Appleton Partners, Inc.

An Age of No Limits

The Era of Big Government Is Not Over

As the calendar moves deeper into summer, we reflect upon a tumultuous quarter. The words "unprecedented," "challenging" and "difficult" seemed to be featured in every television commercial, let alone market commentary. COVID-19 unleashed a severe economic contraction and prompted the largest, most aggressive Federal response ever undertaken.

On April 9th, Federal Reserve Chairman Jerome Powell declared that the U.S. central bank was committed to "forcefully, pro-actively, and aggressively" helping the country recover, and that there were "no limits" to the money the Fed could deploy. The Fed has subsequently reinforced its steadfast support. The incredible Q2 rally in equities and other risk assets was bolstered by the breadth and potency of government intervention, although the eventual implications of these prescriptions remain unknown.

Awash in Stimulus and Liquidity

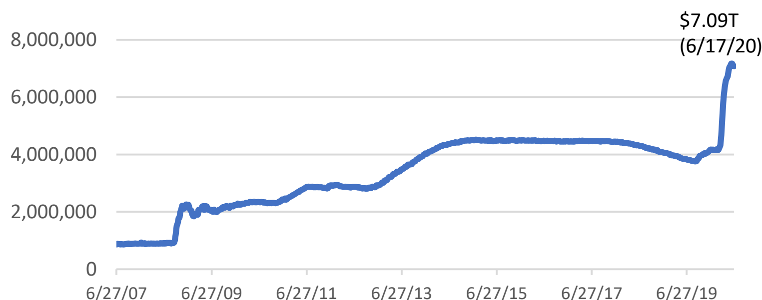
Cumulative monetary and fiscal stimulus may ultimately reach $11-12T, or 47% of GDP.[1] Federal spending through the CARES Act and other programs has provided badly needed income replacement, reduced job losses, and helped maintain the viability of countless small businesses. Central bank facilities also now offer a direct or implied backstop to the short-term funding, corporate credit, asset-backed, and municipal markets. In asset classes such as corporate bonds, the Fed has only recently begun to deploy significant amounts of capital, although its availability has emboldened investors and ignited risk appetite.

The US deficit will likely reach $3.7T in FY 2020, nearly 4 times greater than projected before COVID-19.[2] By comparison, during the Financial Crisis annual US deficits peaked at about $1.4T. The Fed's balance sheet, a proxy for the scale and scope of monetary operations, already exceeds $7T and may reach $10T by the end of 2021, up from less than $4T in Q4 2019.

A New Paradigm?

Traditional economics supports deficit spending when aggregate demand is lacking but cautions that runaway deficits risk pushing up interest rates, crowding out private investment, and eventually inducing inflation. Economists have also long warned that excessive liquidity risks undue speculation and even financial bubbles. Yet budget hawks who once bemoaned vastly smaller US deficits are quiet given the current urgency of large-scale Federal support, and almost by default, a new concept, Modern Monetary Theory (MMT), has emerged. MMT argues that countries that control their own currencies face no inherent spending or budget constraints because they can print money. Inflation is the primary risk should money supply growth far exceed economic capacity. Taxation is a tool to pull money out of circulation to fight inflation, although in practice raising taxes would be politically challenging.

Twenty-four years after President Clinton declared "the era of big government is over," we have come full circle. The intersection between public policy and the capital markets is now arguably more pronounced than at any time since WWII. So, what advice can we offer clients?



Source: St. Louis Federal Reserve

Stick to Fundamentals

Moral hazard is a condition in which one takes on greater risk because someone else is assuming the potential costs. Although Fed liquidity and credit support is a powerful stabilizing force, it runs the risk of inflating asset values, particularly with bond markets seemingly healthy.

At Appleton, we look at credit analysis and equity research on a security specific basis independently of potential external support or market intervention. For example, the possibility of Fed bond buying should not displace assessment of an issuer's underlying creditworthiness. Our focus on quality will not change and across asset classes we invest when a security's price suggests fundamental value, not based on an anticipated external backstop.

Avoid What You Do Not Understand

With Fed Funds likely anchored at 0 – 0.25% well into 2022[3], savers face paltry returns. This can lead to misguided decisions, such as reported by the WSJ on June 1 relative to large losses incurred by retail investors in leveraged Exchange Traded Notes (ETNs). ETNs are structured products that track the value of an underlying asset while using derivatives that amplify gains or losses. Complex products have long been marketed as opportunities to enhance income and total return, yet absent a thorough understanding of an instrument and its risks, we advise staying away.

