COHO PARTNERS, LTD.
Economic Commentary

Second Quarter 2020

““Wait a minute, Doc. Are you telling me you built a time machine...,”

-- Back To The Future   1985

OVERVIEW:

For many 2020 has already been the longest year of our lives. Some have already compared this year to an evil cocktail of the worst parts of 1918, 1932 and 1968 combining the horrible mortality and economic impacts of the Spanish Flu and the Great Depression with the social and political upheaval of the most tumultuous year of the late 1960s.

The last six weeks have exposed an underbelly of our society long ignored with an escalation of riots in over 75 cities in the United States in response to several high-profile murders of black Americans. The ultimate tipping point may have been the appalling murder of George Floyd by Minneapolis police officers on May 25th. The outrage is palpable and not surprising and, as in 1968, the social, economic and political divides and highly polarizing Presidential election could signal a challenging turning point for our country.

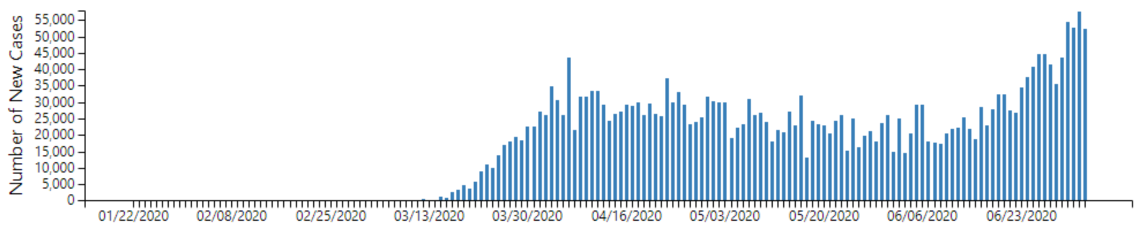
Exacerbating this turmoil is the global pandemic that has already taken the lives of over 130,000 Americans and is disproportionately impacting African Americans and lower-income communities thus increasing these inequalities. As lockdowns were deemed necessary from Covid-19 to prevent the overwhelming of our healthcare system, more than 40 million Americans were immediately left without jobs with a far greater impact on service positions that are skewed toward lower paying positions.

As the majority of the country started to emerge from lockdowns in the second half of May, new Coronavirus cases were broadly trending lower and optimism of the start of a solid economic recovery was high. Following the worst months perhaps in U.S. economic history in March and April, virtually all incremental gains from such a low month over month base comparison seemed to indicate the optimism of such a recovery was warranted. We would caution regarding the cognitive bias of anchoring whereby it is the human tendency to rely too heavily on one initial piece of information (the “anchor”) creating a tendency to interpret subsequent data around that anchor when it still remains poor on an absolute basis.

Regardless of the level of economic improvement, our collective inability to follow CDC guidelines for social distancing and the wearing of masks has contributed to a resurgence of new outbreaks of Covid-19 that are now spreading through areas of the country that had been previously more contained. The chart below from the CDC shows that daily cases troughed around 21,000 new cases per day for the week of June 6th and have now reached over 52,000 daily cases as of the July 4th holiday and are expanding with 41 states now reporting rising case levels.

New Cases by Day

The following chart shows the number of new COVID-19 cases reported each day in the U.S. since the beginning of the outbreak.



These renewed outbreaks have already caused some state and local governments to slow down and, in some cases, roll back many re-opening plans. While limiting social interaction may be necessary from a public health perspective, it will curtail economic activity and potentially set back the recovery. Even without official government intervention, there is the risk that a renewed outbreak could curb spending if households pull back from the economy or businesses close out of further fear of the virus and its impact. Though there is little appetite for further stay-at-home orders or imposed business closures, the resulting decline in economic activity might be substantial and impact the vector of the anticipated bounce back.

It needs to be noted that all the news is not bad as the mortality rate from the virus appears to be falling. In part this is due to a greater emphasis on protecting those most vulnerable in our population and the increase in infections among the young where mortality rates are far lower alongside the more widespread use of newer and better protocols in treating the illness. However, given the lag between cases and death, we would still expect these numbers to rise over the next few weeks.

There are many challenges in analyzing economic data released during a pandemic so it is critical to focus more upon near real-time information and aggressively de-emphasize lagging economic reports that are often obsolete as they are released. Additionally, to focus upon certain data points that merely reflect a shutdown or a re-opening tends to exaggerate the magnitude of change and provides little useful insight. In preparing this commentary, we will attempt to focus more on direction rather than precise economic data as the margin of error is so wide and the current relevancy so limited.

