Weekly Market Commentary
March 9, 2020

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Sometimes the message works, other times it backfires. Policy makers are pulling out all stops to contain fears that are buffeting the financial markets and amplifying the growth-damaging impact from the spreading Coronavirus. Both the federal government and the Federal Reserve are employing emergency measures to stem the tide of anxiety on Wall Street and Main Street, but their efforts have yet to garner the desired results. To be sure, the $8 billion funding bill aimed at containing the virus that was approved by Congress this week should help the cause. But in the short run, it will not motivate people to travel, go to movies, visit amusement parks, the theater or other venues where proximity with others that might be infected with the virus are present, including the workplace. Nor, for that matter, will the fiscal aid do anything to alleviate the disruption to supply chains that threatens to stifle production over the next few months.

Likewise, the Federal Reserve's emergency 50 basis point rate cut this week is not likely to have much of a positive effect over the short-term. The cost of financing is already exceptionally cheap; even lower rates will do little to stimulate additional borrowing in an environment of high anxiety over the economic outlook. At best, it will stave off concerns that the financial markets might seize up and provide support for demand after the coronavirus runs its course. No doubt, the Fed also hoped to restore stability in the financial markets, which have been rocked by the persistent headline-grabbing reports tracking the spread of the disease.

On that score, it failed miserably; indeed, it may even have backfired by conveying the message that there is more to fear than meets the eye. The rate cut announcement on Tuesday did ignite a brief stock-market rally, but the nascent optimism it stoked was quickly extinguished as investors decided to run for the hills, shifting funds out of risky assets into safe havens. The 10-year Treasury yield plunged further into uncharted territory, touching a new record low of under 0.70 percent early on Friday before ending the week at just under 0.80 percent. The push to lower bond yields reflects high expectations that the Fed is poised to cut rates again. History supports those expectations. The emergency rate cut on Tuesday was the first to take place between scheduled policy meetings since the global financial crisis in 2008, and only the seventh since 1998. In every previous case the Fed cut rates again at the next policy meeting. We expect that pattern will be repeated at the March 18 policy confab, followed by another rate cut at the April meeting.

Nor are investors dumping just stocks for the safety of government issues. Other risky assets are also being shunned, including securities in the $1.3 trillion junk bond market. These obligations are from companies that are highly vulnerable to the earnings threat posed by the coronavirus. Among the most vulnerable are energy companies that are being victimized by another plunge in oil prices; on Friday, crude quotes fell to under $42 a barrel, equaling the lowest price since 2016. Energy companies account for 13 percent of triple-C rated bonds outstanding, which is the bottom tier of junk-rated bonds. Not surprisingly, these yields are showing the sharpest increase in the high-yield universe, spiking up by 35 basis points on Thursday alone.

