Perspectives

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Market Update

Key Highlights and News

- **China's Purchasing Managers' Index (PMI) improved to 55.0 in May from 44.4 in April, well ahead of the 47.3 consensus forecast.** This marked the biggest sequential increase on record, the first expansionary reading since January, and the highest level since October 2010 due to new orders. China's oil demand has recovered to more than 90% of levels before the coronavirus pandemic and a backup of crude tankers has formed off China's busiest oil ports as refineries are ramping up production amid a rebound in fuel demand. (*Reuters, Bloomberg)*
- **Eurozone services PMI was 30.5 in May versus April's reading of 12.0 and composite PMI was 31.9 versus the prior month at 13.6.** Both manufacturers and service providers endured further noticeable contractions in output, however. On a country level, the data showed a broad-based improvement in respective composite PMI readings with Italy the best-performing, followed by Germany and France. Spain remained the weakest performing Eurozone nation. *(IHS Markit)*
- **With rates unlikely to go lower, the Federal Reserve (Fed) is focused on how to manage the pace of bond purchases and how to enhance forward guidance.** Fed officials have also said they will examine yield curve control, but do not feel rushed to finalize their decisions at the June 9-10 policy meeting. The Fed also hopes to clear up confusion about its currently open-ended asset purchase program as it looks to shift its focus from improving market functioning to stimulating the economy. *(Wall Street Journal)*
- **Corporate bond sales for 2020 topped $1 trillion before the end of May.** In 2019, a typical year in the bond market, that figure was not reached until November. While initial offerings early in the coronavirus outbreak were limited to the highest-quality borrowers, the universe has since expanded to riskier companies like cruise lines. Demand has generally been strong, often allowing issuers to boost the size of their offerings and to lower borrowing costs. Companies are largely using the bond sales to fortify their balance sheets, rather than to finance capital returns or for mergers and acquisitions. *(Bloomberg)*
- **With Brexit talks between the UK and EU at an impasse, Brussels is looking to Boris Johnson to forge a compromise.** The EU hopes a meeting between Johnson and EU leaders later this month will break the deadlock. The EU could potentially make concessions as long as Britain takes a similar conciliatory approach but Johnson's office has dismissed suggestions of a compromise. Meanwhile, there are increasing concerns that leaving without a trade deal would compound the damage in the UK from the coronavirus and limit recovery hopes. *(Bloomberg)*

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What to Keep an Eye On

- **Trillions of dollars from federal and state relief programs have cushioned the fallout from the coronavirus outbreak for many Americans.** The $1,200 stimulus checks sent to most households, however, are long gone and a second round of relief looks unlikely anytime soon. Also, the $600 per week in extra unemployment benefits will expire at the end of July, leading to concerns that reduced government assistance may lead to a downturn in spending which could further harm the economy and contribute to another round of layoffs. *(New York Times)*
- **The Fed's Main Street Lending Program may fall short of expectations.** Concerns about onerous rates and repayment terms, curbs on buybacks, dividend payments, and executive pay, along with delays in getting the program started, have forced many companies to seek alternatives. *(Politico)*
- **Local government finances are under pressure from the coronavirus.** A poll of nearly 2,500 U.S. cities and towns that are home to 93 million people found that nearly 90% of municipalities expect revenue shortfalls and officials are turning to measures such as borrowing money or cutting key services such as police and fire protection. More than half of U.S. cities and towns expect to cut public-safety spending and more than a quarter plan to lay off workers. State and local government budget pressures continue to be seen as a meaningful recovery headwind. *(Wall Street Journal)*
- **The risk of Washington cutting China off from the U.S. dollar payment system is no longer unthinkable in Beijing.** But this "nuclear option," arising from tensions over developments in Hong Kong's relationship with China, is a low probability event and could hurt the U.S. even more than China. *(South China Morning Post)*

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Our Perspective: Getting Back to Business

Americans continue to ease out of quarantine as a host of re-opening announcements mark first steps towards reclaiming pre-pandemic economic activity levels. Although nationwide coronavirus infections appear to have peaked and 7-day average infection rates continue to decline, a possible resurgence remains a threat as states loosen restrictions. It is important to remain mindful of the reality that the U.S. is still adding to its world-leading tally of 1.9 million confirmed cases as of Thursday[1] and sporadic outbreaks continue to occur.

New York, heavily hit by the virus in March and April, reports dropping coronavirus case counts, but other states have reported outbreaks of cases, particularly near poultry processing plants in Alabama, Arkansas and Mississippi. There is also concern that the past week's civil unrest may lead to spikes in infections. California was the first state to shut down its economy in March and has begun gradually reopening over the last two weeks in an effort to limit economic fallout from coronavirus. Yet, 33,000 new coronavirus cases have been reported over the past two weeks and this week the state reported its highest number of new cases in a single day. As a counterbalance to these figures, California reports relative stability in hospitalizations and that less than 5% of those tested have shown positive results for the coronavirus.[2]

Assessing the trajectory of reopening the economy is proving to be a difficult and inexact science. It seems that for every encouraging statistic, a discouraging one can be found. For example, one frequently watched statistic is changes in driving activity based on driver searches for directions. This data shows driving increased by double percentage digits in the last week of May in five large cities, a finding which appears to show progress. But the data also indicates declines in mobility in six other cities.[3]

[1] *New York Times*
[2] Politico
[3] Nate Silver/538.com

A further complication when attempting to extrapolate trends from the data available is what is termed the 'low base phenomenon.' That is, when calculating the percentage change from a low base, any small increase will yield a dramatic and positive percentage result. In the case of reopening, activity in late March to mid-April was so low nearly any positive change yields impressive percentage results. Increasing percentages of restaurant reservations, truck traffic, and flight bookings appear promising but are still far below pre-pandemic levels.

The Toilet Paper Metric

Perhaps one of the most telling indications of optimism comes from a Nielsen survey[4] which found that purchases of toilet paper and disinfectants have declined 63% and 83%, respectively, from mid-March levels, and sales of pantry items such as canned soup and frozen pizza have also started to return to pre-pandemic levels. As retailers have started to reopen, the survey found, the fastest recoveries have been seen in clothing and accessories stores followed by entertainment and hobby retailers.

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These are meaningful signs that economic recovery is underway which, no doubt, is a welcome development and represents one of the first steps back towards normalization. Combined with unprecedented monetary and fiscal stimulus measures driving improved financial market conditions, investors are seemingly gravitating towards an optimistic outlook for the economic recovery.

Investors should not overlook the risks to this sanguine view. The possibility of further waves of infections remains as we reopen and complacency potentially sets in. Localized economic shutdowns to contain outbreaks, social unrest, heightened geopolitical tensions between the U.S. and China, and an upcoming election which could upend the current political landscape are all possible stumbling blocks on the path to recovery.

As the economy begins to recover, the focus will shift from *when* it will start to *how long* it will take to get back to "normal." This can be a difficult question to answer given the unique set of circumstances driving the contraction. We still don't know how much permanent damage the economy has suffered or what the ultimate shape and speed of the recovery path will look like.

Markets have swiftly rebounded and re-priced risk assets—the S&P 500 Index is up some 40% since its late March low—to reflect a rather rapid return to pre-coronavirus conditions and time will tell if this view is accurate, or perhaps too optimistic. While the nation has started to move into the recovery phase from containment, the normalization phase that follows could prove more challenging than markets currently anticipate.

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: 866-504-7651.

[4] *Financial Times*