The most recent release of the monthly employment report for June is one such example. Though anxiously followed by economists, at the time of its release on July 2nd, we have already started estimating the additional damage to the labor market due to pullbacks and further shutdowns in many parts of the country as the Covid-19 virus has re-escalated. The date of the employment survey was June 12th which represented a near trough in realized virus cases. These are data points that will be made more clear in the July data but remain mostly hazy until data in the fall that is more likely to indicate the progress made.

The basic difficulty in extrapolating much of the economic data is that there are many businesses that cannot reopen in a way mandated by the CDC to assure customers and employees that they are not placing their health at risk yet still remain profitable and sustainable without the lifelines provided by the Federal government. These businesses are primarily found in the travel and hospitality, food services, retail and sports and entertainment industries where more than half of the job losses have emanated. The rolling wave of the virus creates great difficulty and risk in rehiring and furthers economic uncertainty that will likely continue to suppress housing and auto sales. This weakness will likely be joined by further layoffs in the energy sectors due to low global oil prices and continued declines in employment in the state and local government sectors that have been hit hard by declining tax revenues and inadequate federal support.

Despite the economic decline in the second quarter likely coming in as the worst in the history of the United States, the stock market and many economists are clearly looking past this dark period and focusing on the recovery and the optimism that a vaccine discovery may be coming as early as the latter part of the year or in early 2021. With Federal Reserve Chairman Jay Powell pledging to continue to pump liquidity into the system and a strong willingness for the administration to continue to provide additional fiscal stimulus, the market appears to be telling us that we are on the road to a durable recovery.

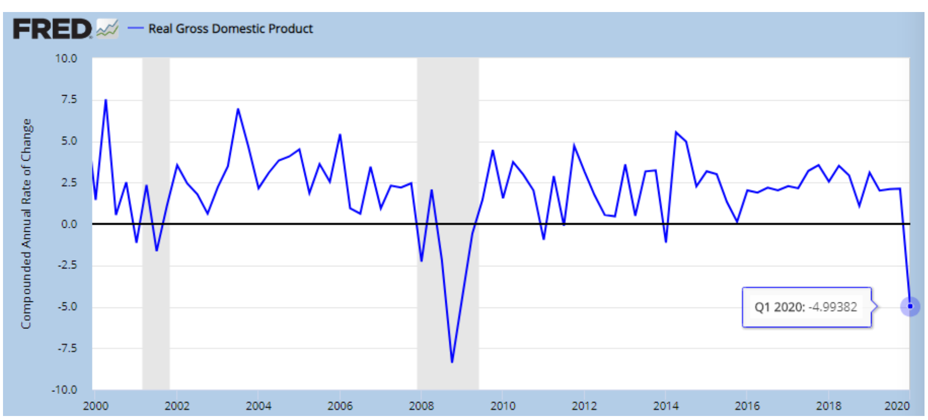
If we do get these additional rounds of stimulus, the total economic infusion is likely to approach $10 trillion for 2020, a number that may be four to five times the likely loss of gross domestic product and cushioning the worst part of the recession and possible aftershocks. Realized and proposed stimulus has overwhelmed economic fundamentals and levitated the valuation of the S&P 500 from an already historically elevated 18x earnings in March to over 23x in June, a level not seen since the 2000 tech mania.

The Great Depression was solvency-induced while the 2020 recession is a combination of an ill-advised trade war in the late stages of an elongated economic cycle and the forced global shutdown of economic activity precipitated by an overwhelming health care crisis. Despite aggressive fiscal and monetary efforts, what is in front of us is still likely to become a solvency crisis especially among smaller firms in the retail, leisure and hospitality sectors on which we have become very reliant in recent years. All of this will take place amid elevated unemployment.

Though our base case is for the deep decline we are experiencing in the just completed quarter to be followed by a solid economic rebound in the late stages of the current year, we expect more modest expansion into 2021 and beyond that may not return us to levels of output experienced last year until 2022. The risk around these forecasts is high and are not pre-ordained. Alternative scenarios may include an acceleration or a second wave of the virus that further impacts consumer confidence and economic activity in the latter half of this year and into 2021. An earlier than expected successful vaccine on the other hand may provide a more U-shaped recovery with the dramatic improvements we have experienced in the capital markets followed by a growing return to work, improved consumer confidence and a stronger recovery starting late this year. Economic uncertainty has rarely been higher.

