MORNING BRIEFING
June 17, 2020

Fed vs Virus Waves

Check out the accompanying pdf and chart collection.

(1) The meltup of the day. (2) Is a two-month lockdown recession a recession or just a natural disaster? (3) Index of Coincident Economic Indicators peaked during February, troughed during April. (4) Both S&P 500 forward revenues and forward earnings seem to be bottoming already. (5) Powell's Put dwarfs predecessors. (6) Corporate bond investors get a Fed Put too. (7) Fed pumping waves of liquidity to offset virus waves. (8) The Fed: Savior of Fallen Angels and Zombies. (9) Now we know how Powell intended to fix corporate debt crisis. (10) Five characteristics of virus-proof companies.

US Economy: Future Shock. The stock market meltup made a spectacular comeback on Monday and Tuesday. On Monday, it was all about the Fed as Melissa and I discuss below. On Tuesday, it was also about better-than-expected May retail sales, an uptick in May industrial production, and a cheap and widely available steroid that may significantly reduce the death rate from COVID-19. As Debbie discusses below, retail sales soared a record 17.7% last month following a 14.7% freefall during April. Industrial production increased 1.4% last month following a 12.5% plunge during April.

The lockdown recession may be shorter than we thought. As Debbie and I observed just last week in our June 10 *Morning Briefing* titled, "The Shortest Recession on Record," the Index of Coincident Economic Indicators (CEI) peaked at a record high during February, marking the end of the longest expansion on record according to the Dating Committee of the National Bureau of Economic Research. We reckoned that the recession could be over by June as lockdown restrictions were lifted by state governors.

However, May's data on payroll employment (released on June 5) and now May's retail sales and industrial production reports (released yesterday) strongly suggest that the bottom was made during April! All three are components of the CEI. We aren't sure that a two-month downturn in the economy, as bad as it was, really should be counted as a recession. It's more akin to the impact of a severe natural disaster. (See my June 13 video podcast, "Tracing out the swoosh recovery."

Strategy: Forward Earnings Bottoming. Yesterday, Joe and I observed that S&P 500 forward revenues is showing signs of bottoming already (*Fig. 1*). Now we also have a fourth week in a row showing that S&P 500 forward earnings is moving higher.

We expected that both would bottom around now given how steeply both have been falling since mid-March. The only surprise to us is that forward revenues is down only 7.4% from its record high during the week of February 20 through the week of June 4. Given the lockdowns which shutdown so many businesses, we expected something closer to the 20.0% peak-to-trough decline during the Great Recession of 2008-09.

On the other hand, S&P 500 forward earnings is down 20.0% since its record high during the week of January 31 through the week of June 12. However, that's just about half the drop that occurred from right before Lehman hit the fan in mid-September 2008 through its trough during the week of May 8, 2009.

A related development is that the consensus estimates for S&P 500 operating earnings in both 2020 and 2021 may be close to bottoming. During the week of June 11, they were $125.48 and $164.00, respectively (*Fig. 2*). Remember that forward earnings is converging toward the 2021 estimate, which currently is about unchanged from actual earnings during 2019.

Here's more good news: The quarterly consensus earnings estimates and their growth rates for Q2, Q3, and Q4 have been flattening in recent weeks after diving during March, April, and the first half of May (*Fig. 3* and *Fig. 4*).

Corporate Finance I: Powell's Potent Put. On March 11, the World Health Organization declared that the COVID-19 outbreak had turned into a global pandemic. The pandemic of fear spread just as rapidly in the US capital markets, especially in the bond markets, which seized up as credit-quality yield spreads soared.

On Sunday, March 15, the Fed responded by cutting the federal funds rate by 100bps to zero and announcing a $700 billion QE4 program of Treasury and mortgage-backed securities purchases. That week, the governors of California and New York issued executive orders requiring nonessential workers to stay home. Credit-quality spreads continued to widen significantly. So on March 23, the Fed introduced QE4ever and posted term sheets on five major credit facilities.

