This Month in the Markets

April 2020

ANCHOR Investment Management

EQUITY COMMENTARY

Stocks Rally on Bad News

The market has begun looking through the pandemic and started pricing in a recovery. The MSCI ACWI Index rose 10.8% in the month with the U.S. S&P 500 Index climbing 12.8%. International markets, as measured by the MSCI EAFE Net Total Return Index rose 6.5%, and the MSCI Emerging Markets Net Total Return Index gained 9.2%.

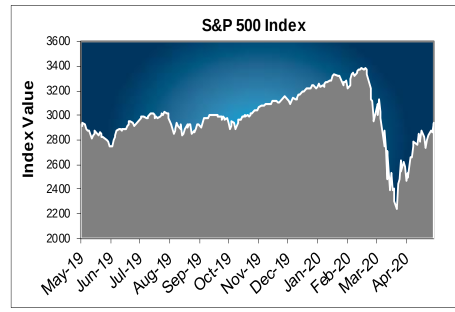
The MSCI ACWI Energy sector was the top sector, climbing 15.8% as investors scrambled to close shorts and potentially add value in an industry that was decimated by the plunge in energy prices. The MSCI ACWI Utilities Index was the underperformer – gaining only 3.8% as investors rotated into higher beta and cyclical exposure

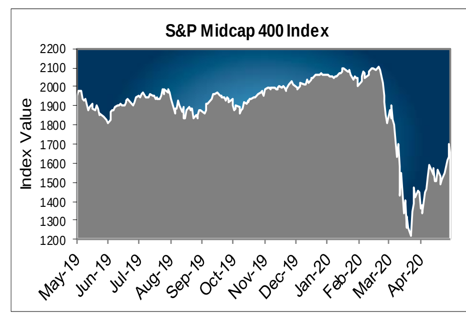
TechnipFMC rebounded over 32% in April as the expectation on the duration of demand destruction for the oil sector began to dissipate. Royal Dutch, however, fell slightly during the month after cutting its dividend for the first time since World War II.

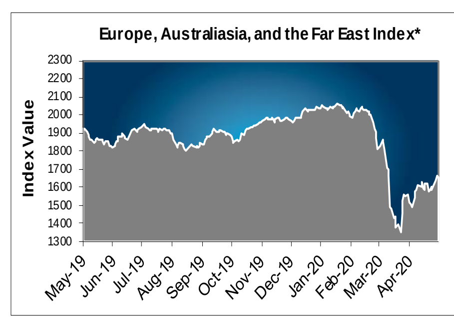
For many, the rapid rise in the stock market may seem counterintuitive and confusing. The S&P 500 had its best month since 1987 despite having the sharpest economic declines ever. Unemployment claims soared in April – pushing the estimated unemployment rate to be around 16% for the U.S. economy. Industrial production tumbled, and GDP just posted its worst quarter since the great financial recession, and the second quarter is expected to experience a record contraction. How could the stock market gain in the face of all this? The short answer is that the market is a discounting mechanism – in other words, it does not trade on historical data but rather a prospective outlook. It is also important to note that terrible data may not affect the market if the market was already pricing for the worst data. In other words, markets do not trade on absolutes but changing perceptions of better or worse on the margin.

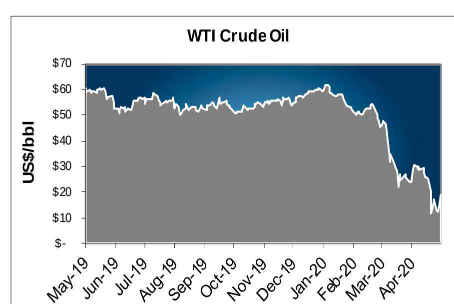
The market is also assuredly pricing in the unprecedented stimulus by the U.S. government – the government deficit could be almost $4 trillion this year! The Federal Reserve is joining in to fight the virus - buying almost anything that moves at this point – including some fallen angle junk bonds. As a result of the decline in inflation expectations, interest rates have fallen to historic lows. The decline in risk-free rates makes stocks more attractive, especially stocks with consistent earnings. As a result, equities remain well bid for those seeking higher yields and total returns.

As we stated before: “If history is any guide, there will be a point that the market dispassionately ignores the virus-related headlines and looks towards the future, and when it does, quality companies with secular growth should perform exceptionally.” This has begun to play out with a number of our equity holdings actually up on the year - companies like Salesforce.com, Tencent, Microsoft, Amazon, Roche, Ahold Delhaize, Essity, Facebook and Danaher all should survive the economic dislocation brought about by the pandemic and will likely benefit from it in some form or another as the world changes.