ECONOMIC IMPACT:

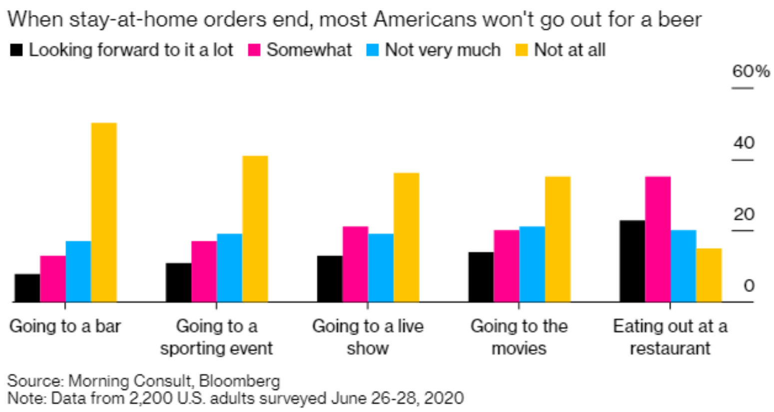
The third and final estimate of economic activity for 1Q stayed true to the early reads at -5.0% on an annualized rate (a/r). Though the first official read of the worst quarter in U.S. economic history will not be released until July 30th, most economic forecasts foresee a decline in economic activity in 2Q of around
-30% on an annualized basis. The worst quarterly decline experienced during the financial crisis (see chart on following page) was -8.4% for 4Q 2008 while the Tech wreck recession of 2001 troughed in 2Q at -1.65%.



A decline of that magnitude would move the absolute level of 2Q GDP back to the level first achieved in 2Q of 2016. When we compare to such a base as the just completed quarter, it is obvious that there will be a recovery from that level but the key will be both sustainability and the length of time that it will take for demand to catch back up to the productive capacity. Re-opening the supply side does not guarantee that we will see demand growth revive enough to support the excess capacity that will exist for now and the near future.

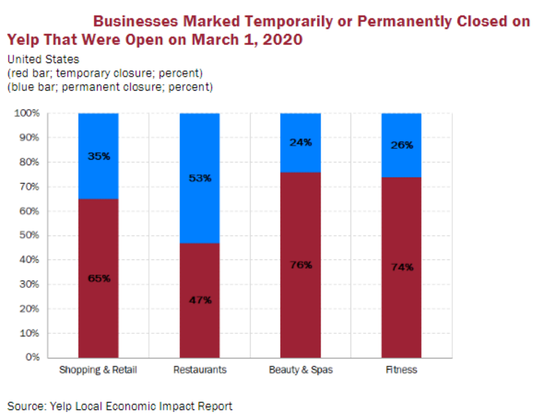
With so much of the data extremely backward-looking, we have turned to more contemporaneous information from non-government providers. Sources such as OpenTable for restaurant reservations, Chase credit card tracking, and consumer surveys, etc,, provide us with information that is extremely helpful as to what is happening on the ground and give us greater insight into current and potential consumer spending and impacts on employment. With the virus now heading the wrong way, these signals are important.

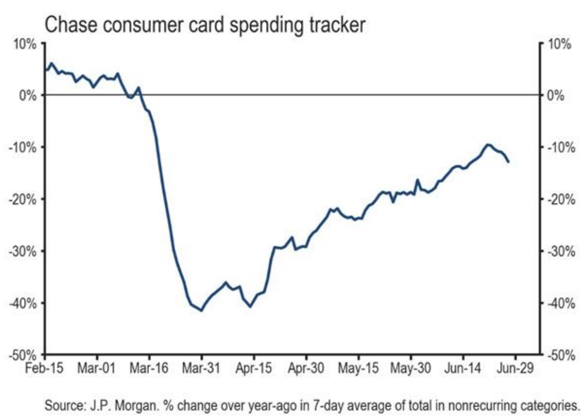
A survey below taken at the end of June indicates the still very high reticence of a large percentage of consumers to return to many of the service businesses especially those that would take place indoors.



According to data from Yelp, the business review and reservation website, as of June 15th, over 139k businesses in the U.S. remained closed, down from 177k in April. What is most concerning about this data and highlights the dramatic impact of the economic shock and behavioral changes we've seen from lockdowns is that over 40% of these business closures were marked as permanent. For restaurants that figure explodes to 53% (see chart below left on following page).

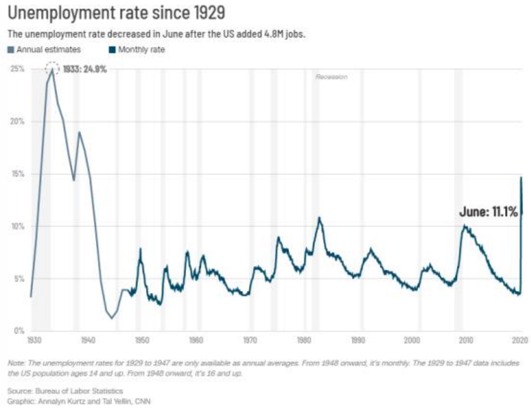
The Chase consumer card spending tracker (see chart on following page on the right) shows credit card spending through June 27th so depicts the early impact of the resurgence of the virus as spending has again downshifted. We fear this continued escalation to have a further negative impact on consumption and, thus, the viability of many small businesses.

