FHN FINANCIAL

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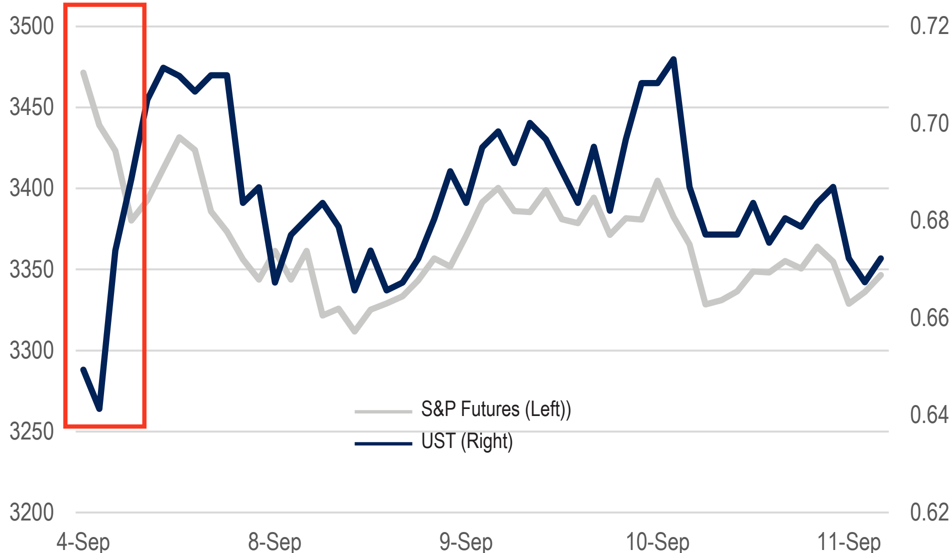
THE WEEKLY REPORT

Interest rates lurched higher last Friday after strong labor market data and traders began to prep for heavy fixed-income supply after Labor Day. Yields were poised to go still higher, but the inability of tech stocks to find a bottom allowed the 4-month yield range to hold into next week's FOMC meeting.

The chart first shows the big bond/stock disconnect on September 4 with the red box that highlights their opposing directions. Supply concerns lingered at the start of the week, then the surprising follow-on drop for tech finally pulled rates lower until the obvious bump higher thanks to the weak 10-yr auction on Wednesday. Thursday's better 30-yr auction was only helpful in keeping rates in line.

Although Treasuries couldn't rally this week, flows were active and maintained .67% as the best clearing level for two-way flows across a wide mix of news and developments. 10-yr technicals were never in danger even on the worst days, while 30-yr UST technicals stressed around 1.48% until the auction results demonstrated renewed interest around 1.46%. Of course, more long supply will provide additional tests next week.

Intermediate maturities continue to shrug off both good economic news and unusual volatility in stocks. 5-yr UST are solidly anchored in the mid .20s, and 7-yr UST will have a hard time getting to or staying above .50% this month.



Source: ICE, FHN Financial

INTEREST RATES & DERIVATIVES P. 2

In looking at possible outcomes for interest rates in early 2021, investors should pay attention to transitions from the early stages of the pandemic economy that are on the calendar for the fall. We list 5 key points, grouping them into three themes as life with Covid-19 continues to evolve. Credit quality rises to the top as the one likely to bring the most drastic reactions if it spills to the worst. If it continues with its current strength, then the household equations will rotate to the highest priority to watch.

INFLATION LAB P. 7

All the charts and details needed to understand August's CPI report, including how a surprising decline in housing prices reduced the impact of an historic monthly increase in used vehicle prices. Clearer price trends may require less interpretation in the fourth quarter. For now, it's time for extra work.

COVID-19 UPDATE P. 11

As cases fall again, details from the hardest hit states show the summer cases varied significantly within states and across different regions. Six months into the crisis, it's still difficult to generalize trends or predict the next turns. A closer look at summer outbreaks in three states and then an update on positive national trends.

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Five Pivotal Transitions Looming in the Fourth Quarter

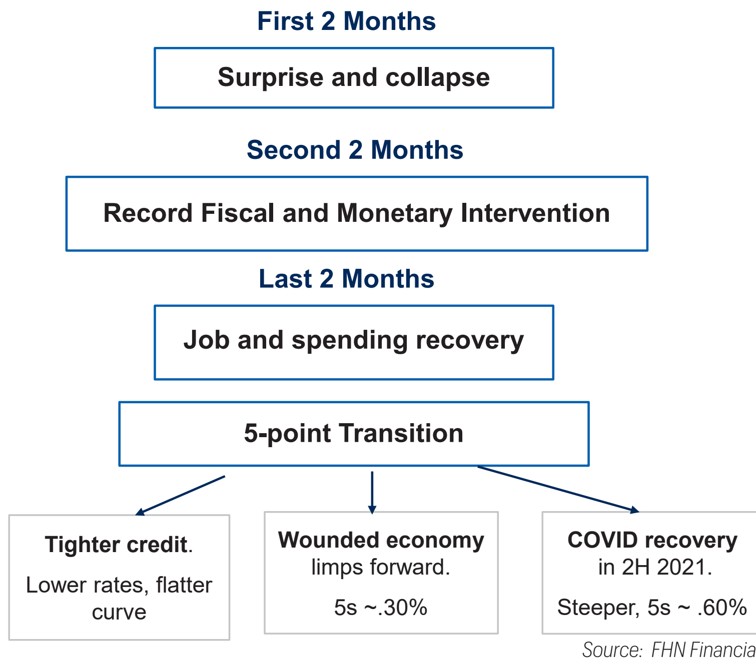
The summer brought better economic progress than expected. That has improved the tone in risk assets and steepened interest rates longer than five years. But, this is still the pandemic's year, not ours, and it will not leave us alone. ***In looking at possible outcomes for interest rates in early 2021, investors should pay attention to transitions from the early stages of the pandemic economy.***

The five items are listed first in expected chronological order, then we'll explore by broader themes and their importance.

