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Rockefeller Insights

Around the Markets

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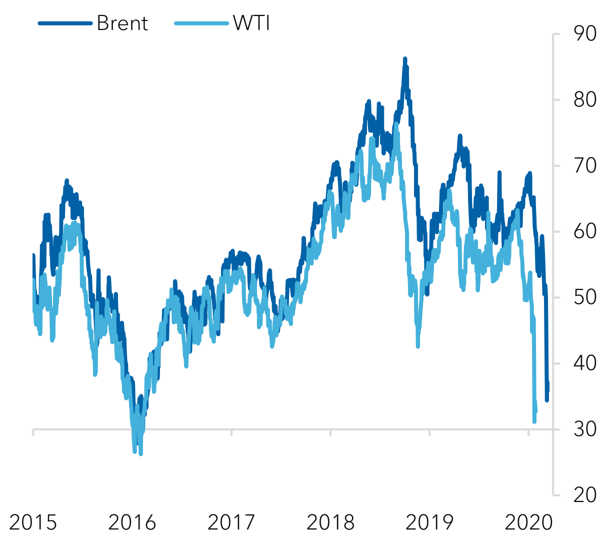
The Storm Before the Calm

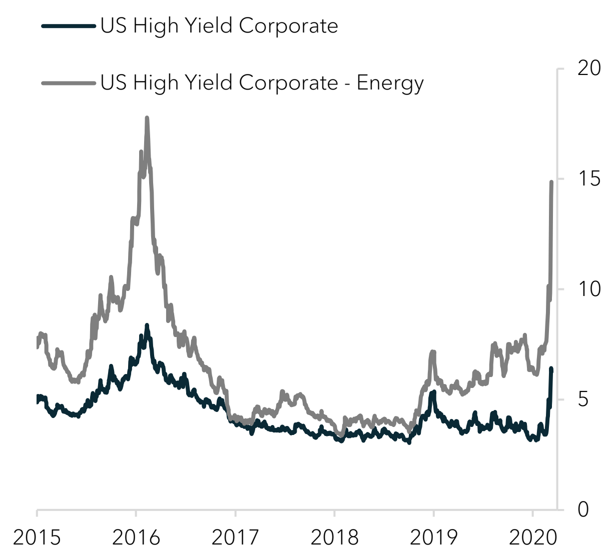
Investors got almost no reprieve from the past two weeks of stock market volatility when the S&P 500 Index fell 7.6% on Monday. This was the worst one-day fall since 2008, prompted by a shock in the Energy sector. Late last week, oil producing powers Saudi Arabia and Russia could not come to agreement on production limits that would support oil prices amidst the virus-induced economic slowdown. The Saudis increased oil production over the weekend, slashing oil prices in the process and launching a price war with Russia.

Brent and WTI Spot Prices ($/barrel)[1]



On Monday, West Texas Intermediate (WTI) oil prices fell 25% to $31/barrel, below breakeven levels for almost all US producers.[2] This marked the largest decline in oil prices since the 1991 Gulf War; many individual oil stocks were down even more. That's because the energy markets were already in fragile condition from the coronavirus-induced slowdown in global demand. Further, years of low interest rates and easy access to credit led to a production boom in the US to the point where the US is now the largest producer of oil and gas.[3]

High Yield Option-Adjusted Spreads[4]



Companies that have borrowed heavily to fund their exploration and production activities may now have to reign in production and slash jobs in order to avoid defaults. According to Moody's Investor Services, North American oil and gas companies have more than $200 billion of debt maturing over the next four years. Many of these loans were made by banks and private investors that are now facing lower collateral values on that debt. The high yield bond market has absorbed much of energy-related debt as well; the sector is the largest component of high yield indices at 14%.[5] As oil prices fell, spreads on that debt widened sharply, indicating the higher risk levels of those investments. Investors with

[1] Bloomberg; data as of 3/11/2020
[2] RS Energy
[3] The Wall Street Journal, 3/10/2020
[4] Bloomberg; data as of 3/11/2020
[5] Deutsche Bank, ICE indices

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exposure to high yield may want to ensure that those holdings align with their tolerance for risk.