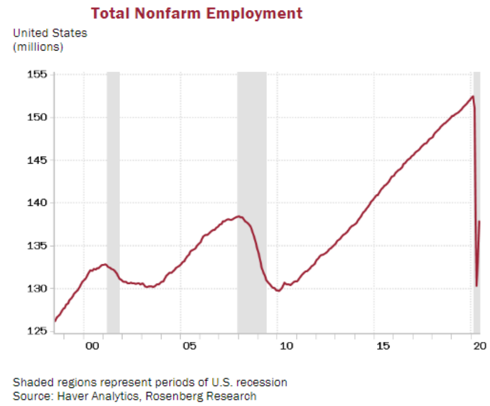




EMPLOYMENT:

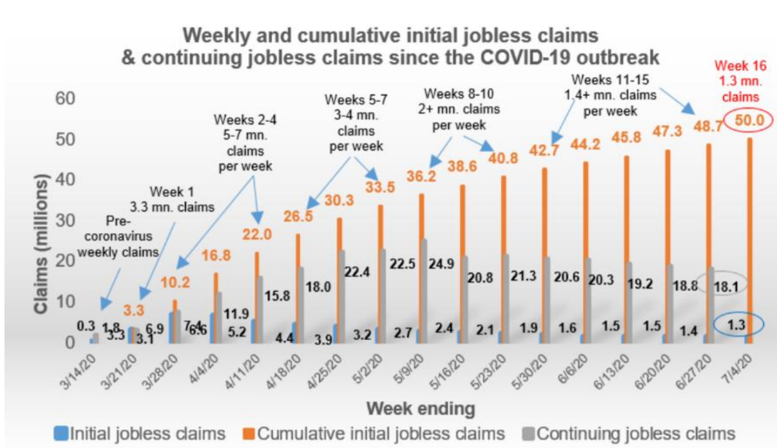
The 4.8 million increase in non-farm payrolls in June provides further confirmation that the initial economic rebound has been far faster than we and most others anticipated. The unemployment rate declined to 11.1% and the underemployment rate fell to 18% (see chart below left), numbers that still likely understate the unemployment tally. The unemployment rate fell by 2.2% as the number of unemployed people declined by 3.2 million to 17.8 million. That still leaves employment 9.6% below its February level (see chart below right) and with the spread of the virus accelerating again, we expect a multi-year period of recovery for the U.S. labor market.





These solid payroll numbers for May and June mean that we have now recovered about 7.5M (34%) of the 22.2M jobs lost in March and April. According to the Bureau of Labor & Statistics (BLS), the number of permanent job losses continues to rise and now total 2.9M after this report. Bottom line is that we have a very solid number of recalled workers as the economy has reopened. In fact, of the total increase in payrolls for the month, 2.74M were in the areas of Leisure & Hospitality along with Retail. Unfortunately, with the Covid-19 virus resurging since the June 12th date of this survey, real time data in everything from new job postings to restaurant reservations imply that we are going to see a much slower pace of recalls and possibly outright losses over the next few months as the calculus for profitability for many are challenged.

It is perhaps more critical to look at the more contemporaneous employment data and on that front progress has been more uneven. Though the rate of initial jobless claims has slowed, the most recent reading of the week ending July 4th still totaled 1.31M, a total that is still more than two times the highest weekly level experienced during the financial crisis and has barely improved since the readings on June 6. Looking at continuing claims of those still on unemployment insurance is also concerning. The Pandemic Unemployment Assistance (PUA) created by the CARES Act for self-employed workers has grown to a record 14.8M on this form of unemployment insurance. When combined with the total of 18.06M on continuing claims, there are now some 32.9M on some form of unemployment insurance. If this total were used to calculate the unemployment rate it would rise to over 20%. Support must continue to move forward (see chart below from RSM which excludes the PUA claims).



While it is great news that the economy is reopening and many are headed back to work, this should be no surprise as no one thought the majority of those temporary layoffs would be permanent. To be eligible for forgiveness of PPP loans, employers had to rehire employees by June 30, 2020. After this date, if the funds provided by CARES have been used for the eligible expenses of payroll and other costs employers have no restrictions on future layoffs. Though the deadline was extended to 12/31 for unused PPP balances if employers are unable to exhaust their loans and restore employment sooner, the large majority will have been rehired. The real test will be getting those who need to find new jobs back to work and that process has not even started.

