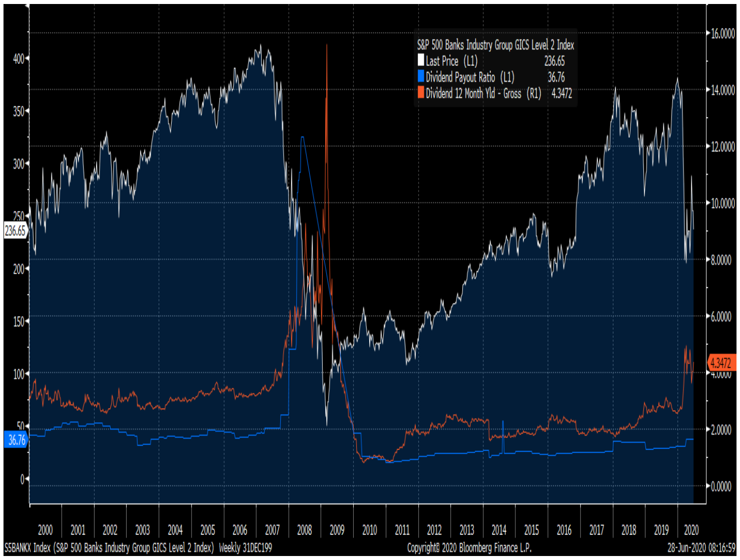
STONE INVESTMENT PARTNERS LLC

Weekly Market Guide | June 29, 2020

CHART OF THE WEEK



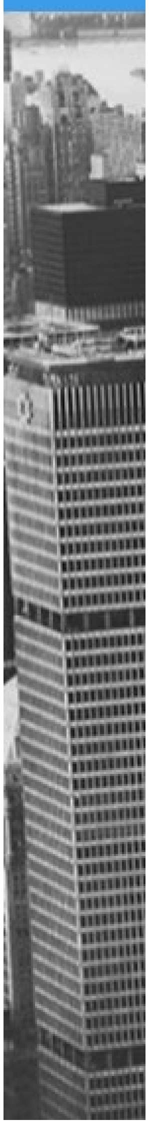
Source: Stone Investment Partners, Bloomberg as of 6/28/2020

In the wake of the release of the Federal Reserve's bank stress tests, banks were down -6.3% and a major driver of the market sell-off last Friday. The S&P 500 bank index has been a poor performer this year, down almost -38% year-to-date. There was hope that the stress tests would provide clarity regarding the status of bank dividends, but the Fed is having the banks submit another capital plan. In the meantime, banks are not allowed to repurchase shares in 3Q and can retain but not raise their dividend subject to a cap of the average last twelve months earnings. Most banks were already unlikely to repurchase shares in 3Q to conserve capital since repurchases had historically made up about 70% of shareholder payouts, so this constraint is largely a non-event. Almost all banks will also be able to continue to pay their current dividend rate in 3Q under the new Fed guidelines. Investors and the banks themselves will remain in the dark about future repurchases and dividends until after the new capital plans which are likely to be in about three months although the exact timing is still unclear. Of positive note, the U.S. banking system currently looks well capitalized. The unknown depth and duration of the coronavirus-induced economic downturn make future estimates of capital adequacy more challenging though and the Fed indicated additional stress tests later in the year as bank and economic data progress. Bank stocks are likely to remain correlated with views on the robustness of the economic recovery. Details about the Fed's bank stress tests are here and here.

