The coronavirus and its devastating toll on public health and the economy remained the theme in markets during the second quarter and we expect that to continue. On the economic front, actions by both the Federal Reserve and Congress lead to a significantly improved investment environment. The liquidity scare and mad rush for cash in March has been largely alleviated. Asset prices have recovered significantly, volatility has lessened, and markets are once again functioning with two-way trading. The public health aspect of the pandemic is clearly not our area of expertise, but if the Federal government deserves criticism, this would be the area where coordination and clarity have been most uninspiring.

The Fed Takes Action and the Markets Respond

In response to the COVID-19 economic shutdown, the Federal Reserve acted with speed and force to stabilize the financial system and ensure orderly banking and securities markets. Last quarter, we summarized the historic measures implemented by the Fed in response to the crisis. This quarter, we assess the effectiveness of each action to date.

Action: Fed Funds Rate Cuts
Result: The Fed cut the federal funds target rate 50bps on March 3 and 100bps on March 15, reducing the rate to the lower bound (0% to 0.25%) almost immediately as the crisis unfolded. By lowering the Fed funds rate, the Fed reduces the cost of borrowing for banks and influences a number of short-term interest rates, including rates on deposits, bank loans, credit cards, and adjustable-rate mortgages. Lower rates encourage borrowing and investment while freeing up more consumer income available for spending versus interest payments.

Action: Quantitative Easing
Result: Asset purchases by the Fed inject liquidity into credit markets and drive down interest rates. The Fed’s asset purchases, in combination with reductions in the Fed funds rate, has resulted in lower borrowing costs and improved market functioning. Yields on two-year treasury securities and ten-year treasury securities have declined 142bps and 126bps, respectively, since the beginning of the year, to 0.13% and 0.66%, respectively. Financial market functioning has improved meaningfully as well, such that the Fed has gradually reduced the pace of asset purchases from $10 billion per day in Treasury securities and $8 per day in MBS at the peak of the crisis in mid-March to $4.0 billion and $4.5 billion per day, respectively.

Action: Emergency bank liquidity facilities
Result: The Fed’s emergency liquidity facilities included overnight and term funding for primary dealers and dollar swap lines for global central banks. These measures helped restore adequate liquidity in the banking system. According to minutes of the Federal Open Market Committee Meeting on June 9-10, 2020, market functioning has improved substantially such that take-up in the Fed’s emergency liquidity facilities has declined.

Action: Commercial Paper Funding Facility.
Result: The purpose of this facility is to provide liquidity to short-term funding markets by purchasing unsecured and asset-backed commercial paper directly from eligible issuers. Commercial paper is an important short-term financing mechanism for the operational needs of many large companies. As of the most recent update (June 10, 2020), the Fed had purchased $4.2 billion in commercial paper. Conditions in unsecured short-term funding markets have improved since March, and spreads on commercial paper have declined to levels near pre-crisis ranges.

Action: Money Market Mutual Fund Liquidity Facility.
Result: Money market funds are widely utilized investment vehicles for families and businesses. The MMLLF is intended to assist money market funds in meeting demand for redemptions by providing a liquidity backstop to banks that purchase high-quality assets from the funds. Through June 30, The Fed had provided $21.4 billion of liquidity to money markets through this program. Unlike 2008, when the Reserve Primary Fund failed, no money market funds have “broken the buck” during this crisis.

Action: Term Asset-Backed Securities Loan Facility.
Result: TALF is intended to support the provision of credit to consumers and businesses by enabling the issuance of securities backed by private student loans, auto loans, credit card receivables, and other assets. TALF is operational but has not purchased a meaningful amount of assets to date.

Action: Primary Market Corporate Credit Facility (PMCCF) and Secondary Market Corporate Credit Facility (SMCCF)
Result: The Fed established these programs to support large businesses through the purchases of corporate bonds and bank loans. The PMCCF provides credit to qualifying issuers by purchasing new issues of corporate bonds. The SMCCF is intended to support market liquidity for corporate debt by purchasing individual investment grade corporate bonds and investment grade and high-yield ETFs. The cap on these programs is $750 billion and the program ends in September. As of mid-June, the Fed had purchased approximately $8.0 billion in bond and market ETFs and $400mm in principal amount of corporate bonds under the SMCCF. The PMCCF became operational on June 29, but no significant purchases have been made to date. While the dollar amount of the Fed’s purchases is not meaningful relative to the size of the credit markets, OIM believes the establishment of these facilities restored the necessary confidence for buyers to take risk and returned the markets to orderly function.

Action: Main Street Lending Program
Result: The Federal Reserve designed the Main Street program to support small and medium-sized businesses (defined as 15,000 employees less or $5 billion in revenues or less) that were generally unable to obtain funding under the Payroll Protection Program for small businesses. Main Street loans are not forgivable but have deferred interest payments for one year and deferred principal for two years. The Fed is currently accepting loan applications but has yet to extend any meaningful economic support through this program. The Fed is considering ways to include not-for-profit organizations in this program.

Congress Provides Fiscal Stimulus and the Results Are Effective

In addition to the heroic efforts of the Federal Reserve to keep financial markets functioning through monetary stimulus, the Federal government has passed multiple pieces of legislation, most significantly the CARES Act, to provide support from a fiscal perspective. Actions included in the Act and the results to date are below.

