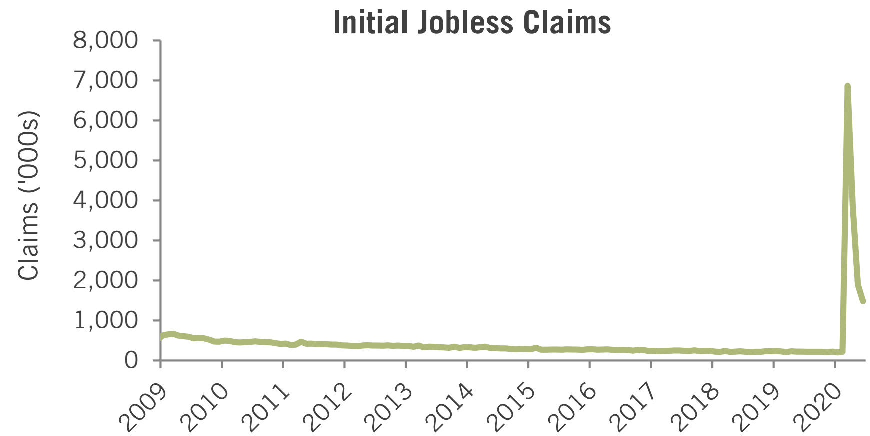
MARKET REVIEW
SECOND QUARTER 2020

ECONOMIC SHUTDOWN TO START THE QUARTER...

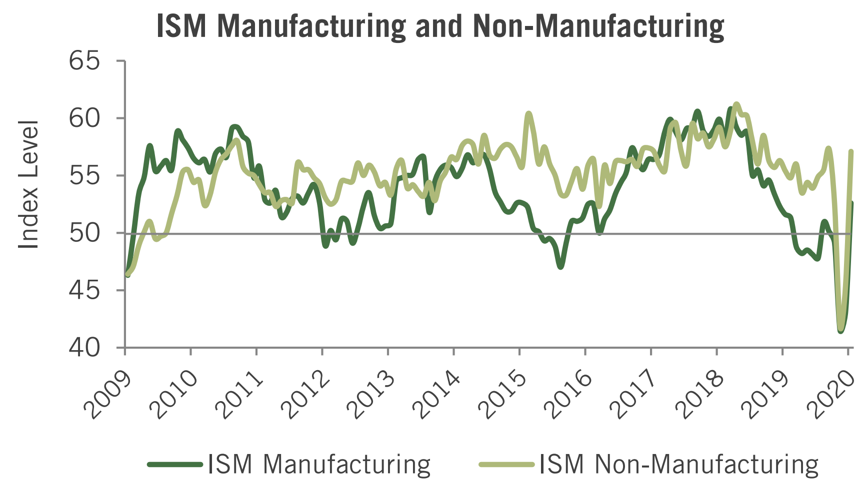
- 1Q GDP growth came in at -5% q/q annualized as Governments around the world enacted dramatic measures in order to control the spread of COVID-19; the pandemic has had a swift and materially negative impact on the economy.
- More recently, many restrictions have been relaxed in order to restart economic activity, and there are early signs that a bottom has been reached and a recovery is underway.
- As a result of better than expected recent data, economists have revised their 2Q GDP estimates to -20% to -30% q/q annualized (still making this the most severe economic downturn since the Great Depression). Forecasts are calling for a strong recovery with +20% q/q annualized GDP growth in the back half of the year (full year -6% to -8%).



