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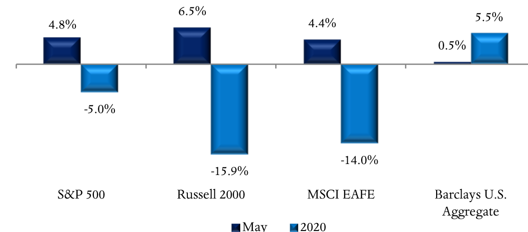
Markets

May saw a continuation of the financial market rally off the March lows. Investors cheered the global decline in Covid-19 cases, positive vaccine and antiviral drug testing results, as well as improved outcomes for those hospitalized by the virus. Improved health-related prospects boosted the probability of a sustained economic recovery and led to some green shoots off extremely depressed levels. Conversely, uncertainty over emergence from lockdowns led to rising political tensions. The S&P 500 index advanced +4.7% in May (-5.0% ytd), while the smaller capitalization Russell 2000 benchmark recovered +6.5% (-16.0% ytd). Once again, growth equities outperformed value oriented ones. Overseas stocks also continued their recovery as seen by the MSCI EAFE index's +4.4% monthly gain (-14.0% ytd). In Europe, the Stoxx 600 index rose +3.5% (-14.4% ytd) as economies slowly emerged from quarantine. Meanwhile, Asian market results were more varied. Chinese stocks on the Shanghai exchange declined -0.1% (-6.0% ytd), but Japanese equities rocketed higher by +8.3% (-6.6% ytd). Emerging markets lagged, with the index bouncing a mere +0.8% in May (-15.9% ytd).

Fixed income markets continued their advance, driven by positive virus-related and economic data points. The risk-free US Treasury curve steepened as the 2-year yield declined -3.5 basis points (bps) to 0.16%, while the 10-year yield increased +1.3 bps to 0.65%, both resting near historical lows. Corporate and high yield bonds continued to rally strongly post March's significant losses, aided by further fiscal and monetary policy support. Exceptionally strong capital inflows boosted the US high yield market by +4.6% in May (-5.6% ytd) with spreads continuing to narrow. Overall, the Barclays US Aggregate bond index added +0.5% in May (+5.5% ytd). In Europe, the 10-year German Bund yield rose by +13.9 bps to -0.45%, the UK 10-year Gilt yield fell by



-4.7 bps to 0.18%, and the Italian 10-year yield tumbled -28.7 bps to 1.48%.

In commodities markets, crude oil rebounded strongly, boosted by reopening of economies and increased mobility (Brent +39.8% to $35.33/bbl; WTI +88.4% to $35.49/bbl). Similarly, industrial and precious metals performed well as seen by copper (+3.0%), iron ore (+20.1%), gold (+2.6%) and silver (+19.3%).

Geopolitical Events

America commenced a multi-stage reopening from its varying degrees of coronavirus related quarantine. These actions were highly debated given that the daily infection rate had only fallen to approximately 65% of peak levels, and that the US is still exhibiting the largest number of daily new infections in the world. Abroad, the rate of contagion across major European and Asian economies fell significantly. However, the UK and certain developing countries remained behind the curve, with the bulk of new infections coming from populous nations including India, Russia, and Brazil. With regard to producing immunity against Covid-19, there were several positive data points from a myriad of vaccines under development, giving hope that at least one will be effective in record time. We have seen some positive first steps, but it is still too early to say with confidence how the public health outlook will evolve, yet we remain optimistic of a favorable outcome.

Political tensions between the US and China rose again

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as President Trump was angered by China's security crackdown in Hong Kong. As such, the US has begun the process of eliminating policy exemptions that give Hong Kong special treatment.

United States

US economic data has been particularly weak given the multi-month virus-related lockdown of the economy. There were, however, some green shoots as employers added 2.5 million jobs in May, reducing the unemployment rate to 13.3%. Hires were driven by the initial reopening of leisure, hospitality and construction businesses, which bore the brunt over the previous two months. Nevertheless, with over 30 million workers still claiming unemployment benefits, and 40% of last month's hires being part-time, the path to recovery is likely to be uneven. The purchasing managers' indices showed that activity continued to weaken in May across both manufacturing and services.

With relaxation of stay-at-home orders, activity is beginning to return to a "new normal" where social distancing is likely to persist, especially among the elderly and those with pre-existing conditions, as well as their direct families. According to the Atlanta Fed, second quarter output is expected to contract at an annualized rate of -53.8%, much deeper than that of the first quarter (-5.0% annualized). Starting in the third quarter, the economy is anticipated to snap back (+21.5% annualized). Barring any further setbacks, overall 2020 GDP is estimated to retrench by -7.2%, with the caveat that there is likely to be a high margin of error.

The US Federal Reserve has rapidly and meaningfully increased the size of its balance sheet in order to stabilize the economy and businesses, commencing on March 15, when interest rates were cut to zero, accompanied by a $700 billion Quantitative Easing program. In May, various previously announced lending facilities, supporting municipalities, corporations and banks, went into effect. The Fed's balance sheet has thus grown to hold over $7 trillion in securities (34% of GDP), a figure that could potentially rise to $10 trillion (48% of GDP) by the end of the year. Of note, assets held on the central bank's balance sheet approximated $3.75 trillion in September of 2019, just prior to commencement of support for the repo market. Fed Chairman Powell, did however, recently signal a hesitance to embark on a negative interest rate policy, pointing out the downside effects on the banking sector.

