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2020 Q2 Economic Recap and Rate Outlook

Scott McIntyre, CFA
HilltopSecurities Asset Management
Senior Portfolio Manager
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP
HilltopSecurities Asset Management
Senior Portfolio Manager
Director
512.481.2012
greg.warner@hilltopsecurities.com

The second quarter began with much of the nation hunkered down to weather what many expected to be a very intense, but short economic storm. The sheer amount of virus-related information gathered and released during the quarter was staggering, and because the contraction happened so quickly, many of the economic numbers were immediately too stale to be relevant. Analysts were lost. It was like putting together a jigsaw puzzle without a picture on the box. As a result, forecasts were often wildly off the mark and many subsequent data revisions were epic in size, but in the complete absence of certainty, the primary focus was on jobs.

The initial sign of serious economic damage emerged in the weekly filings for first-time unemployment benefits. Total filings during the final two periods in March were nearly 10 million. Over a 15-week period ending in late June, the total number of filings topped 48 million. It's highly unlikely that all of these people actually received benefits as the rush to file completely overwhelmed systems in several states. Adding to the mess were countless confused people filing in error.

The first ugly employment report from the Bureau of Labor Statistics (BLS) arrived in early April. The unemployment rate climbed from a 50-year low of 3.5% to 4.4% in March, while nonfarm payrolls shed -701k jobs. The first outright decline in 9½ years ended a record string of 113 months of positive job gains, but it would get much worse. The April report showed company payrolls fell by 20.5 million…which turned out to be a bit of a relief given that the forecast had indicated 22 million. The unemployment rate told a similar story as the 14.7% April headline fell short of the 16% forecast. Still, the official unemployment rate had more than quadrupled from a 50-year low to an eight-decade high in just two months, and the rate was actually understated by nearly five percentage points due to misclassification errors. Another under-reported fact was the number of people working part-time but preferring to work fulltime nearly doubled in April to 10.9 million, driving the so-called underemployment rate up from 8.7% to 22.8%. Bloomberg Economics determined 30% of job losses sustained from February to May were at risk of being permanent.

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The BLS employment reports for May and June were both stronger than expected, with payrolls (re)adding 2.5 million jobs in May and 4.8 million in June as the economy gradually reopened. Over the same period, headline unemployment dropped from 14.7% to 11.1%. This is encouraging, but at this point businesses have essentially returned a third of the workers they'd laid off in the spring, and even that doesn't tell the whole story. According to the Department of Labor, for the week ending June 13th (corresponding with June BLS report), the total number of Americans receiving either state or federal unemployment benefits rose from 30.6 million to 31.5 million, driven entirely by a 1.8 million increase in the "Pandemic Unemployment Assistance" program.

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While many industries suffered, some adjusted quickly and many thrived. The crude oil industry experienced all of these within a two-month period. Energy investors watched in horror in mid-April as the contract price for May delivery of West Texas Intermediate Crude (WTI) experienced a crash for the ages, sinking from around $18 per barrel, blowing past zero to close in negative territory at -$37.63. Simply put, demand had evaporated due to the global shutdown and storage capacity was mostly filled up. There was too much oil and nowhere to put it. This imbalance corrected itself as quickly as it had evolved, through voluntary and forced production cuts and a gradual reopening

of the economy. In May, oil prices surged by a record 88%. By late June, WTI crude was trading back above $40 per barrel. The International Energy Agency (IEA) proclaimed that oil demand would rise by a record 5.7 million barrels per day in 2021, deemphasizing the forecasted -8.1 million barrel per day drop in 2020.

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By most indications, the housing market should probably be floundering, but a combination of online home searches, historically low lending rates, and anecdotal evidence suggesting workers (no longer tethered to their offices in the city) are fleeing to more wide-open spaces in the suburbs, have provided a much needed spark. Existing home sales dropped to a decade low in May after cresting at a 13-year high in February, but a +44% rise in May pending home sales signaled a near-term reversal of the downtrend. New home sales, a timelier indicator, fell in March and April, but staged a strong recovery in May. Going forward, housing will benefit from record-low lending rates, but will likely be restrained by tightening credit conditions. Inability to make payments has clearly concerned lenders as the Mortgage Bankers Association (MBA)'s Mortgage Credit Availability Index dropped to a 6-year low in June.

The auto sector was particularly vulnerable as very few Americans were driving in April, and with unemployment soaring, it didn't feel like a good time to buy. On the other hand, car dealers offered heavy discounts and many consumers were flush with government relief funds. Sales plunged in March and April, but rebounded sharply in May and June, essentially wiping out new car inventories during a period when vehicle production had been halted. According to Ward's Auto, April supply peaked at an overstuffed 119 days, but fell to 61 days in May. Both Ford and GM are poised to ramp up production in July, but Cox Automotive warned that "inventory shortages, fewer incentives, weaker demand and tightening auto loan standards could slow the industry's sales momentum in the second half of the year." The lack of new vehicles put pressure on the used vehicle market as wholesale prices on used vehicles rose 5.74% in the first half of May from the same period last year. This prompted CarMax, the nation's top used car dealer, to recall over 10,000 of the 15,000 employees it had furloughed in April.

