EMSTONE ADVISERS, LLC

*July 10, 2020*

## Numbers in the News

| Indicator | 6/30 Value | Versus 3/31 |
|---|---|---|
| 3-month T-bill | 0.13% | +7bps |
| 2-yr T-note yield | 0.15% | -10bps |
| 10-yr T-note yield | 0.67% | -1bps |
| Yield Curve (2-10yr) | +51bps | +9bps |
| ICE BofAML High Yield (YTW) | 8.45% | +304bps |
| S&P 500 | 3100.3 | +20.0% |
| Dow Jones Index | 25,812.9 | +17.8% |
| Retail Sales (May vs Feb) | $485.5 | -28.1%AR |
| ISM Manufacturing | 52.6 | +3.5 |
| Payroll Employment (000) | 137,802 | -13,288 |
| CPI last 12 months (May vs Feb) | +0.1% | -2.2pp |
| Core CPI last 12 months (May vs Feb) | +1.2% | -1.2pp |
| Personal Consumption Deflator (PCD) last 12 mo (May vs Feb) | +0.5% | -1.3pp |
| Core PCD Last 12 mo (May vs Feb) | +1.0% | -0.8pp |

**Bloomberg Barclays Bond Index Returns**

| | Second Quarter | 12 Months |
|---|---|---|
| Aggregate | +2.90% | +8.74% |
| Government/Credit | +3.71% | +10.02% |
| Intermediate G/C | +2.81% | +7.12% |
| Intermediate A+ G/C | +1.58% | +7.20% |
| 1-3 Year Govt | +0.26% | +4.12% |
| Municipal Bond | +2.72% | +4.45% |

bps = basis points (0.01%)
pp = percentage points
AR = annual rate
NC = no change

Data obtained from various market and government sources by Stoneridge PMG Advisors, LLC. For additional information, please contact our office.

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Anthony J Basile, *Portfolio Manager*
Gail M Habecker, *CFA, Economist*
Folu Abiona, *Portfolio Manager*
Sundar Kuttalingham, *CFA, CAIA, Sr. Analyst*

The longest running expansion cycle in history, that began in 2009, abruptly came to an end in February 2020 as the **COVID-19 shock** forced the U.S. economy to shrink at a 5.0% annualized rate in the first quarter of 2020. In the second quarter, a strong jolt from the full impact of the shock caused the steepest quarterly decline in economic activity since the Great Depression. Incoming data during the quarter, revealed the virulent dynamics of the COVID-19 crisis – its horrific death toll and its disruptive impact.

**Consumption Collapse and Rebound** ❖ Measures adopted to slow the spread of COVID-19 caused a collapse in consumption during March and April. The worst impact was realized during the month of April. Retail sales fell 14.7% – the biggest monthly decline since this data series began in 1992. Sales at restaurants and leisure spending declined more than 30% as people stayed home. Discretionary spending on items such as clothing fell by 75.2%, and several major retailers filed for bankruptcy. Unit sales of automobiles plunged almost 50% in April. But, thanks to swift and massive fiscal stimulus, there was a stronger than expected rebound in May. Still, analysts estimate that personal consumption likely contracted at an annualized rate of at least 30% in the second quarter.

**Plunge in Manufacturing** ❖ The sharp contraction was not limited to retail sales and the services sector. Industrial production declined 12.5% in April following a 4.6% decline in March as U.S. manufacturers shutdown their production lines. The plunge in monthly manufacturing output in April was steeper than at any point in the last century. Manufacturing activity continued to remain depressed in May. But there were encouraging signs of a revival in June as factories gradually started reopening.

**Staggering Job Losses** ❖ The precursor to the collapse in consumption and manufacturing was the disruptive shutdown of nonessential businesses, which triggered widespread fur-loughs and job losses. A cumulative total of over 40.7 million people filed for unemployment insurance benefits in the first ten weeks following the shutdown. During the initial weeks, the sudden flood of unemployment filings overwhelmed the system for handling the claims in many states. The official non-farm payroll fell by 20.8 million in April and unemployment rate rose to 14.7%. About 7.5 million jobs were cumulatively added back during May and June as furloughed employees were recalled upon the reopening of the economy. Nevertheless, the job losses from the shock are ongoing and the unemployment rate remains in the double digits.

**Swift Policy Response** ❖ As the COVID-19 crisis vividly unfolded during March and April, both monetary and fiscal policy makers sprang into action to provide relief for beleaguered businesses and workers. New fiscal spending on pandemic aid, including payroll protection and unemployment benefits, has approached $3 trillion. Notably, there was coordinated policy response to the crisis from Congress, the Administration, and the Federal Reserve. As part of the COVID-19 relief package, known as the CARES Act, Congress appropriated $454 billion to be utilized by the Treasury as a backstop for absorbing potential losses in programs to support the flow of credit to businesses. The Fed, in coordination with the Treasury, has utilized this earmark to create new facilities supporting the markets for corporate bonds and loans. The announcement of these initiatives `helped stabilize the financial markets.

