Market Update from Thrivent

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The “Shelter-in-Place” Market

It is hard to believe that in three short months we have gone from hearing about a strange virus emerging in China and seeing news accounts of that country’s seemingly draconian steps to contain its spread, to now being faced with it in our own communities. The virus will have significant and far-reaching ramifications for years to come, affecting government policy, politics, social behavior, economics, business and capital markets. What have been some of the recent effects, and will these be long-lasting factors for investors to consider?

Economic Impact

The preliminary estimate of GDP for the first quarter indicated the economy declined at a 4.8% annual rate, heralding the start of a recession. The most striking impact has been on the labor market, as more than 26 million unemployment claims have been made in just the last five weeks—a weekly average of approximately 5.3 million. These disturbing numbers are in stark contrast to the roughly 220,000 average weekly claims recorded over many previous years. Employment, income and consumer spending are the key drivers to the U.S. economy. As the economy slowly reopens on a state-by-state basis, employment levels will take a long time to recover, thus diminishing final demand for goods and services for some time to come.

With final demand suppressed, corporations will be reluctant to make significant investments to grow or improve their businesses. This issue is magnified given the relatively high level of debt that corporations collectively have taken over the previous long expansion. Fortunately, the interest cost to service this debt is at historically low levels, while the banking system and bond market have been willing to provide long-term funding. It’s also expected that corporations will significantly curtail stock buyback activity. Corporations had been the single biggest buyer of their own stocks over the past few years, which helped to propel prices higher.

The federal government has quickly responded to this crisis. The Federal Reserve has opened its extensive monetary “tool box” to keep the “monetary plumbing” of the economy running in an orderly manner, while Congress has also stepped in to provide unprecedented fiscal support to individual citizens and businesses. These programs are not “stimulus” measures as compared to past government initiatives, but they are intended to be a financial bridge until the economy fully reopens. The cost of this bridge is significant; the government will have to issue trillions of dollars in debt for the foreseeable future. The long-term implications of this huge ramp up in federal borrowing, along with extremely accommodative Federal Reserve policy, is difficult to ascertain. Conventional economics would indicate the potential for higher inflation and higher interest rates in the long term. However, these are not conventional times. High levels of unemployment, excess productive capacity globally, collapsing commodity prices (especially oil) and diminished private sector borrowing demand are powerful countervailing forces to higher inflation.

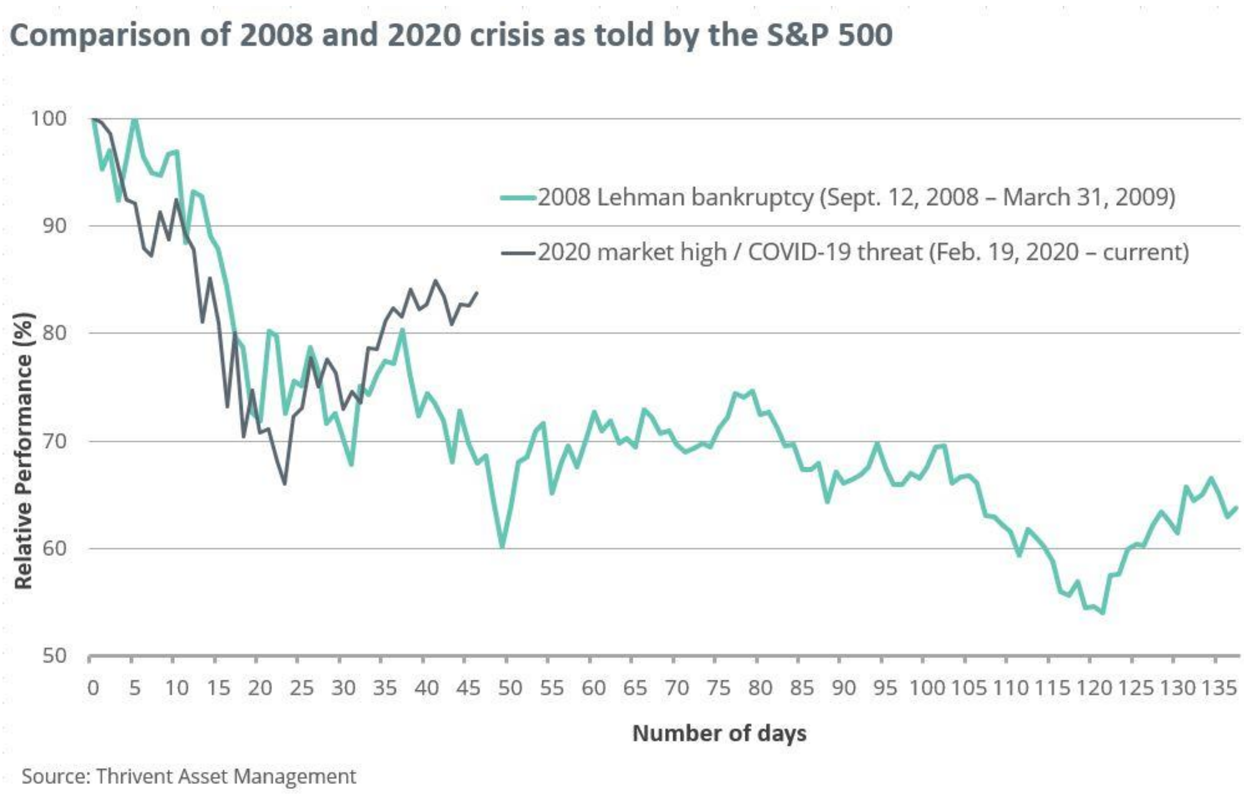
What are the implications of this economic and policy backdrop for the capital markets?