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Overall retail sales dropped a record -8.2% in March, before smashing that record in April with a -14.7% plunge. However, in May overall sales rocketed upward by +17.7%, leaving retail sales just 8% below the pre-virus period from a year ago. Unfortunately, the two terrible months have been enough to crush businesses already operating on the margin. As the stores shutter, Moody's Analytics projects retail vacancies to reach a record 14.6% in 2021. In an odd twist, the WSJ reported that many retail stores plan to put spring clothing in storage for next year instead of slashing prices to clear inventories.

On June 8, the NBER Business Cycle Dating Committee confirmed the obvious: The U.S. had officially entered recession. The NBER identified February as the end of the longest economic expansion on record and determined the contraction began in March...And, it likely ended in May as sales and employment rose sharply from still undetermined depths. All indications point to both the deepest and shortest recession on record, although the initial reading of second quarter GDP won't be released until the end of July. Technically, it may be over, but it won't feel like a recovery. The damage was jaw-dropping, and in all likelihood what transpired in just a few short months will dramatically reshape daily life for many years to come.

It's been said many times, but is worth repeating: The virus will ultimately determine the timeline of the recovery. Unfortunately, this became painfully clear in mid-June. The seven-day moving average of new cases in the U.S. retreated for much of the quarter, bottoming out at 21,282 on June 9th. Since that time, as Americans resumed normal activities, the cases began to creep higher. By the end of June, in just three weeks, the 7-day average (Worldometer) had increased by over 100%. On July 2nd, the single day total topped 57,000 with the July 4th weekend suddenly looking quite ominous. But, while cases have increased, virus-related deaths have clearly trended lower. At the end of June, nationwide seven-day average fatalities had dropped to 596, down nearly 75% from its peak in mid-April. Experts believe the decline in deaths is due in part to increased testing, improved

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treatments and the fact that the virus is now affecting a disproportionate number of younger (and generally healthier) Americans.

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While GDP was tumbling, stocks were already in recovery mode. As the virus reasserted itself, stocks barreled forward. The NASDAQ Index reached a fresh historical high to end the quarter, while the S&P 500 index crept within 1% of its 2020 opening level. Clearly, Q2 earnings will be hammered, but with about 40% of S&P 500 companies suspending their earnings forecasts for the year, all bets are off. Momentum and fear-of-missing-out, along with the problem of where else to put investment dollars are contributing to the rally…as is blind hope. However, Bank of America's June Global Fund Manager Survey indicated many professionals are skeptical, with bears outnumbering bulls by over a three-to-one margin. A majority of these managers believe we're in the midst of a bear market rally and not the beginning of a new bull market. Actions by Congress and the Fed have fueled stock gains and postponed numerous bankruptcies, but nearly 20% of U.S. companies now fall into the zombie category, according to research firm Axios, meaning profits can't cover debt service cost.

Bond yields, already near record lows all along the curve, were uncharacteristically stable throughout the quarter. The Fed, not expected to raise rates until late 2022 at the earliest, has flattened out and anchored the short end of the yield curve, while QE, low inflation expectations and negative global yields have capped the intermediate to long end. For the foreseeable future, bond market volatility is likely to be minimal.

Q2 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	3/31/2020	0.00%-0.25%	0.06%	0.15%	0.25%	0.38%	0.67%
High			0.19%	0.22%	0.26%	0.47%	0.90%
Low			0.03%	0.11%	0.14%	0.27%	0.56%
End	6/30/2020	0.00%-0.25%	0.03%	0.15%	0.15%	0.29%	0.66%

Source: Bloomberg

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Economic and Interest Rate Outlook

The quarter began and ended at a crossroad. The virus threat intensified, diminished, and then reemerged. Depending on your point-of-view, the economy could go either way. Amid so much uncertainty, there's plenty of support for either outcome, but concern is warranted. Richmond Fed President Thomas Barkin compared the economic trajectory to "riding the elevator down, but needing to take the stairs back up."

After crashing to historical lows, the first few steps are easy, but further gains will be dependent on whether or not Americans feel safe enough to emerge from their homes and resume normal activities. Social distancing is incompatible with economic growth. According to a new ABC News poll, the number of Americans worried they'll be infected by the virus has risen from 69% in early June to 76%, with 56% now believing the economy opened up too quickly. The path of the virus has much to do with the gloomy outlook as the quarter ended with daily new cases reaching a record high over 22 consecutive days.