1. *Additional fiscal stimulus from Congress*. Three issues here. First, is the willingness to set aside political perspectives to provide an economic cushion the Federal Reserve cannot. The ability to act may be more crucial than the contents of a bill. Second, if there is no action this fall, it could easily change the timing and nature of Fed guidance. Next, the idea of a meaningful federal lifeline was a vital part of the second quarter economic turn. The possibility the CARES Act was the end of the line is disheartening.
2. *Business failures and permanent layoffs*. The v-shaped recovery to date and prospects of a vaccine motivate many businesses to hang on until better times arrive. The economics of operating below 85% of capacity are excruciating for businesses of any size, however. The important transition to watch: How many shut their doors or downsize to wait for the actual arrival of an economy not controlled by the pandemic.
3. *Cumulative toll on households*. The poster child for altered existence is virtual school and down-sized education. No school in the spring felt temporary. Parents are unlikely to feel that way now because the promise of "normal" is much farther away. Household spending and sentiment are more important, near term, than the elections.
4. *Credit delinquencies and defaults*. Bankers and regulators have incorporated the first wave of the pandemic into their loss reserves and risk attitudes. Standards have tightened, but nothing actually tightens credit capacity like the reality of rising losses.
5. *Fed credit programs*. After a slow start, can the Main Street facility get enough traction to work if it's needed? If investors pull back from the corporate bond market due to bullet #4, will Fed limits on corporate purchases be enough?

<u>Bottom Line</u>: The second quarter enjoyed a flurry of support and better than expected news. The summer's virus outbreak slowed but did not stop the recovery. These transition pivots – again, completely excluding the election – will go a long way to sustaining or stopping current positive trends.

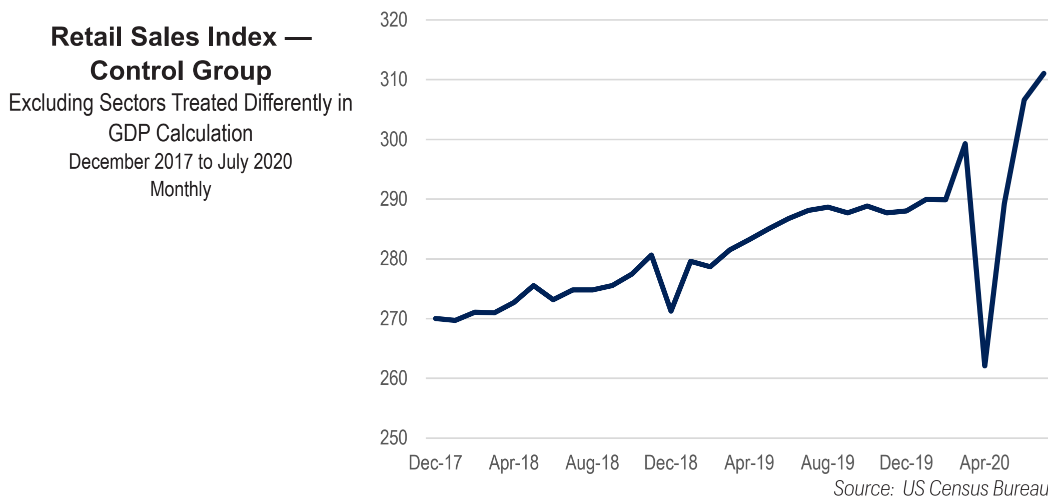
This flow chart outlines the broad history to date and the potential impacts on rates in 2021, using three broad alternatives:



Source: FHN Financial

Three themes in the transition period, starting with households

Economic forecasts widely acknowledge the excess capacity created this year and the accompanying weak prospects for capital investment. That leaves GDP dependent on household consumption and government spending. With tax revenues down for state and local governments, consumer spending rises further in importance.



Source: US Census Bureau

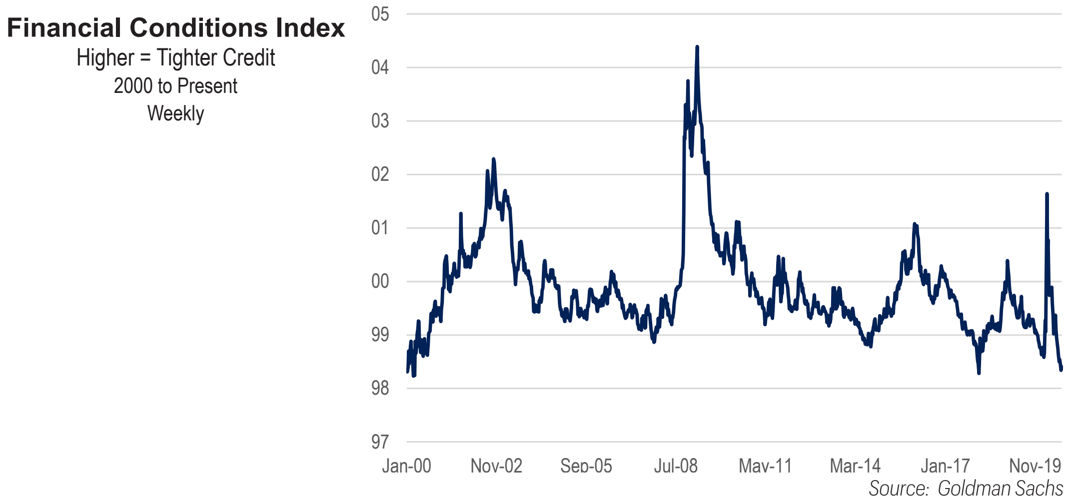
The surge in June and confirmed in July included a healthy amount of spending related to the transition to pandemic requirements that focused on electronics, autos, and other necessities for work/school from home and transportation. Macro data suggests August saw additional spending, partly because there were still funds available from second quarter stimulus transfers to lessen the blow of their demise at the end of July.

