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Marketing Material

BEYOND THE BOUNCE: CREDIT SPREADS – AN EQUITY ALTERNATIVE

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IN A NUTSHELL

_ The sharpest GDP decline and bounce appears to have occurred within the second quarter.
_ Wide credit spreads are equity alternatives: spreads are tighter, but still attractive.
_ Stimulus 4.0 in the political works: municipal credit and some big banks should benefit.
_ Second-quarter earnings season – after week one: capital markets buzz, lenders brace.

THE SHARPEST GDP DECLINE AND BOUNCE APPEARS TO HAVE OCCURRED WITHIN THE SECOND QUARTER

As data pours in for second-quarter earnings and the U.S. economy, it seems that the sharp decline and initial bounce in jobs and consumer activity both occurred within the second quarter. The bounce came earlier than we expected, beginning in mid-May, but it is losing momentum early in the third quarter given the spread of the virus to the U.S. south and west and the slow and cautious return to people's normal working and spending routines in the hard hit northeast.

Continuing jobless claims are down 7.5 million from the 25 million early May peak, but weekly initial claims remain troubling at 1.3 million last week and are now probably related to longer lasting layoffs. Retail spending on goods rebounded strongly in May and June. June was up 1% year-over-year, only -1% from January and the second quarter was -7.5% vs. the first quarter. Goods are a third of personal consumption and services two-thirds. Services are vulnerable in this pandemic recession. Retail sales on goods and credit-card data provide helpful consumer indicators, but service spending on healthcare, shelter, education, childcare, travel, entertainment and other services are larger and take longer to accurately assess for final GDP measures.

There is also the matter of consumption vs. payment, as rent and loan delinquencies have jumped and healthcare consumption shifts to emergency Covid-19 treatment. We do not mean to be pessimistic or discount the recovery and resilience of the U.S. economy during this sudden and severe shock, but we think the damage to the economy in the second quarter has yet to be well measured and understood. If the second quarter includes the worst of the shock (lockdowns), but also the best of the reopening and stimulus bounce, then the year still has big challenges.

WIDE CREDIT SPREADS ARE EQUITY ALTERNATIVES: SPREADS TIGHTER, BUT STILL ATTRACTIVE

Credit spreads can be thought of as an asset class separate from bonds. Credit spreads are clearly a risk asset like equities, but as an isolated risk premium (comparable to an equity risk premium) they are neither a real nor simple nominal asset. Commodities, real estate and equities should have returns that pass through inflation over the long-term through inflationary pricing power; owing to production and associated asset replacement costs that rise with inflation. However, nominal assets like cash and bonds do not have such natural inflation pass through, which makes inflation their nemesis. But inflation does not threaten spreads; it is usually beneficial, particularly when recovering to normal (reducing default risk). Owning corporate or municipal credit against duration matching Treasury shorts or equivalent futures positions, allows spreads to be targeted investments. A combination of credit and inflation spread targeted investing can be an equity alternative.

Investment-grade corporate and municipal credit spreads have tightened a lot since March, but both remain wider than historical norms. Our asset allocation strategy this crisis has been to overweight large cap growth stocks and seek value in investment-grade bonds. Equities have outperformed credit, owing mostly to mega-cap growth stocks, but credit has kept pace with value equities. While some think that value stocks will now lead a further equity rally, we prefer to still stick with credit and seek more bond substitutes if technology does not deliver very strong earnings beats and outlooks during the second-quarter reporting.

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STIMULUS 4.0 IN THE POLITICAL WORKS: MUNICIPAL CREDIT AND SOME BIG BANKS SHOULD BENEFIT

The Federal government's response to the municipal-bond market has been sufficient to date, but more should be needed soon for state and local governments given sharp tax-revenue declines unlikely to recover soon. We expect Congress to pass another +1 trillion U.S. dollars stimulus package this summer. It should include support to state and local governments and extend, albeit reduce from 600 U.S. dollars, extra weekly unemployment benefits beyond July 31. This fiscal support, should help municipal-credit spreads tighten more and temper the outlook for loan losses at banks. The biggest banks are our preferred play in value stocks, but at other value industries we generally still prefer the issuer's bonds. Municipal spreads might benefit the most from the next stimulus, as A-rated tax-exempt muni bonds are less expensive relative to similar A-rated corporate bonds, currently offering a spread of +13 basis points (bps) compared to the 5-year average of –55bps. DWS reduced its 2020 tax-free muni supply forecast to 375 billion dollars (from 440 billion dollars) as we expect new money issuance and refunding to decline due to Covid-19 and higher muni yields. This represents an 11% decline in supply from 2019.

SECOND-QUARTER EARNINGS SEASON – AFTER WEEK ONE: CAPITAL MARKETS BUZZ, LENDERS BRACE

Bottom-up second-quarter S&P 500 earnings per share (EPS) dropped slightly to 23.22 dollars, -43% year-over-year, after last week's reports, despite a 5%+ beat led by big banks owing to further estimate cuts elsewhere. Blended sales growth is -11.2% year-over-year and the net margin is 7.7% vs. 11.7% last year. Big banks had very strong capital markets revenue, but much of that was offset for the group overall by large loan loss provisions (LLPs). The 10 S&P 500 banks that reported so far took a 39.2 billion dollars LLP in the second quarter, which is 0.8% of their total net loans. This compares to a 30.0 billion dollars LLP for all 18 S&P 500 banks or 0.5% of loans in the first quarter and a 46.4 billion dollars LLP or 1.2% of loans at the pit of the financial crisis in the second quarter of 2009. Big banks may continue to build loan loss reserves through 2020, but the rate of provisioning has probably peaked. We believe some big banks offer value if the recovery and stimulus are adequate to put the highest loan loss provisions behind and to substantially normalize in 2021.

GLOSSARY

One basis point equals 1/100 of a percentage point.

A corporate bond is a bond issued by a corporation in order finance their business.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Large cap firms generally have a market capitalization of more than 10 billion dollars.

Loan-loss provisions are an allowance for bad loans, for example due to customer defaults or a renegotiation of the terms of a loan.

Municipal bonds (Munis) are debt securities issued by a state, municipality or country.

In economics, a nominal value is not adjusted for inflation; a real value is.

In economics, a real value is adjusted for inflation.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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