Stagonomics

Weekly Market Recap

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As we encroach upon the fifth week of quarantine, equity markets are beginning to provide glimmers of hope. For investors, this hope has been derived from the speed with which equity prices have recovered over the past two weeks. After declining approximately 37% from its February peak, the Dow Jones Industrial Average has recovered about 30% of these losses in the past month. No other bear market has featured such a potent recovery from its bottom, which is a strong indication that this particular “bear” market will be historic both in terms of its severity and brevity. The combined efforts of Congress and the Federal Reserve has injected

optimism into the investment community, allowing some investors to now feel comfortable purchasing securities given the economic backstop provided by these two entities. After all, history has proven that "fighting the Fed" has been a losing proposition for investors. Credit markets have also indicated some positivity, as credit spreads and the yield curve are beginning to revert back to levels that are consistent with less stress in the marketplace. It seems that given the current status of the campaign to contain the coronavirus, financial markets have looked past the worst of this economic and financial shock. However, we have not yet emerged from the proverbial woods, as we still must figure out how to safely and productively reopen the economy and get people back to work.

Although we originally doubted the merits of this most recent rally in equity prices, the strength and speed with which equity prices have recovered is encouraging. Being that equity markets reflect *future* economic expectations, one can conclude that the worst of this economic lockdown has already been priced into risk assets. This, however, does not mean that investors should become complacent, as the potential for a correction still exits, especially considering that most indices are in overbought territory. However, despite the possibility of a near term correction, we believe that this rally is here to stay, so long as the government can successfully reopen the economy and seamlessly get people back to work.

Our positive outlook in regard to this rally depends on the cooperation of credit markets. We would like to see a continuation of the loosening of credit conditions as indicated by the following market dynamics.

The first dynamic we would like to see continue is the tightening of credit spreads. Credit spreads typically act as a strong indicator of investor confidence, as more confident

investors play a role in tightening credit spreads by demanding riskier assets. The excess demand for these riskier assets depresses their yield, causing the spread between riskier corporate debt investments and riskless government debt investments to narrow. This phenomenon occurs as investors become more comfortable in the given economic environment, as a stronger economic backdrop bodes well for riskier investment endeavors.

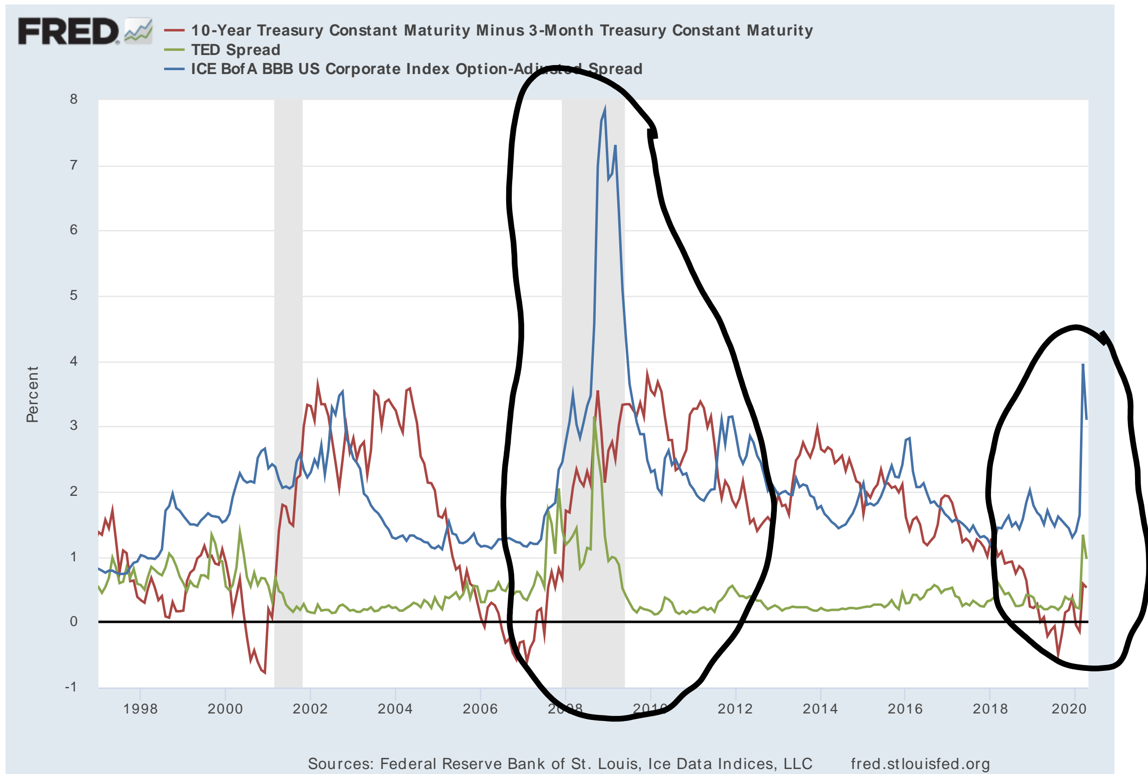
In a similar manner, we are also monitoring the slope of the yield curve as we believe it will provide timely signals about the state of the economic environment. For example, before the onset of this economic crisis, the spread between the 10-year US Treasury Bond and the 3-month US Treasury Bill went negative. This phenomenon typically precedes a recession. However, almost a month after turning negative, this spread dramatically increased by about 136 bps. This increase in the spread between long and short term government securities occurs as a response to the Federal Reserve's attempts to reinvert the yield curve by reducing interest rates on shorter-term government securities. As prior economic crises have ensued, this spread between long term government securities and short term government securities had remained elevated for an extended period of time. However, during this particular economic crisis, the spread between longer term and shorter term government securities as indicated by the 10-Year US Treasury Bond and 3-month US Treasury Bill receded almost immediately after the original spike. We believe that this dynamic is a positive development, as it indicates that liquidity conditions in the economy have returned to a normal, less volatile state.

In conjunction with the yield curve and credit spreads, we also monitoring the TED spread to gauge the state of credit conditions in the economy. This spread has acted in a similar manner to the spreads on Treasury securities. The TED Spread increased substantially during

the liquidity crisis that emerged on March 18th, however in recent weeks it has rapidly decreased, indicating that credit conditions have become more accommodative, which bodes well for the soon-to-reopen economy.

The combination of these three credit market dynamics are important to monitor as they offer key insights into economic and financial conditions. If the trends referenced above begin to reverse, we will again start to question the validity of this rally.

It is our hope that these positive dynamics continue, however we have identified some potential headwinds that could undermine the durability of this rally. Firstly, we believe that there is a potential technical set up that could exacerbate a downward move in equity prices. Bets against the S&P 500 have been mounting, and being that the index is currently overbought, this short interest could potentially exacerbate a move to the downside. The second headwind risk lies in the preemptive opening of the economy. If the Trump administration is too hasty in opening the economy, a relapse is possible, which would severely undermine an economic recovery.



Here are the three credit market indicators we are monitoring. Notice the similarities between the trend that is occurring now and the trend that occurred during the 2008 financial crisis.