Market Impact

A sudden and sharp decline in the economy and aggressive policy responses have pushed yields on U.S. treasury bonds down to levels previously unthinkable, with most treasury securities yielding under 1%. Yields on corporate bonds have now stabilized, but in a wide range, depending on credit quality; from 2% for high-quality borrowers to 10%-plus for high-risk borrowers. With inflation trending down in the near term and the Federal Reserve doing everything it can to support markets, interest rates are expected to remain low for quite some time. Although rates are low, credit spreads are very wide, providing meaningful income relative to inflation. With investor cash levels very high and earning inconsequential yields in money market funds, and foreign bond markets at negative yields, expect the demand for incremental yield to resume. A well-diversified portfolio of bonds will remain a key component of an investor's asset mix. For investors in higher tax brackets, municipal bond yields are compelling, particularly given the very real possibility of tax rate increases to help offset budget deficits in future years.

The stock market's surprising rally since the end of March has been powerful, yet also instructive. Once again, the broad market's 30% rally from its bear market low illustrates the overwhelming influence of Federal Reserve policy actions and historically low interest rates. Flooding the market with liquidity, as the Fed has done, almost always results in stronger stock and bond markets.

The accompanying chart shows how much stronger this rally off a bear market low has been, compared to market behavior during the Great Financial Crisis. Obviously, massive government response has been a main near-term driver. However, two key longer-term changes in the environment have been key as well. 1) Banking system reforms since 2008 have proven to be helpful in that the system is much better positioned to weather this shock. In fact, it is now a key agent in distributing government cash to citizens and low-interest loans to business. Banking is now part of the solution, not part of the problem. 2) Technology stocks, which have become much more pervasive in the economy and are dominant components of the market, are less prone to traditional business cycle swings. In short, many of these technology business models are well positioned for a "shelter-in-place" economy. Consequently, many technology stocks have been less affected than other sectors of the market. In fact, the NASDAQ Index, which is dominated by technology companies, is now only down 1% since the beginning of the year, as compared with a 13% decline in the Dow Jones Industrial Index.



Although this rally in risk assets off a bear market bottom has been more rapid and powerful than previous crisis environments, it is still similar in that it's characterized by extreme volatility. It's anyone's guess as to where stocks will be in the near term, but the searing experience of the coronavirus crisis will keep volatility high, with the probability of anxiety-producing declines likely.

Longer term, therapies and vaccines will be developed to thwart this and other variations of coronavirus. Some “green shoots” of optimism on this front continue to emerge from the bio/pharma industries and have contributed to recent market enthusiasm. As always, economies, businesses and even social behaviors will evolve. Some business and financing practices will fundamentally change, presumably for the better.

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