May 2020 Economic Statistics

	May-20	Dec-18	Dec-17
Federal Funds Target Rate	***0 - 0.25%***	2.25-2.50%	1.25-1.50%
Consumer Confidence Index	***86.6***	128.1	122.1
Manufacturing PMI Index	***43.1%***	*54.1%*	59.7%
Unemployment Rate	***13.3%***	*3.9%*	4.1%
JPY/USD	***107.77***	*109.56*	112.67
USD/EUR	***1.1098***	*1.1469*	1.1996
Gold/oz.	***$1,726.30***	*$1,282.73*	$1,302.45
Oil (WTI)/bbl	***$35.49***	*$45.41*	$60.42

Europe

The spread of Covid-19 has receded across the eurozone, with daily new infections now approximately 90% lower than the early-April peak. Austria and Denmark are seemingly leading the region in reopening their economies, with the UK and Portugal trailing. Germany, whose economy is expected to shrink by 7.1% in 2020, has sought to mitigate the negative effects of the coronavirus by instituting tax cuts, supporting labor, and planning for an extra €130 billion in social spending. Further, a European Union "rescue fund" calls for the European Commission to borrow €750 billion from financial markets, equivalent to approximately 5.4% of the region's GDP, to be funded by EU budgetary resources (with contributions to be based on a country's Gross National Income). Specifically, €500 billion of spending is to be made available, mostly as grants, with the remaining €250 billion targeted towards loans to any EU country, but focused on those most in need. This credible policy mix should help countries with already high debt levels, such as Italy, to access funding without having to issue more of their own debt and, in turn, lead to the narrowing of sovereign borrowing costs.

The European Central Bank, under the terms of its monetary stimulus programs, purchased over €125 billion of government and corporate bonds in May. In addition to the Commission's rescue fund, the ECB's pandemic purchase program was expanded by €600 billion on June 4 (bringing the total planned central bank bond buying to €1.35 trillion, through June 2021). Even with the aforementioned fiscal and monetary support, the eurozone's economy is expected to contract by 8.7% in 2020, with inflation near zero, before rebounding to 5.2% growth in 2021 and 3.3% in 2022.

The United Kingdom's first quarter GDP declined by 2.0% quarter-over-quarter, the worst reading since 2008. The UK government's Job Retention Scheme, introduced to curtail unemployment, was extended until the end of October, though some of the burden will shift to businesses in September. The program provides workers put on furlough with 80% of their salary (currently up to £2,500 per month), leading circa 77% of businesses to apply. Despite this support, unemployment increased from 3.5% to 5.8%.

Asia

The number of reported coronavirus cases in Asia has trended down and economies are reopening, led by first-hit China and South Korea. High levels of testing and contact tracing have been key features of their exit strategies, and appear to be working. Reduced incidence in Japan is also a positive for the region. However, a large increase in cases in India, Russia, and Pakistan have put pressure on their economies, with knock on effects globally.

The Chinese economic recovery appears to be unfolding more rapidly than initially expected. Manufacturing activity expanded in May, registering 50.7%. But there is also evidence that the initial pent-up demand for factory output may stall, due in large part to lackluster overseas buying. In response, policy makers have pledged a slate of stimulus measures to boost the economy, though the response has fallen short of efforts during previous, less severe, downturns. As such, Premier Li Keqiang indicated at China's annual legislative conclave that the country would formally abandon its 2020 growth target, due to uncertainty surrounding the pandemic.

Outlook

Investors have found some cause for optimism as containment measures have seen infection rates decline in many countries. Now the focus has shifted to how successful lockdown exit strategies will be, and the level of associated rebound in activity. Financial markets are well aware that the nadir in global economic output is likely to be seen in the current quarter. However, significant uncertainty remains over when economies can fully and sustainably reopen and how quickly they will rebound. Central banks and governments have so far helped cushion the blow to the global economy, but success will be measured by the extent to which companies avoid insolvency and labor is re-hired.

US corporate earnings reports for the first quarter of 2020 showed that earnings contracted circa 14% year-over-year, reflecting the severity of the Covid-19 pandemic. Defensive sectors such as consumer staples, utilities and health care were more resilient and had positive earnings growth. High demand for technology, driven by increased remote interactions, aided the sector. To the downside, financials, energy and consumer discretionary were the worst hit segments. Earnings for the second quarter are expected to fall in excess of 40% over the year-ago period, which should mark the low point of the cycle. Given the inherent uncertainty, we continue to favor a high quality approach to equity investing, with a focus on companies with strong balance sheets and pricing power, that would benefit from an improvement in the outlook but would also survive if the outlook deteriorates.

In fixed income markets, the near-zero levels of sovereign bond yields, prevalent across the developed world, has been a crushing blow for risk-averse savers. This has highlighted the dearth of alternatives to risky assets, for anyone seeking returns above "true" inflation, driving fund flows into below investment grade bonds, and equities with dividends. As such, we continue to recommend a cautious approach towards fixed income investing, preferring select alternative assets, as well as non-market correlated opportunities, as part of a diversified asset allocation.

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Sources: Barclays, Bloomberg, Bureau of Labor Statistics, Conference Board, Department of Agriculture, Federal Reserve, Financial Times, IMF, Institute for Supply Management, MSCI, Reuters, Russell, Standard & Poor's, and the Wall Street Journal.