We are concerned that the very positive headline readings may obscure these concerns and lead policymakers to conclude that additional aid to those out of work is less necessary. We feel that would be a serious policy error that would put in jeopardy a nascent recovery that we think is in play. This is especially critical now as the economy heads toward a July 31 fiscal cliff with the expiration of Pandemic Unemployment Assistance. Not replenishing unemployment benefits would likely result in a sharp decline in household consumption in late summer and early fall.

HOUSING & AUTOS:

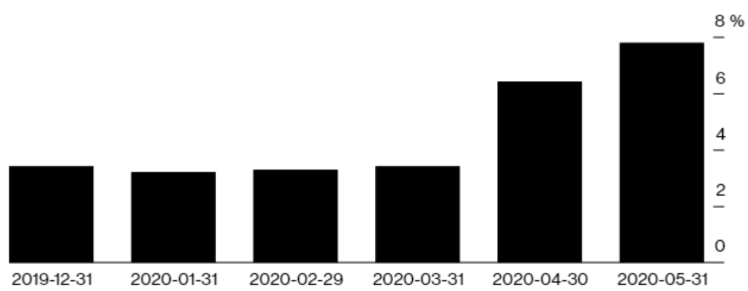
Housing and autos are critical to the U.S. economy and were virtually closed from mid-March until early May. Unlike services which when foregone are lost forever, these areas were expected to show signs of pent-up demand as we emerged from lockdown. While autos have rebounded from the lows of April when an annualized rate of 8.7M light vehicle sales were registered, the most recent June figure is only 13.0M, a level almost 25% below the averages of the final quarter of 2019. However, that has not been the case with the housing market. New housing starts, new home sales and even now pending home sales have all followed the explosion in mortgage applications (see chart below) that we started seeing in late April and represented the highest level in 11 years.

Sources: Mortgage Bankers Association, Bloomberg

We are hesitant to call this a long-term trend yet. We suspect that adding to typical pent-up demand was an initial surge of purchases from high end home buyers looking to exit the cities for the suburbs driven by lifestyle changes caused by the virus. Applications are not closings. Banks may not be allowed to foreclose on anyone right now but they are not ignorant to the surge in delinquencies (see chart below) and what may be a large supply of homes still to come on the market. Credit standards are tightening by the day. Moreover, it is hard to envision a more than temporary housing surge with employment and income growth under such historic pressure. Indeed, the last 2 weeks of June into July saw a moderation of applications for purchase. The impact of credit here and on the recovery for the economy as a whole will be critical.

Rising Delinquencies

Covid-19 has led to more mortgages being 30 days late



Source: Black Knight Inc.

In attempting to ensure that what befell delinquent homeowners and debtors during the financial crisis does not repeat itself, both Congress and the Federal Reserve are perversely cutting off much of the flow of credit that many of their actions are designed to stimulate. Part of the stimulus package was an allowance that homeowners hurt by the coronavirus or its economic fallout could ask their mortgage servicers for permission to pause their payments for up to 12 months. If the mortgage is backed by the government, the mortgage servicer is generally supposed to grant the request. Additionally, many credit-card, auto-loan and personal-loan lenders continue to allow consumers to skip or pause payments, in hopes of buying time for the economy to recover and for consumers to get back on track with their payments.

While the banks are allowing payment deferrals on a huge percentage of these loans, the federal government has stipulated that banks cannot penalize their customers for these deferrals by notifying the credit-reporting agencies about their delinquent payments. This rule is making it much harder for banks to make credit decisions on new loan applications and is moving the lending institutions into capital preservation mode. Rather than keeping the lending spigots wide open, banks are instead tightening all forms of lending standards and making fewer loans.

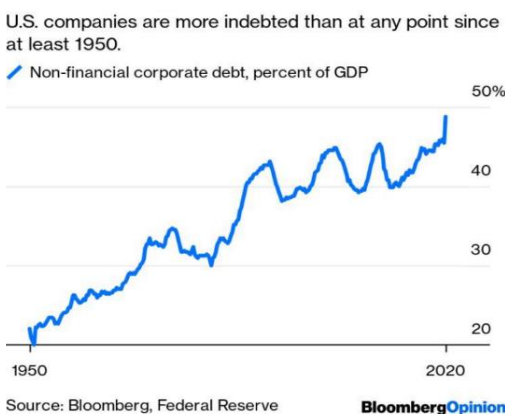
FISCAL & MONETARY RESPONSE:

