LIQUIDITY INSIGHTS

Focus on short-term fixed income

Q2 in Review: Despite rebound from COVID-19 lockdowns, recovery depends on the pandemic and policy response

June 2020

IN BRIEF

• Markets cheered as COVID-19 cases slowed, policymakers swiftly intervened on an unprecedented scale and economic activity and employment picked up. Anticipating a fast recovery, the S&P 500 rose 20.5% over the quarter.

• While GDP is forecast to swing to 20% annualized growth in Q3 from a likely 30% contraction in Q2, we do not expect a V-shaped recovery. The pandemic has scarred business activity and employment and it could take as long as 10 years for the U.S. economy to reach its long-term output potential.

• Short-term bond markets recovered substantially in the second quarter; Libor rates declined materially as risk aversion cooled and money flowed back into prime money market funds.

• The pace of the recovery will be determined by the pandemic, the public health response and policymakers’ additional measures.

MARKET COMMENTARY

The first half of 2020 defied expectations. After the economy was brought to a halt in the first quarter by the COVID-19 outbreak and subsequent lockdowns, the Federal Reserve (Fed) intervened forcefully and quickly with monetary policy and packages of unprecedented size and scope. We estimate that $17.1 trillion in global policy response has been committed (though not yet all spent): $6.2 trillion in quantitative easing, $3.5 trillion in direct fiscal stimulus (grants) and $7.4 trillion in indirect fiscal stimulus (loans).

As the growth of coronavirus cases began to slow during the second quarter, markets reacted quickly. Investors priced in a swift recovery for an economy that had previously been on solid footing before the pandemic. The S&P 500 rose 20.5% for the quarter, interest rates were at or near all-time lows, and credit spreads had recouped nearly all of the widening of Q1. Thanks in part to the government stimulus programs, economic activity revived more quickly and energetically than market participants had anticipated. Impressive jobs and consumption data pointed to significant pent-up demand and a strong initial rebound from the dramatic collapse in economic activity.

The recovery likely began in May. Real consumer spending surged and consumer confidence, as measured by the Conference Board index, climbed to 98.1 in June from 85.9 in May. The economy added 4.8 million jobs in June, 1.8 million more than expected, according to June’s Labor Department report. The June unemployment rate declined to 11.1% from May’s 13.3%, an impressive speed for improvements, however employment is almost 15 million jobs lower than in February.

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Short-term bond markets recovered substantially in the second quarter. Libor rates declined materially as risk aversion cooled and money flowed back into prime money market funds. Three-month Libor ended the second quarter at a yield of 0.30%, well off its peak of 1.45% at the end of March and down 4 basis points (bps) from the end of May.

Net U.S. Treasury Bill issuance increased, given the enormous U.S. government aid package. The 3-month Treasury Bill yield rose 5bps during the quarter, to end at 0.14%. The 12-month Treasury Bill yield ended down 1bp, at 0.15%.

**TREASURY BILL YIELDS (%)**

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<tbody>
<tr>
<td>Series 1</td>
<td>0.00</td>
<td>0.00</td>
<td>0.15</td>
<td>0.15</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
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<tr>
<td>6-month U.S. T-Bill</td>
<td>0.00</td>
<td>0.00</td>
<td>0.15</td>
<td>0.15</td>
<td>0.30</td>
<td>0.30</td>
<td>0.30</td>
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<tr>
<td>Fed Funds</td>
<td>0.00</td>
<td>0.00</td>
<td>0.15</td>
<td>0.15</td>
<td>0.30</td>
<td>0.30</td>
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Source: Bloomberg; data as of March 31, 2020.

**U.S. PORTFOLIO COMMENTARY**

The weighted average maturity (WAM) of our onshore and offshore prime funds in the **Liquidity Strategy** was in the 50- to 58-day range and the weighted average life (WAL) was in the 75- to 85-day range for most of Q2. Three-month Libor fell 115bps to end the quarter at 0.30%. One-month Libor fell 83bps to 0.16%. Early in the quarter, term investments were primarily focused on fixed-rate securities in the 1- to 9-month area. In addition, we continued to purchase floating-rate securities in the 6-month to 1-year area, vs. 1-month Libor, 3-month Libor given compelling spreads relative to fixed-rate alternatives. We generally carried 30% to 35% in overnight liquidity and 40% to 50% in monthly liquidity. We will continue to focus on term security purchases, both fixed and floating.

For our **Managed Reserves Strategy**, we maintained a long duration position with the view that the Fed would keep rates near the zero bound for the foreseeable future. Front-end spreads tightened to pre-COVID-19 levels, leaving remaining value further out on the yield curve, beyond 18 months, which is where we concentrated purchases. We positioned portfolios to participate in the risk rally by adding spread duration as Fed programs are supportive of risk assets.

