SMITH
CAPITAL INVESTORS

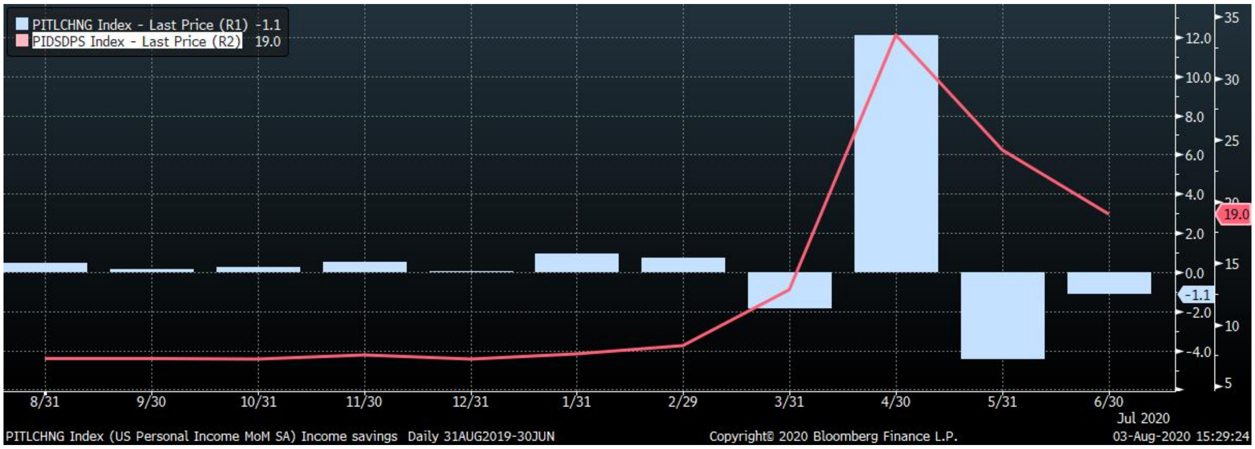
Crosscurrents in August will Setup for Clarity in September

In what is traditionally a sleepy month in Fixed Income land, we have many crosscurrents this August, with two key focuses – The Virus and Washington. Both will shed light on the expected pace of economic recovery and the prospects for better growth. As we work through the month, we expect to gather additional clarity around the virus, reopening, vaccine development, the much anticipated fourth stimulus package from Washington, and the general health of the economic backdrop. Growing concerns around debt levels and rising Government deficits (risk of higher U.S. Treasury yields) will contend with a very strong seasonal for Treasury yields in August (historical rally - lower yields). We expect to gather a good amount of information around the above-mentioned crosscurrents this month with a hope of greater clarity going into September and the remainder of the year.

Recent Economic Data Grabbed Our Attention

Incomes, as expected, fell in both May and June after the stimulus bolstered April numbers. Consumers chose to save verse spend, lifting the savings rate to 33.5%. We would not read too much into the increase in the savings rate, except that uncertain times lead to more caution in discretionary spending. Supported by both strong fiscal and monetary support, post-April, spending showed signs of recovering. In typical fashion, the dramatic political antics in Washington have delayed additional stimulus. We are waiting on a compromise on the fourth fiscal package which may include some form of an extension of the $600 per week unemployment boost payment, another round of stimulus checks, and possibly a back-to-work bonus. We hope that Washington drives the conversation toward more productive uses of fiscal stimulus with a keen focus on our ailing infrastructure and getting people back to work. Unfortunately, our hope may be a fantasy as transfer payments seem to be better received than work incentive programs these days.

Stimulus Checks Boosted Both Income and Savings in April, Declining in May and June



Blue bar: Personal Income MoM. Red line Personal Savings as a % of disposable Income

