Perspectives

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UnionBank
The Private Bank

MAY 29, 2020

Market Update

Key Highlights and News

- **Dr. Anthony Fauci, the nation's leading infectious disease expert, is excited about Moderna's announcement regarding progress on a vaccine.** While he understands concerns about the lack of details in the company's recent update, he said he has looked at the data and considers it quite promising. *(CNN, National Public Radio)*
- **Only 49% of Americans said they would get a vaccine to prevent the coronavirus.** An Associated Press–NORC Center for Public Affairs Research poll found that another 31% said they were not sure yet, while 29% said they would not get a vaccine. The poll's findings are consistent with surveys of willingness to take the yearly flu shot. *(The Hill)*
- **Another 2.12 million Americans filed for unemployment benefits in the week ending Thursday.** The Labor Department report was slightly higher than estimates and the prior week's figure was revised higher to 2.446 million from 2.438 million jobless claims. *(Yahoo Finance)*
- **In a letter to employees, the Chief Executive of Starbucks wrote that the company had regained around 60–65%** of the prior year's comparable U.S. store sales. In China, comparable store sales were around 80% of their levels the previous year. *(Deutsche Bank)*
- **The International Energy Association (IEA) said the coronavirus outbreak is expected to unleash a significant decline in global energy investment this year.** The IEA's annual World Energy Investment Report also warned of "serious" implications for energy security and clean energy transitions due to the pandemic as global investment plunged 20% compared to the 2% growth it estimated at the start of 2020, which would have been the largest annual increase in six years. *(CNBC)*
- **Preliminary Purchasing Manager Index (PMI) readings for May rose from April's rock-bottom levels.** PMIs, however, remain below the 50 percent mark that separates economic expansion from contraction. In a change from prior surveys, manufacturing PMIs tended to outperform services PMIs. *(Deutsche Bank)*

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What to Keep an Eye On

- **A weekly dashboard of filings for unemployment benefits, mortgage applications, air travel and public transit showed slight but steady improvement from depressed levels.** Hotel occupancy across the U.S. has risen for five straight weeks: 32.4% for the week of May 16, up from a low of 21% over a month earlier, but still well below the 62% seen at the beginning of March. *(Bloomberg, Wall Street Journal)*
- **The World Bank's incoming chief economist, Carmen Reinhart,** said that "COVID-19 is like the last nail in the coffin of globalization." *(Deutsche Bank)*
- **Senate Majority Leader Mitch McConnell hinted at more coronavirus aid for states in a future rescue package.** McConnell suggested another coronavirus stimulus package is "not too far off" which could include more funding for states as they begin slowly reopening and liability protections for businesses. *(Fox Business)*
- **U.S. equities are expected to end the year around current levels according to a Reuter's poll of nearly 50 market strategists and fund managers.** The median forecast for the S&P 500 index is to end 2020 at 2,950, a 1.4% decline from Tuesday's close and an 8.7% pullback from the end of 2019. Fiscal and monetary stimulus measures are expected to keep stocks from retesting March lows, but the equity market still has to weather double-digit earnings declines in each of the next few quarters, concerns about a second wave of layoffs, and behavioral changes that could impede consumption. *(Reuters)*
- **Permanent layoffs are likely as some firms say they won't open when allowed or will do so with reduced staff.** According to Labor Department data, 88% of people who lost jobs in April anticipated at that time that their absences would be temporary. But later surveys revealed greater apprehension among those dismissed that they will be rehired. *(Wall Street Journal)*
- **The Federal Reserve's "signaling" effect may have helped the equity market in recent weeks.** A meaningful improvement in credit market functioning from the depths of the coronavirus crisis in March has allowed U.S. investment grade companies to issue more than $200 billion of new bonds. Of the emergency facilities announced in March and April by the Fed, only five are fully or partially operational and usage of the programs is around $95 billion, less than 4% of the minimum funds available. Also, the Fed's balance sheet could top $9 trillion by the end of 2020. *(Financial Times)*

Senate Majority Leader Mitch McConnell hinted at more coronavirus aid for states in a future rescue package.

Our Perspective: Whatever It Takes

Beginning March 15, the Fed unleashed a barrage of emergency monetary stimulus measures beyond the two Fed Funds rate cuts that have moved short term rates to near 0%. Together, these programs are intended to ensure capital markets continue to function in an orderly manner during the pandemic and to reinvigorate the domestic economy paralyzed by lockdown orders intended to contain the spread of COVID-19.