*MSCI EAFE Index

FIXED INCOME COMMENTARY

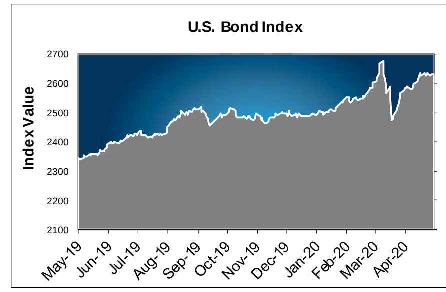
Corporate Bonds Rally

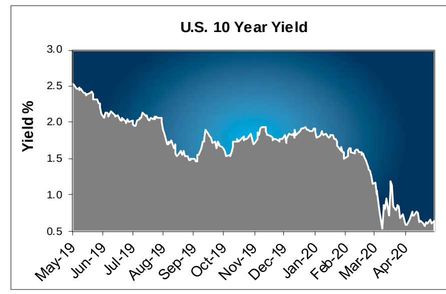
After the manic volatility and sell-off of ‘March Madness’, April by comparison was quite tame (oil market excluded!). The USD was largely flat, indicating the rush for dollars that occurred in March has at least temporarily abated thanks to the swift action by the Fed to expand its dollar swap lines (to more countries and size). This is also evidenced by the normalizing of currency basis swap spreads in April, which had turned sharply negative in March. Treasury yields were largely flat across the curve, while credit spreads rallied.

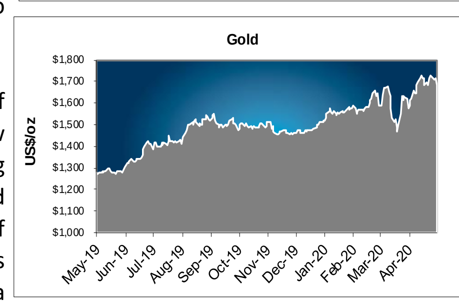
It may seem counterintuitive that credit spreads (compensation investors receive for taking on credit risk) narrowed in April, while economies across the globe were largely shuttered. Afterall, the record initial weekly jobless claims, continuing claims figures, and the -4.7% decline in U.S. real GDP in Q1 point to the severity of the economic slow-down. Furthermore, rating agencies have been on a downgrading spree – downgrading both corporates and sovereigns alike. However, it is important to note that bondholders are contractually senior to equity holders, and companies with strong cash flow generating ability, and/or ample liquidity will be able to ride out the storm, all else equal. The ace in the hole, however, is that the Fed will not only be supporting investment grade bonds through its primary and secondary purchasing programs, but also “fallen angels” (companies that are downgraded to high yield).

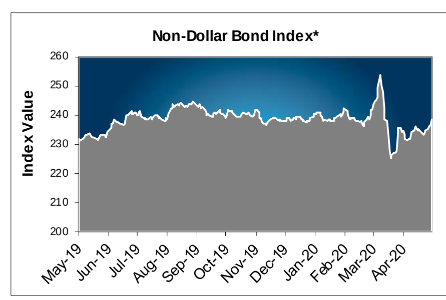
As we have cited in the past, BBB-rated companies represent approximately half of the investment grade universe. Many investment manager’s mandates do not allow them to buy high yield bonds. Thus, the risk of a wave of BBB-rated bonds being downgraded to high yield (a market with a much smaller buyer base) would exacerbate the sell-off in an already perilous economic climate. If credit spreads of fallen angels blow out, it will indirectly push credit spreads wider for all corporates and impact funding costs for all. This risks a liquidity issue transforming into a solvency crisis. This is exactly what the Fed wants to avoid. It wants to keep the credit market gears greased so companies can access debt markets at affordable levels until the economy gets back on its feet. Thus far it has worked. Companies came to the new issue market in droves in April, with many deals well-oversubscribed. Over $37 billion of high yield debt was priced in April, the largest monthly total since March 2017. From a moral hazard perspective, whether the Fed should do this is another conversation entirely, but we must deal in what is. The reality is that the Fed is supporting corporate credit markets and that is very bullish for corporate bonds, in general. The tremendous rally in Treasuries this year (the 5Y Treasury yield was 0.36% at April-end), further adds to the attractiveness of corporate bonds.

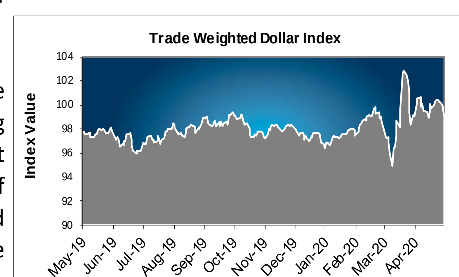
We were underweight corporate credit for most of 2020 favoring Treasuries, as we did not feel the credit spread offered adequate compensation. This positioning served us well in March when Treasuries rallied, and corporate credit underperformed. Although we expect volatility to remain elevated, on the back of March’s blow-out we added corporate credit exposure with attractive risk/reward profiles and sold Treasuries. As such, we are now overweight corporate credit. We have added companies with strong liquidity profiles, who also qualify for the Fed’s corporate bond buying programs.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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