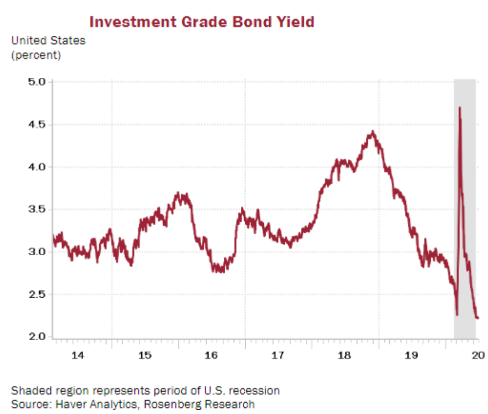
The aggressive actions of Congress and the Federal Reserve have been at the heart of any economic stabilization that we are seeing with four major laws enacted since late March in response to the escalation of Covid-19 and the mandatory lockdowns of much of the country. The Coronavirus Aid, Relief and Economic Security Act (CARES) was the largest of the fiscal packages, expanding the federal budget by $1.7T. This included direct payments to households of $293B, the Payroll Protection Program (PPP) of $377B and increases in unemployment insurance of $268B. With a fourth bill in late April expanding monies for the PPP, the total measures adopted totaled almost 13% of GDP over a six-week period.

An important side aspect of this legislation was the provision of another $454B in equity investments for emergency lending programs by the Federal Reserve that could be leveraged into corporate bond buying facilities. This allowed the Fed to circumvent the Federal Reserve Act and buy non-investment grade bonds that had recently been downgraded and, junk bond exchange-traded funds (ETFs) along with supporting investment grade bond markets.

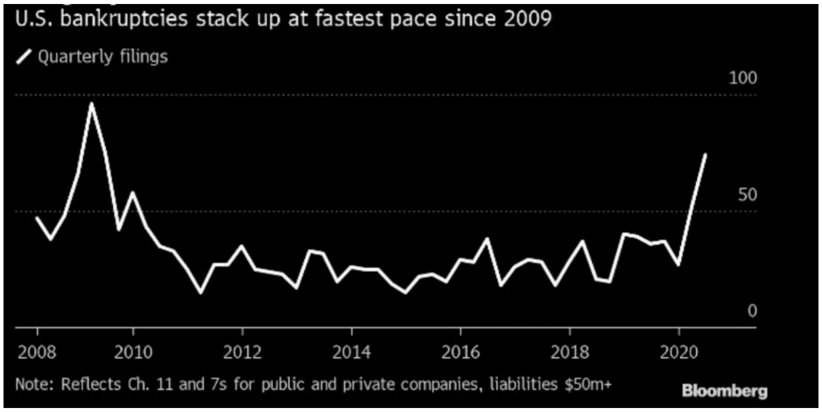
We have noted for the better part of the last two years that the Achilles heel of the U.S. economy was likely in highly leveraged corporate balance sheets. As of the end of the first quarter, Bloomberg noted that there were about $1.3 trillion of high-yield bonds outstanding, up from $786 billion a decade ago. The investment-grade credit market has more than doubled to $6 trillion in the same period with almost 51% of that market now rated BBB up from only 30% as recently as 2009. This was the area of potential "fallen angels" (investment grade bonds that have their credit ratings lowered to junk status) that Fed Chairman Jay Powell was directly targeting.

The Fed's impact on the financial markets has been monumental. U.S. investment grade companies have successfully issued a staggering $840B of debt in the first half of the year during the worst recession since the 1930s, more than the prior full year record. Adding this to already stretched balance sheets has moved the non-financial debt ratio to GDP to an all-time high (see chart below left). With the backstop of the Fed, the market insatiably gobbled up this debt with such fervor that the yield on investment grade bonds during this period dropped from 4.7% to an all-time low of 2.2%, completely arresting and reversing the early market impact (see chart below right). Additionally, lower-rated companies have also managed to issue a record $180B through June.