Source: Bloomberg, Bureau of Economic Analysis 6/30/2020

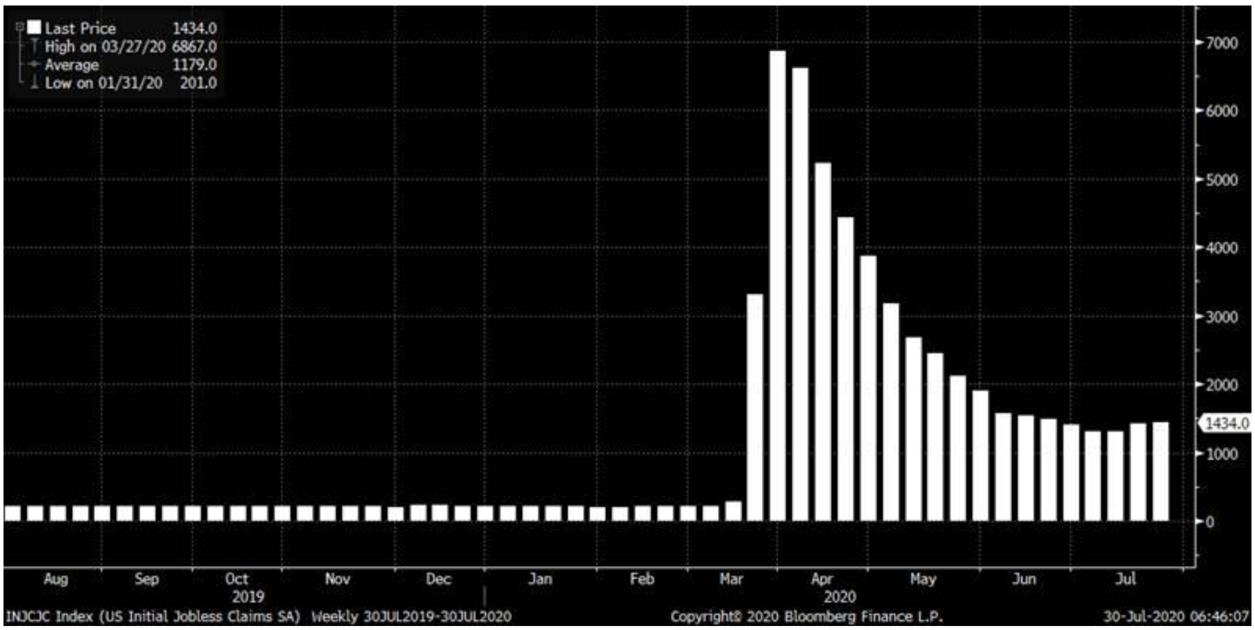
The recent setback in the economic recovery has been evident in the July high-frequency data, however, ISM Manufacturing in July reached levels marked in March 2019. The underlying components were strong and pointed to a broadening recovery in manufacturing, but we will caution that the commentary within the report still points to uncertainty, slowing patterns, layoffs, and conservative forecasting. Patience will be the most challenging element in charting the reopening and recovery. We remain favorable on the prospects of a rebound in the manufacturing industry.

ISM Manufacturing Returns to Levels from March 2019

Source: Bloomberg, ISM 8/3/20

As we look to the end of the week, Nonfarm Payrolls will take center stage. The consensus is for 1.5mm jobs to be created and for the Unemployment Rate to decline to 10.5%. We expect the July number to show continued recovery in the labor market but caution that the recent stall in Initial Jobless Claims will be reflected in the August data, which is released in September. As we dig through corporate earnings releases, we are paying very close attention to management's comments around labor. While we believe that the economic recovery is in the early stages, we fear that as part of the 'Great Reset' theme we laid out months ago, that management teams will use this period to make more aggressive decisions around the restructuring of their businesses, potentially putting upward pressure on the unemployment rate and extending the duration for those unemployed.

Initial Jobless Claims Have Moved Higher the Past 2 Weeks



Source: Bloomberg 7/30/20

Flashback Friday

Late last Friday triggered an eerie flashback for many of us. Fitch downgraded the United States outlook to negative from stable, citing "the ongoing deterioration in public finances and the absence of a credible fiscal consolidation plan." The release also noted that "high fiscal deficits and debt were already on a rising medium-term path even before the onset of the huge economic shock precipitated by the coronavirus." We continue to believe that there will be a point in the future when U.S. Treasury yields sell-off due to higher debt and deficits, but it is important to remember that Treasuries rallied in August 2011 after the S&P downgraded the United States. We wait and watch to see if Moody's and S&P will chime in post Fitch's comments. We find it hard to argue that we should NOT be concerned when Fitch expects debt to reach 130% of GDP by 2021 but acknowledge that the Keynesian response by Governments around the globe is critical in getting the economy back on solid footing. Now is not the time to be concerned with aggressive fiscal stimulus and loose monetary policy.

30-yr U.S. Treasury Yield Rallied ~ 135 bps from August to October 2011

Source: Bloomberg 7/31/20

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