Everyone has an opinion, but if the infectious disease experts and the Fed Chairman are to be believed, the current situation has grown more serious. In an interview on June 29th, infectious disease expert Dr. Tony Fauci told a Senate panel he was "very concerned" about the direction of the spread and warned that if Americans did not take precautions

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new cases could rise to 100,000 a day. That same day, Fed Chairman Jay Powell, testifying before the House Financial Services Committee, acknowledged the recovery had begun sooner than expected, but the outlook is "extraordinarily uncertain and will depend in large part on our success in containing the virus." Powell also said "a full recovery is unlikely until people are confident that it is safe to reengage in a broad range of activities."

In late June, the IMF revised its 2020 global growth forecast sharply lower from -3% to -4.9% and its U.S. forecast from -5.9% to -8.0%. Weeks earlier, the World Bank had predicted global growth at -5.2%. The IMF expects the global economy to expand by +5.4% in 2021 and the U.S. by +4.5%, but cautioned that downside risks remain significant.

We're clearly in the midst of an economic rebound, but up to this point, it's been driven mostly by hope, as well as massive government spending and Fed support. As of early June, CARES Act direct payments had been sent to 160 million Americans totaling almost $270 billion. In addition, approximately 30 million Americans have received an additional $600 per week in unemployment benefits over and above state benefits, which average less than $400 per week. According to Barron's, the median unemployment benefit had swelled to 134% of worker income with 20% receiving twice the income they'd previously earned. The big question for individuals who are still not working is whether that $600 per week government subsidy will be extended beyond July 31st …and the answer may well be no. Labor Secretary Eugene Scalia said in early July that the economic recovery has been better-than-expected, and does not believe it necessary to extend the emergency unemployment program. This may be the fiscally appropriate action, but it won't help grow the economy.

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The Paycheck Protection Program (PPP) had doled out forgivable loans totaling over $520 billion to nearly 5 million U.S. "small" businesses, intending to cover about two-and-a half months of operating costs. The original deadline to apply timed out on June 30th, but with approximately $140 billion remaining in the fund, the deadline to apply was extended to August 8th, giving this business lifeline another month. PPP has kept millions of companies with fewer than 500 employees afloat, but here too it isn't yet clear whether additional dollars will be allocated when the original amount is depleted.

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State and local governments are facing a budget gap estimated at $1 trillion next year as tax and fee revenue collapse. The initial $500 billion in CARES Act support wasn't nearly enough. Without additional assistance, massive cuts to services and personnel are likely to follow. The Economic Policy Institute estimated state and local job losses of 5.3 million in 2021 in the absence of a substantial aid package.

The final first quarter GDP report, released in late April, showed the U.S. economy contracted by an annualized -5.0%, the worst showing in 11 years. The initial measure of second quarter GDP won't be released until the end of July, but it's certain to be the weakest single quarter on record. Forecasts are all over the board (and being recalculated daily) but the Atlanta Fed's GDPNow model had calculated an eye-popping -36.8% plunge as of July 1st. A drop of this magnitude leaves behind a lot of damage. The CBO forecasts that every quarter through the end of 2021, American consumers will buy $300 billion to $370 billion less than they would have if the pandemic had never happened.

The easy part of the economic recovery is now behind us. Flipping the switch from closed to open unleashed a wave of pent-up demand and brought back a third of furloughed workers. The June Bloomberg economist survey showed a median second quarter GDP forecast of -35%, followed by a +19.9% rebound in the third, but as we move forward, it gets more challenging. As mentioned earlier, additional government spending would help, but with the national debt now above $26 trillion, Congress may be less generous going forward. The Fed has pledged to continue backstopping debt of all varieties and is unlikely to raise the overnight target in the foreseeable future. In fact, not a single FOMC member expects a rate hike this year or next, while just two of 17 expect a single quarter point increase in 2022.

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With interest rates certain to hover near zero for years, the cost of debt will remain low. This is a big plus when climbing out of a major contraction, both for individuals and businesses. Household balance sheets were in relatively good shape when the year began, and with stocks recovering almost all of their 2020 losses and home prices resiliently high, this remains the case for many Americans. Consumers will also find relief at the gas pump as the national average for a gallon of gasoline over the Fourth of July weekend was the lowest in 15 years. And perhaps the best hope for an extended rebound is on the virus front. A tremendous amount of progress has seemingly been made not only on the vaccine, but also on COVID treatments. Forbes reported there are more than 100 vaccines in the development stage with nine of these already in human trials, while Gilead's Remdesiver has been shown to reduce both symptoms and recovery time. With the fatality rate falling sharply and mask use gaining acceptance, there's reason to expect Americans will sidestep another lockdown even if cases continue to rise. In the meantime, the fabled v-shaped recovery is on the backburner as the third quarter begins with more questions than answers.

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