Even if oil prices recover, it is unlikely that demand will rebound sharply. Global demand for oil is in structural decline as fuel efficient standards rise and consumers of energy switch to alternative sources. It is likely that the industry will be subject to increased bankruptcies and consolidation as weaker players are absorbed.

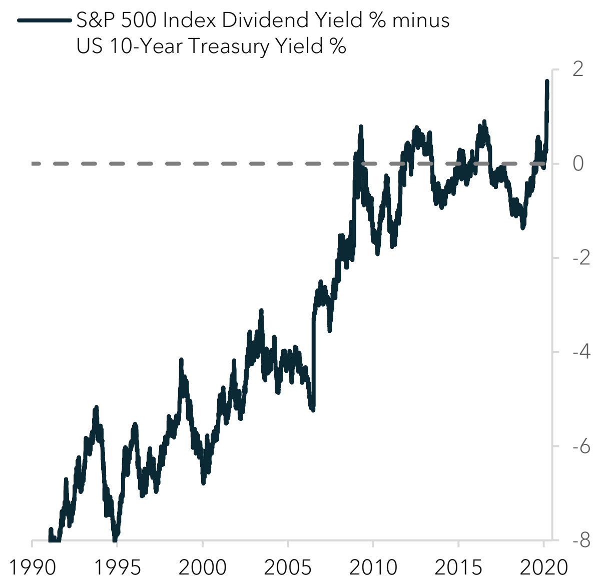
Opportunities Beyond the Oil Patch

We suggest that investors examine their Energy holdings based on overall portfolio composition and goals. Currently, we prefer a relatively low allocation given existing concerns, with a focus on higher quality producers or integrated companies that are strong cash flow generators.

Often investors choose energy-related stocks for their above average dividend yields. We believe the risk of dividend cuts has risen along with lower anticipated profit margins. Many oil stocks are likely to still offer good yields, but we caution investors to be more selective given recent events. For those interested in attractive dividends, we suggest looking beyond those stocks whose yields are currently attractive simply because the stock price has fallen. Financials may be attractive even though they face challenges from low interest rates. Many stocks in this sector have track records of consistent dividends, and balance sheets are generally in good shape. REITs also offer attractive dividend yields and operate across a wide variety of industries and geographies. There are attractive yields available in many segments including multi-family housing, communications and data centers.

Income-oriented investors may also want to consider preferred stocks. Preferreds combine the characteristics of both stocks and bonds and have the same types of risk as do both asset classes. However, they tend to offer relatively high yields, and generally have low correlations to stock and bond indices, thereby offering a degree of portfolio diversification.

S&P 500 Dividend Yield is 1.5% above US 10-Year Treasury Yield[6]



Should oil prices stay contained for a prolonged period, we expect there to be benefits to consumers through lower gasoline prices and to industries such as transportation where fuel is a significant cost. Additionally, many emerging market nations, like China, India and Turkey, are net importers of oil and would likely benefit.[7]

Fiscal Stimulus Is Likely to Be Limited in an Election Year

Markets have priced in aggressive monetary stimulus by the Federal Reserve to boost the

[6] Bloomberg; data as of 3/11/2020

[7] PIMCO Global Markets

economy, but fiscal proposals thus far have failed to generate bipartisan support.

On the one hand, Trump's proposal centers on suspending payroll tax through December 31st. On the other hand, Democrats are focused on paid sick leave and unemployment insurance.[8]

The bipartisan package of $8.3 billion approved on Wednesday last week is intended to be used only to combat the spread of the coronavirus. More than $3 billion of the funding is designated for the research and development of COVID-19 vaccines and treatment. In short, the emergency coronavirus response bill is not intended to address the economic impact associated with the virus.[9]