We have trimmed exposures to some segments of the energy market, consumer cyclicals and some consumer asset-backed securities (ABS). We continue to actively manage the credits in the strategy. Seeking to participate in the ongoing rally amid strong technical demand, we added high-quality corporate credit names that we expect will withstand the downturn.

For our **Short Duration Strategy**, because the portfolios had entered the COVID period with very little risk, we took the opportunity to thoughtfully add risk back at depressed levels, mostly high quality investment grade credit. We have held an overweight position in credit for all of Q2, however we took various opportunities to take profits where we felt the upside to spreads were limited. Currently, our risk in the portfolios is 50% of our risk budget, with an up-in-quality bias.

**KEY U.S. ECONOMIC DATA**

<table>
<thead>
<tr>
<th>USA</th>
<th>Current Month</th>
<th>Prior Month</th>
<th>Dec. 31, 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>DJIA</td>
<td>25,812.88</td>
<td>25,383.11</td>
<td>28,538.44</td>
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<tr>
<td>S&amp;P</td>
<td>3,100.29</td>
<td>3,044.31</td>
<td>3,230.78</td>
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<tr>
<td>2-Yr US Treasury</td>
<td>0.15</td>
<td>0.16</td>
<td>1.57</td>
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<tr>
<td>10-Yr US Treasury</td>
<td>0.66</td>
<td>0.65</td>
<td>1.92</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>11.1</td>
<td>13.3</td>
<td>3.5</td>
</tr>
<tr>
<td>Chg in Nonfarm Payrolls (3 mo, Avg)</td>
<td>-4409</td>
<td>-6243</td>
<td>205</td>
</tr>
<tr>
<td>Housing Starts (000s, saar)*</td>
<td>974</td>
<td>891</td>
<td>1365</td>
</tr>
<tr>
<td>ISM Manufacturing Survey</td>
<td>52.6</td>
<td>43.1</td>
<td>47.2</td>
</tr>
<tr>
<td>U. of Mich. Consumer Confidence Sentiment</td>
<td>78.9</td>
<td>73.7</td>
<td>99.3</td>
</tr>
<tr>
<td>Consumer Price Index (YoY %)*</td>
<td>0.1</td>
<td>0.3</td>
<td>2.1</td>
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* Currently showing the most recent published number as of May. June data has not been released.
SARR: Seasonally Adjusted Annual Rate
We maintained our short duration positioning vs. benchmarks. We continue to own agency mortgage-backed securities (MBS) and spreads are looking more attractive as other sectors have outperformed. We are cautious on ABS given our concern about the U.S. consumer, however we are not concerned about the securities already in the portfolios given the significant protection embedded in the bonds.

OUTLOOK: EXCERPTS FROM OUR QUARTERLY GLOBAL FIXED INCOME VIEWS

The health crisis resulting from Covid-19 has materially shifted the economic outlook. Data covering the time in which shelter-in-place recommendations were in force suggest unemployment levels far exceeding the global financial crisis and a sharp drop in economic activity. The U.S. service sector, which makes up 70% of the economy, will be the biggest challenge during this recession. As states begin to re-open, we anticipate continued stress, particularly for small businesses, as businesses will be mandated to operate below capacity and consumers re-emerge cautiously. We anticipate a full recovery may be slow as regions follow different time tables for reopening, dependent on the virus’s development.

A tremendous amount of damage has been done globally. Many businesses will need to rethink their business models, including anything that involves large gatherings of people. We expect a persistent social distancing drag, and considerable scarring, from the sudden stop in activity.

Certainly, the future of fiscal stimulus will be important in determining the recovery’s path. We are concerned about approaching fiscal cliffs in the U.S. as support packages lapse. We are eyeing whether a new round of layoffs could ensue if business owners need to resize their workforces for diminished consumer activity. And what if a vaccine and/or treatment are still far off?

We believe that this is no time for policymakers to rest on their laurels. They must agree to the next round of fiscal support and central banks need to be committed to maintaining enormous levels of accommodation. There are encouraging signs in both the U.S. and Europe.

We believe we are seeing the deepest and shortest recession that anyone has experienced. Lawmakers’ willingness to work with central bankers to engineer a recovery is, perhaps, something that could only be born out of crisis. It could very well mean that central banks are implicitly fixing the rate of funding for all levels of government, businesses and households.
If you have further questions about this or other topics of interest, please reach out to your J.P. Morgan Asset Management Representative.

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