FHN FINANCIAL

JULY 31, 2020

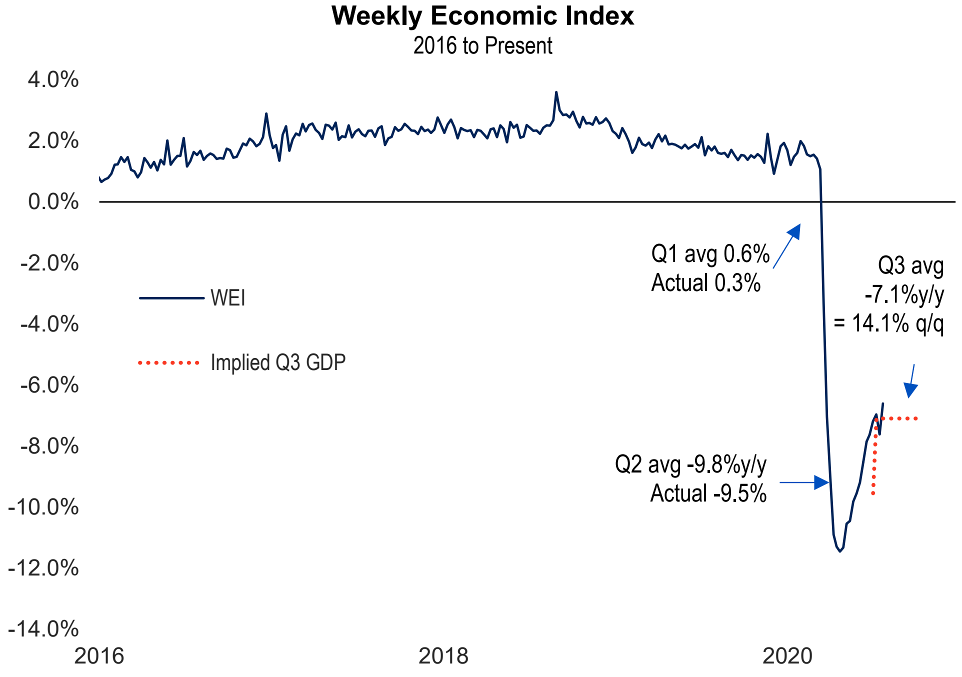
THE WEEKLY REPORT

Next week is going to be even busier than this week, making it easy to get distracted from core economic issues that lie at the heart of global markets. The second quarter GDP report again demonstrated the importance and ease of the Weekly Economic Index, an invaluable short cut to see real time trends that translate directly into US GDP.

Chris Low annotated the chart. It highlights the WEI's accuracy in measuring the change in GDP in the first two quarters, both within .3% of the actual results. With that track record, it is a must follow for portfolio managers.

Through July, the third quarter is running toward a 14% gain over the second quarter, a bit of a disappointment given earlier tracking that suggested a 20% bounce. The slowdown is no longer news – the signs have been tangible with the exception of purchasing manager surveys. But, at least the setback appears to have been temporary and things are moving in the right direction in the latest week.

With most quarterly earnings reports in hand, markets will be watching Congress, the Treasury debt refunding, ISM surveys, and the July labor market report. Oh, and Joe Biden's pick as his running mate.



Weekly Economic Index
2016 to Present

Q1 avg 0.6%
Actual 0.3%

Q3 avg
-7.1%y/y
= 14.1% q/q

Q2 avg -9.8%y/y
Actual -9.5%

Source: Federal Reserve Bank of NY, FHN Financial

INTEREST RATES AND DERIVATIVES P. 2

Rates fell this week and they can go lower. They were supposed to moving higher, or at least in a range. Chair Powell said nothing new, but everything he said framed the current predicament for the US so clearly it was impossible to miss his meaning.

COVID-19 UPDATE P. 8

Key national numbers are plateauing after almost two months of chaos. Unfortunately, deaths will not slow their march until the week of August 10.

