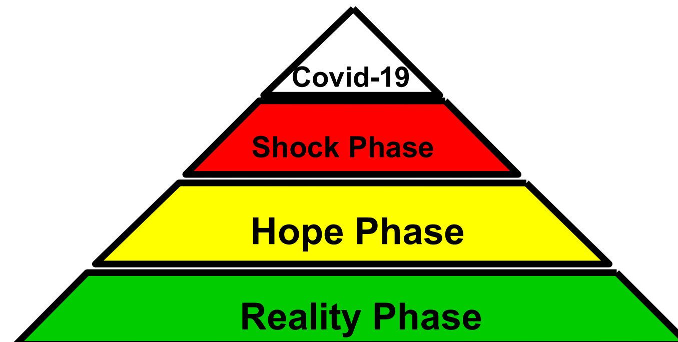
VANDERBILT Ave.
ASSET MANAGEMENT

2nd Quarter 2020

The pandemic has resulted in increased uncertainty and volatility for both the economy and investment markets.



The Shock Phase has been completed. We are currently in the Hope Phase where the expectation is for a fairly quick turnaround and a return to a normal recovery. The Reality Phase is where the markets realize that it will be a long-term, slower recovery out of the Covid-19 downturn.

The depth of the **recession** and the shape of the **economic recovery** will depend on three factors. The first is how quickly the economy re-opens. As the Director of the National Institute of Allergy and Infectious Diseases, Dr. Anthony Fauci, has stated "it will not be like flipping on a switch." With the virus still active in the population, policy makers will likely reopen in a staggered sequential fashion. The longer the economy remains closed the more we are likely to see an erosion of both human and fiscal capital which could easily undermine a recovery. The second factor is whether a second wave of coronavirus will cause a new round of shutdowns. Southern and western states are currently experiencing a significant increase in infections. In addition, most medical experts believe that as the new flu season begins in the fall, the coronavirus will come back. A contagion reoccurrence is strong enough for us to consider the situation as a black swan tail risk. The final factor is to what extent will businesses and consumer behavior differ once the economy reopens? We believe to some extent, at least in the first few months, people will be more reluctant to travel by plane, go to restaurants or take public transportation as the economy slowly reopens. Duration of behavioral changes will likely vary across age brackets, reflecting different risk factors.

Many analysts are claiming that the current crisis and recession is similar to the Great Depression of 1929, but there are reasons why this is different than the Great Depression. In the current environment, the U.S economy is losing tens of millions of jobs. However, if we analyze the numbers, we find that a large percentage are furloughs (i.e. temporary layoffs versus permanent shrinkage of the workforce). Employers appear to be keeping employees close by in anticipation of the economy reopening. During the Great Depression jobs were permanently lost because there was no demand and no capital. There was no safety net during the Great Depression. Also, the collapse of the banking system was one of the major reasons for the Great Depression. Today, U.S. banks are well capitalized and credit markets remain reasonably stable and liquid. In addition, during the Great Depression the U.S. economy was an industrial based economy. Industrial production fell by more than half during the 1930s. Today, the U.S. economy is more service oriented and far less industrial based. Finally, during the Great Depression several major

policy mistakes occurred. The Federal Reserve actually tightened monetary policy in order to maintain the gold standard. In addition, the U.S. government implemented several austerity measures. The government also passed the Smoot-Hawley Tariff Act in 1930 which resulted in more pain and loss of global demand. In the current crisis, the U.S. government has spent some $2.9 trillion in stimulus to boost the economy and the Federal Reserve has slashed the fed funds rate to near zero along with basically providing unlimited liquidity to the capital markets.

VAAM's base **economic forecast** is for a quick and strong bounce as the economy reopens and Federal Reserve and fiscal stimuli start to have an impact. GDP growth should then stabilize to around 1.5% in line with productivity and population growth. A slow recovery path would leave many Americans behind and risk long-term employment prospects. There are several major influences on our forecast. While the lower unemployment rate (11.1%) was a welcome surprise in June, the employment situation remains bleak. Nearly 49 million people have filed for regular unemployment insurance since the crisis took hold. The expectation is for the unemployment rate to continue to recover but stay in double digits for the remainder of the year. Real GDP for the first quarter was -1.3% (-5.0% on an annualized basis). Incomes have increased (due to government support payments), but much of it has been saved as the U.S. saving rate rose to a record level in April. The expectation is for real GDP to drop at an annualized pace of about 30% in the second quarter. Large fiscal and monetary stimulus programs have helped ease financial conditions, but more will be needed to support the recovery. The expectation is for additional fiscal measures, but on a lesser scale. Also, the Fed is likely to ramp up its current purchasing programs but will refrain from pushing rates into negative territory. Finally, Non-manufacturing conditions remain depressed due to weak new orders and business activity is still contracting.