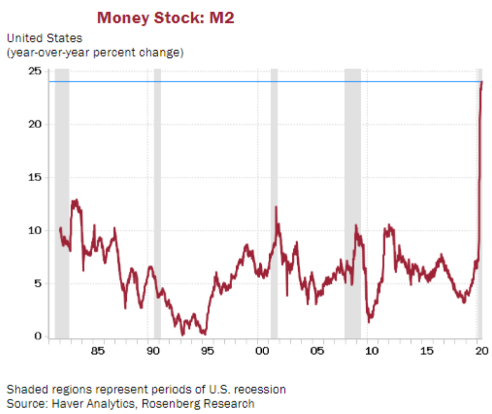


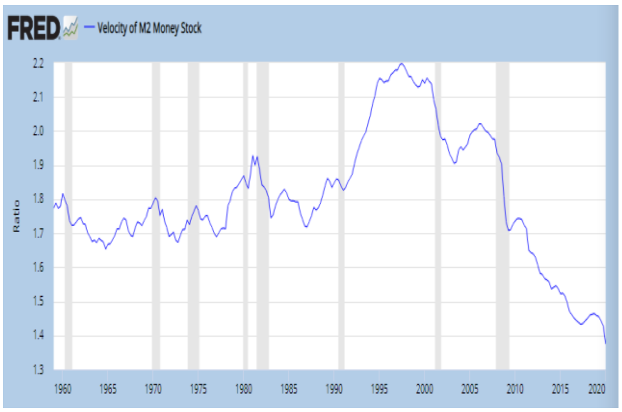
Though temporarily good for the functioning of the bond markets, Fed actions have obscured natural price discovery. This reduced credit spreads on corporate and municipal bonds to levels which hardly seem appropriate in a deep recession. The Federal Reserve can provide additional liquidity to the markets but can do nothing to improve cash flows and solvency concerns and bankruptcies are continuing to spike. The second quarter of 2020 witnessed the second largest wave of bankruptcy filings ever trailing only the depths of the financial crisis in 2009 with 75 filings over this period for companies with at least $50M in liabilities (see chart below). High yield bond analysts are expecting defaults in this space between 8% and 13% for 2020, a level that would historically imply credit spreads to Treasuries of around 1000 basis points. Recently these bonds are trading around a 600 basis point spread to riskless Treasury bonds a level that is nowhere near pricing in the risks associated with deteriorating cash flows. Irrespective of the future trend of the virus, we expect these issues to increase.



MARKETS:

By moving into the position of being the primary buyer of Treasury bills, notes and bonds and now corporate bonds, the Federal Reserve has expanded its market generosity to levels never seen before still hoping against hope that this trickles down into the overall economy. As seen in the chart below on the left, never before has the stock of money as measured by M2 been expanding even close to the recent rate that is over a 24% increase over the last year. Historically, this would be perceived to be highly inflationary and may eventually turn out to be just that. But for now, the velocity of money (a measure at which this money turns over in the economy) continues a two-decade decline near all-time lows (chart below right). Bank lending (which supplies the credit to the economy) and consumer and business reticence to spend (with already high levels of debt) restrains this credit multiplier. With the current and prospective environment among the most uncertain in economic history, we do not expect banks or consumers to change this behavior any time soon.





This excess liquidity has certainly found a home in financial assets with results from 2Q for the S&P 500 the best since 1998, a startling disconnect from underlying economic fundamentals. For the quarter, the S&P 500 rose 20.5% erasing much of the decline in the first quarter and bringing the year-to-date return to a still negative -3.1%. The long-running divergence between growth and value not only continued but expanded to a mind-boggling 26% so far in 2020 with the Russell 1000 Growth index up 9.8% while the Russell Value index shows a YTD decline of -16.2%.

As the largest contributors to this style bifurcation continued to be the large cap technology and consumer names of Apple, Amazon, Alphabet, Facebook and Microsoft, we have seen an extreme narrowing in leadership that has skewed to the largest (and now most expensive) companies in the index with the median stock in the S&P 500 off -11.0%, far greater than the market-cap weighted overall total (see chart below).

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

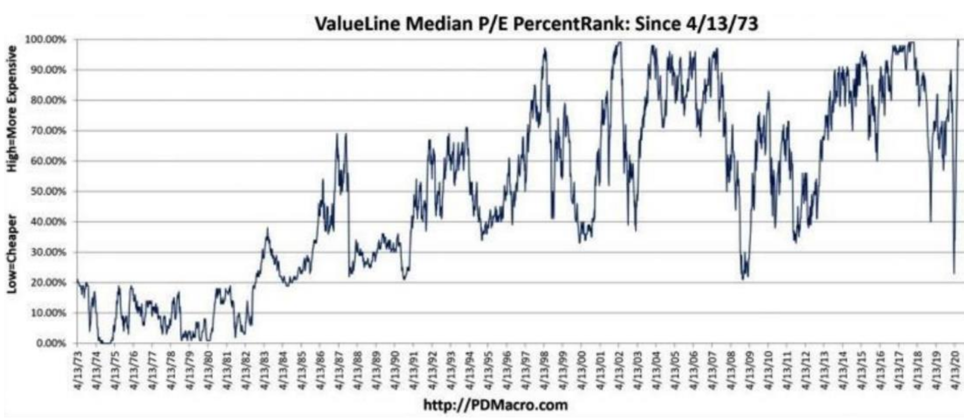
Souce: Ycharts

This growth dominance is also reflected in the more growth-oriented Nasdaq Composite index now in positive territory for the year at +12.1% following a +30.6% 2Q while the traditionally value-oriented Dow Jones Industrial index registered a still strong but more modest gain of +18.5% for 2Q bringing the return for the year to a still negative -8.4%.