Three of the new facilities dated back to the Great Financial Crisis and were reactivated. The big shockers were the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF). For the first time ever, the Fed was going to lend a hand to the investment-grade corporate bond market. On Monday, the Fed announced that the SMCCF would start buying corporate debt, and promised to activate the PMCCF soon, as discussed below.

The Greenspan Put, the Bernanke Put, and the Yellen Put all resulted from actions taken by the Fed under those three chairs to give stock prices a boost when they seemed to need it to avert a meltdown. The Powell Put saved the day in late 2018 when the Fed chair started to pivot away from raising the federal funds rate in 2019 to actually lowering it three times instead. The S&P 500 soared 44.0% from December 24, 2018 to a record high on February 19, 2020.

In response to the Great Virus Crisis, Powell provided the biggest Fed put of them all, boosting both stock and corporate bond prices. The result has been to stop the 33-day meltdown in stock prices, which lasted from February 19 through March 23, and to allow corporations to raise piles of money at record low interest rates:

(1) *Corporate bond yields.* The Aaa-rated and Baa-rated corporate bond yields fell to record lows of 2.44% and 3.45% on Monday (*Fig. 5* and *Fig. 6*).

(2) *Corporate bond issuance.* Over the 12 months through April, nonfinancial corporations raised a record $1,175 billion. We estimate that at least half of that was used to refinance outstanding bonds (*Fig. 7* and *Fig. 8*).

Corporate Finance II: No Asset Left Behind. The Fed is intent on offsetting the adverse impact on financial markets resulting from any flare up in the first wave of the viral pandemic or any second wave that might emerge after the first wave. The stock market sold off sharply last Thursday on fears that reopening the economy will lead to less social distancing triggering another wave of the virus. The market rebounded a bit on Friday, but then proceeded to fall again Monday morning on unsettling news over the weekend about rising cases of infection around the country.

Have no fear, the Fed is here with another wave of liquidity:

(1) *Secondary facility is first.* At 2:00 pm on Monday, the Fed released a press release with the following rather detailed headline, "Federal Reserve Board announces updates to Secondary Market Corporate Credit Facility (SMCCF), which will begin buying a broad and diversified portfolio of corporate bonds to support market liquidity and the availability of credit for large employers."

The Fed announced that it was expanding its Secondary Market Corporate Credit Facility (SMCCF) to purchase individual corporate bonds to complement its current purchases of exchange-traded funds. This special purpose vehicle (SPV) is capitalized with $25 billion provided by the Treasury under the CARES Act, and can leverage that up by 10-to-1 to $250 billion.

But wait, there's much more: The SPV includes the Primary Market Corporate Credit Facility (PMCCF), which will be able to leverage $50 billion in capital to purchase up to $500 billion in corporate bonds directly from issuers.

As part of its (almost) no-asset-left-behind (NALB) program, the SMCCF will purchase bonds rated BBB-/Baa3 (the lowest investment-grade category) as of March 22, 2020, but were subsequently downgraded to junk. Nevertheless, they must be rated at least BB-/Ba3 as of the date on which the facility makes a purchase. These so-called "fallen angels" accounted for 50% of outstanding investment-grade bonds before the virus hit the fan.

The SMCCF began purchasing eligible ETFs on May 12 and will begin purchasing corporate bonds on June 16. Purchases are expected to cease no later than September 30 of this year.

(2) *Primary facility is second.* The PMCCF is expected to become operational in the near future. Additional details on the PMCCF are forthcoming. It will provide companies access to credit by purchasing qualifying bonds as the sole investor in a bond issuance, or purchasing portions of syndicated loans or bonds at issuance. (For more, see FAQs: Primary Market Corporate Credit Facility and Secondary Market Corporate Credit Facility.)

(3) *A big drop in the bucket.* A billion here, a billion there, adds up to $750 billion in financial support for the corporate sector. The Fed's recently released *Financial Accounts of the United States* shows that during Q1, nonfinancial corporate bonds outstanding totaled a record $6.0

trillion and loans totaled $3.8 trillion (*Fig. 9*). Loans from depository institutions totaled $1.3 trillion, while "other loans" (including leveraged loans) totaled $1.9 trillion (*Fig. 10*).