Eleven initiatives, identified by an alphabet soup of acronyms from CPFF to TALF, are estimated to add up to $3 trillion of liquidity into the financial system.[1] Highlights of the unprecedented Fed measures include:

- Backstopping loans issued by banks participating in the Paycheck Protection Program.
- Two credit facilities for large firms and a $75 billion lending program for small and mid-sized companies.

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[1] Source: *Financial Times*

- Re-opening a facility to offer collateralized loans to large broker-dealers and another program to encourage money market liquidity.
- Encouraging banks to make use of the Fed's Discount Window as an emergency source of liquidity.
- Lower reserve requirements for banks intended to encourage increased lending.
- Programs to buy commercial paper, municipal bonds, and corporate bonds.
- A commitment to purchase an unlimited amount of government debt, so-called Quantitative Easing, that began with a plan to purchase at least $700 billion to start.

From the beginning, when Fed Chair Jerome Powell said on March 15 that "We're going to go in strong starting tomorrow," he has not minced words when describing the need for massive liquidity injections in the economy to prevent serious short- and long-term damage. Testifying before the Senate Banking Committee last week, he said the "precipitous drop in economic activity has caused a level of pain that is hard to capture in words" and that the Fed is "committed to using our full range of tools to support the economy in this challenging time even as we recognize that these actions are only a part of a broader public-sector response."

According to FactSet, the S&P 500 Index is expected to see earnings decline by 21% for calendar year 2020.

Many of the eleven measures follow the playbook the Fed opened during the Great Financial Crisis while other programs are seeing their first use. The Fed's traditional lever, cutting the Fed Funds Rate, is intended to convince investors to shun treasuries in favor of riskier assets such as stocks and real estate along with an expectation that companies will take advantage of low rates and investor confidence to expand, hire and invest in new plants and equipment. The goal is to create a virtuous circle of growth.

Earnings Swoon while Markets Soar

The fundamental and psychological impact of the Fed's swift, all-in effort to stave off a seizing-up of the economy and financial markets was felt almost immediately. After the Fed unloaded its "monetary bazooka" on March 15, one-month T-bill yields plummeted from 0.92% to 0.11% as of Wednesday and the 2-/10-year Treasury bond spread widened to 49 basis points. With lower government bond yields, a steeper yield curve and a credit market funding backstop in place, investors revaluated the asset class risk/reward trade-off. U.S. large cap stocks, in particular, reaped the benefits of such an aggressive monetary policy despite facing challenging times ahead as reflected in bearish corporate earnings forecasts.

According to FactSet, the S&P 500 Index is expected to see earnings decline by 21% for calendar year 2020. Revenues are also forecast to fall each quarter before finishing the year down by 4%. Adding to uncertainty, 35% of S&P 500 companies have decided to not provide guidance on expected earnings for 2020.[2]

Despite woeful earnings and revenue growth estimates for this year, and only modest improvement in forecasts for next year, FactSet reports that analysts remain bullish on the stock market with 52% of S&P 500 stocks carrying "Buy" ratings, 42% at "Hold" and only 6% designated "Sell." Stocks in the energy sector, which has been hard-hit by slumping demand and oil prices, carry the highest percentage of "Buy" ratings.

[2] Source: FactSet Earnings Insight, May 22

One heuristic of investing is that analyzing the potential for corporate growth of earnings, profits and dividends in the wider environment of economic growth is a key element in determining whether to invest in stocks. That approach seems to have been abandoned recently as bad news on the earnings front does not carry the penalty it once did: FactSet also reports that weak earnings releases typically lead to 3% price drops but only 1% falls in recent weeks. Meanwhile, the S&P 500 has risen by over 30% since late-March despite forecasts that U.S. Gross Domestic Product may decline by as much as 30% this quarter.

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On top of the wave of monetary policy support, several theories have been advanced to explain stock market exuberance in the midst of a recession. These include a prevailing expectation for a rapid economic recovery scenario as the country re-opens. The so-called "V-shape" recovery outlook has been a source of optimism allowing investors to look past the current turmoil.

While a quick rebound in economic activity is possible, we remain concerned that such a scenario is far from certain and that the equity market may have gotten ahead of itself with a push from monetary policy. Ultimately, only an end to the pandemic will allow the economy to fully heal and this is an aspect the Fed has no control over as Powell has stressed in his public comments. Should economic growth take a slower path to recovery, it would be reasonable to expect corporate earnings to undershoot current expectations. For this reason, investors should be aware of the downside risks central banks may have mitigated, but not eliminated.

To hear our latest insights on market developments, please join us on the first and third Wednesday of the month at 9:00 a.m. PT. Dial in: 866-506-8264.

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