Capital Markets Group

Points to Ponder

July 10, 2020

The First Tee...

Future Shock...as pandemic persists, we need to prepare for bad and hope for better:

- The recent rebound in economic data could have a short shelf-life if the coronavirus infection rate continues to re-accelerate and a vaccine remains elusive (damage control moratorium):
  - Another New Normal...the post COVID-19 recovery is looking likely the resemble the restrained financial crisis rebound:
    - Economy characterized by companies and consumers cautiously emerging from the crisis, building buffers against next:
      - Company efficiency will be under pressure as firms become less global in an effort to rearrange supply chains and labor needs:
        - Production will be shifted back to the U.S. as companies place a greater emphasis on improved resiliency rather than cost cutting.
        - Main Street America is predicting as many as 7500 small businesses could close in the next five months without aid if the crisis persists:
          - 60% of small businesses say they need spending to return to normal by the year-end to remain open...bankruptcies could be prolific in the coming months.
        - Government involvement in companies will remain elevated as greater emphasis will be placed on control of items deemed essential, such-as medical equipment...industries that have received government funded support will also be subject to limitations and restrictions.
      - Households, concerned about health and finances (job security) will remain defensive, saving more and spending less:
        - The expanding gaps in income and wealth are being magnified by the pandemic...investors have benefited from the rebound is stocks as the Fed applies unprecedented stimulus, while low-wage workers are having to rely on unemployment benefits as jobs have been furloughed.
- The international situation is a mixed-bag...emerging market economies experiencing added difficulties:
  - Three critical variables impacting global growth in the coming months *(and possibly years)*:
    - 1. Virus containment or eradication. 2. Sufficient stimulus in place. 3. Extent post pandemic caution constricts activity:
      - Regardless of the outcome, consumer behavior will be different in the future...how different is primarily based on finding a vaccine.
  - Stimulus is sketchy...most major advanced countries have done enough, limited funding is binding emerging countries:
    - For emerging countries, high borrowing costs and dependence on foreign funding are a binding constraint:
      - Countries that have controlled the virus and are reopening are experiencing a drag from countries still on lock-down.
  - The slower and more extended the recovery, the more negatively impactful the financial and social issues become...government stimulus can only do so much; business and consumer confidence have to be mended.

Fed Feeding Frenzy...Central Bank's balance sheet has exploded, rising by $3 trillion since mid-March to $7 trillion (the balance sheet is on track to exceed $10 trillion by year-end...double the amount from financial crisis):

- Raising the risk bar...if the Fed buying trend continues, the Central Bank will hold more Treasury and mortgage-backed securities than the private sector, while the private sector will hold more deposits and cash than in the past *(drowning in liquidity)*:
  - These actions lower interest rates, forcing private investors to take larger risks for returns (stock market driver)
- The Fed's risk exposure has surged compared to its QE buying seen in the financial crisis:
  - A decade ago, the Central Bank was purchasing U.S. Treasury and mortgage-backed securities...today, purchases include municipal debt, junk-bond exchange-traded funds and BB rated corporate bonds (below investment grade...*junk*)
    - The Fed is also making loans to medium-sized businesses that are under severe financial stress due to the pandemic:
      - Some of the credit risk has been offset to the U.S. Treasury (taxpayers) which has a 10% first -loss exposure on the Fed's holdings.
    - The Fed's balance sheet is currently growing at about $660 billion a month...$120 billion in Treasury and mortgage backed bonds, $353 billion in foreign-exchange swaps and $186 billion in special liquidity and lending facilities
  - What may end-up being a larger Fed gamble is the considerable amount of interest rate risk incurred:
    - A large portion of the assets held by the Fed are longer term...these obligations are primarily funded by overnight bank reserves:
      - If the Fed needs to raise short-term rates in the future (if inflation growth rises above target for instance) the cost of the liabilities it uses to fund the balance sheet would exceed the return on the assets (this was the Savings & Loan dilemma when rates spiked in the 80's):
        - Higher interest rates in the future would also be a problem for the Treasury Department...paying debt service on its huge amount of borrowing.
- The Fed has taken bold and needed steps to reduce the pandemic's financial destruction:
  - The aggressive buying actions is changing the composition of assets held by the private sector:
    - Future inflation threats can be controlled if the FOMC is willing to raise interest rates to keep credit demand in-check.

