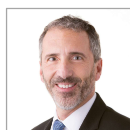
THRIVENT ASSET MANAGEMENT

Market Update from Thrivent

March 24, 2020



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Equity markets soared today with the S&P 500 bouncing more than 9% and the Dow Jones Industrial Average posting its best day since 1933 with an 11.4% gain. Energy, financials and industrials—including airlines—led the way. U.S. markets were catalyzed by expectations of the passing of an unprecedented Congressional spending bill totaling roughly $2 trillion. Additionally, intervention by the Federal Reserve helped stabilize fixed income market functioning. Lower valuations, following a 34% plunge in the S&P 500 from the high reached last month, drew in investors. The market was primed for a near-term reversal as sentiment readings for key markets, such as S&P 500 futures, were near or at record-low negative readings. International equities markets also rose, with key Asian and European markets rising between 4% to 11%.

Credit markets

Credit markets rallied strongly alongside equity markets, helped in part by the Fed's unprecedented level of intervention to unclog the plumbing of financial markets. This included supporting money markets and municipal markets, buying billions of dollars in U.S. Treasuries and mortgages, and—for the first time ever—purchasing corporate bonds and ETFs. As a result, Treasury, cash and corporate markets have started to trade more efficiently and function better. The Fed plans on buying a staggering $625 billion in securities this week, with daily buying totaling $75 billion in Treasuries and $50 billion in mortgages. Also, corporate bond prices rallied. For those interested, more detail on the credit market—and opportunity—follows at the end of today's piece.

The economy

Economic data for March is beginning to filter out, painting a picture of a sharp slowdown in economic activity. Preliminary surveys of global economic activity for March plunged with record-low readings for the service segments of economies. While manufacturing also contracted, it held up better than expected. In the U.S., a composite reading of manufacturing and service segments came in at 40.5; a reading below 50 means contraction. Economic forecasts are calling for the economy to contract sharply in the second quarter before starting to rebound. Also, jobless claims this week are expected to set a record, with most recent estimates surpassing 2 million or more.

The coronavirus pandemic

Developments were mixed in the fight to slow the spread of the coronavirus. China announced it would remove lockdown measures in Wuhan on April 8th, marking an end to 11 weeks of lockdown. In Italy, however, the country suffered its second-largest daily death count after seeing a slowing trend the past few days. The U.S. is now home to the largest daily increases in cases, with total cases reaching more than 50,000. More than 20 states have implemented some form of stay-at-home orders.

Additional insights into credit markets

Corporate credit has sold off sharply with falling earnings estimates and intense selling pressures driving down prices. The deluge of selling has at times overwhelmed the market, resulting in dislocated prices, but also in our opinion, long-term opportunity. While many of the companies standing behind corporate bonds will see their earnings plunge and some will default, markets already have priced-in severe outcomes. Both investment-grade bonds and high yield bonds have reached pricing levels that have historically led to attractive return opportunities.

Investment-grade credit has already received a boost on news that the Federal Reserve will, for the first time, buy investment-grade corporate bonds directly from companies in addition to buying corporate bonds in the secondary market. The Fed also will buy investment-grade corporate bond ETFs. LQD, a large ETF that invests in investment-grade bonds, rallied more than 7% yesterday on this news.

High-yield bonds were excluded from the Fed's buying programs as they carry greater credit risk, such as the risk of default. Defaults are expected to rise, with most estimates now greater than 10%. Pricing, however, already reflects higher default probabilities. Defaults are a lagging indicator, while markets are forward looking. By the time a company defaults, its problems are usually reflected in bond prices and yield spreads. Spreads are a form of risk premium that compensate investors for risks. The spread for high yield reached about 1,100 basis points as of Monday, which means it offers 11% more yield than similar duration U.S. Treasuries.

Historically, spreads this large present good buying entry points, even if the market continues to fall in the near term. At a spread of 900 basis points, or 9%, high yield forward annualized returns have been strong, with average one-year returns of 34.7%, with a low of 0.5% and high of 61.4% over the past 33 years, according to JP Morgan's index returns. (Note: 33 years is essentially how long the high-yield market has been in existence.) Over a five-year period after spreads have breached 900, the average annual returns have been 15.3%, with a high of 20.5% and a low of 9.7%.

For example, high yield bonds suffered significant price declines during the financial crisis in 2008 and early 2009 before rebounding sharply. High yield posted a -26.2% return in 2008 but bounced back strongly in 2009 with a 58.2% return followed by a 15.1% return in 2010, as measured by the Bloomberg Barclays High Yield Index. High yield even outpaced the S&P 500 total return in 2009 of 26.5% and was essentially even in 2010. Leveraged loans performed similarly to high yield.

Historically, market recoveries often follow a sequential pattern in recovering from severe downturns with credit leading the way. High-quality credit typically recovers first, followed by lower-quality such as high yield, and then equities. This can be because pricing can become dislocated from underlying values, caused in part by less liquid trading in high yield and selling pressures. Also, high yield in a downturn usually trades at a discount, with pricing currently at 79 cents on the dollar for the market as a whole. A steady stream of income also helps, especially when yields reach double-digits.

Importantly, creditors have a priority claim on a company's assets over equity holders. As an analogy, one can look at homeownership: the price of a home with a mortgage, home-equity loan and the owner's equity from a down payment and additional principal paydown. The mortgage bank has the first claim on the house, the home-equity lender comes next, and only if market values are above those claims does the homeowner have any equity.

A company's capital structure is similar. Bondholders get priority. Secured-debt holders are first in line, followed by unsecured debt holders. Any value left after those claims belongs to equity holders. It makes sense, then, that credit would lead a recovery where valuations have plunged along with earnings. Credit is first in line.

History is no guarantee that future high yield returns will repeat past patterns. The high-yield market may remain volatile with further price declines, but given past patterns, we believe valuations look attractive to start building positions for long-term, income-oriented investors who can withstand volatility.

All information and representations herein are as of March 24, 2020 unless otherwise noted.

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