

## ***Current Market Update/Outlook***

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### **Current Outlook – Short & Long-term:**

- The US economy faces a health crisis that has morphed into an economic crisis - involving a credit crunch and a recession. The negative GDP effect of the Covid-19 related economic shutdown is dependent on the duration of the shutdown. A two-month shutdown could curtail GDP by 5 - 8%. If it were to extend to 4 months, the reduction could be 10 - 16%. The fiscal stimulus of \$2.2 trillion, representing 12% of GDP, would replace income, and offset some of the demand declines from the Covid-19 related shutdown.
- The combination of the fiscal stimulus and large scale open-ended asset purchases by the Fed have put a floor under the credit markets. This mitigates volatility, and provides support to risk assets.
- The equity market has started to rebound on the improvement in fixed income and credit markets. However volatility is likely to persist until either testing is widely available and confirmed Covid-19 cases peak then start to decline in the US and Europe, or if a pharmacological solution such as an anti-viral treatment or vaccine emerges. A surge in cases and/or a spike in negative economic and earnings data could cause some retracement of the equity rebound in the near term (likely the second quarter).
- It is very difficult to forecast the epidemiology of this pandemic and the duration of the shutdown, making it hard to predict S&P earnings for 2020. Assuming a reduction in EPS to \$120, from \$163, in 2019, and a rebound to \$160 in 2021, we can see the S&P around 2,880 by YE 2020 due to some expansion in P/E multiple as volatility subsides, given the relatively high equity risk premium against the backdrop of low interest rates. We expect some out-performance by steady growth firms that benefit from long term trends such as digitization (cloud computing, artificial intelligence, data centers, VR, automated mobility and IOT). We also expect steady high income producers such as Staples and Utilities to perform well in a lower rate environment. We do see some challenges still in sectors directly impacted by the virus, such as Transportation, Lodging, and Energy. Incidentally, the convertible market is dominated by companies in the former category, as well as Healthcare, and has very low exposure to the latter. We expect short rates to stay near zero, and longer treasuries to rally at first on bad economic news, but to sell off as the economy begins to restart, ending the year near a 1% yield for the 10-Year Treasury.
- Medium/longer term, we expect above normal returns over the next few years. The US economy was in great shape coming into this health crisis, with high consumer confidence and savings rates. However,

the high levels of debt (both sovereign and corporate) and the disinflationary impact of lower oil prices may lead to slower growth with low inflation. Low rates, combined with dynamic and secular change we expect in the economy, such as digitization and work from home, leads us towards secular growth companies. We would lean into quality growth Technology and Healthcare companies with strong balance sheets and low earnings variability that would benefit from the spending that is going to happen as we emerge from this health crisis.

## **Markets We Invest In**

- Long convertibles (VXA0)\* have participated 67% in the downside of the S&P year to date. Through 3/27/2020, they have returned -14.02% YTD (VXA0) vs. -20.89% for S&P 500. The participation has been a bit higher than expected because credit spreads have blown out and the market has cheapened. High Yield credit spreads in the cash market have blown out from around 400 bps at the start of the year to 1100 bps at the highs this month. The asset class has also cheapened by about 3%.
- We expect convertibles to perform in line with the equity markets in the event that the 10% upside from current levels is realized for the S&P. The current delta of the universe of around 51.8% is likely to increase as the market appreciates due to convexity. Convertibles will also benefit from a higher income profile than the S&P. Finally we expect the cheapness to revert substantially, and credit spreads to compress as well.
- Were the market to retrace some of its gains during Q2 on worse health developments or worsening economic data, we expect the convertible market to participate in only about a third of a possible 15% downside in the equity market near term due to high convexity in the asset class, absent further cheapening and further credit spread widening.

## **Liquidity**

- Trading has been more orderly recently, and the dislocation of previous weeks has dissipated. Flows have been generally balanced. Improvement in the credit markets since the intervention by the Fed has helped.
- Even in previous weeks, when liquidity was more challenged, volumes were elevated, even though bid/ask spreads were wider. Convertibles were still much more liquid than the High Yield market, with the entire convertible market turning 2 - 2.5X per year, compared with about 1X for high yield.

## Other Information

- From a structural perspective, the convertible market is uniquely and attractively positioned to weather the storm. The average convertible bond price after the selloff is 97, with a yield-to-best (Greater of CY/YTM/YTP) of 5.1% and call protection of 2.9 years. The market has a highly convex structure, with a high degree of principal protection and lower bound return of 5%, absent a credit event. The average delta is 51.8%, which will ramp up were the market to appreciate, but also drop rapidly were the market to drop.
- Technology and Healthcare are the biggest sectors in the convertible market. Our portfolios are overweight these sectors, with an emphasis on strong balance sheets and companies levered to secular growth dynamics of the economy that have bonds with excellent convexity and risk/reward. The companies underlying our portfolios have lower leverage, better liquidity ratios, higher free cash flow yield, higher ROIC, and higher market cap, and, therefore, should be more resilient in a recession.
- We have been carefully upgrading the quality of our portfolios, and keeping a close eye on emerging or extant credit risk.

*\*Convertibles: ICE BofA All US Convertible Index (VXA0)*

*Statistics quoted in above Portfolio Manager commentary sourced from Barclays, BofA Global Research, SSI internal research.*

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