AMB Wealth Management

3rd Quarter 2020 Newsletter

July 8th, 2020

As we wrote our last quarterly letter, we were in the midst of one of the deepest and quickest market declines in history. The market was pricing in a complete collapse of the US economy in the second quarter, and the initial data justified these assumptions. Consumer confidence plummeted, housing cratered, and business investment came to a halt. Unemployment peaked at approximately 20 million jobs lost with a rate of 14.7%. The biggest driver for the US economy is consumer spending which makes up around 70% of GDP; and with the economy shuttered and jobs lost, spending was muted. The economic impact of the lockdowns will show up in 2nd quarter GDP numbers which are certain to be historic. Economist estimates for the quarter are wide-ranging, from a 30% to 50% decrease in GDP. However, we are beginning to see some signs of life in the US economy. May and June payroll numbers were better than expected, the labor participation rate has started to increase, and the unemployment rate is coming down as the US economy begins the reopening process.

Despite the negative economic impact of the shutdown, the market was resilient in the 2nd quarter. The S&P 500 and the Dow Jones Industrial Average both posted approximately 20% returns, marking their best quarter in two decades. The tech-heavy NASDAQ, returning around 30%, had its best quarter since 1987. Global markets rallied alongside US markets. Developed international markets were up almost 15% while emerging markets returned around 18%. As you may remember in our March 18th market update, we stated that we were net buyers of equities at that time. We thought the market had reached a point where value was being offered, but we did not expect a 30+% market recovery from the March 23rd lows. Even with this surprising recovery, our disciplined investment process allowed us to participate in this move higher.

135 South Madison Ave
Thomasville, GA 31799
229-225-1500
www.AMBwealth.com

Interest rates were calm throughout the quarter and finished close to where they started. The curve steepened slightly, as the front end remained anchored in the zero-bound range and the 30-year Treasury yield moved up 6 basis points. The most significant activity in the fixed income market was the tightening in credit markets. The Federal Reserve has taken extraordinary steps to keep markets functioning correctly and part of their response was to buy credit. This policy decision by the Fed compressed spreads by approximately 200 bps and 150 bps on high yield bonds and investment grade corporates respectively. According to their latest comments, it seems the Fed will continue these measures for the foreseeable future. Even though we have seen a massive move down in rates this year, we believe it is important to note that the Treasury curve, as measured by the 2-10-year spread, has actually steepened and is now at levels last seen in 2018. In our view, this is a positive for the economy going forward.

Monetary & Fiscal Stimulus

With 1st quarter GDP reported at -4.8%, the longest US economic expansion in history ended. Fortunately, monetary and fiscal responses to this crisis took only days to enact and, we believe, helped to stave off a depression. These measures included the Fed lowering short term rates to a range of 0.00 – 0.25% and stating that they intend to keep those levels until mandates are reached on both unemployment and inflation. This means we will see lower-bound rates throughout the rest of this year and probably through 2022.

During the meltdown in March, the Fed was most concerned with dysfunctional markets and liquidity drying up, much like what occurred during the 2007-2008 global financial crisis. In response, they implemented a full range of liquidity programs under the Federal Reserve Act. Quantitative easing restarted which included the buying of corporate, high yield, and municipal debts along with purchases of MBS and Treasuries. The Fed also increased their repo operations and set up a loan facility. These are all extraordinary measures and have shored up the liquidity issues so far.

Monetary policy can only do so much. Providing liquidity is not going to generate a spark to the economic engine. That spark needs to come from fiscal policy and in the 2nd quarter it came in the form of a $2 trillion stimulus package. The government also authorized Paycheck Protection Program loans for businesses to help bridge the gap until the economy improves. These measures have helped, but we are afraid without another stimulus package, the economy could once again begin to falter, especially with the looming threat of a second wave of COVID-19. If we begin to see rollbacks in the reopening of state and local economies, we would expect a negative reaction from markets without a boost from another stimulus package.

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Equities Outlook

Our outlook for equity markets remains mixed as we continue to see both positive and negative backdrops for the economy. Since these circumstances hinge on a virus for which there is no cure, we believe the rational approach is to stay cautious and prudent. We will do so by holding more cash than usual and only deploying it when we believe the risk/reward profile has become more attractive.

Fundamentals remain supportive for equity prices, excluding valuations in certain sectors. Inflation remains low along with suppressed interest rates. As we mentioned before, the yield curve remains upward sloping, the dollar seems to be weakening, and the price of oil has stabilized for now.

Our outlook regarding the drivers of the current market move remains unchanged. The low volatility/high momentum trade is still overcrowded and in need of a major pull back. Defensive and Technology stocks are currently at some of their richest valuations in history. In contrast, cyclical/value stocks remain depressed and are now cheaper (relative to growth) than they were during the dot-com bubble.

We are currently in unprecedented times and, going forward, our strategy will be to look for opportunities in order to take advantage of dislocated valuations on both the buying and selling side. We strive to be flexible in executing our portfolio strategy, due to the pandemic's propensity to cause rapid changes within the markets.

Fixed Income Outlook

Fixed income markets are becoming more difficult to navigate with interest rates expected to remain at historically low levels. With the current uncertainty surrounding the global economy, we continue to favor high credit names in the middle of the yield curve. We still believe risks lie inside the credit markets even with the backstop the Federal Reserve has put in place; therefore, our focus will be on investment grade corporate bonds and municipal debt. Spreads in these two areas have compressed but not nearly to the extent that we witnessed pre-crisis.

Conclusion

After the abysmal start to the year, the 2nd quarter rebound was a welcomed relief. Market participants have been able to recover most of their losses, as long as they stayed invested and refrained from panic during the downturn. As we have mentioned in our previous market notes, "panic is not an investment strategy" and those that do panic usually regret it.

Conclusion (continued)

So far, the economic indicators in May and June have been better than expected which is keeping hope alive for a shorter recovery time. However, it is our belief that a second round of stimulus will be needed as the reopening of the economy is taking longer than initially anticipated. The resurgence of the virus has put many states on hold and even some previously open areas of the economy are being closed again.

After the recent market rally, we believe now is a time for patience. We also believe another buying opportunity will arise over the next few months where we will once again become net buyers, but currently the risks outweigh the rewards. Former Berkshire Hathaway manager Lou Simpson once said, “In many ways, the stock market is like the weather in that if you don’t like the current conditions all you have to do is wait a while.” We agree and are anticipating more favorable conditions in the future.

We are honored to serve as your financial advisors through these uncertain times. Please reach out with any questions you may have.

Matthew J. Roach, CFA
Director of Portfolio Management