The Russell 2000, a domestic index of smaller companies, enjoyed a 25.4% quarterly return reducing the losses for the year to -13.0%. International investing enjoyed a strong final month of the quarter but still lagged with the MSCI EAFE index of developed economies showing a quarterly gain of 14.9% narrowing the loss for the year to -11.3%. The MSCI Emerging Market index moved ahead 18.1% in the quarter and is still off -9.8% for the year.

In the fixed income space, the efforts of the Fed contributed largely to the rebound in the Bloomberg Barclays US High Yield sector return of 10.2% in 2Q reducing the loss for the year to -3.8%. The overall Bloomberg Barclays Aggregate Bond index enjoyed a 2.9% quarterly gain and is up +6.1% for the year.

The powerful gains in financial markets have pushed valuations of traditional metrics to levels not seen since early 2000. The well followed Value Line Composite index computes the price earnings ratio by taking the trailing six months of realized earnings along with the estimates for the six months ahead thus combining the trailing and forward valuation metrics for the median stock in the 1700 stock index. By this measure the near half century estimate of this analysis now depicts the index at the single highest valuation ever.



However, many analysts have given 2020 earnings a pass and are focusing on what is viewed as a strong profits rebound in 2021. Consensus earnings estimates according to data from FactSet show current year earnings to be a -22% decline from the level of 2019 to $127 per S&P share but bouncing +28% in 2021 to $163 (basically to the level of earnings in 2018). We are concerned that valuations on the 2021 expected rebound are priced to perfection and assume an economy returning to prior levels over the next year while also ignoring an increasing possibility of sweeping changes to the corporate tax laws that helped elevate profits in 2018.

We have long noted the influential role corporations have played in the demand side of the equity market via share repurchases alongside the expansion of debt to fund this swap. In fact, according to data provided by Goldman Sachs, from 2016-2019 corporations accounted for significantly more than 100% of total equity demand as households, mutual funds, pension plans and even foreign investors were individually and collectively net sellers of U.S. stocks.

Our expectations continue to be that most companies will need to (or in the case of banks be required) conservatively husband cash throughout the economic downturn. Our view was and remains that most companies would need to retreat from this allocation of capital to better cushion balance sheets against what happened to top line revenue growth in the just completed quarters. Removal of Corporate America from the role of primary buyer of stocks would likely have a negative influence on share prices. We did not expect that role would be taken by retail investors in ways reminiscent of the dot-com bubble of the late 90s.

Perhaps lured by the flood of economic stimulus and the increasingly entrenched view that the Federal Reserve will do anything to prevent a decline in the stock market, retail investors are stepping into the void created by the estimated 80% decline of net corporate demand. Goldman Sachs is now estimating the share buyback decline of about $500B to be partially offset by a roughly $270B increase in this retail demand. Over the four years noted above, retail investors in net bought only $41B in stocks (see chart below).

Buyers and sellers of US stocks

as of June 19, 2020

	Net US equity demand ($ billions)					
Category	**2016**	**2017**	**2018**	**2019**	**1Q 2020**	**2020E**
Foreign Investors	$ (186)	$ 117	$ 96	$ (190)	$ 187	**$ 300**
Households	(7)	133	(96)	11	7	**280**
Corporations	677	285	610	537	129	**100**
Mutual Funds	(112)	(133)	(121)	(221)	(66)	**(130)**
Pension Funds	(213)	(109)	(148)	(206)	(119)	**(200)**
Life Insurance	(25)	(6)	(45)	1	(5)	**-**
Other	(17)	(24)	(3)	(26)	2	**-**
less						
Foreign equities by US	22	140	194	(251)	115	**250**
Credit ETFs	96	124	101	157	22	**100**
Included among holders above are:						
Equity ETF purchases	188	347	210	$ 166	$ 50	**150**

Source: Federal Reserve Board and Goldman Sachs Global Investment Research

In the analysis, Goldman highlighted the part that retail traders have played in the S&P 500's nearly 40% surge from its March bottom. Perhaps spurred on by the boredom of lockdowns, a fear of missing out has been enticing the re-emergence of day traders notably those on the commission-free brokerage site, Robinhood. Most have pounced on those companies whose fates teetered on bankruptcy such as airlines, cruise operators, car rental agencies and casinos and sent their stock prices soaring.

At Coho Partners we prefer to invest in high quality companies with greater clarity around their business models, resilient earnings streams, anticipated growing cash flows, strong balance sheets, and reasonable levels of expectations and valuations. As we expect recent levels of volatility and uncertainty to remain with the financial markets, we feel this philosophy to be well suited to address the unique challenges facing our current environment.

Sincerely,

Rick S. Wayne, CFA

Eric M. Hildenbrand, CFA