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Vaughn Asset Advisory Weekly Market Commentary & Update

Fed unconcerned About Asset Bubbles as Rebound Continues

Markets rebounded last week, erasing about half of the losses from two weeks ago in what we continue to view as healthy price action. Regional leadership was mixed, with international developed markets outperforming (MXEA +2.1%) due to strength in European markets, emerging market equities lagging (MXEF +1.6%), and domestic equities slotting in between the two (SPX +1.9%).

Rotation-to-value optimism dampens a bit

Digging deeper into the style and factor space, some of the optimism around a pro-cyclical rotation to value and small-caps has been pared down. Growth outperformed value by almost 200 basis points (bps) last week [Figure 1] and the NASDAQ beat small-caps by about 150 bps. After the extremely volatile price action under the hood over the last five weeks, we think this is likely to chop around until we get more clarity. Earnings season, which is set to start in mid-June, could be that clarifying catalyst.

Pro-cyclical rotation optimism pared down last week

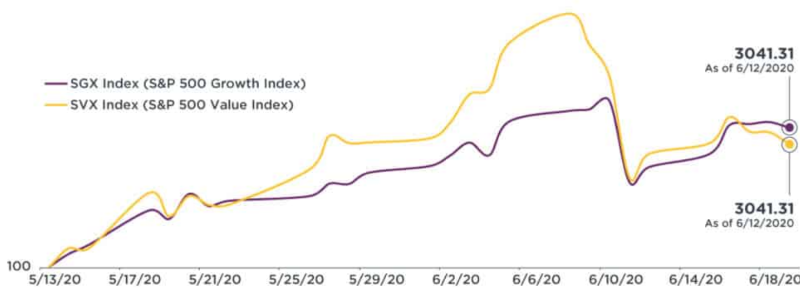

Figure 01 - Source: Horizon Investments | Bloomberg

Push-pull dynamic moving markets now

Markets continue to be driven by the push-pull dynamic between reopening the economy and the increased health risk of doing so. Given the massive wall of stimulus from the fiscal and monetary fronts, that likely points to a whippy, headline-driven market with an upward drift.

For example, the S&P 500 is at about the same level it was in the beginning of June, yet the VIX is around 30% higher, signaling perhaps that the market is more nervous this time around, whether due to Covid-19 or perhaps even upcoming elections [Figure 2].

This increased volatility also suggests that the euphoric “stocks-can-only-go-up” retail sentiment is coming back down to reality. The market may be a bit more balanced now than it was at the beginning of the month.

S&P 500 at early June levels but VIX now 30% higher

Figure 02 - Source: Horizon Investments | Bloomberg

Economic activity rebounding strongly

The news on reopening was undisputedly positive last week. Tuesday’s Retail Sales report blew expectations out of the water, showing that the U.S. consumer is eager to spend.

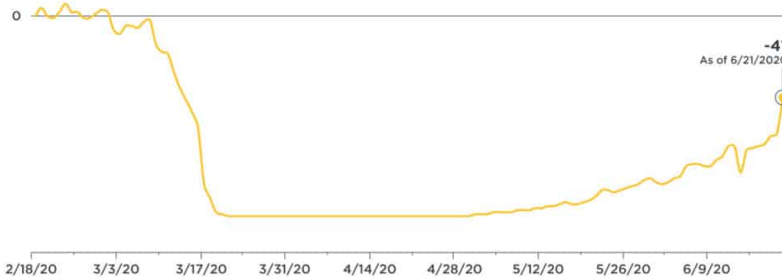

Figure 03 - Source: Horizon Investments | Bloomberg

Less traditional high-frequency data continues to tell a similar story and shows activity restarting faster than we expected. For example, a look at recent OpenTable data shows restaurant activity is now down only 41% on average versus 84% at the beginning of June [Figure 3].

Virus spread still a concern

But it's also becoming increasingly clear that this faster economic restart carries with it greater risk of coronavirus spread. Cases are increasing in about half the states, and more worryingly, positive test rates and hospitalizations are rising as well. Apple (AAPL) announced the closure of 11 stores in 4 states and China closed schools and cancelled over a thousand flights to stymie a flare up in Beijing. The recovery may slow and is likely to be bumpy if these trends continue.