**Flood of Liquidity** ❖ In responding to the COVID-19 crisis, the Fed pumped massive liquidity into the financial system. The Fed's balance sheet expanded in size as well as scope, at a pace that dwarfed the quantitative easing actions undertaken during the financial crisis of 2008. The flood of liquidity swept through the markets for not only Treasuries and mortgage-backed securities but also a wide range of risk assets including commercial paper, municipal securities, and other credit securities. Apparently, this helped disconnect risk asset prices from the economic data reflecting the damage inflicted by the pandemic. In the second quarter, the S&P 500 Index climbed steadily, shrugging off the dire economic data, and retraced most of its first quarter losses. Firms with access to financial markets easily raised capital to shore up liquidity at low cost, as investors snapped up record issuance of investment-grade corporate bonds. Concurrently, there was record issuance of new debt by the U.S. Treasury, most of which was purchased by the Fed.

**Near-term Outlook** ❖ During the second quarter, U.S. GDP likely contracted at an annualized rate of more than 30%. If so, it will have been the steepest quarterly contraction in history. A snap-back recovery may have begun as businesses reopened in May, leading to forecasts of double-digit annualized growth rate in the third quarter. However, this view is subject to headwinds from a resurgence of virus infections. By the end of 2020, the overall level of output is expected to be lower than in 2019. The prospect for sustained recovery remains uncertain under the cloud of COVID-19. But there is no uncertainty about the trajectory of the U.S. sovereign debt. The debt-to-GDP ratio is on track to rise rapidly and exceed the historic record levels seen during World War II.

**Fixed Income Outlook** ❖ The fear of the unknown that caused financial market participants to avoid risk has essentially been quelled by the Fed. Massive fiscal and monetary support created a strong appetite for public and private issuance. With Treasury issuance at a record pace, it was no surprise that government bonds underperformed in the second quarter. As the Fed pinned down short-term interest rates at 0.00% to 0.25%, Treasury rates inside of ten years were slightly lower while longer 30-year rates rose 9 basis points (0.09%) to 1.41%. Two-year notes declined 10 basis points (bps) to 0.15% while ten-year notes slid only 1 bps lower to 0.66%, modestly steepening the U.S. Treasury yield curve (two-year vs. ten-year). After being inverted by as much as 21 basis points in the fourth quarter of 2019, the curve ended last quarter positively sloped at 51 bps. That was modestly steeper than 42 bps at the end of the previous quarter.

Corporate credit recovered significantly from its March lows. After a brief retreat in April, market performance soared in May and June. Clearly, the strength was not due to economic performance. Nearly every sector suffered business interruption, or at the very least, expensive modifications in how business is conducted. Instead, the strong market performance was due to the Fed's promise to back-stop almost the entire credit market. Corporations' need to tap the debt markets has been widespread as they moved to replenish reserves in preparation for the economic uncertainty ahead. On the other hand, investors stung by ultra-low rates and searching for yield, were motivated to add credit to portfolios.

Investment-grade corporate credit for all maturities had a second quarter excess return of 8.47%, although for the year-to-date they remain negative across the board. This underscores the relative strength of U.S. Treasuries during this year's historic and sudden move lower in rates. Year-to-date credit returns are still strong, particularly on the long end; however, the likely trend is for lower returns. Rates are extraordinarily low, so the moves that produced strong rallies are likely behind us.

Excess returns for the quarter were positive for every sector. Outstanding strength was seen in the energy sector. This reflected oil's price recovery from its worst level as some activity resumed globally. We saw double digit returns in sectors such metals and mining, paper, and supermarkets. The strength in metals and mining can be rationalized on increased demand for gold as fears of inflation circulate following the Fed's massive injection of liquidity. The paper sector has enjoyed strong demand to produce tissues and towels of all kinds. And, of course, "pandemic pounds" have been added to waistlines as many of us comforted ourselves with food to the benefit of supermarkets. One notable area of relative weakness was airlines. Concerns about the staggering cost of inactivity and the cloudy outlook for air travel no doubt hurt the performance of bonds in this sector.

With Fed policy on hold, short-term rates (five years and shorter) should remain in a narrow trading range, plus or minus 10 bps from quarter-end closes. Longer maturities, specifically ten-year notes, should continue to trade in their recent range of 0.50% to 0.90% over the next quarter. These are extraordinary times: an ongoing pandemic, social unrest, and a Presidential election on the horizon. So far, monetary and fiscal policies have kept markets liquid and functioning. We can only hope navigating the economy and markets through these choppy waters remains a priority through the election season.