Source: Bloomberg

...BUT POSSIBLE RECOVERY UNDERWAY

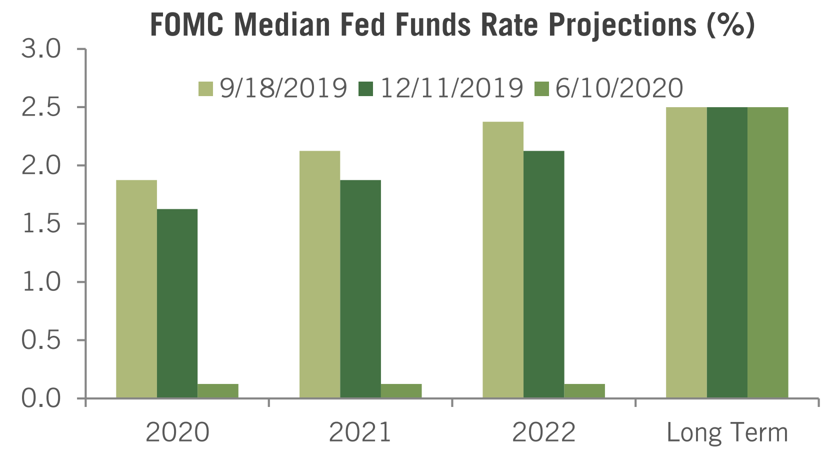
- May and June saw the creation of 2.7 million and 4.8 million jobs respectively. While not enough to make up for the 21 million jobs lost in April, both months surprised to the upside; however, initial unemployment claims have stagnated at around 1.5 million per week since the beginning of June and continuing claims have remained at more than 19 million after peaking in May at 25 million.
- With the turnaround in the unemployment trend came a turnaround in consumer spending: retail sales fell by 14.7% m/m in April before increasing by 17.7% m/m in May.
- Measures of business activity show a similar pattern as the ISM Manufacturing Index rebounded into expansionary territory in June, to 52.6, following a deep contraction in April and May. Notably, this is a "diffusion" index that does not indicate the magnitude of change, rather, it is indicative of the direction (trend) of activity.
- Going forward, a delicate balance between economic welfare and health concerns will need to be struck as the global health system continues to learn the best way to deal with the disease.



Source: Bloomberg

EXTRAORDINARY GOVERNMENT AND CENTRAL BANK ACTION…

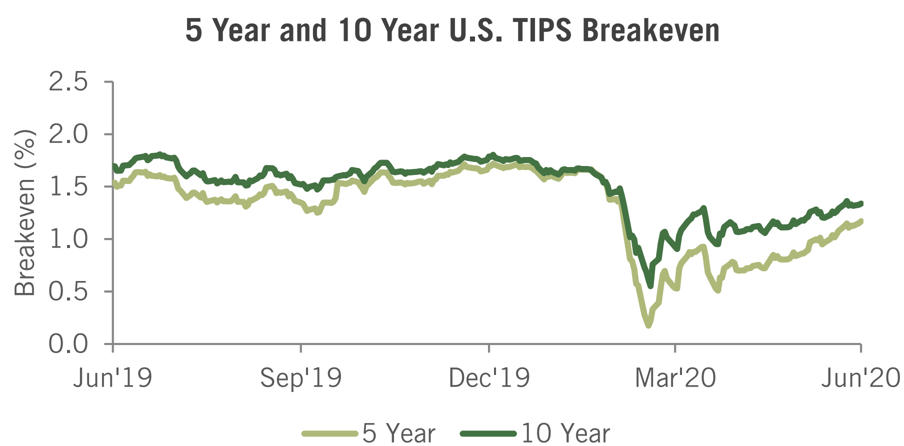
- Both monetary and fiscal policy responses to the pandemic have been massive: the Fed cut its policy rate to zero, enacted unlimited QE, and initiated a number of credit facilities, while Congress unanimously passed the ~$2 trillion CARES Act and is currently wrangling over $3 trillion of additional stimulus spending designed to provide ongoing support.
- As expected, the Fed kept interest rates unchanged at its June meeting, while published forecasts indicate that officials almost universally agree that policy rates will remain near zero for at least the next several years.
- To date, the Fed's credit facilities have largely gone unused relative to their capacity as it seems the Fed's signal that it will do "whatever it takes" to restore market functioning to pre-COVID levels was enough in and of itself. Regardless of their utilization, these programs remain in place and could provide a necessary backstop should markets unravel again.



Source: Federal Reserve, Bloomberg

…KEEPS INFLATION SUBDUED, BUT EASES DEFLATION FEARS

- The Fed remains opposed to negative rates but has suggested that "yield curve control" could be an additional policy tool. Current debate appears focused on the difference between strengthened forward guidance and yield curve control.
- On the inflation front, both headline and core CPI were basically zero m/m in May after falling considerably in April, while y/y numbers fell to 0.1% and 1.2% respectively.
- Market measures of inflation confirm subdued inflation expectations with 5-year and 10-year breakeven inflation rates ending the quarter at 1.17% and 1.34% respectively. The Fed's policy actions have thus far convinced the market that deflation can be avoided but underwhelming inflation only serves to strengthen the Fed's resolve to keep rates lower for longer.