Expanding on this week's theme of possible transitions this fall, consider four factors for consumer spending.

> **Schools.** A first wave of vaccines targeted at the most vulnerable might include schools, but it's not in the discussion currently. With a residual base of infections too large to shrink considerably this year – and public health worries about flu season – the 2020/21 school calendar will see more misses than hits. How do parents balance their children, work, and financial planning? Public education is infrastructure for 40% of US households.
>
> **Pandemic.** Covid-19 upset lifestyles. Can it bring more change this year? It's in vogue to talk about vaccines, but the more immediate question is how behavior adapts to extended precautions and the inability to return to normal. The last two months reflected a willingness to risk infection to attempt a new version of normal.
>
> **Elections.** All year, consumer sentiment has been sharply divided by party affiliation. After a close election, one side will be disappointed. It would be unusual for an election to sway sentiment for an extended period, this is an unusual period.[1]
>
> **Job headlines.** Unemployment remains oppressive. Those with jobs, however, can take heart from the rapid improvement the last three months. Saving could increase, then, if job headlines turn sideways for several months or move lower as indicated by real time data this month.

Second broad theme: Credit

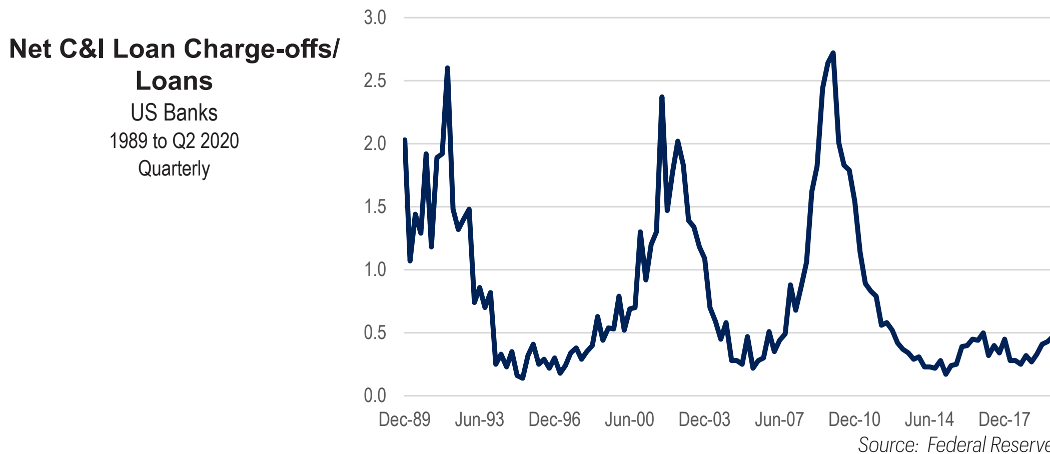
The credit cycle in a typical recession lasts at least two years, depending on the severity and the effectiveness of fiscal and monetary policy responses. It is easy to forget the "cycle" part of the credit cycle in this recession because March's emergency interventions avoided the "disappearing liquidity" start to the cycle. Look 2020's abrupt improvement to "financial conditions" that are the most timely measure of credit availability compared with 2008-2009.



[1] Sentiment did fall after the November 2012 election that created a split government in Washington and previewed the first fiscal cliff. That's the only noticeable impact during the last 20 years.

Previous recessions didn't enjoy that intervention so the transition question this fall is whether ample front-end liquidity will alter the next phase of the cycle – actual credit delinquencies and loan charge-offs. The next question is whether loan forbearance provides a second source of liquidity to bridge the pandemic period.

The credit cycle has been unavoidable in the past because of the power of negative surprises…losses that exceed initial reserves. Those losses create fear that adds further tightening that offsets the Fed's easing. The chart of C&I loan charge-offs in the last three major recessions indicates the time required to move past surprises. From the start of a recession to when charge-offs start falling is at least 18 months and it can run for 2-3 years.



As noted on page 2, the chilling effect can run longer than the charge-offs as regulators urge lenders to exercise caution. ***Another overlay that can be added to the percentage of loans charged off is the Fed has not discussed raising rates until they have stabilized near the lows.***

Credit is a topic by itself, separate from the transition period explored here. It forms the centerpiece of the second FHN Financial presentation at the virtual seminar on September 22, including the history of the Fed's attempts to influence credit availability the last 25 years. [**Click here to register for the Seminar**.]

Third theme: Government stamina and support + elections

Aside from Fed policy, financial markets have largely ignored matters surrounding government policy and stimulus the last two months. Two months of uncertainty and government stalemate is well within business and household tolerances. It's roughly par for the course. Another two months, though, may stretch the boundary line far enough to suggest more help is not coming, even after the election.

- Markets may be fine with waiting for governments to act, but real people remain on edge. Demonstrations and civil unrest – plus new zeal for peaceful social and political change – indicate short fuses around the country, even before taking any negative pandemic trends into account.
- Strained state and local finances may cause cuts to essential services that would raise further questions about government commitment to reducing the economic and inequality burdens of 2020.