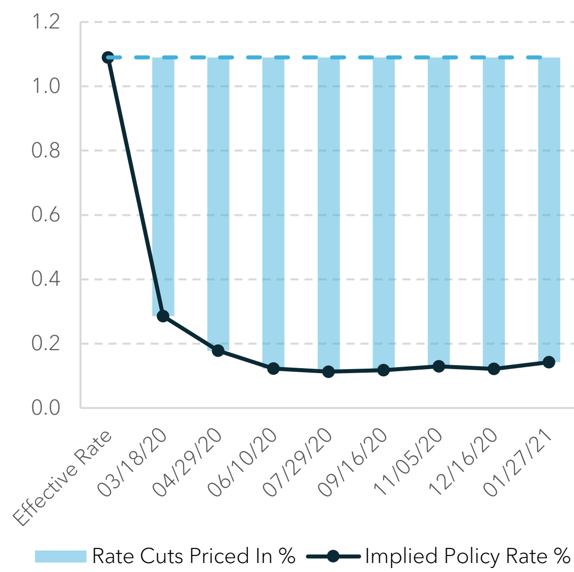
In order to tackle the virus' potential effect on GDP over the next few quarters, we believe that broad, aggressive measures tackling health care, demand suppression and supply disruption will be needed. Absent the high likelihood of a severe recession in the US – which we do not view as a base case scenario – we do not expect to see a major fiscal stimulus with bipartisan support in the near term.

With Rates Racing to Zero, What Else Is Left in the Fed's Toolkit?

One week ago, the Fed executed an emergency rate cut of 50bps, reducing the Fed Funds rate to a range of 1.0% to 1.25%.

Following a brutal global equities selloff on Monday, the probability – as implied by the futures market – that the Fed will cut rates by an additional 100 bps to near zero percent by its next scheduled FOMC meeting on March 18th has increased to 70%.[10]

Fed Funds Futures Implied Overnight Rate %[11]



We suspect that rate cuts will do little to directly boost the economy or the financial markets. Nonetheless, given the Fed's aversion to negative interest rates, the expectation of these aggressive cuts serves as a strong signal that the Fed will likely need to embark on even more aggressive monetary stimulus. Compared to rate cuts, we believe that a liquidity injection into the banking system via repo operations is more effective at easing credit conditions, as signs of scarce liquidity have already emerged. Although the Fed previously announced plans to gradually wind down its repo operations after April, we believe that the operations will continue for longer.

Since the global financial crisis, banks are required to hold enough high-quality assets to meet funding obligations. The Fed's preference for cash over Treasury securities has resulted in "cash hoarding" by banks during distressed times, such as now. The Fed could encourage banks to lend by

[8] The Wall Street Journal, 3/10/2020
[9] The Wall Street Journal, 3/4/2020

[10] Bloomberg, data as of 3/11/2020.
[11] Bloomberg; data as of 3/11/2020

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communicating that it considers Treasuries on par with cash.

The Fed can do more, i.e., directly purchasing certain securities such as Treasuries from the market. During Mondays' sharp market selloff, investors rushed for safe havens like Treasuries. The 10-year and 30-year US Treasury yields briefly fell to 0.32% and 0.71%, respectively. At these levels, bondholders will likely not be compensated for inflation for years. Investors must have rising expectations that the Fed embarks on a new round of quantitative easing.

Entire US Treasury Yield Curve Fell Sharply[12]

As Treasuries have already rallied significantly, the Fed can provide substantial additional stimulus by purchasing mortgage-backed securities (MBS). Doing so can tighten MBS spreads and subsequently lower mortgage rates. This should raise consumer confidence and spending by encouraging home sales and refinancing.

Ultimately, we believe the greater near-term risk to the economy is a short-term liquidity crisis, particularly among businesses. Increasingly stricter measures taken to mitigate the spread of the virus (e.g., school closures, travel restrictions, event cancelations, etc.) could curtail spending, depress hiring, and potentially lead to a rise in defaults. What the Fed does to prevent a pullback in credit availability to corporations is likely to have a profound impact on the prevention of further slowdown in US economic growth both during and after the virus outbreak.

Although the Fed is not authorized to buy risky assets such as corporate credit (absent a change in the law), the Fed can develop bank funding programs that in effect subsidize bank credit extension to minimize a pullback in credit availability to businesses and households.

Remember Diversification? It Is Back.

In 2019, the Fed delivered three rate cuts, and the 10-year Treasury yield fell from 2.7% to 1.9%. During this period, the S&P 500 Index generated a price return of nearly 30%, 90% of which is explained by price multiple expansion (as opposed to forward earnings growth). Over 100% of the price multiple expansion was driven by falling long-term rates.

