2Q 2020
Market Commentary

The first half of 2020 was filled with unprecedented events, none more significant than the emergence of the COVID-19 pandemic. Along with the health crisis came the government-mandated economic shutdown that brought many sectors of the economy to a near-complete halt. The result was the sharpest, deepest, and most dramatic recession in recent decades, along with panic selling in the stock and corporate bond markets.

The recession appears to have been the shortest on record as well, hitting its bottom in April or early May. Within the broad stock market indices, the panic selling produced a record quarterly decline, yet this was followed by a record (or near record) quarterly gain in the 2nd quarter. At SKBA, with the dramatic stock market decline, we were not afraid to act by investing client assets in new opportunities near the bottom of the panic selling period.

The question now is, will the initial economic rebound be sustained in the second half of 2020? The hastily-established plan to shelter in place and to shutdown “non-essential” businesses in the economy was not designed to eliminate the virus but to lower the peak in cases and deaths that would overwhelm the U.S. hospital system. It will take the development of a vaccine(s), much like the vaccines for smallpox and polio, to control the virus. Indeed, there are promising new drugs in the development stage, but finding a cure is at least months away if not significantly longer.

Some states with densely-populated cities were late in implementing mask-wearing and social distancing mandates. Even worse, as was the case with New York, the initial decision to off-load COVID-19 cases from regular hospitals to nursing homes was a huge mistake. But with a great deal of trial and error, the country and the healthcare system have learned and adopted better methods, techniques, and treatments.

The increase of cases in states that initially had low infection rates cannot be simply seen as the beginning of the “second wave” of infections. Whereas the initial infections rapidly hit the most vulnerable populations (the elderly and those with compromised immune systems), the recent rise in the pace of infections has so far come with a lower death rate. After such a long SIP (shelter in place) period, the proper practices in social distancing and mask wearing were widely ignored. So the virus’ spread accelerated as young people, in particular, rushed to pools, bars, beaches, and protest marches.

The reported economic statistics for May and June highlighted what has become a remarkably robust initial recovery. For example, after losing over 30 million jobs with the shutdown, the 2.5 million net jobs added in May and the 4.8 million in June (reported on July 2nd) were far greater than weak consensus expectations. One of the ongoing questions is, will the gains be lost as states slowdown or reverse some of the steps to reopen their economies? The answer appears to be yes and no. A slower reopening does appear likely. The dilemma in returning to another lockdown, however, is that business failures will continue to accelerate, meaning many small businesses, like restaurants, will never reopen their doors. This part of employment losses would take years to recover.

The impact on mid-to-large size corporations has been equally dramatic and unprecedented. Although banks and financial sector stocks felt the brunt of the financial crisis in 2008 and 2009, nearly all corporations faced some negative impact from the SIP orders. The table below highlights the impact on companies that were members of the S&P 500 index near the start of the pandemic.

Over the last several decades, never have so many corporations withdrawn earnings guidance, halted stock buybacks, or suspended dividend payments. These three “suspensions” were discussed in our newsletter, “The Suspense in ‘Suspend,’” and this table highlights the total announcements or actions taken in each category from February through June.

Suspended	Guidance	Buybacks	Dividends
# of Companies	200	196	45
% S&P 500	40%	39%	9%

Source: SKBA Analysis from Company Reports/FactSet

These statistics are a stunning reflection of how severely the pandemic has impacted corporate balance sheets and cash flows. In 2009, banks were basically required to slash dividends and eliminate stock buybacks, but as stated earlier, the impact is much broader today. As we've often indicated, when the going gets tough (economically speaking), companies halt buybacks first; but with 40% of S&P companies withdrawing earnings guidance and separately 39% suspending buybacks, investors should not expect to be bailed out by stock buybacks or rising earnings guidance.

Furthermore, we have examined companies to determine if they might be forced to cut dividends, omit them permanently, or only suspend them temporarily as this is indicative of what they believe is happening to their underlying earning power. In this process, we evaluated which companies of interest might reflect the true "temporary" nature of the suspension as opposed to those companies that are likely to use the "suspension" as a means to permanently lower their dividend rates.

Of particular interest to SKBA have been the companies that either sustained dividends during the crisis or even raised dividends during the COVID-19 shutdown. Excluding four companies that more than doubled their dividends during this period, 119 S&P companies actually raised dividends by an average of 8.1%. This is a demonstration of financial strength and stability, not weakness. The overall result of our top-down and bottom-up research efforts suggested most of the downside risk to the economy and financial markets was fully discounted in prices near the end of March.

We came to these conclusions independent of the emergency actions of the Federal Reserve Board and the stunning $2 trillion in federal assistance programs. While many of these programs were helpful, they also carried unintended consequences that are counterproductive.

One of the Fed's responsibilities is to prevent financial market panic. As financial markets began to freeze up, the Fed properly came in to shore up liquidity. This should be a short-term effort, but it has turned into a massive injection of monetary reserves to allow it to go well beyond shoring up liquidity. Returning to its prior zero interest rate policy (ZIRP) with the Fed Funds rate set near 0% until the end of 2022 and buying ETFs to inject liquidity into high-yield corporate bond markets are just as likely to distort markets as they are to help private markets function properly.

The suppression of interest rates with short-term yields near 0% and the 30-year T-bond yield hovering around 1.5% is not helpful to future growth. Such policies haven't helped Japan's economy to grow more rapidly, nor Europe's, and they are more likely to hinder U.S. economic growth rather than help it. With flawed MMT policies (Modern Monetary Theory) winning the day for now, investors seeking income will have to look elsewhere for return, not the U.S. Treasury bond market.

On the deficit spending side, certainly federal programs like the PPP (Paycheck Protection Program) have been successful in enabling small businesses in need to survive the shutdown period and to rehire as SIP restrictions began to be lifted. Bankruptcies would have been far worse and the recession extended if they had not been in place. Thankfully, the program's benefit period has been extended into August for employers to continue to rehire. At the same time, programs that cause former employees to choose unemployment over employment (due to the $600 premium in weekly unemployment insurance benefits) hurt the economic recovery rather than help it. Fortunately, this distortion in incentives disappears at the end of July.

The pace of the recovery is likely to flatten over the summer months even if another massive federal spending program is enacted. While election polls have a notoriously bad record of predicting the outcome of presidential elections, they point to a likely change in the party in the White House. Markets' fears about the policy instability this might create have yet to surface to any great degree, and this may become a headwind to further improvements over the next three months. At the same time, financial markets also often favor a split in party affiliation between the House and Senate. Maintenance of the current status quo would likely be viewed as beneficial regardless of which party wins the presidency.

Since the market's bottom in March, it indeed climbed the wall of these worries in April, May, and June, benefiting the recovery of SKBA's value strategies. In our view, the relative attraction of value-oriented stocks and bonds appears more likely to hold up if market volatility returns again.

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