CION INVESTMENTS

Directions to the New Normal

Welcome to the most hated market rally in history. All it took for the NASDAQ to hit a new all-time high was a worldwide pandemic, a strict quarantine, a recession, civil unrest and record unemployment. It was a surreal quarter. Davey Day Traders are loudly out earning investment pros and the only thing everyone can agree on is that the equity market is totally disconnected from economic fundamentals.

So when are we getting back to normal? That is, when do we go back to the way things were before the coronavirus? The question is phrased as if normal is an existing destination. It should be clear by now that normal no longer exists to return to. As investors are realizing, tomorrow's normal won't look like the past.

Spending is down but has skyrocketed in certain niches. Savings are way up. And bedrock assumptions about the economy are being rewritten in real time. Investors who are betting on things returning to a normal will miss the permanent cultural shifts being catalyzed by the virus. We discuss some of the unexpected impacts after a review of Q2 performance.

Q2 Economic and Market Performance Summary

Economic Performance

Surprising no one, the United States is now officially in a recession. Unemployment remains elevated but is quickly recovering from coronavirus-induced highs. In June, 4.8 million jobs were added following May's gain of 2.7 million. We are still down more than 15 million jobs from February, before the virus struck the US. Some states are testing the waters with reopening, as the virus continues to ravage the US. If states were countries, they would represent 13 of the 20 worst hit by the virus, as measured by infection per capita. More fiscal help is being discussed as the state-by-state patchwork of reopening is having mixed results.

Monetary Policy Review

Central Banks deployed monetary artillery to offset the damage done by the coronavirus. The Fed's alphabet soup of lending support programs total $2.3 trillion. So far, the Fed's interventions have worked. Equity markets are stable and credit markets are so robust that the Fed's much-touted Main Street Lending Program has sparked little interest from borrowers. Globally, central bank intervention as a virus response is the norm. Central bank balance sheets in advanced economies are projected to expand more than 20% by the end of the year

US and Global Equity Market Summary

Unprecedented amounts of monetary and fiscal stimulus has helped prop up the equity market. In quarterly isolation, equities had stellar performance. The S&P 500 was up 20%, the Russell 2000 up 25%, and the Dow up 18%. After a brutal Q1, most US indices are still down year-to-date, but significantly less than they were at the end of Q1. Volatility remains elevated after a massive Q1 spike. Equity market returns have been concentrated across a few stellar days – missing just five of the best trading days in 2020 would have lowered returns from borderline breakeven to down 30%.

The virus-induced global recession devastated equity markets outside the US in Q1. In Q2, those equity markets significantly rebounded from Q1's precipitous drops. Most, however, are still down double digit amounts year-to-date. Only China showed positive performance through Q2. Trade disputes are no longer in the headlines and, given the fragile state of the US equity market and the approaching election, may be unlikely to resume before 2021. All eyes are on a vaccine as an essential element to bringing markets and the economy towards full recovery.

Credit Markets

As defaults and downgrades surged in H1, investment grade issuance surged to a record level of $1.2 trillion thanks to the Fed's support. Investment Grade returns hit 5% YTD. There were moderate declines in the High Yield and Leveraged Loans markets, down YTD 3.8% and 4.6%, respectively. The Fed's unique interventions - purchasing ETFs and even individual securities - helped maintain order and restore investor confidence in the credit market. CLO markets remain dislocated, allowing flexible managers to take advantage of this specialized sector. With rates near zero and LIBOR hitting 5-year lows post Q2, yield remains elusive for most investors.

The full economic impact of the coronavirus has yet to be felt. We focus on a few key themes that can guide investors however long the recovery lasts. The longer it takes before the economy reopens, the more likely consumers will consider the present state of high savings, low consumption, and no in-person shopping or mass gatherings, the new normal. How should investors position themselves for an uncertain timeframe? Read on

An Increased Savings Rate Will Be the New Normal

The gig economy brings flexibility with the tradeoff of fewer benefits. Their jobs may not have been steady, but they were readily available and typically only an app away. Then came the coronavirus.

Suddenly, the flexible jobs that millions relied on disappeared. No industry was safe. In NYC, cab rides dropped from 506,000 rides a week before the pandemic to just 28,500, a 94% decline. Restaurants, travel, and retail industries were devastated as stores shut and spending plummeted. A new source of economic vulnerability was brought to light.