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Doors Open to Lower Rates

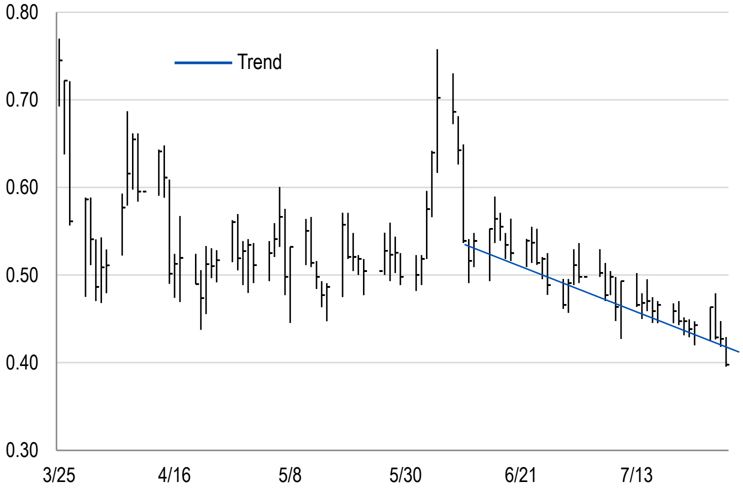
The second quarter story was the effective central bank and fiscal response that kept markets on an even keel. The broad assumption has been the third quarter would carry forward the June economic rebound and that would be enough to thwart any new problems. If anything, rates would trend upward with a steepening bias. We thought a range was more likely.

The FOMC made no policy changes this week, yet Chair Powell's not-so-veiled commentary around the need for further fiscal stimulus put investors on edge. Technicals and yield curve models suggest room for a further decline in 7-yr UST yields while 5s knifed through resistance at .23%. ***It is likely 7s reach .35-.375%.*** Daily flows in high-grade structures point to strong appetite from core portfolios for 7-yr and 10-yr maturities, confirming what's visible in the charts.

7-Yr UST Yields

March 25 to July 31 (1:00 PM EDT)

Daily



Source: FHN Financial

The trend resumed its downward path because other markets are suddenly vulnerable, not because there's a new strategic reason to add Treasuries. Consider just several of the hot markets of the second half of July and what pushed them forward. The percentage gains are for July through the 30th:

- Gold up 9.3% this month at its peak close on July 29 because of inflation fears and successful re-openings in Europe after surviving the pandemic.
- High yield corporates up 4.5% with excess returns of 4.1% as few questioned the current run of credit availability.
- Emerging market stocks up 9.3% on a weaker dollar as real yields fell (due to the same inflation and political fears driving gold).

In some fashion, each used the "excuse" of low interest rates for their rise, not always aware of why rates are so low to begin with. Jerome Powell, however, ran a master class on the underlying economic reasons rates are low during his July 29 press conference.

Benefits of fiscal support so far versus this summer's extension

Chair Powell studiously avoids talking about what Congress should do this summer (or anytime), but he speaks very distinctly between the lines. Read these two excerpts from the press conference and then try to build an argument the Fed isn't worried about the amount and form of federal support. It's very hard to do.

> ...I would say that the response from the fiscal authorities was strong, it was fast, it was broad, and appropriately so. And I think we are seeing the results of the earlier strong fiscal actions. When you see the spending that's happening, when you see small businesses staying in business even though the economy hasn't fully successfully sustainably reopened yet in many places, you are seeing what happens with that money. And so in a broad sense, it's been well-spent. It's kept people in their homes. It's kept businesses in business, and that's all a good thing. I think in the broad scheme of things, that there will be a need both for more support from us and from more fiscal policy. Fiscal policy is up to Congress. You see the ongoing discussions that they're having. And it suggests to me that there is – you know, that both sides, they're wrangling over various provisions – but nonetheless [both] believe that there is a need for some additional fiscal support.

With respect to restaurant and hospitality workers:

> Many of those people are going to find it hard. They can't go back to their old job. There won't be enough jobs for them. So I think those people are going to need support. I can't say what the exact level should be. It's not our role, but they're going to need support if they're to be able to pay their bills, to continue spending money, to remain in their current rental house or apartment or a house if they own it. So I think there will be a need.

Whatever Congress decides with regard to unemployment supplements it cannot boost the economy the way the CARES Act did:

- PPP loans were vital lifelines for small business to cushion the lockdown period. Demand for PPP fell sharply in the second half of June and never recovered. The reasons are varied, but unless retooled quickly it will not pump money into the economy in the third quarter as it did in the second.
- Enhanced federal unemployment payments were an emergency approach that caused some dislocations for employers trying to recall workers. Senate leaders appear determined to trim the benefits to find a better equilibrium between support during a time of need while adjusting to the obvious improvement in spending and hiring during the last two months of the second quarter. The counter argument is basically it's <u>never</u> a good time to cut benefits which leads Republicans to fight even harder for a bright line to divide the second and third quarters.