WEEK IN PREVIEW

- Geopolitical: The fragile relationship between the U.S. and China will be watched and remains a risk to the economic outlook with China's National People's Congress reportedly working on the national security legislation for Hong Kong this week. This meeting coincides with Wednesday's 23rd anniversary of Chinese rule in Hong Kong. USMCA, the U.S., Mexico and Canada trade agreement, takes effect on Wednesday. U.S. financial markets are closed on Friday and the bond market closes early on Thursday in observance of Independence Day.
- U.S.: While the economic data are clearly improving relative to the nadir, the recent increase in COVID-19 cases has called into question the possible pace and strength of the recovery. After a large positive surprise in May, the June jobs report will be watched closely to judge the rebound in employment. June ISM manufacturing is expected to reach near the 50-level separating growth from contraction after falling to a low of 41.5 in April. Fed Chair Powell and Treasury Secretary Mnuchin are scheduled to testify before the House financial panel on Tuesday. Readings for our U.S. Reopening Monitor deteriorated last week with the primary driver being the financial market indicators, but new COVID-19 cases in the U.S. rose again on a week-over-week basis. Underlying high frequency economic indicators remained in a positive trend, but OpenTable diners fell likely indicating the impact of increased infections. Please see our weekly **U.S. Reopening Monitor** and our ***Guide to the U.S. Reopening Monitor*** for more details.
- S&P 500 Earnings Estimates: Consensus estimates for 2Q remain around -43.9% year-over-year (Y/Y). More attention should be paid to forward estimates with 2020 earnings unchanged last week at -21.6% Y/Y. 2021 earnings estimates improved stabilized at about +29% Y/Y. Judging future estimates is complicated with many companies removing earnings guidance due to the unknown depth and length of the shutdown related economic weakness. Five S&P 500 companies report earnings this week with 2Q earnings season really starting with the big banks during the week of July 13.
- Europe: Eurozone June economic confidence rose to 75.7 from 67.5. June consumer inflation for the Eurozone is expected to remain low at 0.2% Y/Y. The European Union and the U.K. meet to discuss a possible trade deal, but negotiations seem likely to fail with the U.K. leaving the common market at the end of 2020.
- Asia: China's industrial profits rose to 6.0% Y/Y in May. Both official and Caixin PMI readings for June will provide a reading on the economic recovery. PMI readings should remain above 50 but show little in any improvement. Japan's May labor market readings are expected to deteriorate with unemployment rising to 2.8% and job-to-applicant falling to 1.22. 2Q Tankan surveys are generally expected to deteriorate from 1Q across the board.
- Central Banks: The central banks of Bulgaria, Colombia, and Sweden are scheduled to meet with Colombia expected to lower their policy rates. The U.S. Federal Reserve releases the minutes from their June 10 meeting.

WEEK IN REVIEW



- Stocks fell by -2.9% for the S&P 500 with all eleven sectors lower for the week. U.S. economic data was generally constructive, but rising coronavirus infections and open questions about the bank stress test results weighed on stocks. Technology (-0.5%), consumer discretionary (-1.9%) and materials (-2.5%) outperformed the S&P 500, while energy (-6.4%), financials (-5.3%) and communication services (-5.2%) were the biggest laggards. WTI (-3.2%) and Brent (-2.8%) fell with MLPs (-10.5%) and the energy sector (-6.4%) falling sharply. Small cap stocks narrowly outperformed the S&P 500 with the Russell 2000 lower by -2.8% but small cap value stocks fared worse at -3.9%. The 10-year and 30-year U.S. Treasury yield were lower at 0.64% and 1.37% respectively.
- High yield credit spreads widened reflecting decreased risk appetite. AAA municipal bond yields as a percentage of Treasuries increased, causing municipal bonds to underperform. The negative revenue impacts of the economic lockdown on local governments and talk of state bankruptcy have driven municipal bond valuations to low levels relative to Treasuries. Allowing states to declare bankruptcy should remain an unlikely outcome with the heart of the issue really about the size and distribution of Federal government aid to the states.
- The U.S. dollar was marginally stronger against developed and emerging market currencies. Developed international stocks as measured by MSCI EAFE outperformed the S&P 500 returns in U.S. dollar terms (-1.3%) and on a hedged-currency basis (-1.25%). Emerging market stocks outperformed the S&P 500 with the non-hedged return of -0.3% for MSCI EM.
- The 10-2 yield curve narrowed to +47 basis points. Another curve measure of three-month yield six quarters forward minus the current three-month yield fell to +4 basis points. The yield curve has historically provided an accurate forecast of future recessions when the difference in these measures turns negative, also known as inversion. Yield curves are one of the major indicators that we monitor to judge recession risk, but these inversions typically happen more than a year in advance of an economic recession and external shocks like the current coronavirus outbreak might not be accompanied by one. Stocks have historically had significant advances post-inversion.

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Disclosures

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