Source: Bloomberg

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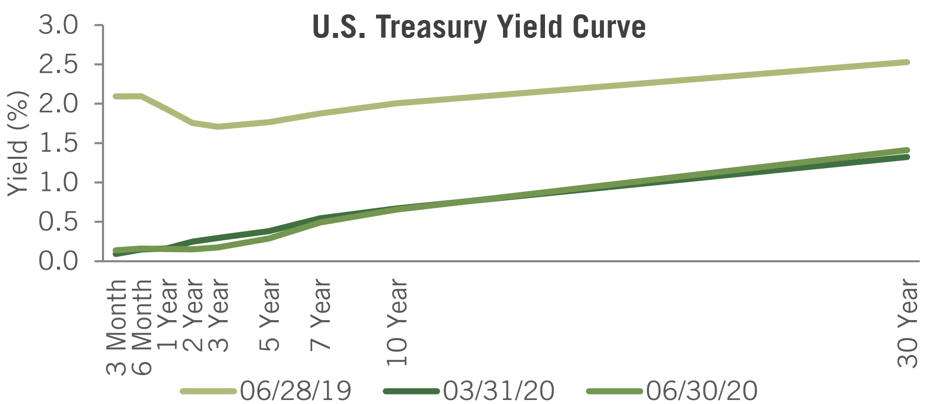
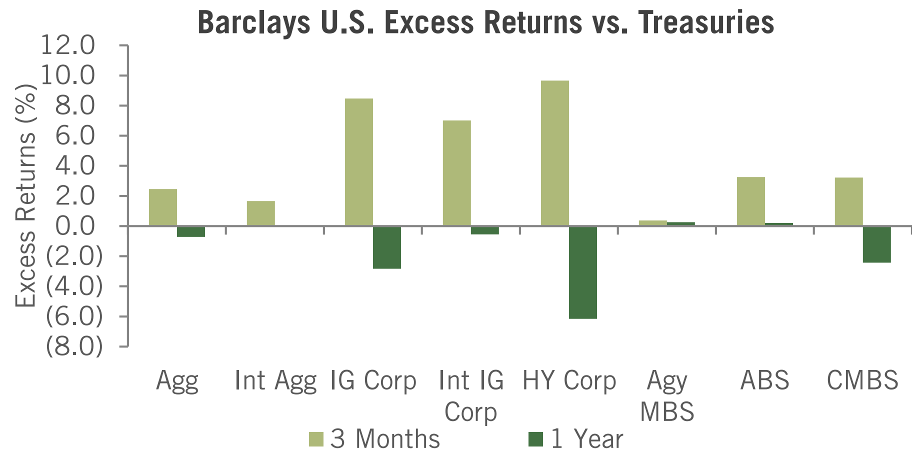
NON-TREASURY SECTORS OUTPERFORM AS SPREADS TIGHTEN, TREASURY RATES UNCHANGED



Source: Bloomberg



Source: Bloomberg Barclays

- Markets have responded favorably to historic Fed intervention and Government stimulus. Equity markets staged an impressive turnaround, rallying almost 40% to end the quarter within spitting distance of where the year started.
- High quality fixed income spread assets responded in kind with some sectors rallying back to pre-COVID-19 levels, while Treasury yields were largely unchanged during the second quarter with rates at all but the longest maturities still below 1%.
- Spread sectors outperformed like-duration Treasuries during the quarter as spreads tightened. Corporates outperformed other spread sectors overall, while longer Corporate bonds outperformed short/intermediate maturities, and BBB and crossover/high yield issuers outperformed up-in-quality names.
- The Corporate new issue market was open for business with investment grade issuance of almost $700 billion in 2Q; year-to-date supply of nearly $1.2 trillion has already surpassed full year supply in 2019*.
- After an initial deluge of buying ($788 billion gross since the end of March), the Fed has settled into a pace of adding $40 billion Agency MBS per month, net of paydowns, going forward. In addition to providing a liquidity backstop, ongoing Fed QE will provide technical support for Agency MBS spreads by effectively creating negative net supply.
- ABS spreads tightened dramatically as liquidity flowed through the system and short swap spreads tightened. With spread levels for on-the-run ABS approaching pre-COVID levels and well inside of TALF funding, program subscription has been practically zero. Year-to-date, ABS new issue is 32% lower than during the first half of 2019*.
- The CMBS primary market remains extremely quiet, with new issue volumes down 28% y/y*. At present, the market is not expecting much in the way of new issue for the remainder of the year. The TALF program could provide a much needed backstop should spreads widen meaningfully. We expect CMBS conduit delinquencies to test the GFC high of ~11% in the coming months.

**Issuance sources: JP Morgan, Citi, and Bloomberg*