The era of "bad news is good news" is over. In fact, the negative correlation between stocks and bonds has been particularly pronounced over the past few weeks. Investors have become focused on corporate earnings, as growth visibility remains extremely low.

Given the novelty of the COVID-19 virus and the increasing number of confirmed cases in major developed countries, the potential magnitude of global economic impact caused by supply-side disruption and – increasingly – demand depression

[12] Bloomberg; data as of 3/11/2020 4PM EST

remains uncertain. One thing that we do know for certain is that ample liquidity and low rates alone will not lift stock prices, as they did in 2019.

Rates have rallied significantly over the past week. However, we believe that it is still too early for investors to starting locking gains and/or substantially trimming their duration exposure.

Given the particularly pronounced negative correlation between stocks and bonds throughout the current market turmoil, we continue to believe that rates can serve as a "parking spot" as we ride through volatility and wait for attractive entry back into stocks – until then, rates have the potential of moving even lower from current levels.

Recalculating…

Last week we wrote that consensus earnings growth for the S&P 500 Index was 6.9% for 2020[13] with a caveat to expect downward revisions. It is probably not an "if" but a "when" for analysts and strategists in the US to begin publishing lower expectations for company earnings. We expect to see estimates for at least Q1 and Q2 EPS lowered from their original levels, but how much lower will they be? And to follow on that, stock prices have come down—are they low enough? These are the questions we have been asked over the past couple of days.

Monday's selling had the look and feel of panic; market circuit breakers were used to halt trading for 15 minutes on Monday morning, the first time they have been used in 23 years. By the end of the day, most major equity indices were down 19% from record highs set in February—just 1% shy of christening a new bear market. Even with an almost 5% recovery of prices on Tuesday, the S&P 500 remained 15% off its high set on February 19.

S&P 500 Index 2020 EPS growth forecasts had already fallen by over 7% through March 6 according to FactSet.[14] And the Index's P/E valuation, based on current forecasted EPS, has fallen from over 19x to around 16.5x.[15] In our view, the stock market is already discounting a lot of bad news.

So Should I Stay or Should I Go?

The classic title lyrics asked by English rock band The Clash in the early 1980s are what investors are asking today amidst current market volatility. The simple answer from us is: stay.

We acknowledge that supply and demand disruptions related to the COVID-19 virus, lower oil prices, lower interest rates and slower global economic growth are likely to have meaningful effects on corporate earnings and we would not be surprised to see further downward adjustments to both market prices and earnings forecasts.

Nonetheless, we have several reasons to be optimistic. Prior to the COVID-19 breakout, the US economy was quite strong, with housing, consumer spending and employment all robust. While we expect these metrics to worsen, they will decline from healthy levels and need to severely deteriorate for us to become worried about a recovery. We are already witnessing a boom in the refinancing business as a result of lower rates.

The US corporate sector appears fairly resilient, as profit margins have been strong and numerous productivity/technology enhancements have reduced the demand for human capital in many industries. The quest for growth seems intact: reportedly over $40 billion in merger & acquisition deals were announced during Monday's oil price-induced selling.[16]

If China's economy is a pattern for other markets, we are optimistic that recovery from virus-induced downturns can be short-lived. Traffic in major

[13] FactSet, 3/5/2020
[14] FactSet Earnings Insight, 3/6/2020
[15] FactSet, 3/10/2020
[16] Bloomberg, 3/10/2020

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Chinese cities has recovered almost to pre-virus levels and industrial activity is slowly rebounding.[17]

A China economic recovery bodes well for industries dependent on its supply-chain dynamics, like semiconductors and electronics within Technology, along with consumer goods/apparel. Defensive sectors such as Health Care, Utilities and Consumer Staples have held up better than more cyclical sectors in the recent market downturn. Together these groups represent a significant contribution to market return and can help cushion portfolios in the event of further weakness.

We encourage investors to approach these volatile markets with caution and to seek opportunities that are consistent with their overall investment strategy, and we continue to emphasize the value in periodic portfolio rebalancing.

[17] The Wall Street Journal, 3/11/2020

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