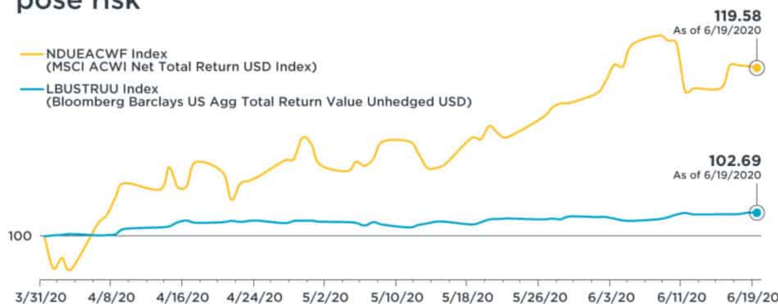

Figure 04 - Source: Horizon Investments | Bloomberg

Quarter-end rebalancing could pose equity risk

The calendar, being quarter end, flags a potential risk to equities over the next week. So far this quarter, global equities (MXWD) are up almost 20% while the return from bonds has been below 3% [Figure 4]. We could see some equity supply over the next two weeks as institutions rebalance their portfolios back to their target allocations.

Bond yields hold steady

Despite the rebound in equity prices, bond yields largely held onto their move lower from two weeks ago, with all major tenors plus or minus 1 bps week-over-week (WoW). Last week's price action further reinforces our view that the yield breakout to the topside was just a headfake. Lower-for-longer yields is the story here.

Mixed week for credit markets

It was a mixed week for credit, as investment-grade (IG) bond spreads were flat and high-yield (HY) were 15 bps wider. This is somewhat disappointing as the Federal Reserve announced it will start buying cash bonds, instead of ETFs, to support credit markets. But as we've noted, credit markets have done a remarkable amount of healing already.

Fed Chairman dismisses asset bubble concerns

In his testimony to Congress, Federal Reserve Chairman Jerome Powell largely reiterated the points he made in the post-FOMC meeting press conference two weeks ago. Rates will stay low and the Fed will act aggressively to support the recovery, which they believe will take years to materialize. Importantly, Powell dismissed concern about inflating asset bubbles. In doing so, Powell has given investors one less reason to worry over a withdrawal of accommodative policy. That's bullish for asset prices.

One of the Fed members that had been discussing yield curve control for some time dampened enthusiasm for it last week. We have been expecting it to be put in place by the end of the summer, but it appears the Fed will save this tool for if, and when, long-end rates move higher.

What to watch next

Covid-19

The market will continue to closely watch positive test rates, new infections and hospitalizations from Covid-19. More flare-ups like ones we've seen in Florida, Texas, California, the Carolinas, and Arizona, could soften the robust uptick in activity we're seeing now. Apple, which was among the most aggressive companies in closing stores at the outset of the coronavirus outbreak and which has again closed down stores in some hotspots, could be seen as a leading indicator for how other major companies may respond to increasing Covid-19 flare ups or hospitalizations.

PMIs in the U.S., Europe, and Japan

PMIs on Tuesday may allow us to start differentiating based on restart velocity. While the data overall are expected to continue to show a rebound, the employment sub-index is still lagging new orders. That's not unexpected, but the big question will be whether that can ratchet back up as the pace of recovery quickens.

Jobless claims

Thursday's jobless claims are expected to continue to fall, though the overall level remains high (1.35 million expected this week). We will have seen 11 consecutive weeks of declines in new jobless claims. That's a good thing, as long as we continue to see declines and don't see rates stabilize at the current level.

Personal income and spending data

In light of the major beat in income last month and the strong Retail Sales Report last week, we'll be watching this data closely on Friday. In April, Personal Income was up 10.5% likely due to one-off stimulus and extra unemployment insurance payments. Income for May is expected to fall and essentially confirm that April was a fluke. On the spending side, however, we expect levels to rebound, confirming last week's retail sales report and showing stimulus is getting spent.

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