its purchases."*

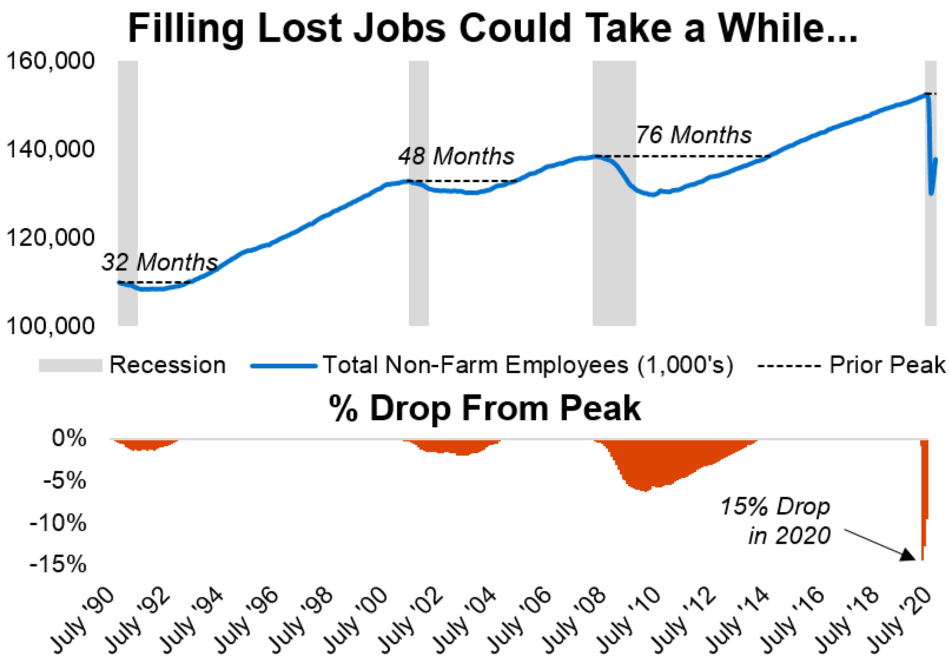
The Federal Reserve, then, was successful in thawing out the bond market. While this move allowed companies to access debt capital more easily, nothing fundamentally changed because of the Fed's action. Companies would still struggle with the effects of the lockdown, debt financing or not. But the Fed's purchase program significantly reduced investor expectations of future defaults. Using credit default swap spreads (basically the price of insurance against a bond defaulting), investors were pricing in that over 60% of all companies that issued high yield, or "junk", bonds would default in the next 10 years. Less than one month later, that cumulative implied default rate had fallen to less than 50%.



Source: DoubleLine, FFWM Research

While the Federal Reserve's actions may not have improved the underlying credit quality of individual companies, they did have the effect of opening the floodgates for new corporate bond issuance. Even as default probabilities and credit rating downgrades surged, companies have been issuing debt at record levels. In the first six months of 2020, investment-grade companies issued about $840 billion of new debt, matching 2017's record *for an entire calendar year.* Companies rated below investment-grade were able to issue $180 billion in "junk" bonds, which exceeded the previous first half record set in 2015. A perceived backstop provided by the Fed's purchase program appear to be fueling this buying binge, as investors seem to think that there is little risk that rates will rise any time soon as long as the Fed keeps buying. Companies, for their part, are taking advantage of incredibly low interest rates to lock in cheap financing.

One area of fundamental data that is improving are the economic data points. True, this improvement is coming off of record-low levels; but, markets generally care about which direction data is trending more than the absolute levels. One thing that is important to note, however, is that while improvement is happening it could take quite a while for the data to get back to previous high-water marks. Take earnings for the S&P 500 Index, for example. Currently, Wall Street analysts estimate that earnings per share for the S&P 500 will total about $125 – which is roughly what the market earned in 2016. With the rolling waves of COVID infections hitting the economy, it is unlikely that earnings will fully recover any time soon.



Source: St Louis Federal Reserve, FFWM Research

Another area of the economy that should be slow to recover is in the jobs arena. As you can see in the chart at right, the impact that this pandemic has had on the jobs market has been huge – non-farm employees fell by 15%, triple the decline during the Financial Crisis. Also, note that the steeper the decline, the longer it took jobs to reach previous highs. If it took 76 months for the job market to recover from a 5% decline, it follows that it may take longer than that to recover from a 15% decline.

The longer it takes for these jobs to come back, the longer the impacts of this pandemic will hamper our economy. With ~70% of the American economy dependent upon consumer spending, high unemployment will naturally be a drag on overall activity. The rolling wave of infections that is now hitting various parts of our country casts some doubt on the nascent economic recovery.

Besides economic uncertainty, several other risks to the market exist. Companies are getting ready to announce earnings for the second quarter. After having largely retracted any future guidance during the first quarter, it will be interesting to hear how management teams describe how they see the business environment going forward. Trade tensions between the US and China have been reignited. Stresses related to the pandemic and efforts out of Beijing to reduce Hong Kong's autonomy have combined to bring the conflict back to the front page.

Uncertainty about this year's Presidential election is also a market risk; the probability of a Democratic sweep is rising, which would likely hamper investor sentiment. Even the logistics of holding a national election during a pandemic could pose risks - if "hanging chads" caused market insecurity in the 2000 election, imagine what the possibility of a mail-in election could do to investor sentiment.

Entering 2020, we were taking a "barbell" approach to positioning our clients' portfolios. We still believe that this stance remains appropriate, counter-balancing "riskier" allocations with "safer" choices. In our view, now is not the time to be too aggressive or too conservative. Having recently trimmed equity exposure following the strong market rally, the asset allocation within our client portfolios remain fairly neutral relative to their long-term targets. Within equities, we continue to favor large domestic stocks (the "safer" choice) as well as emerging markets equities (the "riskier" choice). Within fixed income, we have focused on "safer", more liquid areas of the bond market that are less exposed to interest rate shocks; we've also re-introduced "riskier" high-yield bonds into the mix. As for the alternative asset class, we adjusted our allocations to volatility-mitigating managers, with an underweight to real estate.

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