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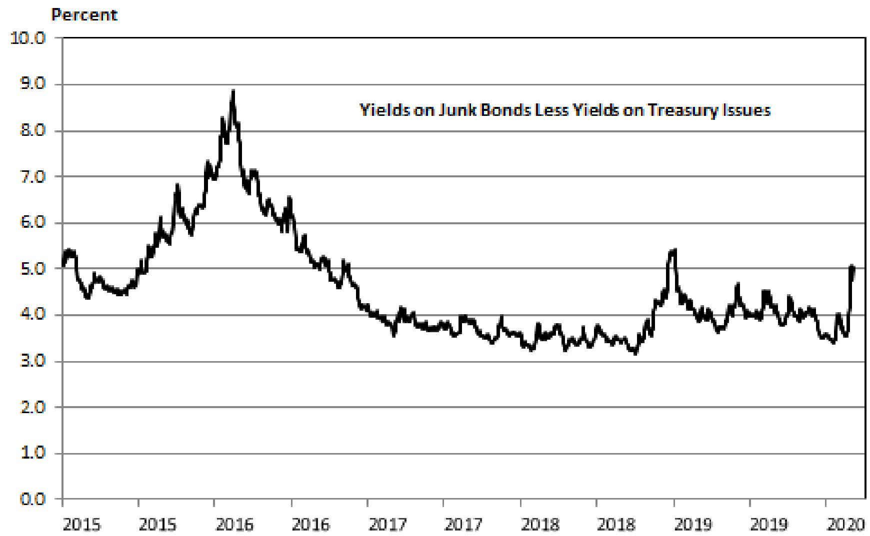
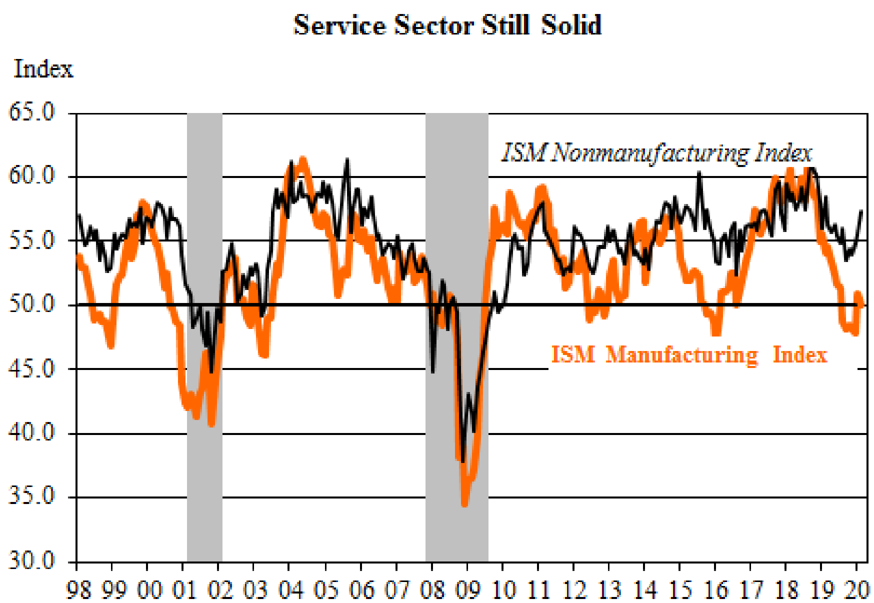
So far, the upward pressure on other issues below investment grade has been relatively modest, and the overall spread between yields on junk bonds and Treasury issues has not widened out as steeply as it did during previous external shocks, most notably during the oil crisis in 2016. But credit spreads are widening and the flight to quality that is now gaining traction should reinforce the trend. Importantly, if the economic disruption from the coronavirus exacts a big toll on company profits, a host of company downgrades are sure to follow. There is currently $3.4 trillion of BBB-rated debt outstanding, which is just a notch above junk rating. Should they join the expanding list of “fallen angels” via downgrades, they will become ineligible for investment by many institutions, including life insurance companies and pension funds, shutting them out of the capital markets.

