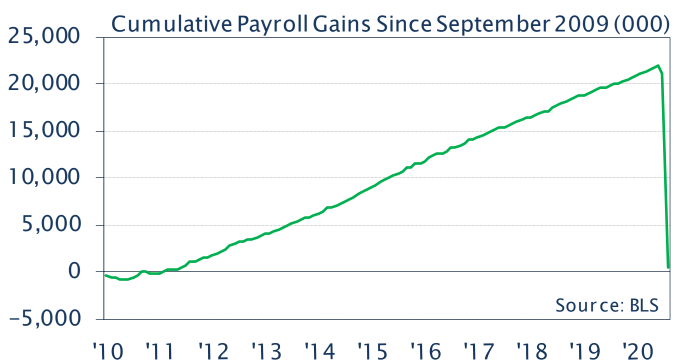
MAY 2020

INVESTMENT UPDATE

The past two months have been a roller coaster ride for humanity, as we collectively come to grips with what may become the most lethal global pandemic in more than 100 years. Not since the flu pandemic of 1918, which killed between 50 and 100 million people, have we faced a fast-moving virus with such lethality. In heavily-populated areas the coronavirus has spread at an exponential pace, as deaths now number in the hundreds of thousands worldwide. Stay-at-home orders and closings, along with strict social distancing, has slowed the spread of the virus, but there is no vaccine expected for many months.

The result is a massive disruption to the daily life of nearly every person on the planet, impacting households, businesses, and organizations of almost every type. Investment professionals are faced with many unknowns to sort through—and if there's one thing we don't like, it's the prospect of not having a clear path forward. Nevertheless, we have to use our judgement and experience, along with all the analytical tools at our disposal, to make decisions based on risks and rewards. For Agincourt, the first step in the process is to examine the macro outlook; what are the major drivers impacting bond prices today, and how are those likely to change over the next few months? That's what we'll focus on in this *Investment Update*.



Recent economic numbers have been dismal, especially those measuring the US labor market. Since the Great Depression, the worst periods of unemployment were in 1982 and in 2009, when the unemployment rate rose to a little above 10%. The recently-released report for April showed US unemployment blowing through those levels, reaching nearly 15%, with non-farm payrolls showing a monthly decline of more than 20 million jobs, as the US economy lost nearly all the jobs created since the end of the last recession in just two months (see chart on this page). Worse, due to errors in counting who was unemployed, the Bureau of Labor Statistics reported that the true unemployment figure for April should have been closer to 20%. We know that job losses are continuing into May; ultimately, we could be facing unemployment rates of more than 25%.

As we all know, there's no more important measure of an economy's relative health than its labor market. A loss of jobs as large as we are now witnessing has widespread effects on demand, spending, investing, saving, and lending. When people lose their paychecks—or even when there's the threat of reduced wages—economic growth is sure to slow. Moreover, societal problems worsen when jobs are lost, as crime rates rise, debt piles up, families come under stress, and skills become outdated. These problems only worsen when unemployment stays high for extended periods.

It's for these reasons that policymakers both here and abroad are establishing programs to keep their economies from collapsing from historic job losses. These policies can be separated into two broad groups: fiscal policies and monetary policies. It's worth noting, however, that the line between the two has been blurred since the financial crisis, as the Federal Reserve's monetary policies have expanded to include newer programs that go far beyond the traditional function of controlling the nations' money supply. Let's take a look at what's been done on both fronts.

Fiscal policies are broadly defined as "government spending"—using federal and local funds to provide (or take away, once they are no longer needed) what's not provided by the private sector. This includes police and military spending, the funding of public education, retirement and health benefits (including Social Security), and infrastructure spending. Taxes pay for these services, and when tax revenues are insufficient, the government will borrow money (e.g., selling Treasury securities) to fund the shortfall. At the Federal level, Congress passes enabling legislation to fund programs; likewise, state government programs are funded by state legislators.

There have been three major coronavirus-related acts passed by Congress. The first was in response to President Trump's request in late February for $2.5 billion to fight the spread of the virus. Congress approved $8.3 billion in emergency spending, signed into law by the president on March 6, with funds earmarked for research, emergency supplies, and public health initiatives, including almost $1 billion for state and local agencies. The bills passed by nearly unanimous majorities in both the House and Senate.

Less than two weeks later, the Families First Coronavirus Response Act was signed into law. This legislation provided, as its name implies, protections for workers who take medical leave as a result of the virus, whether for their own health or for family members. The Act also provides free COVID-19 testing and treatment for workers covered under employer-sponsored or other qualified health care plans. The FFCRA provided additional funds for state unemployment funds.