A famous, yet somewhat apocryphal, statistic is that 40% of Americans can't come up with $1,000 in an emergency. After the coronavirus, expect that number to decline as increased savings are becoming the new norm.

The US saving rate hit a record in April, spiking to 33%, an all-time high and nearly double the previous highest savings rate of 17.5% in 1974. The key question is if this is a temporary dislocation or a structural change. As the US is a consumer driven economy – US consumer spending accounts for 70% of GDP – a high savings rate will hold back recovery.

The collective action of prudent savers will be the invisible headwind to a full economic recovery.

Overall Spending Declines with Some Bright Spots

It's no surprise that overall spending is down. There are distinct sets of winners and losers, as measured by the year-over-year change in spending. Online platforms are crushing it. The winners of the quarantine: delivery services (+50%), gaming, e.g., Twitch, Nintendo, Fortnite, etc. (+75%), and online grocers (+80%), are all sectors that make the quarantine livable. The losers: basically everyone else.

A nationwide shutdown was imposed without much thought or discussion. People made do. Now, many are looking past the shutdown and envisioning a different future.

Twitter, for instance, will allow all staff to work from home permanently. Folks who now own a squat rack or an exercise bike might not ever return to the gym. With clarity derived from distance, people are realizing that they don't miss many of the pre-quarantine habits they once took for granted.

Habits adopted now will drive recovery in the short term, while permanent behavior shifts will drive long-term changes.

New Behavior and its Secondary Effects Will Be Key Investment Themes

"Social distancing means financial Armageddon for commercial real estate and municipalities in coming months," noted R. Christopher Whalen, an investment banker quoted in The Washington Post. Whalen believes the coming commercial real estate explosion will dwarf the residential mortgage bust of the 2000s. It's already starting to happen. Landlords have seen the percent of rent paid decline from 93.5% in May 2019 to 58.6% in May 2020.

If work from home maintains its popularity post-virus, municipalities will have to survive with less. Unbelievably, after the longest bull market in US history, pension plans as of Q1 were still incredibly underfunded. Yields are low and will remain that way for a while. Real estate investments are no longer the steady income source they were once assumed to be. It could get a lot worse.

If cities lose their desirability, those who can leave will flee to the suburbs for more space, better schools, and lower taxes. The remaining residents will have to cover high fixed costs. Because the first to flee cities are likely the well-off, the burdens will fall overwhelmingly to those who remain. Higher taxes will come with fewer services as pension funds become more underfunded and the underlying tax base retreats. This negative feedback loop has put state and local pension funds in a difficult position and their response is instructive.

Pension fund and large institutional investors who need both yield and non-correlation are turning to private assets, which now make up 26% of global pension fund assets. (Private assets include private debt, real estate, and private equity.) Such markets are not only shielded from some of the volatility of the public markets but also can offer diversified exposure that no liquid asset class is able to replicate. During the quarantine, asset selection helped selective managers position for a recovery. Credit managers with low leverage and dry powder were able to swoop in on select private transactions as markets reeled.

Market performance for the remainder of the year will be driven by the development of a vaccine and any second wave of infections. In both cases, expect a swift market response. Given the dispersion of returns and elevated market volatility, active asset selection can capitalize on winners and mitigate the losses for underperforming assets.

This time really is different. Prior recessions were the result of over expansion and financial excesses that needed to be worked through. We have never been in a self-induced recession before. Although the shutdown was forced by the government, consumer spending had dipped before it was imposed. Bars and restaurants saw significant revenue decline in early March and travel had already slowed. Consumers decided they didn't feel safe even before the quarantine went into effect.

Currently more than half of Americans won't attend a concert, sporting event or movie if there is no vaccine. This gives a hint to what a recovery could look like — it will happen when people feel comfortable going out and spending, not when the government allows it.

For investors, things are changing. Index funds may be losing their luster. Active and flexible asset managers are poised to take smart risks and capitalize on dislocations. The few managers that have experience over different market cycles, e.g., going back to the financial crisis and dot com bubble, are in a good position to take advantage of opportunities across different sectors. As yields remain low everywhere and the real estate sector seems vulnerable, other alternative investments may be able to provide what mutual funds and ETFs are lacking.

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