- In addition to schools, state governments also have to make key decisions whether they are going to lower pandemic restrictions as they have in the last four months. Looking at a "stringency" index that measures the level of restrictions, there are minimal differences in pandemic outcomes between the most lenient and states with tighter policies.
- Voter attitudes at the election are top/down this month – hardening their impressions at the top of the ticket. If it becomes apparent Congress missed an important stimulus opportunity before the election, though, attitudes toward Congressional races could split votes in swing states even if Joe Biden maintains his polling lead and wins.
- The FOMC might shed light next week on its tolerance for no additional fiscal stimulus and the hodgepodged public health responses to the pandemic. It cannot be happy about the school situation, to take one headline example. It could choose to wait until after the November 3 election. It can take that extra time, and December is not out of the question. It cannot wait until January.
- At this time, we do not see the Presidential election as a fall transition for two reasons. First, the market's current assumption is Joe Biden would be more centrist once he takes office. Second, the move to a new Congress and new Administration will not be completed until the end of the first quarter of 2021. Policy agendas have five months to develop (and change) after November 3 before they start marching forward.

This list of transitions has emphasized the potential for negative changes in order to contrast with current upbeat attitudes seen in risk markets, hiring, and consumer spending. In the nature of potential transitions, of course, there's a chance they don't all happen (or that none do). Within the government theme, though, the likelihood remains the current inaction can last only so long. Dislocations this year have been too severe not to bring aftershocks.

Summary

Of the themes presented, credit rises to the top as the one likely to bring the most drastic reactions if it spills to the worst. If it continues with its current strength, then the household equations will rotate to the highest priority to watch.

Housing Partially Offsets Higher Auto Costs

Core CPI continued to run above expectations in August, led again by outsized moves in the price of used cars and trucks. The 5.4% monthly increase contributed to the 1.2% increase in transportation costs (less fuel). Last month, airline fees drove an even bigger increase in the transportation component that weighs in at 15% of the core.

Focusing on a small component of the overall picture is not an attempt to explain away a larger than expected increase – .38% vs a .2% forecast – but to look at the unusual moves related to pandemic disruptions of old spending patterns as referenced on page 3.

Price Index for Used Cars and Trucks
Seasonally Adjusted, Monthly
2011 to August 2020

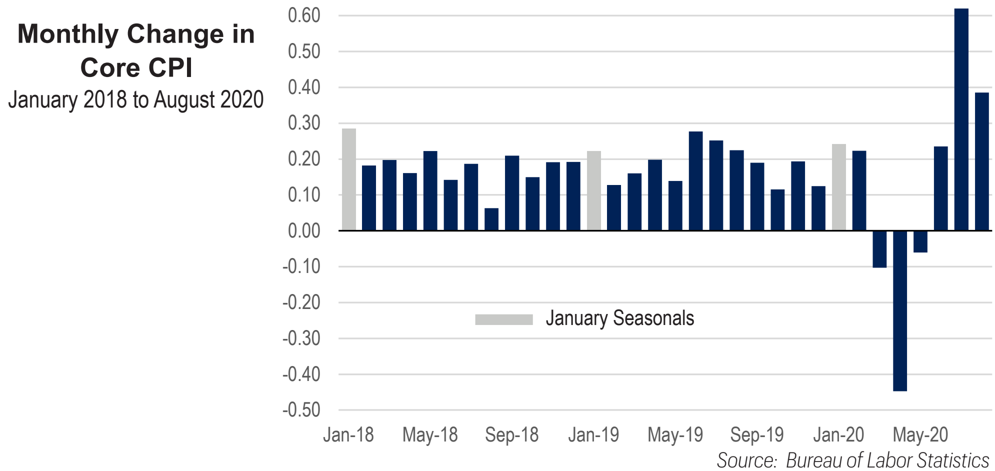
Source: Bureau of Labor Statistics

Where do used car/truck prices go next? Demand is clearly outstripping supply but are higher prices driven by monetary policy and government stimulus or a temporary imbalance? Inventories of used vehicles were clearly been a depreciating asset in the five years from 2014-2019. Overall, transportation inflation remains hard to trend:

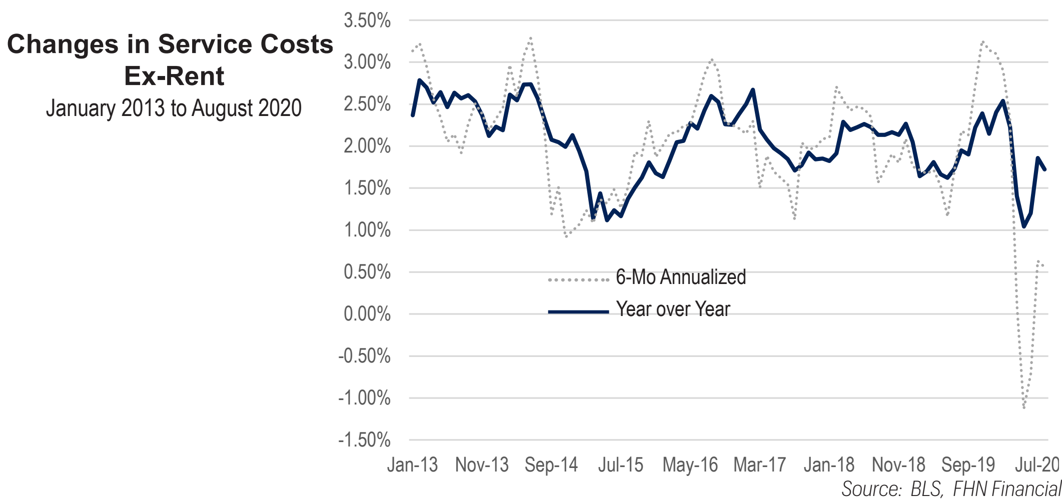
Monthly Percentage Changes in Transportation Prices (Ex-Energy)
Year to Date 2020

Source: BLS, FHN Financial

Interest rates briefly moved higher after the initial CPI release as this chart was the first pattern recognized...before traders and algorithmic programs could absorb the details. Within an hour, inflation expectations had fallen vs Thursday, not risen.