(4) *Zombies on life support.* The Fed issued its first semi-annual *Financial Stability Report* during November 2018. The latest one was issued May 2020. All four reports recognized that there was too much dodgy corporate debt. Here is what the latest report had to say on the subject:

"At the beginning of 2020, about half of investment-grade debt outstanding was rated in the lowest category of the investment-grade range (triple-B)—near an all-time high. The amount of debt downgraded from investment grade to speculative grade in 2019 was close to the historical average over the past five years. However, almost $125 billion of nonfinancial investment-grade corporate debt has been downgraded to speculative grade since late February, and expected defaults may rise if the economic outlook and corporate earnings are revised downward. Widespread downgrades of bonds to speculative-grade ratings could lead investors to accelerate the sale of downgraded bonds, possibly generating market dislocation and downward price pressures in a segment of the corporate bond market known to exhibit relatively low liquidity."

The report sounded the alarm on leveraged loans as well:

"Defaults on leveraged loans ticked up in February and March and are likely to continue to increase, with the specific contour highly dependent on the path of overall economic activity. Such developments would weaken the balance sheets of lenders, including CLOs that hold leveraged loans, and amplify the economic effects of COVID-19."

During his October 30, 2019 press conference, Fed Chair Jerome Powell was asked about financial stability. He responded: "Obviously, plenty of households are not in great shape financially, but in the aggregate, the household sector's in a very good place. That leaves businesses, which is where the issue has been. Leverage among corporations and other forms of business, private businesses, is historically high. We've been monitoring it carefully and taking appropriate steps." He didn't specify those steps. However, the Fed's three interest-rate cuts during 2019 undoubtedly kept lots of zombies alive and fed their appetite for more debt.

As a result of the Great Virus Crisis, we now know how Powell is dealing with the corporate debt crisis. He is buying lots of it and enabling corporations to issue much more of it!

Corporate Finance III: Survival of the Fittest. In recent Zoom video calls with our accounts, we often discussed the traits of companies that are most likely to survive these tough economic times. I asked Melissa to do a brief review of current articles on this subject. Here is her summary:

(1) *Strong balance sheet*. Plenty of cash reserves to sustain business during a slowdown are paramount. Low debt to EBITDA tops the list of recession friendly fundamentals. Low debt outstanding is crucial to survival. Nevertheless, access to short-term financing is a plus in the event that a big drawdown becomes necessary.

Low, or the ability to lower, working capital by shortening inventory conversion, lengthening supplier payment terms, or accelerating accounts receivable terms may have helped auto companies survive the latest recessionary event, as a February 2019 CFO.com article anticipated.

Companies that manage a low cost of capital and apply stringent metrics to their capital investments and potential acquisitions may do better in difficult times. Top performers during the 2008 crisis included companies that had a high return-on-invested-capital, as discussed an October 2017 *Financial Times* article.

(2) *Sustainably high profit margins*. When revenues fall, high profit margins help to maintain profits and cash flow. Efficient use of SG&A resources is key. For companies that require a sizable headcount, those that scrutinize the need for new hires and/ or have the ability to scale down headcount quickly are likely to perform better when the worst happens. However, companies need to be careful not to cut back too much, on marketing for example, because that could make it harder to recover as the broader market improves, a February 2009 *Harvard Business Review* article pointed out.

(3) *In essential industries, or agile*. No crisis is exactly the same, so industry risk depends on the sort of downturn. During the Great Recession’s housing crisis, for example, homebuilding stocks were a bad place to be. Following the onset of the pandemic, high-contact industries like travel and hospitality have severely suffered. But there are tried-and-true industries, like consumer staples and utilities, that typically hold their own in a prolonged downturn. Companies such as discount retailers will typically see revenues rise as consumer income

falls. People will always need healthcare, especially now. (For more, see Seeking Alpha's March 2020 list of "Best-Performing S&P 500 Stocks During 2008 And 2020 Crises.")

