Abner Herrman & Brock
asset management

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Searching for Visibility

In the second quarter, we experienced one of the most dramatic stock market rebounds in history. Since falling to its low on March 23rd, the S&P 500 index subsequently rebounded over 30%. There were several factors which combined together provided the rationale for investor enthusiasm. The Federal Reserve's actions of lowering interest rates and buying back corporate debt, in coordination with the US Treasury's stimulus, improved the prospects for a US economic recovery. The curve in COVID-19 cases had been flattened in the largest hotspots which led states to begin to reopen and finally, investors became optimistic that a vaccine would come to the market soon and bring life and the economy back to normal. More recently, the pullback in the market has been a consequence of an increase in COVID -19 cases in some states as a result of reopening.

Unfortunately, there is limited visibility on the timing and the trajectory the economic recovery will have when it emerges from the full shut down. Whether the recovery will be a "V" shaped recovery or a "U" shaped, which infers a more protracted recession, will have an impact on growth expectations for corporate earnings. Until there is a vaccine, the normalization of everyday life will be hindered. Thus, the viability and timing of a vaccine is paramount. Additional concerns for corporate earnings include the recurring trade tensions with China and of course, the presidential election in November which will certainly portend potential policy changes which will vary the outlook for the economic recovery and thus, stock and bond prices.

Complicating matters is the challenge of measuring the economy during this period of shut down. The ability to gather accurate data has become more difficult which has rendered traditional economic statistics relatively meaningless. For example, the unemployment rate had large swings from month to month because of the closing and reopening of various businesses during the period. May's jobs data included a significant percentage of employers that resumed hiring as the economy slowly started to open up again. Although this rise insinuated that a lower unemployment rate could be expected in the future, the expectations are not fully reflecting the number of businesses or employees that will never return to work. When the statistics become less volatile, the numbers will be more meaningful and reflective of the underlying longer term economy. In the meantime, however, it leaves a void of requisite information from which to gauge future growth and thus limits investor visibility.

Fixed Income

The bond yield curve in the quarter reached its steepest pitch since 2016. This is the result of both non-market and market forces. The non-market force being the Fed depressing the short end of the yield curve via its decision to buy corporate bonds with a maximum five-year maturity, a form of monetary stimulus. The intermediate part of the yield curve has not declined as precipitously, not only, because it does not have the same 'Fed' buying, but also because of the expectation for a return to a normal level of inflation in the future when the economy recovers after moving past the pandemic. This part of the yield curve is much more reflective of market activity and thus economic expectation.

Corporations have taken advantage of the lower interest rates and have already issued over $1 trillion in new debt in the first five months of 2020. The amount of debt issued this year is more than the full year 2019. Some companies are issuing debt to help cover short term cash flow concerns but many companies are issuing longer term debt. More specifically, many companies are choosing to issue ten year bonds rather than five year bonds to lock in the lower rates for a longer period of time. The Fed's statement that it does not plan on raising interest rates until at least 2022 provides the expectation for the yield of short term maturities to remain very low. Therefore, the steeper yield curve provides an attractive yield to maturity for investment grade corporate bonds in the five to ten-year maturity range.

Taxable Bond portfolios are positioned with a ten-year maturity ladder which has slightly increased the portfolio duration. The individual bond holdings are evaluated using our rigorous credit research process. We identify investment bond opportunities by employing quantitative credit screens which highlight the relative attractive valuations for each available issue. These research screens include a thorough analysis of proprietary measures of each firms' interest coverage, overall level of debt, and its future earnings prospects.

Municipal Bonds have offered more attractive yields because of the concern of states and local governments to manage through the costs of the pandemic. In an unprecedented action, the Fed promised to buy shorter maturity municipal bonds and thus flooded the market with confidence. Similar to taxable bonds, this has decreased the yield on short maturities, while the curve has steepened to provide additional return for intermediate maturities. For clients in higher tax brackets and in higher taxed states, these returns are especially attractive on an after-tax basis, particularly relative to inflation.

Municipal bond securities are reviewed by our proprietary municipal bond credit screening process before they are purchased for client portfolios. The analysis screen evaluates the amount of reliance a municipality may have on state funding versus funding from property taxes, which are much more stable. Additionally, the bond must have an underlying rating of A or better, a positive fund balance and include hurdles for various evaluation of metrics which include geographic, demographic and climate risk in order to discern the highest quality investment opportunities.

Equities

The exuberance of the stock market during the quarter caught many investors by surprise. COVID -19 has begun a tectonic shift in the way we work, shop and live. In response to this shift, AHB has repositioned the equity and balanced client portfolios by investing the portfolio in companies that can grow their earnings in our new normal environment and reducing exposure to those areas, such as travel and hospitality which are negatively impacted.

The two sectors that appear to be able to provide solutions to the problems of the pandemic and thus may have opportunistic future growth as a result include Technology and Healthcare. The technology sector is leading the market, returning just over 11% for the year with the five largest technology companies now comprising 20% of the S&P 500's total market capitalization. Another sector that may benefit is the Industrial sector, from a future infrastructure bill, as well as increased Defense spending due to heightened tensions with China and rising geopolitical tensions globally.

In closing, these are unprecedented times for the world. Managing investment portfolios in this climate requires focus, endurance, stability and fortitude. Our relentless dedication to consistent risk adjusted returns has allowed AHB to thoughtfully reposition the client portfolios from the pre-pandemic global outlook to the post-pandemic environment. We are finding investment opportunities in new areas that may thrive in the new environment. Our research efforts are focused on seeking to identify change and we expect these world changes to create new and different investment opportunities in the years ahead. We are enthusiastic and optimistic that there will be a return to normalcy and we look forward to the many silver linings that will become apparent in the months and years to come.

Have a safe, healthy and restful summer.

AHB Investment Team

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