At the turn...

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The Back Nine...

Eat Your Vegetables...COVID-19 fallout could decrease meat demand to a 9-year low:

- Global per-capita meat consumption is forecast to fall 3% due to food-safety concerns, changing diets, falling supplies and higher prices for animal protein (according to the United Nations):
  - The pandemic has caused consumers to cut-back on their grocery bills and restaurants to close:
    - Before the pandemic, 50% of all meat was consumed outside of the home in the U.S....people will still consume the same amount of calories but will do so at home utilizing less meat while eating more plant-based proteins due to health and environmental concerns:
      - It is estimated meat and dairy are responsible for as much as 18% of global greenhouse gas emissions caused by humans.
  - This year's per-capita meat consumption will decline for the first time since 2014, and will continue to contract at least through 2025...according to the University of Missouri's Food & Agriculture Policy Research Institute:
    - If consumers get used to less meat due to pandemic conditions, this could bring a new era of global eating habits.

COVID Contagion…financial markets adjust to pandemic (stimulus plays key role in rates and values):

- Data format: July 1, 2019 / January 1, 2020 / April 1, 2020 / July 1, 2020:

Equities

Dow: 26599 / 28634 / 21917 / 25812
S&P 500: 2941 / 3230 / 2584 / 3100
NASDAQ: 8006 / 8972 / 7700
Russell 2000: 1566 / 1668 / 1153

Commodities

CRB: 181 / 185 / 121/ 137
Oil: $58.47 / $61.06 / $20.48 / $39.27
Gold: $1409 / $1517 / $1628 / $1780
Copper: $271 / $283 / $222 / $271
Natural Gas: $2.30 / $2.18 / $1.64 / $1.75

Treasuries Issues

3mo: 2.12% / 1.51% / .06% / .16%
6mo: 2.09% / 1.60% / .13% / .18%
1yr: 1.92% / 1.59% / .14% / .16%
2yr: 1.78% / 1.58% / .22% / .16%
3yr: 1.71% / 1.62% / .27% / .18%
5yr: 1.76% / 1.69% / .36% / .29%
7yr: 1.87% / 1.83% / .53% / .49%
10yr: 2.00% / 1.92% / .67% / .66%
30yr: 2.52% / 2.39% / 1.33% / 1.41%

Currencies

Euro: 1.137 / 1.121 / 1.103 / 1.123
Yen: 107.85 / 108.61 / 107.54 / 107.93
Peso: 19.22 / 18.926 / 23.672 / 22.992
Canadian $: 1.309 / 1.299 / 1.406 / 1.357
Yuan: 6.866 / 6.963 / 7.082 / 7.065

Grain Futures

Corn: $4.31 / $3.87 / $3.41 / $3.41
Soybeans: $9.23 / $9.55 / $8.87 / $8.38
Wheat: $5.27 / $5.58 / $5.69 / $4.92

Borrowing Benchmarks

Libor:
1mo: 2.398% / 1.762% / .984% / .178%
3mo: 2.319% / 1.908% / 1.433% / .307%
SOFR: (U.S Secured Overnight Financing Rate)
1day: 2.42% / 1.55% / .01% / .08%

Job / Inflation Indicators

Unemployment: 3.7% / 3.5% / 4.4% / 11.1%
Consumer Price Index: 1.6% / 2.3% / 1.5% / .1%
Core PCE Index: 1.5% / 1.6% / 1.7% / 1.0%

Federal Funds Open: 2.37% / 1.56% / .02% / .08%
Prime Rate: 5.50% / 4.75% / 3.25% / 3.25%

19th Hole...

We are never prepared for what we expect.

James Michener

Ross Elford, First Vice President

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