Focus on What You Can Control

Macroeconomic forecasting is inherently uncertain, and today's environment is no exception. How this age of no limits ultimately plays out will be fascinating. Opinions abound and there are no clear answers. Nonetheless, we are optimists and believe in our ability to find attractive investments in ever changing markets. Proprietary analysis drives our investment process and we also emphasize fundamentals in personal financial planning. We recommend clients focus less on economic and market projections and more on their family's financial needs and circumstances. Revisit goals, time horizon and risk tolerance. Because committing to a well-structured, long-term asset allocation plan offers the best means of navigating uncharted waters.

1. Morgan Stanley Wealth Mgt., 6/15/20 2. CBO, as reported by Roll Call, 6/8/20
3. Federal Reserve minutes dated 6/10/20

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q2 2020 began with a slight uptick in yields after a strong Q1 rally before prices once again rallied as demand accelerated and credit spreads tightened over the remainder of Q2.
- Municipal fund flows strengthened in late May after early Q2 outflows. $15.5B of net inflows were posted over the last 7 weeks of Q2, with Long-Term funds gathering more than half. Intermediate and High Yield funds brought in about $2B each.
- The short end of the muni curve steepened during Q2, in part due to an expectation of no change in Fed Funds into 2022. The overall curve reflected a bull steepener with yields falling across maturities.

AAA Muni	3/31/20	6/30/20	QTD change
2-yr	1.06%	0.27%	-79 bps
10-yr	1.33%	0.90%	-43 bps
30-yr	1.99%	1.63%	-36 bps

- Liquidity remains at a premium. SIFMA, the weekly VRDN benchmark, began Q2 at 1.83% only to quickly drop to 0.36% by 4/15 before grinding lower to finish Q2 at a paltry 0.09%. Selling of VRDNs ahead of an extended 7/15 tax deadline is likely.
- After falling in March, issuance slowly returned in April and May as markets strengthened before ramping up in June (+23% vs. June '19). Total YTD issuance is now up 14.3% vs. 2019, largely due to taxable muni issuance rising 230%.
- New taxable muni supply is masking a 9.1% decline in YTD tax-exempt new issuance. Consensus estimates now call for about $415B of total 2020 muni issuance, down from $430B anticipated at the outset of the year.
- The bid-side remains strong and there is relative value vs. USTs. Despite receding from Q1 highs, the 10-year AAA Muni/UST ratio ended Q2 at 134.3%, still elevated vs. a post-1990 average of 86.8%.
- The Fed should remain highly accommodative and it is difficult to see UST yields moving materially higher anytime soon. Our 10Yr UST trading range stands at 0.60–1.20%, although we are mindful of longer-term budget and Fed balance sheet impact.
- Our Intermediate Municipal duration target is 4.65-4.75 years and we expect the curve to maintain its relative steepness with Fed Funds anchored at 0-0.25%.

Investment Grade Corporates & Treasuries

- Fed rate cuts altered the UST curve over the course of Q2. A reduction in the discount rate from 1.75% to 0.25% drove rates inside of 10 years down by 126 to 143 bps, whereas long bond yields fell by 98 bps. We expect range bound yields during the 2H of 2020 given rising COVID-19 cases and resultant economic weakness.
- The Fed's normalization efforts initiated in 2017 have been tossed aside as its balance sheet now exceeds $7T. However, inflation remains muted which should keep yields very low for some time to come.
- The Fed's market support was extended in June to include the purchase of $428M of individual corporate bonds. Their broad backstop has enhanced investor confidence, although we remain vigilant about security specific credit analysis given low nominal yields, tight spreads and ongoing economic risk.
- Retail flows over the last several months have been very strong. YTD net flows into IG bond ETFs of $76.96B greatly exceed $56.45B realized over the same period last year.

Equities

- The S&P 500 enjoyed its best quarter since 1998, recouping the majority of its Q1 losses. Historic monetary and fiscal policy response in April and May eased investors' worst-case fears, and the economy began to reopen.
- The equity markets have diverged considerably from the economy, which has steadied but remains far from pre-pandemic levels. Investor skepticism is reflected by sustained equity fund outflows. By contrast, money market funds have added $1T since March to a near-record $4.7T. This "dry powder" could prove to be a 2H tailwind.
- The growth style's persistent outperformance relative to value has been led by Technology and Healthcare. This trend aligns with our focus on larger stocks with attractive growth characteristics and healthy balance sheets.
- Q2 earnings season will be revealing. Consensus S&P 500 earnings estimates of -44% for Q2 and -22% for FY20 have stabilized after sharp declines, thereby giving the market a confidence boost.
- Falling earnings expectations coupled with a surge in equity prices have left valuation levels at multi-year highs. While we do not see much short-term predictive power, it leaves a much narrower margin of error for a market already facing questions about COVID-19, economic reopening, further stimulus prospects, and the upcoming election.

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