It was also helpful that services excluding rent stopped rising.



Energy keeps climbing while food prices normalize (for now)

The two non-core components also made news but in offsetting directions when it came to expectations. One reason for forecasts of .2% for core CPI was food prices were supposed to rebound more than .07% from July's decline. Meanwhile, energy came in largely as expected.

	Weight	Aug	July
OER	24.21	0.123	0.213
Housing less OER & Energy	14.93	0.219	0.258
Food & Beverages	14.13	0.072	-0.410
Transportation less Motor Fuel	12.14	1.192	2.350
Medical	8.98	0.066	0.407
Energy	6.17	0.871	2.544
Education & Communication	6.81	0.108	1.119
Recreation	5.76	0.733	-0.592
	93.14		
Other	3.16	-0.159	0.289
Apparel	2.67	0.622	1.075
Alcohol	1.03	0.267	-0.290
	6.86		

Source: FHN Financial, BLS

Here is Chris Low's bottom line on CPI (edited):

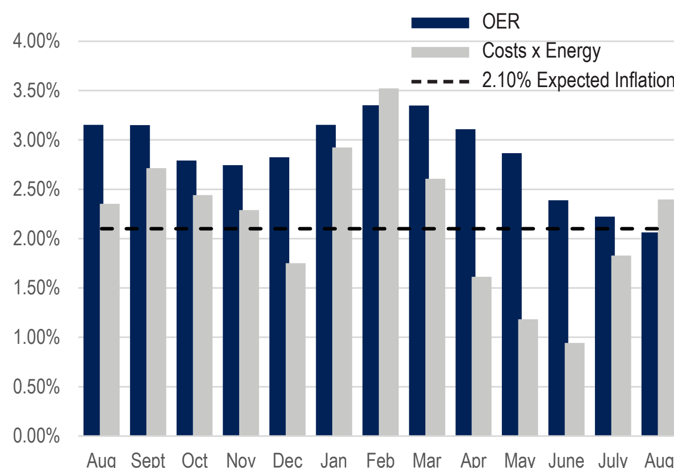
> The economy is recovering faster than expected. Aside from stubbornly high jobless claims, August output data have exceeded expectations so far. The big rise in used car prices reflects the demand recovery. Auto production was depressed during the pandemic, sales – used and new – fell less than production. Pricing power is returning in apparel and recreation, too. Year-on-year inflation is far from fully recovered, but inflation is returning faster than expected because the economy is reviving faster. The FOMC year-end core inflation forecast was 0.9% in the June SEP. It could rise next week.

Housing continues down-side surprises

The popular thesis that inflation will rise due to (or in spite of the pandemic) relies more than ever on the concept that the heaviest weights in the CPI will remain stable while 2020-2021 factors will push the rest toward or above 2%. This is not the Fed's view, at the moment, but it certainly drives the bond market. Below-trend housing costs, though, were definitely a surprise.

Housing Owners' Equivalent Rent

Housing Costs Ex-OER and Energy
Annualized 4-Month Changes
August 2019 to August 2020

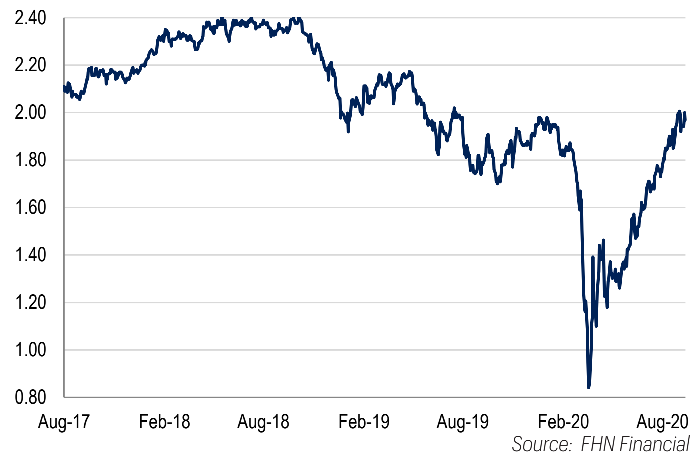


Source: BLS, FHN Financial

A 2% annualized 4-month rate on owners' equivalent rent is a first in more than three years. The previous edition of Inflation Lab had a long section on where housing costs may go next (TWR - 8.14.2020.pdf) and the topic will remain important for the rest of the year. The current FOMC is completely unaccustomed to seeing big changes in housing costs unless they are going up. For a time, they're likely comfortable dismissing 2020's slower pace as related primarily to the pandemic.

Inflation expectations return to levels from year-end 2019

Despite the details of the August report, investors are not changing their view of this summer that inflation is going to have little trouble meeting the Fed's new target over the long run. Look for expectations to continue to climb into October as well.