Credit Spreads Are Widening

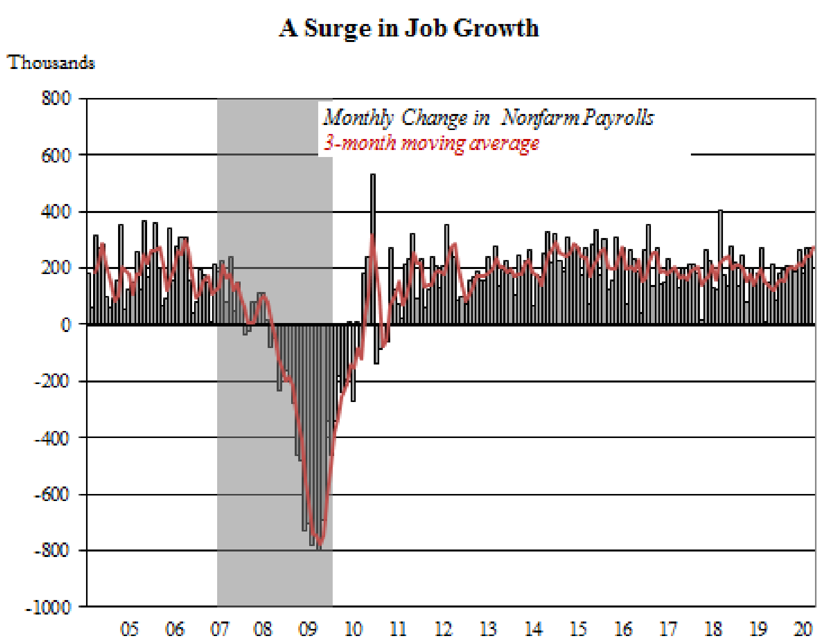


That, in turn, poses more of a risk to the economy than the plunge in stock prices, which mostly damages the portfolios of wealthy investors. Losing access to capital funds prevents these companies from refinancing maturing debt even as their lowered credit standing may shut off access to credit from other lenders. This potential credit squeeze would deprive companies from obtaining working capital needed to fund payrolls and sustain operations. No doubt, the Fed would ramp up efforts to keep funds flowing to affected sectors, but if the revenue stream to vulnerable companies withers along with shrinking demand there is little policymakers can do to prevent an upsurge in defaults, bankruptcies and escalating layoffs. This is a time-honored feature of a recession, which we now view as having a 40 percent probability of occurring this year.

That said, if the Coronavirus is the straw that breaks the expansion’s back, it is pushing against a much stronger spine than thought a week or so ago. It now appears that just before the virus surfaced the economy was in the midst of solid recovery from last year’s tariff-related slump. The first tangible indication of that strength appeared in the surveys of purchasing managers from the Institute for Supply Management (ISM). While the ISM surveys revealed early signs that manufacturers were being hurt by the coronavirus, particularly in the form of supply disruptions, that was hardly the case for the much larger services side of the economy. The ISM index of non-manufacturing activity surged to a one-year high in February; what’s more, all of the sub-indexes held firmly above the 50 threshold, which separates expansion from contraction. The new orders index – a gauge of forward momentum – jumped by 6.9 points, matching the highest level in more than four years.



Importantly, service-providing companies were stepping up hiring, as the employment index climbed to a nine-month high during the month. As impressive as that was, the subsequent hard data on the job market was even more so. On Friday, the Labor Department reported that the economy generated an eye-opening 273,000 jobs in February, far greater than the consensus expectation of a 170,000 increase. Adding to the strength, the increases over the previous two months were revised higher by 85,000, yielding a three-month average increase in payrolls of 254,000. You would have to go back to September 2016 to find a stronger gain over a comparable three-month period.



The employment gain was as broad as it was strong, with only three industries shedding workers. The biggest loser was retail, long a victim of e-commerce competitors, which suffered a drop of 7,000 payrolls during the month following a 6,000 loss in January. In 2019, retailers shed an average of 3,000 workers a month, so the shrinking of brick and mortar establishments in the face of online competition is not letting up. On the flip side, a broad swath of industries expanded payrolls, led by health and education (+54K), leisure and hospitality (+51K) and professional and business services (+41K).

Most other measures of the job market were solid. The labor force participation rate held at an eight-year high of 63.4 percent, the unemployment rate fell back to 3.5 percent, matching the lowest since December 1969 and, critically, the robust job market is trickling down to the less-skilled segment of the population. The share of the population without a high school diploma holding a job shot up to 45.1 percent from 43.4 percent, hitting a record high since this data was first compiled back in January 1992. A minor blemish of the report that may reflect early signs of the Coronavirus is a slight uptick in the number of workers who were involuntarily holding part-time jobs.

While average hourly earnings rose by a decent 0.3 percent in February, the annual increase slipped back to 3.0 percent from 3.1 in January and moved further behind the cycle high of 3.5 percent set last February. Hence, despite the ever-tightening job market, there is still no sign of upward momentum in wage growth. This is one of the more perplexing features of the job market that still does not have a convincing explanation, particularly since upward wage pressure seemed to be building a year ago. However, the aforementioned increase of less educated workers to payrolls may be playing a role, as their lower wages drags down the increase in average earnings.

However, as impressive as the latest jobs report is, it is looking at labor conditions through a rearview mirror. Keep in mind that the Labor Department surveyed businesses and households during the week that spanned the twelfth of the month. While the Coronavirus was on the radar screen at that time, its magnitude and severity was far from apparent. Since then, anecdotal evidence pointing to weakness in the job market is piling up, highlighted by this week's announcement of a hiring freeze at major airlines. We suspect that the blow to the economy from the coronavirus will start to become more evident with the March reports on jobs, consumer spending and production. The only consolation provided by the surprisingly strong reports for February is that the prospective setback in economic activity will be coming off of a higher starting point than thought.