MILLRIVER
WEALTH MANAGEMENT

OUTLOOKS

April 2020

ECONOMIC OUTLOOK

Summary

Since the majority of economic data is presented on a lagged basis (i.e., March data usually represents February information), many economic releases throughout March have been more or less dismissed by the investment community. This is because markets tend to look toward the future, and we now live in a world of economic data that's "pre-coronavirus" (before mid-March and the spread of the virus in the United States) and "post-coronavirus" (after mid-March, when "shelter-in-place" and "essential activity only" contagion mitigation efforts were put into effect). The difference between most "pre" and "post" economic data points are expected to be staggering.

The first post-coronavirus economic data points have detailed new claims of unemployment benefits. The figures indicate that at least 9.9 million people lost their jobs during the last two weeks of March, a truly enormous and unprecedented number. This compares to the prior high in weekly initial unemployment claims of 695,000 in October of 1982.

While corporations in non-essential industries are no longer generating revenue and are either laying-off or furloughing employees, there is a silver lining. The U.S. Government is doing its best to try to financially assist those Americans most impacted by the virus, while also helping many "non-essential" businesses stay afloat. Through the CARES Act of 2020, unemployment benefits are being increased by an extra $600 per week (the equivalent of 40 hours worked at $15 per hour) on top of the normal benefit that an individual would receive. In addition, approximately 90% of individuals in the U.S. will be receiving a one-time stimulus payment from the Government of, at most, $1,200 per person or $2,400 per couple, with an additional $500 per child. Both small and large businesses are being offered loans with stipulations limiting employee layoffs, dividends and stock buybacks.

As long as individuals do their part by maintaining social distancing and adhering to state and local policies, we will curb the growth of the virus. The world is filled with many bright minds that are working toward, and will soon discover, a proper treatment and vaccine. When they do, we will soon be able to collectively get back to work and move forward.

Positives

The Federal Reserve cut interest rates to the 0.00% to 0.25% range and restarted QE programs

The U.S. Government passed the CARES Act of 2020

Pending and existing home sales beat expectations

Negatives

Consumer confidence decreased to the lowest levels since 2017

Markit Services PMI falls to lowest level since 2009

The Dallas Fed Manufacturing Outlook of Business Activity dropped by the largest amount ever

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EQUITY OUTLOOK

Summary

Equity markets have been upended in the U.S. and around the globe as investors come to terms with the scope of the COVID-19 virus, the economic impact and the hit to corporate earnings. The S&P 500 hit an all-time high in March before experiencing the fastest fall to bear market territory and ending with the worst opening quarter since 1938. Stocks sold off broadly across all regions and regardless of company size. All economic sectors were lower in March, though there was quite a bit of variance. Energy and financial stocks bore the brunt of the sell-off declining 34.8% and 21.3% respectively. Not surprisingly, health care and consumer staples held up better losing just 3.8% and 5.4%. The developed EAFE Index declined 13.4% and the MSCI Emerging Markets Index lost 15.4%.

U.S. markets actually closed the month in rally mode. The S&P closed 15.5% off the closing low established on March 23. This was partly a relief rally off of what were heavily oversold conditions. The massive government stimulus package also influenced the market's response.

It's important to remember that the stock market is a discounting mechanism, constantly attempting to anticipate all future information and data points to forecast how those considerations impact stock prices. Over the last several weeks, the market has been digesting all of the negative news but also forecasting possible outcomes good and bad. In doing this, the equity markets are likely to find a bottom before the worst of the virus and the economic impact are recorded.

Capital markets will continue to remain volatile over the course of the next several months. The number of new cases and fatalities is expected to peak in the coming weeks but the economic impact will likely linger for much longer. At some point, we will look back and recognize this to be an extraordinary buying opportunity for long-term investors but markets are likely to remain choppy in the short term.

Positives

Aggressive and historic government and central bank response

Stock valuations are historically inexpensive but the corporate earnings outlook is cloudy at best

Negatives

U.S. new coronavirus cases and deaths have yet to peak

Economic fallout will be wide

Unknowns

Timing of return to "normal"

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FIXED INCOME OUTLOOK

Summary

The coronavirus has a clear stranglehold on not only the world's health organizations but the world's economies and capital markets as well. What started as a virus epidemic has evolved into an economic contagion. As investors sold stocks and riskier bonds, proceeds piled into the safest most liquid market on the planet, the U. S. Treasury market. The yield on the 2-year Treasury note was already down from 1.57% at the start of the year to 0.92% at the beginning of March. Likewise, the 10-year note yield had declined from 1.92% to 1.15%.

The acceleration in COVID-19 cases and "shut-down" orders as most of the country tried to flatten the curve sent yields tumbling from those levels. The Fed slashed the overnight rate back to the zero bound (0.00% to 0.25% range) in two emergency meetings. By the end of the month, the yield on the 2-year note had dropped to 0.25%, a level last seen in 2013. Setting new historic lows, the 10-year note closed March at 0.67% after reaching an intraday low of 0.31% on March 9. For the first time in history, Treasury bills had a negative yield. Yes, investors paid for the privilege to loan money to the U.S. government.

Credit spreads soared as investors became increasingly concerned that even the highest rated corporate borrowers will struggle to repay loans in a near-zero revenue environment. At one point, purchasers of investment-grade bonds were requiring about 3.50% more in yield than they were to own Treasury notes. This spread narrowed to about 2.75% by month's end but this was still a far cry from about 1.00% in the beginning of the year.

In an attempt to circumvent the economic fallout on the population and on employers, the Federal government, the Treasury and the Federal Reserve have worked together on a dizzying array of actions to thwart further damage as the country is forced to shelter in place. The government has enacted three stimulus packages totaling trillions in economic support and relief. The Fed has leveraged funds granted through the Treasury Department to support markets that had become illiquid.

We do not know yet how this will ultimately play out, but for the time being, the markets have stabilized and even rebounded somewhat. For instance, even though the secondary investment-grade debt market struggles with liquidity, the primary market has seen record new issuance as investors still appear hungry for yield. Short-term lending facilities seem to have eased concern in some of the repo markets.

We have long been proponents of the "lower-for-longer" thesis and current events only reinforce our conviction. We continue to recommend full duration positioning. With regard to sectors, high-quality corporate bonds appear attractive at these levels, but we acknowledge that we are in unprecedented times and that further distress could remain ahead. A balanced approach is more warranted than ever.

Positives

Federal Reserve's rate policy unlikely to increase in the next few years

Economic demand has been eroded by the virus fallout

Negatives

Fed policy already at the zero bound

Fiscal restraint has been thrown out the window

Investors could sell bonds and buy stocks at discounted prices

Unknowns

Ability to contain the spread of the coronavirus

Whether fiscal stimulus will create future inflationary pressures