For those not positioned in one of those industries, companies that are easily able to pivot may thrive. In a May 2020 article, Forbes provided 10 examples of businesses that transformed during the pandemic, including: commercial airlines using empty passenger cabins to transport cargo, otherwise empty hotels offering day rates for work-from-home employees, and shuttered brick-and-mortar retailers offering curbside pickup and expanding digital ordering. Technology stocks tend to be cyclical, but the power of technology during the current crisis to help companies pivot to an even more digitally connected world is a huge positive development.

(4) *Quality client & supplier base*. Inevitably, consumer purchasing behavior will likely change for the worse when economic times are not on solid footing. Customer quality is important. Maintaining credit qualified clients and cutting ties with those that are at risk of paying late, or not at all, will support positive cash flow when revenues are soft. On the supply-side, the main issue is ensuring that any inventory or product components are not at a significant risk of slowed delivery, or lack of availability. Companies that think through supply-chain risk management strategies will benefit.

(5) *Prepared & experienced leadership*. Experienced, prepared, creative, and agile are leadership characteristics that serve companies well when things go wrong. The CFO.com article noted that many of today's young middle managers have never experienced a downturn during their careers. Not that there's anything wrong with that, but corporate leaders need to at least be prepared with scenario planning and risk analysis.

CALENDARS

US: **Wed:** Housing Starts & Building Permits 1.093mu/1.225mu, MBA Mortgage Applications, EIA Crude Oil Inventories, Mester. **Thurs:** Leading Indicators 2.5%, Initial & Continuous Jobless Claims 1.3m/19.8m, Philadelphia Fed Manufacturing Index -23, EIA Natural Gas Stocks, Mester. (DailyFX estimates)

Global: **Wed:** European Car Registrations, Eurozone Headline & Core CPI 0.1%/0.9% y/y, UK Headline & Core CPI 0.5%/1.3% y/y, Canada Headline & Core CPI 0.0%/1.4% y/y, Australia Employment Change & Unemployment Rate -125k/7.0%, Guindos, Mersch. **Thurs:** Japan

Headline & Core CPI 0.1%/-0.2% y/y, BOE Interest Decision & Quantitative Easing 0.1%/£745b, European Council Meeting, ECB Economic Bulletin, BOJ Monetary Policy Meeting Minutes. (DailyFX estimates)

STRATEGY INDICATORS

AC World ex-US MSCI (*link*): This index has risen 2.2% in dollar terms so far in June, but is down 13.9% ytd. In local-currency terms, the index is up a lower 1.1% in June to a slightly worse 12.3% decline for 2020 to date. The US dollar price index is up 29.7% since its March 23 low, but is still in a bear market at 20.6% below its cyclical high in January 2018. It had been down as much as 38.8% on March 23. The local-currency price index is up 23.5% since its March 23 low to 14.4% below its record high on January 2020. It had been down as much as 30.8% on March 23. Local-currency forward revenues is down 11.2% since its record high in May 2019 with 10.0ppts since COVID-19 hit the news in late January. Local-currency forward earnings has dropped 21.4% since COVID-19 and is 25.5% below its record high in October 2018. Revenues are expected to fall 4.9% in 2020 and rise 7.9% in 2021 following a gain of 2.1% in 2019, and earnings are expected to fall 15.8% (2020) and rise 27.8% (2021) after falling 6.2% (2019). The industry analysts' sales forecasts imply short-term 12-month forward revenue growth (STRG) of 0.9% and short-term 12-month forward earnings growth (STEG) of 4.4%, down from 4.1% and 10.0% before COVID-19 hit the news. Both of these measures appeared to have bottomed at the end of May. The profit margin implied by analysts' earnings and revenue estimates calls for a drop to 6.3% in 2020 from 7.1% in 2019, and an increase to 7.4% in 2021. The forward profit margin forecast of 6.8% is up from a 10-year low of 6.6% at the end of May, but is down from a nine-year high of 8.3% in October 2018. The Net Earnings Revision Index (NERI) for the AC World ex-US MSCI was negative in May for a 26th straight month following six positive readings. It tumbled to an 11-year low of -23.9% from -20.1% in April. That compares to a 76-month high of 2.7% in May 2017. The forward P/E was at a record high of 15.9 due to substantially lower forward earnings, but drops to 14.1 using normalized forward earnings. Those readings are up from their March lows of 10.8 and 10.2, respectively. The index's current 17% discount to the World MSCI P/E remains near a record low.

