QUARTERLY REPORT

INVESTMENT PERSPECTIVE

30 June 2020

Following the largest quarterly decline on record in Q1 2020, the S&P 500 and Russell 2000 Value rose 20.5% and 18.9%, respectively during the second quarter. This equity market rally is consistent with the unprecedented monetary and fiscal policy support that went into the economy and with the bottoming of economic activity in late March to early April.

We continue to monitor high frequency data to ascertain the trajectory and sustainability of the ongoing economic recovery. While the recovery continues, the rate of improvement is starting to moderate as pent-up demand is being exhausted and economic agents remain leery of taking on incremental risk. There are still approximately 30 million people on unemployment benefits and the various components of the fiscal stimulus package are set to begin expiring in August. Without an extension of many of these components or additional stimulus added to the economy, it will not be possible to return our economy to its previous level of economic output and sustain risk assets at current valuation levels. Fortunately, monetary officials and members of congress are aware of this fact and will likely move quickly, barring an interruption by the political calendar, to implement additional measures, as necessary.

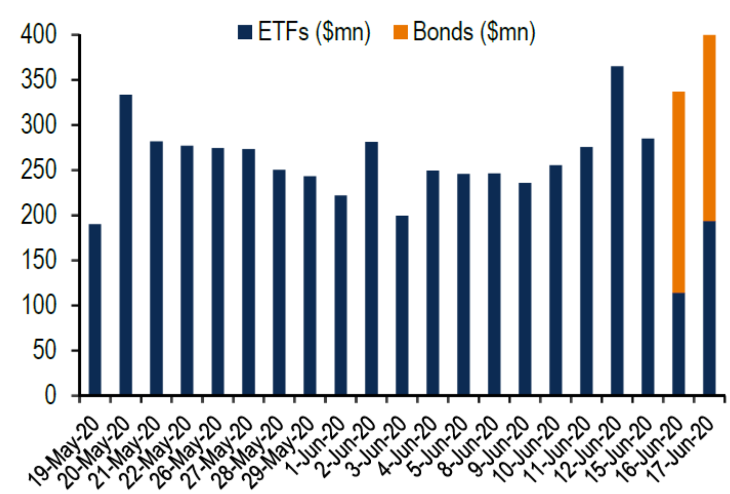
While the United States has finally reached the point where the Federal Government has become the marginal lender and spender of last resort, we are not alone. Planned stimulus measures across Europe and Asia are likely to dwarf those undertaken during the global financial crisis of 2008/2009. While policy support is very much warranted, investors will be dealing with the intended and unintended consequences of these actions for many years.

The Bloomberg Barclays Aggregate Index continued to perform well in the second quarter finishing up 2.9% in the quarter and up 6.1% year-to-date. While Treasuries traded in a narrow range for most of the quarter, Corporate bonds recovered the first quarter selloff returning 9.0% and are now up 5.0% year-to-date. Better than expected economic data and less pessimistic corporate reports and earnings guidance drove returns. The Federal Reserve also committed to maintaining the federal funds rate at 0.00% to 0.25% until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.

Credit spreads began the quarter at +255 basis points over Treasuries but narrowed to +142 by quarter end. This improvement in credit spreads was a continuation of the tightening that began toward the end of the first quarter after U.S. fiscal and monetary Covid-19 stimulus packages were announced, which restored liquidity to the high-grade sectors. Additionally, the Fed began buying ETFs and individual corporate bonds during the second quarter (Figure 1), which was bullish for credit investors and viewed as a backstop should economic conditions deteriorate. The Fed is primarily targeting U.S investment grade corporate bonds with maturities inside five years. This action should be supportive of our portfolio as we continue to manage our portfolios with a shorter duration than the benchmark with an overweight allocation to higher quality corporate bonds.

Municipal bonds also benefitted from the recovery in the market with the ICE BofA 1-10 Year AAA-A Municipal Index returning 2.6%. With demand expected to outpace supply again in 2020, we anticipate another good year for the tax-exempt market.

Figure 1: SMCCF daily corporate bond and ETF purchases



Note: Purchase amounts are as of transaction dates and include accrued interest.
Source Federal Reserve; SMCCF update, PMCCF in place, BofA Global Research

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