Some Details and Observations from the Summer Outbreaks

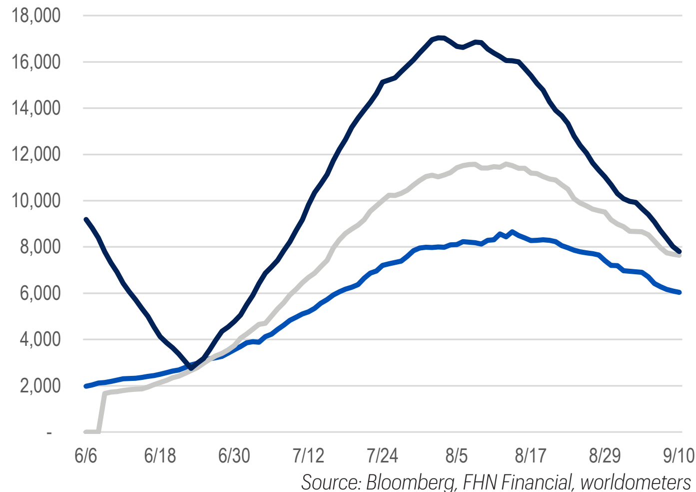
The summer was traumatizing and left no time for nuanced analysis. As cases fall again, details from the hardest hit states show the impact varied significantly within states and across different regions. Six months into the crisis, it's still difficult to generalize Covid-19 trends or predict the next turn in its path.

We start with a quiz based on this chart that computes a running total of cases/million for three states. Which one reduced its restrictions first and which had the least stringent policies in the middle of the summer?

Active Cases/Million Among Three Large States

June 3 to September 10

Active = Cumulative Cases for Previous 5 Weeks



The three states from highest to lowest:

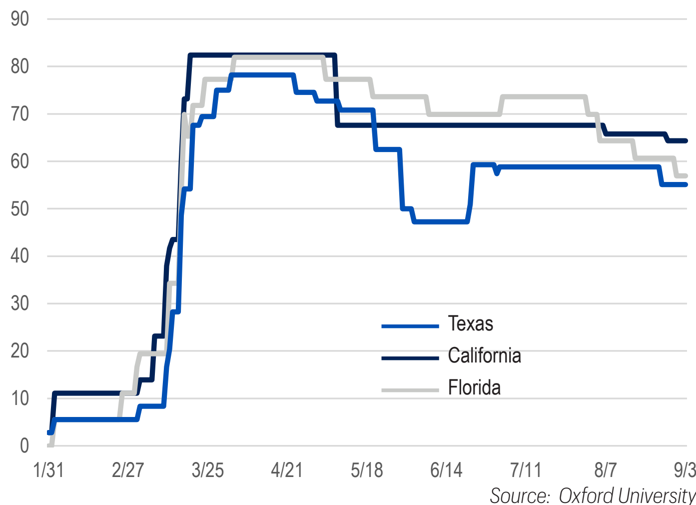
- Florida
- Texas
- California

California lowered its statewide restrictions to the greatest degree in early May, while Texas reached the lowest level of these three states in the first week of June. This analysis uses Oxford University's government "stringency" index, a broad look at global policies and actions using the same scale for each country...and now across the US for each state.