These two were just a warm-up for the biggest coronavirus-related legislation to date, the Coronavirus Aid, Relief and Economic Security (CARES) Act, by monetary value the largest economic stimulus package in US history. Totaling an estimated $2.2 trillion, the aid package was signed into law on March 27. Needless to say, it provides a wide-ranging list of benefits and incentives to both institutions and households. By dollar volume, approximately $500 billion is allocated towards loans to institutions (with fewer than 10,000 employees). Another $350 billion is earmarked for the Payroll Protection Program, which provides low-interest loans to small businesses and non-profits whose operations have been negatively impacted by the coronavirus, to cover payroll, rent, interest payments, and utilities through June 30. The funds for the PPP were exhausted within two weeks, so additional legislation was signed on April 24 to increase the program by an additional $320 billion. Loans made under the PPP will be forgiven if the institution keeps covered employees on their payroll, and if other conditions are met.

The CARES Act also provided relief, both direct and indirect, to individuals and households, worth an additional $750 billion. Included here are subsidies for unemployment insurance, worth up to an extra $600 per week above the state unemployment compensation. Workers are also eligible to receive advance payments against federal tax credits for 2020, up to $2,400 for married couples, $500 per dependent child, and $1,200 for individual filers. There are additional tax benefits for charitable contributions, relief for student loans, and relaxation of certain restrictions on individual retirement and savings plans. Lastly, the legislation provided additional funding for medical research, equipment, hospitals, and community health care.

Collectively, these three “phases” of fiscal relief (three and a half, if you include the add-on to the PPP), add up to roughly 10% of annual GDP in the US, nearly three times the relief allocated in the wake of the global financial crisis in 2009. But this doesn’t count the monetary stimulus that’s been rolled out by the Federal Reserve over the past couple of months. We’ll quickly review that next.

On March 3, the Fed lowered its overnight lending rate, the Fed funds rate, by 50 basis points, to 1.25%. Less than two weeks later, on March 15, as it became clear that the spread of the virus would severely slow economic activity, and with stocks and other risky assets in a steep selloff, the Fed (on a Sunday afternoon, no less) announced a major monetary stimulus package. Like Phase 3 of the economic stimulus package, this one pulled out all the stops, including dropping the funds rate back to its financial crisis range of 0%-0.25%, and a statement that the Fed would use “its full range of tools to support the flow of credit” and stabilize the wobbly capital markets.

The Fed made additional announcements over the next few days; it would begin another round of quantitative easing (QE), and would increase its holdings in Treasuries and mortgage securities by $500 and $200 billion, respectively. It announced a number of never-before-used initiatives as well, including a revamp of the Fed’s repo facility, with zero reserve requirements and lending rates of near-zero, as the Fed makes “a shift to an ample reserve regime.” Two days later, it announced the re-establishment of two financial crisis-era programs, a primary dealer credit facility, and a commercial paper funding facility, in order to insure low cost short-term funding for broker/dealers and businesses. Finally (and perhaps, most important to Agincourt), it announced two new programs on March 23, one that would purchase new issue investment-grade corporate bonds and exchange-traded funds (ETFs), and another that would buy high grade corporate bonds and ETFs trading in the secondary market. These programs will purchase as much as $750 billion in corporate bonds and ETFs in the coming weeks and months.

The announcement of the Fed’s corporate bond purchase facilities had an immediate and positive effect in bolstering investor confidence. During the second half of March the yield differential between high-grade corporates and Treasuries, which had reached crisis levels, came back down to earth, normalizing borrowing costs for corporations, and calming the broader capital markets. This narrowing continued throughout April and into May, despite the fact that it wasn’t until last week that the Fed made its first purchases of corporate credits (via broad investment grade ETFs).

These are the major programs, but there are other, more limited initiatives that have been rolled out to address specific market dislocations, such as the mortgage forbearance program that is allowing homeowners to defer mortgage payments for up to 12 months. Any missed payments will be tacked on to the end of the loan, extending the final payoff for up to one year. And there could be more easing yet to come with Congress now debating additional assistance as well as the extension of popular programs such as the payroll protection plan.

The continuing recovery of the stock and credit markets over recent weeks is encouraging, and reflects the breadth and magnitude of policy responses to the virus. But money alone will not eliminate this virus, and even if the most devastating period of the pandemic is behind us, the path to recovery—both economic and societal—is sure to be long and uneven.

Thanks for reading. Stay safe, everyone!