COVID-19-related shocks to demand for energy and other goods and services has led to a strong disinflationary effect on prices. Headline core CPI dropped to a five-year low of 1.2%, the lowest since March 2011. Core CPI comprised a consensus to the downside, confirming our view of **short–term** deflationary pressures. The market seems to have already discounted the present low inflation rate with the 10-year breakeven rate currently at 1.3%. VAAM looks for potential **inflationary pressures longer term.** A number of factors should be taken into consideration in anticipating a rebound in inflation for the longer term**.** These include sticky and rising labor costs, significant acceleration in Medicare payments, rising healthcare insurance costs (2019 rose to 20.4%) and perhaps a rebound from low oil prices. A return to inflation is also suggested by the Fed's massive liquidity injection to support the economy and the resultant growth in the money supply. Reduction in globalization and an increase in trade protectionism will mean higher manufacturing costs and implied lower corporate margins, that is unless corporations can pass higher costs on to the consumer. If they can do that, then that would translate to higher inflation. It is important to note that if the velocity of money should increase (combined with higher M2 growth), then that too would imply a higher inflation outlook.

Fiscal and monetary support and stimulus programs have, and will continue, to play a major role in propping up the economy until there is a vaccine and the beginning of a return to normalcy. As a result, the **federal budget deficit** will experience a significant expansion. The U.S. federal budget deficit is on track to exceed $4 trillion in 2020. The nation's debt will rise to levels not seen since the country emerged from World War II. When the ratio of debt to GDP exceeds 90%, the rate of median growth falls by one percent while average growth falls even more. Currently, total debt to GDP is 108%. Modern monetary theory promulgates that countries that issue debt in their own currency can finance growth through deficit spending if rates and prices remain low. Debt-stabilizing interest rates (DSIRs) estimate the average cost of funding needed to keep the debt-to-GDP ratio stable. It is based on three variables: the level of government debt, the size of the primary budget balance (ignoring interest payments) and projected

nominal GDP growth. DSIRs range from 1.7% in Germany to -1.5% in France. A DSIR of -1.3% for the U.S. does not mean the policy rate will get pushed into negative territory. We think that is unlikely. It does however mean that government debt will move onto an explosive path if the average cost of funding is kept very low.

During the first half of the year the **yield curve** moved in a bull steepening mode (as outlined below)

	6/30/20	12/31/19	Change
3-monthTreasury Bills	0.13	1.54	-1.41
2-year Treasury Note	0.15	1.57	-1.42
5-year Treasury Note	0.29	1.69	-1.40
7-year Treasury Note	0.49	1.83	-1.34
10-year Treasury Note	0.65	1.92	-1.27
30-year Treasury Bond	1.41	2.39	-0.98
10-year vs. 2-year	50	35	15

Due to the severe economic ramifications of the pandemic and resultant lock down, the Federal Reserve significantly lowered interest rates across the yield curve through FOMC policy action and quantitative easing by purchasing a broad spectrum of fixed income instruments. The curve was somewhat more positively sloped as the two-year declined 15 basis points more than the 10-year. The Fed has said they plan to maintain low rates into 2022 to support the economy and afford time for a return to normalcy. Fed Chairman Powell stated, “we are not even thinking about thinking about raising rates”.

Corporates

Covid-19 and the Federal responses to the health crisis has driven corporate bond performance during the first half of the year. During most of March, corporate spreads widened quickly as the U.S. economy “shut-down”. As shown in the table below, corporate spreads reached their widest levels on March 23rd. Due to this move in spreads, the negative return of corporate bonds versus comparable U.S. Treasuries also peaked at -12.67% for Intermediate Corporate Bonds and -6.66% for 1-3 Year Corporate Securities.

Bloomberg Barclays Corporate Spreads & Excess Return

	12/31/2019	3/23/2020	3/31/2020	6/30/2020
Inter. Corp.Spread	0.67%	3.85%	2.72%	1.16%
YTD Change		3.18%	2.05%	0.49%
YTD Excess Return		-12.67%	-8.96%	-2.04%
1-3 Corp. Spread	0.33%	3.91%	2.57%	0.67%
YTD Change		3.58%	2.24%	0.34%
YTD Excess Return		-6.66%	-4.24%	-0.42%

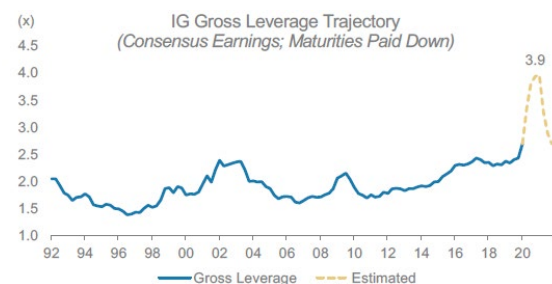
* All Spreads & Excess Returns are from the Bloomberg Barclays Corporate Intermediate or 1-3 Corporate Index
* All Spreads & Excess Returns are based on Sovereign Yield Curve