US Stringency Index

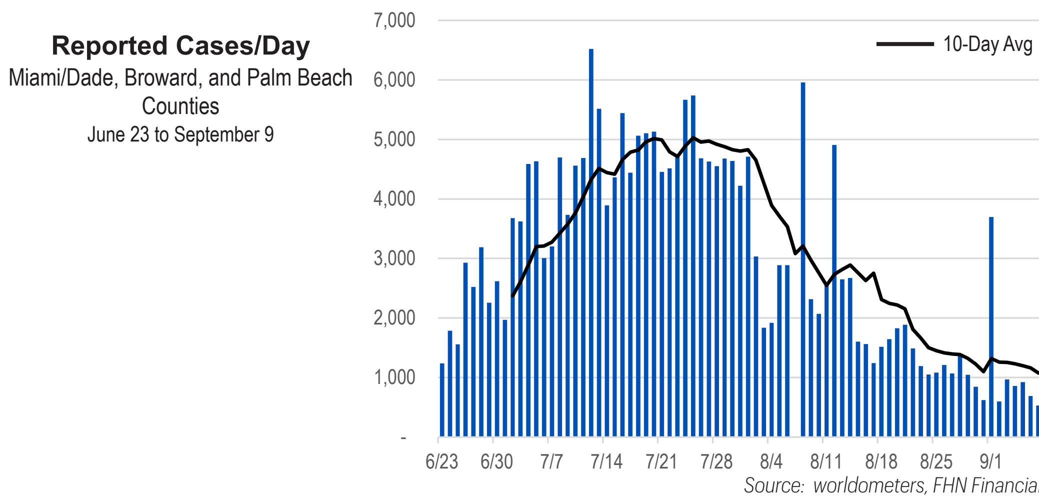
January 31 to September 4

Daily



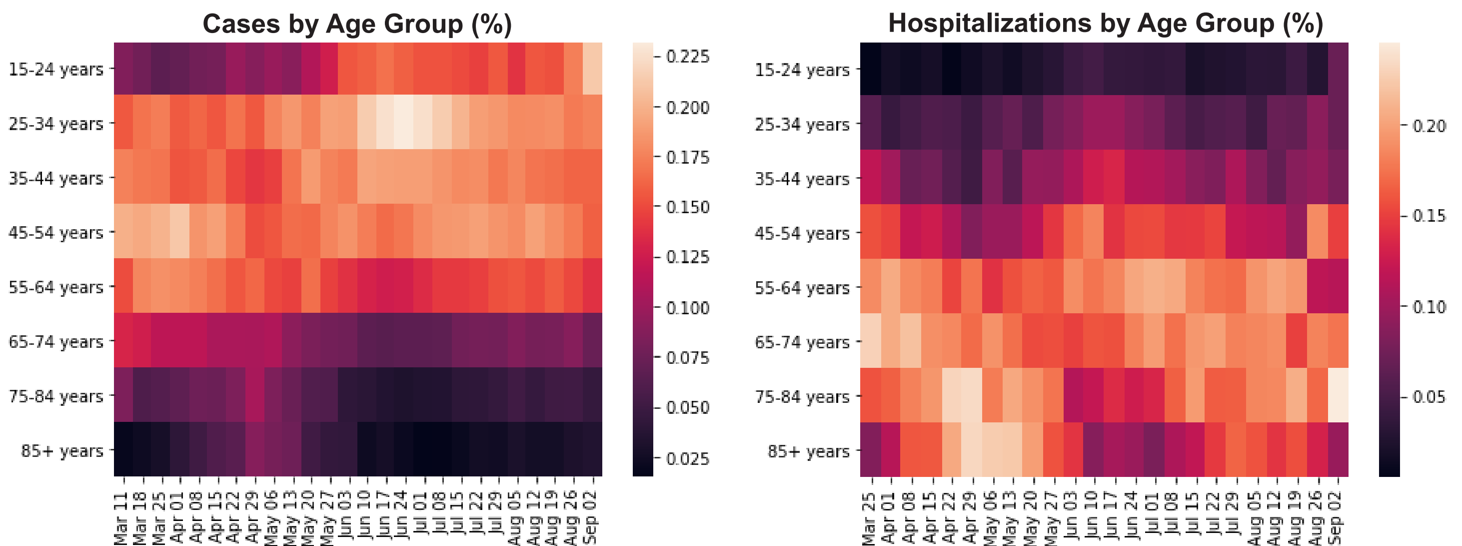
Although the university's rigorous work relies on numerous indicators, it is not here to support statistical analysis but to illustrate that ***the common assumption – government policies about behavior can strongly influence the spread of infection – doesn't prove out no matter how often it's repeated.*** Instead, different factors appear to account for both the spread and the impact of the illness.

The other immediately noticeable summer development in the first chart is that despite Florida's miserable and deadly experience at the peak, it enters mid-September at the same place as Texas. The answer to the riddle of Florida begins and ends with the unique experience of the Miami/Southeast Coast Counties.[1] They saw rapid case increases that *sustained* in July in contrast to dwindling numbers in the outbreaks among three other large metro areas across the state.



Source: worldometers, FHN Financial

The well-chronicled concentration in cases there among the younger population reduced the mid-summer severity statistics. Unfortunately, as the cases/million fell in August higher mortality rates among the older population took the statewide numbers above the national average. Here are the heat maps that show the percentage of cases and hospitalizations by age group. The breakdowns remained remarkably consistent over time.



Source: State of Florida, FHN Financial

[1] Miami/Dade, Broward and Palm Beach counties.

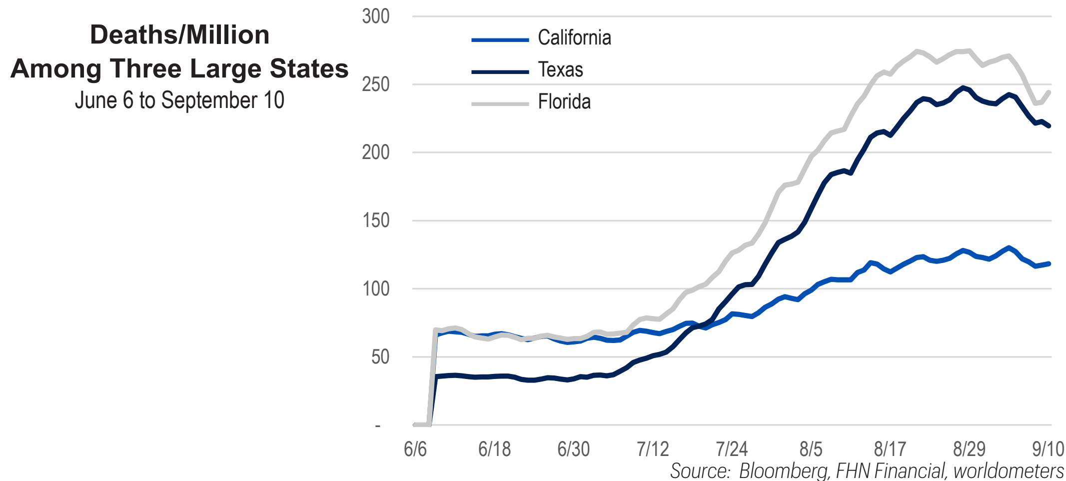
Texas

Like Florida, Texas also has four major metropolitan areas but even the largest didn't dominate the numbers across the state. Here are the most recent numbers relative to the state overall:

	Active Cases %	Population %
Houston	26.4%	26.2%
Dallas/Ft. Worth	22.3	24.4
San Antonio	8.8	4.4
Austin	7.6	4.8

Statistics across the state paint the opposite picture of Florida. ***It is the rural, least dense regions of the state that unfortunately represent the worst outbreaks, particularly measured by the differences in mortality rates by county.*** The large metro areas account for 67% of the population but only 43% of the deaths in the last five weeks. Florida, by contrast, shows the large metro areas with 62% of the population and 59% of the deaths for the same period.

Based on quite different circumstances and how the pandemic played out in Texas and Florida, they both ended (alas) at the same place in deaths/million on a 5-week average basis. As stated at the top of page 2, 2020 belongs to the pandemic and it constantly surprises.



