

ECONOMIC OUTLOOK

Summary

Since the beginning of the coronavirus-related lockdowns, economists have predicted that the Bureau of Labor Statistics payroll report for May would show the ugliest data in the past 80 years. Instead, what we actually witnessed was one of the greatest head-scratchers of all time. Rather than reporting an expected loss of 7.5 million jobs, the economy actually *gained* more than 2.5 million jobs. In a month where the unemployment rate had been expected to touch 20%, it actually *improved* from 14.7% in April, *down* to 13.3% in May. This improvement wasn't due to unemployed individuals leaving the work force because the participation rate climbed *higher*. All of this seemed to catch the financial industry off guard.

What does this data mean for the economy moving forward? There are a couple schools of thought:

- 1) This may be the first step toward a "V-shaped", or quick economic recovery. This is the optimistic case and would suggest that employees are being hired back from coronavirus lockdowns much quicker than anticipated. This is possibly corroborated by the surprisingly positive (or less negative than expected) ADP jobs information.
- 2) This may not change a thing. Some contend that the job losses for April were understated and the job gains for May were overstated. But we don't know how severe the second wave of COVID-19 outbreaks will be (which may not be until winter), so we still can't fully understand the overall economic impact since lockdowns may need to be reinstated.

If you choose to follow the optimistic camp, you are surely focused on the fact that the consumer should be well-positioned for the reopening of the economy with the stimulus from the

CARES Act, additional unemployment benefits and a personal savings rate of 33%. However, if you choose to be concerned about a second wave, you probably are focusing on the rapid increase of cases in South America (currently their winter), so much so that Brazil now has the second most cases in the world and paused releasing statistics on new cases and deaths. Regardless of which camp you are in, we are all still trying to figure out how this virus will create long-term changes to everyday life and behaviors and how all that might impact the economy moving forward.

Positives

The economy gained 2.5 million jobs in May vs -7.5 million estimate

While still at high levels, initial unemployment claims have declined for 10 consecutive weeks

Manufacturing may have bottomed and is trending higher

Negatives

Retail sales ex-autos plummeted 17.2% vs expectations of -8.5%

Producer Price Index (PPI) declined by the most since 2015 (a sign of weak demand)

Pending home sales (month-over-month) were the lowest since May 2010 (-21.8%)

EQUITY OUTLOOK

Summary

April's momentum continued in May, with the S&P 500 rallying 4.8% for the month. The catalyst for the move seemed to center around the gradual reopening of the economy, hope for a vaccine and the prospect of additional fiscal stimulus. Market leadership was narrow to begin the month. Growth stocks outperformed value stocks in the first half, with a handful of the usual, large technology companies continuing to carry the torch. However, in the latter half of the month, market breadth widened considerably with value/cyclical stocks and smaller companies catching a meaningful bid. This has historically been a positive sign for equity investors.

Market participants still have much reason to take pause. Bear markets have historically lasted much longer than the four weeks we experienced at the end of the first quarter. This brings into question whether the bear market is truly over or we're simply witnessing a bull rally in a continued bear market. In addition, the economic wound between the U.S. and China was reopened. China's handling of the Covid-19 virus has been openly questioned by the Trump administration. Chinese legislators made matters worse by passing new security legislation over Hong Kong in late May. This was marked by widespread global condemnation. The likelihood of a second wave or rolling waves of the COVID-19 virus are considered likely by many health officials. The civil unrest in several major cities adds another element of uncertainty.

We are now less than six months away from the 2020 elections with the outcome of the presidential race and control of the Senate and House very much in doubt. Given all of these

bearish and bullish considerations, it is highly likely we'll continue to see volatility in the equity markets. In fact, we believe there will be a great deal of push and pull in both directions. For long-term investors, we continue to believe equities will provide superior returns over other asset classes.

Positives

Broadening equity market participation

Health care and pharmaceutical industries continue to make medical breakthroughs concerning the COVID-19 outbreak

Many retail investors have been on the sidelines throughout the rally – the pain trade is higher

Negatives

Rising geopolitical tensions

As people let down their guard, additional virus waves appear possible

Unknowns

The presidential election is basically a coin flip at this time

Any additional round (or two) of stimulus is likely to be met by partisan bickering

FIXED INCOME OUTLOOK

Summary

Treasury yields remained in relatively narrow trading ranges for the month of May with the 2-year Treasury note varying by only 6 basis points (bps) and the 10-year moving within an 11 bps range. By the end of the month the curve steepened ever so slightly with short rates lower by a few bps to 0.16% and the 10-year increasing by a single basis point to 0.65%. The newly issued 20-year bond, the first of that tenor since 1985, was well received and closed the month at a yield of 1.18% after being issued with a yield of 1.22%. The 30-year increased 12 bps over the month to close at 1.41%. With longer maturity yields ending the month slightly higher, Treasury debt in aggregate delivered a negative return of -0.25%, bringing the five-month return down to 8.61%. Without the impact of longer maturity bonds (those 10+ years to maturity), intermediate notes delivered a slightly positive return of 0.18% bringing the year-to-date return to 5.73%.

We believe there is nearly zero chance the Fed will be able to raise the overnight rate at any time in the next few years. As such, there is little reason to expect yields on the front end of the curve (2 years and in) to increase beyond the high end of the Fed Funds target rate of 0.25%. Longer maturity notes, such as the 10-year, could increase slightly as the market absorbs the massive supply, but even that should be limited. Investors know that a steep curve with no Fed increases forthcoming is a free gift to investors as bonds appreciate in value as they age and “roll” down the curve. We believe that a 100 bps spread between the 2-year and 10-year is about the maximum that will be achieved as the economy reopens and the worst of the virus fears subsides.

For the second consecutive month, investment-grade corporate bonds significantly outperformed Treasury notes as spreads narrowed further from about 195 bps in aggregate, to about 173 bps at month’s end. Most of this move occurred

in the second half of the month in concert with the rally in all risk markets, especially equities. Investment-grade corporate bonds returned 1.56% for the month bringing their year-to-date return to 3.00%. As this return still trails Treasury market returns by over 5% for the five-month period, we believe there is still ample room for corporate bonds to outperform going forward as the economy reopens and risks of downgrades subside. As such, we are maintaining our overweight to high-quality, investment-grade corporate bonds.

Positives

Investment-grade corporate bond yields remain attractive relative to Treasury debt

With virtually no chance of a rate increase, Federal Reserve’s rate policy should cap rates across the curve

Demand destruction caused by the virus will lead to lower inflation, not higher

Negatives

Fed policy already as low as likely to be in the future

Record level of Treasury and corporate debt issuance

Investors could sell bonds as they fear inflation due to monetary expansion

Unknowns

Progress towards a vaccine for the coronavirus

Trade tensions with China are back in the forefront