EMU MSCI (*link*): The EMU's MSCI price index is up 3.5% in dollar terms so far this month and down 15.1% for 2020 to date. In euro terms, the price index is up a lesser 2.1% in June, compared to a 15.5% decline ytd. The US dollar price index is up 32.2% since its March 23 low, but is still in a bear market at 23.2% below its cyclical high in January 2018. It had been down as much as 41.9% on March 23. The local-currency price index is up a lower 26.2% since its March 23 low, but is still in a correction at 18.8% below its cyclical high in January 2018. It had been down as much as 35.7% on March 23. The US currency price index remains a whopping 38.9% below its record high in October 2007 while the local price index is down 27.7% from its March 2000 record high. Euro-based forward revenues is 10.0% below its five-year high in November 2018 with 8.6pts due to COVID-19. Euro-based forward earnings is 41.33% below its record high in January 2008. It's down 30.5% from its cyclical high in November 2018 with 27.6pts due to COVID-19. Analysts expect revenues to fall 6.3% in 2020 and rise 6.5% in 2021, compared to a 2.1% gain in 2019. They're looking for earnings to fall 28.4% in 2020 and rise 35.9% in 2021 following a drop of 4.7% in 2019. Forecasted STRG of 0.2% is up from a record low of -0.9% at the end of April. It remains below the 3.2% expected before COVID-19 and also compares to a six-year high of 5.0% in April 2017. Forecasted STEG of -0.8% is up from a record low of -6.7% at the end of April. That's down from 9.9% before COVID-19 and compares to a 78-month high forecast of 21.0% during February 2017. The forward profit margin of 6.1% is at an 11-year low and down from 7.7% before COVID-19. That compares to a nine-year high of 7.9% in January 2019. The implied profit margin is expected to drop from 7.0% in 2019 to 5.3% in 2020 before improving to 6.8% in 2020. NERI was negative in May for a 20th straight month and in 30 of the past 33 months. NERI fell to a record low of -35.9% in May from -29.4% in April. That compares to an 11-year high of 8.1% in May 2017. The forward P/E was at a record high of 17.0 due to substantially lower forward earnings, but drops to 14.8 using normalized forward earnings. Those readings are up from their March lows of 10.2 and 9.7, respectively. The index's current 11% discount to the World MSCI P/E has improved from an eight-year low 18% discount during March. That compares to a record-low 25% discount during 2011 and is well below the 1% premium during April 2015—the post-euro-inception record high.

Emerging Markets MSCI (*link*): The EM MSCI price index has risen 3.9% in US dollar terms so far in June to a decline of 13.3% ytd. In local-currency terms, EM is up 3.1% in June and down 9.3% ytd. The US dollar price index is up 27.4% since its March 23 low, but still in a bear market at 24.0% below its cyclical high in January 2018. It had been down as much 40.4% on March 23 from its cyclical high. The local-currency price index is up 24.7% since its March 23 low to 15.3% below its record high in January 2018. It had been down as much as 32.1% on March 23. Local-currency forward revenues is down 14.0% to a two-year low from its record high in May 2019 with 10.0pts due to COVID-19. Local-currency forward earnings is 22.1% below its record high in October 2018 with 15.9pts due to COVID-19. Revenues are expected to decline 1.0% in 2020 and rise 10.9% in 2021 from a 5.3% gain in 2019. That's expected to lead to an earnings decline of 5.4% in 2020 and a gain of 26.9% in 2021, following a 2.5% drop in 2018. Forecasted STRG of 4.8% is up from a five-year low of 3.6% at the end of April, which compares to a four-year high of 9.6% in January 2017. STEG of 9.9% is up from a 14-month low of 7.5% in April, but remains well below its cyclical peak of 17.5% in March 2017. The implied profit margin is expected to drop from 6.2% in 2019 to 5.9% in 2020 before improving to 6.7% in 2021. The forward profit margin of 6.3% is up from a four-year low of 6.1% at the end of May, and compares to a six-year high of 7.4% in April 2018 and a 10.3% record high in December 2007. NERI was negative for a 27th month in May as it fell to an 11-year low of -18.7% from -15.8% in April. NERI had been positive for only three months through January 2018 after 80 months of negative readings through October 2017. Emerging Markets' forward P/E of 13.6 is the highest level since late 2018 due to sharply lower forward earnings, but drops to 12.2 using normalized forward earnings. That's up from their March lows of 10.1 and 9.3, respectively. The index is trading at a 29% discount to the World MSCI P/E, which is near the biggest discounts of the past 14 years.