Action: $350 billion Paycheck Protection Program.
Result: Forgivable PPP loans were designed to assist small businesses and help keep workers on payrolls during the pandemic. Demand for the program was robust, implementation was relatively quick, and the initial $350 billion was exhausted. Congress amended the program in late Q2 to add an additional $320 billion and ease stipulations for forgiveness.
OIPPEHEIMER INVESTMENT MANAGEMENT

To date, approximately $540 billion of the $670 billion in total funds have been utilized. While the program generated controversy over who received funds and whether they truly helped small businesses in need, the initiative as a whole must be considered a success. The program quickly injected over $500 billion into the economy and incentivized the retention of workers.

Action: $290 billion in stimulus payments, $260 billion for expanded unemployment insurance

Result: The effects of stimulus payments and expanded unemployment insurance benefits can best been seen in personal income and spending data. Personal income declined 2.2% month over month in March, increased 10.8% in April due to stimulus payments, and declined 4.2% YoY in May as stimulus distributions declined but were partly offset by increased unemployment benefits. Consumers were reluctant to spend, however, as personal spending declined 6.6% and 12.6% MoM in March and April, respectively, before gaining 8.2% in May as the economy reopened. Indexed to February levels, May personal income was 3.8% higher than February but spending was 11.7% lower. Consumers have mostly saved government benefits as they await clarity on employment prospects.

Action: $290 billion in tax cuts, deferrals, and other benefits for businesses

Results: Tax cuts have and deferrals have freed up business cash flow for investment and spending. Equity and credit markets have recovered significantly. On the other hand, the federal budget deficit in June alone exceeded the deficit for all of 2019.

Action: $150 billion in direct aid to states

Result: States have managed to fund increased expenses for public health initiatives, but budgets are under severe pressure and significant spending cuts are looming. Many states do not have rainy day funds and cannot borrow to fund deficits. Programs and payrolls will be cut, creating a headwind to the economy in 2H20.

Action: $385 billion to aid to hospitals, veterans’ care, FEMA and others

Result: Distribution of this aid seems to have been successful to date. Stockpiles of protective equipment have improved, COVID testing capacity has expanded, and hospitals have reopened for elective procedures. Bed capacity remains adequate in most areas of the country, though virus surges have required pauses or rollbacks in public health reopening guidelines in some areas. These measures have provided essential support to households and businesses when the nation’s unemployment rate dramatically increased and incomes plummeted. The speed with which they were approved and signed into law was historic. Though more fiscal help may be needed, the rare cooperation in Washington this spring provided ballast to the economy and mitigated long-term damage.

Economic Review

Economic data has tracked largely ahead of our projections detailed in our Q1 letter. GDP declined at a 5.0% rate in Q1 and Bloomberg consensus estimates look for a historic 33.7% rate of decline in Q2. Forecasters expect a sharp rebound in Q3 (+18.0%) and Q4 (+6.9%).

After 22 million jobs were eliminated in March and April combined, employment numbers have improved more quickly than anticipated. The economy recovered 2.7 million and 4.8 million jobs in May and June, respectively. The unemployment rate peaked at 14.7% in April. Including workers as misclassified as employed but who were absent from work in April would have increased the rate to approximately 19.7%, close to OIM’s 20% estimate of peak unemployment. Unemployment declined to approximately 12.1% in June including misclassified workers. For perspective, unemployment topped out around 10% in the Great Recession. We expect the recovery in jobs to remain uneven as continued gains from reopening are partly offset by layoffs in the airline and government sectors and the potential for resumed public health restrictions in areas with surging virus cases.

Interest rates remained largely stable at low levels in Q2. The 10 year treasury yield declined 1bps in the quarter to 0.66%, the 2 year declined 10bps to 0.15%, and the yield curve steepened modestly. Inflation (as measured by CORE PCE) has declined from 1.8% in February to 1.0% in May, below the Fed’s target of 2.0%. Oil prices have recovered from approximately $20 per barrel in March to $40 in June, but remain below December levels close to $60. Despite the recovery in energy prices, we do not expect a significant increase in inflation or interest rates. Inflation ran below the Fed’s target when unemployment was 3.5% - we do not expect significant wage growth or inflation now that unemployment is in the double digits.

Outlook and Strategy: Patience is a virtue... that pays off!

As we entered Q2, credit spreads were beginning to normalize from their historic wide of mid-March. Trading with depth of bids and offers has returned to the credit markets after a few rugged weeks in the spring. New issuance has been robust as companies have fortified liquidity to ride out the COVID storm. Most corporate sectors have tightened significantly. We believe the high quality companies with strong balance sheets and stable liquidity sources that form the traditional core holdings of our portfolios will survive and recover, though the road to recovery will be slow and bumpy.

We believe the Federal Reserve will continue to keep the federal funds target rate at 0.00% to 0.25% for the foreseeable future. They will also step in if liquidity issues return to the market, though we do not assign a high probability to that outcome. The programs implemented by the Fed and Congress have effectively mitigated technical fixed income risks so far. However, fundamental underlying credit risks are very much in play. We continue to like both Investment Grade and High Yield corporate debt but expect only limited spread tightening for the balance of the year. Volatility will remain in the market until a vaccine is developed for the coronavirus. We do not expect the virus to simply go away and we continue to manage investment risks with regard to public health.

Our portfolios have held up well in this crisis, as they have in past crises. Our consistent returns are the result of our investment process — working diligently each day to measure risk between various opportunities and assess relative value. We learned from the Great Recession that there were many investors who did not understand what they owned in their fixed income portfolios and underestimated the embedded risks. It is clear to us that there will always be a place for long-only, fundamental fixed income managers.

Should you have any questions on strategy, performance or business development, please do not hesitate to contact us.

Thank You

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