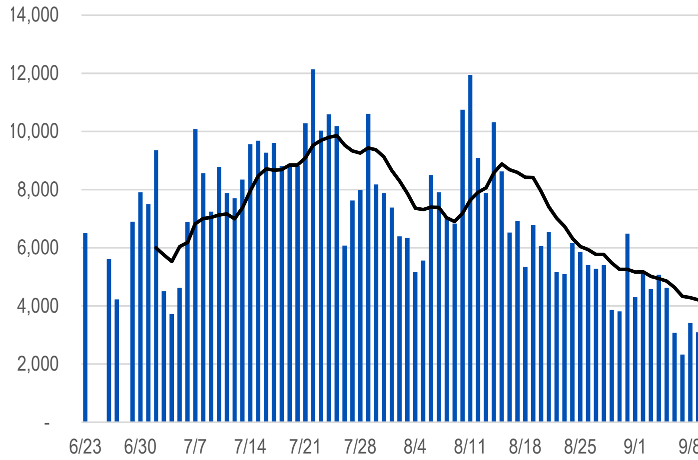
California

The largest state in the country has been unable to make much progress on its pandemic outbreak, but as seen in the above charts, never saw the big peaks that plagued Florida and Texas. Due to rising cases outside the major metropolitan areas, though, California cases double-peaked with a second in the middle of August. The background level of infection remains too high. Good news: The retransmission rate continues to fall there.

Active Cases in California

June 6 to September 10

Active = Cumulative Cases for Previous 5 Weeks



Source: Bloomberg, FHN Financial, worldometers

National Update

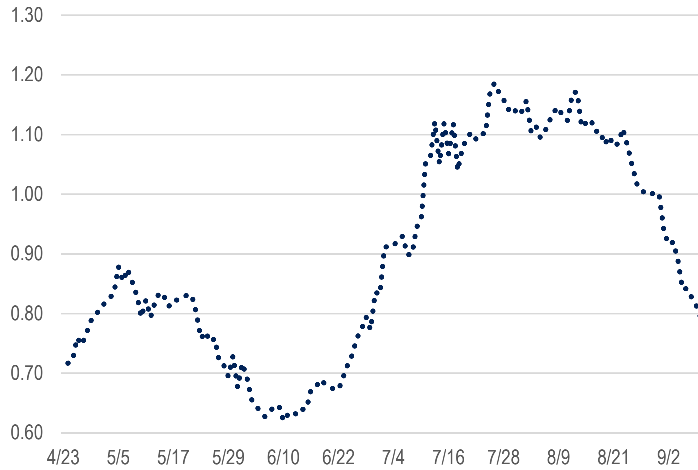
Total number of active cases has made progress since the last update. The improvement does not yet reflect the cumulative total of cases on college campuses in recent weeks, so the trend could slow.

US Active Covid-19 Cases as Adjusted by FHN Financial

April 24 to September 10

Cases Relative to Changes in Testing Levels over Time

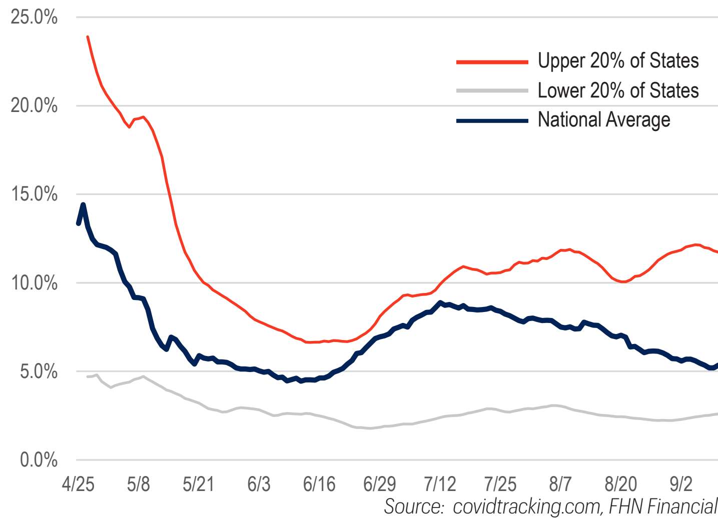
Daily (Millions)



Source: FHN Financial, worldometers

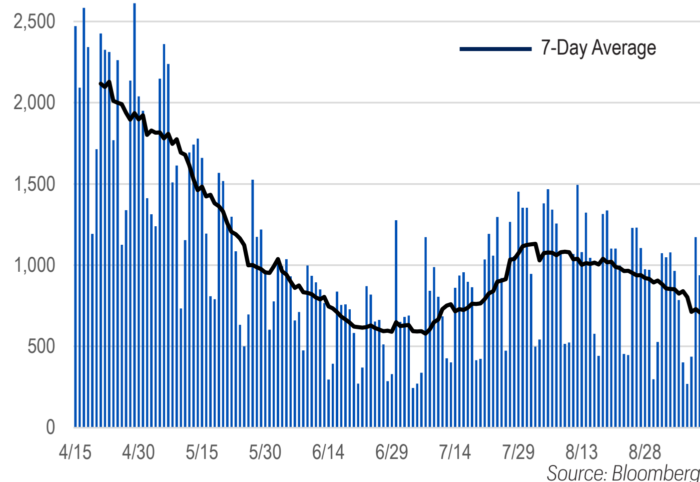
There continue to be a scatter of “rogue” states with faster growth, higher retransmissions, and difficult severity, but national positivity averages and hospitalizations are still declining.

Positive Tests/Total
7-Day Moving Averages
April 25 to September 10



The 7-day average of reported deaths each day has fallen near 750. The previous low was about 675/day.

Daily Reported Deaths
April 15 to September 10



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