US ECONOMIC INDICATORS

Retail Sales (*link*): May retail sales was in the record books for the third month in a row—though this time it's on the plus side! Nominal retail sales skyrocketed a record 17.7% last month after falling at record rates of 14.7% in April and 8.2% in March. Meanwhile, core retail sales—which excludes autos, gasoline, building materials, and food services—jumped a record 11.0% in May after a record 12.4% plunge in April; March sales had climbed 3.3% to a new record high. Adjusted for inflation, we estimate headline sales rebounded 17.8% after steep declines of 13.4% and 7.2% the prior two months, while real core retail sales jumped 11.1% in May after an 11.0% slide in April. The latter is showing a 1.8% (saar) advance during the three months through May, based on the three-month average, following a 1.5% fall and an 8.1% rise over the comparable periods in April and March, respectively. Last month, all of the 13 nominal retail sales categories were in the plus column—with many off the charts: clothing stores (188.0%), furniture stores (89.7), sporting goods, hobby, musical instrument & book stores (88.2), electronic & appliance stores (50.5), motor vehicle dealers (44.1), and food service & drinking places (29.1). Smaller double-digit gains were recorded by miscellaneous store retailers (13.6%), gasoline service stations (12.8), and building materials & garden equipment stores (10.9), followed by smaller sales gains in general merchandise stores (6.0), food & beverage stores (2.0), and health & personal care stores (0.4).

Industrial Production (*link*): Industrial output improved in May, but fell short of expectations. Output rose 1.4% last month, smaller than the consensus forecast of a 2.9% rebound, following a revised record 12.5% decline in April—which was sharper than the initial loss of 11.2%. Meanwhile, the move up in manufacturing production was more impressive, climbing 3.8% after sliding 15.5% and 5.3% the prior two months. By market group, there were lots of plus signs last month. Business equipment production rebounded 5.8% in May, after a two-month plunge of 29.1%, driven by a 53.8% surge in transit equipment output—which had plummeted 65.5% and 25.8% in April and March, respectively. Production of industrial equipment climbed 2.5% after sliding 22.3% during the two months ending April, while output of information processing equipment edged up 0.9% in May after declines of 5.3% and 0.9% the prior two months. In the meantime, consumer goods production jumped 3.9%—its biggest monthly increase since the early 1970s—reflecting a record 23.8% advance in durable goods output—led by an 81.9% surge in automotive products; consumer nondurable goods production edged up 0.7%, following a two-month drop of 7.9%.

Capacity Utilization (*link*): The headline capacity utilization rate recovered to 64.8% in May after sinking from 76.8% in February to a record low of 64.0% in April; it was at a cyclical high of 79.6% during November 2018. May's rate was 15.0ppts below its long-run (1972–2019) average and 1.9ppt below its trough during the Great Recession. Manufacturing's capacity utilization rate climbed to 62.2%, 2.2ppts above April's record low of 60.0%, but still 1.5ppt below its recession trough of June 2009. The utilities' capacity utilization rate continued to slide to new record lows, sinking from 73.5% in February to 69.1% in May, while the rate for mining fell from 90.2% at the start of the year to 75.4% last month—which was the lowest since September 1986.

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