The corporate bond market began to recover as the Federal Reserve took decisive action to support the economy and more specifically the corporate fixed income market. The Fed’s action included facilities to

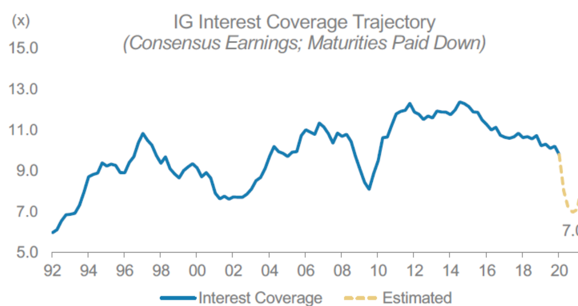
purchase new issue corporate debt, funding of newly issued asset-backed securities and importantly, a fund to purchase secondary corporate debt. The announcement immediately and dramatically improved liquidity in the corporate bond market even though the Federal Reserve did not begin to purchase secondary corporate securities (Maturities of 1-5 years and rated investment grade as of March 23rd) until the end of June. By the end of the quarter, corporate spreads had tightened from March 23rd by 2.69% for intermediate maturity securities and 3.24% for the shorter 1-3-year maturity bonds. Though excess returns over comparable U.S. Treasuries remains negative for the year, they did recover significant ground from late March with positive returns of over 10.6% for intermediate bonds and over 6.2% for shorter maturities. The Federal Reserve's intent to purchase was sufficient to allow investment grade issuers to access the new issue market for a six-month record of $1.376 trillion. As a comparison, this amount exceeds 2019 full year issuance and is only $100 million less than that issued in 2017 and 2018.

The sudden and sharp reduction in economic activity has clearly increased both downgrade and default risk for the corporate bond market. Though defaults have already occurred and are expected to remain elevated, this risk is mitigated due to the investment grade ratings of our current holdings. Therefore, our focus is on the risk of downgrade, which can have a significant negative impact on performance.

The combination of declining cash flows as measured by Earnings Before Interest Depreciation & Amortization ("EBITDA") and Gross Debt rising, a key component of corporate quality, has taken a serious hit. As shown below, Investment Grade Gross Leverage of 2.69x had risen to unprecedented levels during the first quarter. This leverage number is expected to continue to deteriorate through year-end, reaching 3.9x. Interest coverage also deteriorated during the first quarter, reaching 9.8x. Interest coverages are also likely to continue to fall to extremely low levels due to higher debt levels, interest charges and lower cash flow, also shown below.



Source: Bloomberg, Dealogic, Refinitiv, Morgan Stanley Research estimates



Source: Bloomberg, Dealogic, Refinitiv, Morgan Stanley Research estimates; Note: EBITDA estimates based on consensus earnings estimates for S&P500 constituents by sector; coverage floored at 0x; removes 2Q20 fallen angels in projected quarters; 2Q20 interest expense adjusted for net issuance; assumes maturities paid down in 2H20 and interest expense removed.

These financial fundamentals and the high degree of uncertainty in any economic forecast at this time has placed a significant number of investment issuers at a clear risk of a downgrade to non-investment grade over the coming quarters. Our focus, therefore, is on non-cyclical names in industries such as Technology, Defense, Healthcare and other selective companies with strong balance sheets that can carry them through the next year. Conversely, lower rated companies in stressed industries are being de-emphasized. These companies are generally trading cheap to the sector but are also high risk. Industries include Energy, Retail, Retail and Commercial REITS, Consumer Cyclical (i.e. Auto), and Materials. In addition, our portfolios remain underweight Baa3/BBB- rated investments.

During the second quarter, we added several new names at attractive spreads. Examples include **Abbvie**, a pharmaceutical company which completed its purchase of Allergan in May. The combined company has

a diversified portfolio of drugs including Humira, Skyrizi, Rinvoq, Botox and Restasis. Leverage is elevated due to the recent acquisition. They, however, have strong cash flow and expect to reduce their debt by $15-18 billion by end of 2021. The company has forecasted leverage to hit 2.5x by then. **Northrup Grumman**, a major defense supplier, was also purchased. Nearly 85% of their revenue is from the U.S. government, which provides relatively stable cash flow. Last quarter, 2.7x net leverage and interest coverage of just under 10x support the investment in this stable credit. Within the financial sector, **Wells Fargo** was purchased. It is the fourth largest bank in the U.S. by assets. Their phased in CET1 capital ratio is slightly stronger than the industry average at 10.7% and nonperforming assets as a percentage of Tangible Common Equity + Reserves is 4.31%. Though 2nd quarter charge-offs should remain elevated, their trading operations, especially fixed income, should offset some of this weakness. Our portfolios are overweight to higher rated issues and hence has a slightly lower spread than the overall corporate market. This positioning is conservative and prudent given the high level of current uncertainty.