The market is listening to political arguments and trying to figure out what the package will be based on how both sides have achieved compromises before. Usually, any legislation is good, but not in this case. ***The point is the dollar amounts will be less and run for a shorter time period. Now that re-openings are failing in three of the largest states in the country, the stakes are higher than they were when Congressional plans were made a month ago. It starts August behind schedule and too light.***

Inflation expectations ahead of two realities

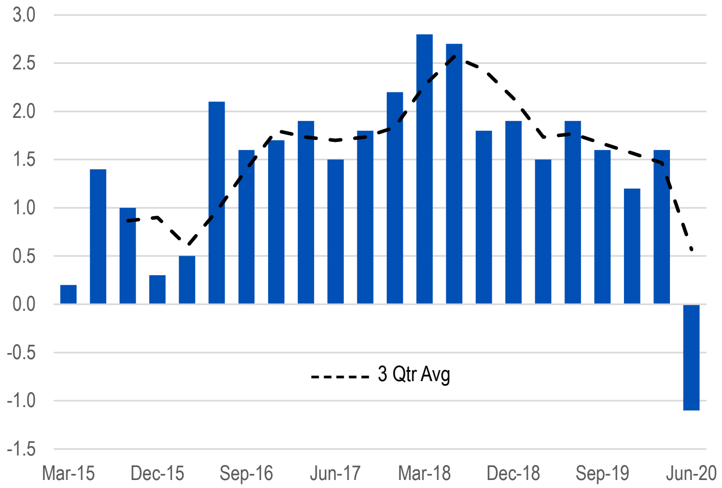
This month, 7-yr and 10-yr yields have dropped 8bp and 11bp respectively. Inflation expectations for both maturities, though, rose 18bp through July 30. ***The most likely "source" of still lower rates, then, is a retreat in inflation concern that is not completely offset by an increase in real rates.***

Core prices embedded in real GDP calculations fell more sharply than expected in the second quarter. The annualized quarterly decline in core prices in the spring rewrote the chart:

Annualized Core GDP Deflator

2015 to Q2 2020

Quarterly



Source: BEA, FHN Financial

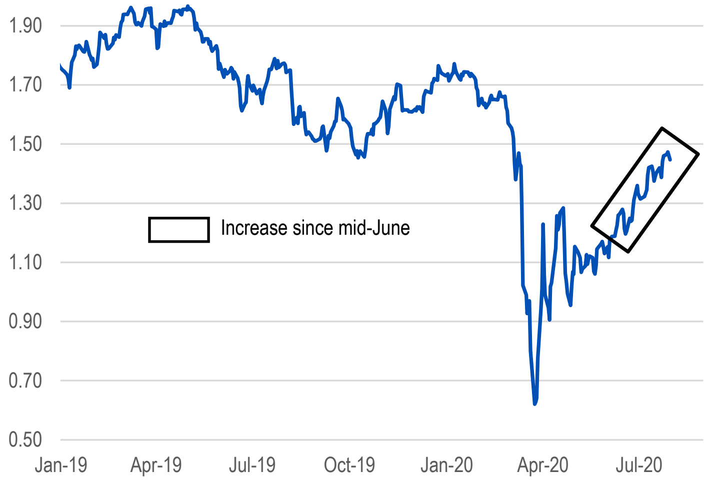
In the annual GDP revisions released each July, the core price index was revised lower in seven of the last eight quarters.

The slow inflation burn coming into 2020 supports Powell's observation at the press conference.

> I think fundamentally this is a disinflationary shock. I know there is a lot of discussion about how this might lead to inflation over time. But you know, we're seeing disinflationary pressures around the world going into this. Now we see a big shock to demand, and we see core inflation dropping to 1 percent. And I do think for quite some time we're going to be struggling against disinflationary pressures rather than against inflationary pressures.

Powell's comments, though, were either overlooked or were directly rebuffed. Market reaction to monetary policy remains hardwired despite rapid change in central bank thinking. Wednesday afternoon after the FOMC statement and press conference brought a classic market reaction, one that could have been straight out of 2009. The Fed read "dovish" so stocks rose, the dollar fell, inflation expectations rose quickly, and the curve steepened.

10-Yr UST Breakevens
2019 to July 31 (1:00 PM EDT)
Daily



Source: FHN Financial

If inflation expectations fall, do real rates go up again?

Usually, this is not the right question. The two components follow different and complex fundamentals. Investors should expect them to move independently…except during recessions. So, right now the short answer is "yes." It matters, though, whether the increase in real rates offsets any decline in inflation on a one-for-one basis.

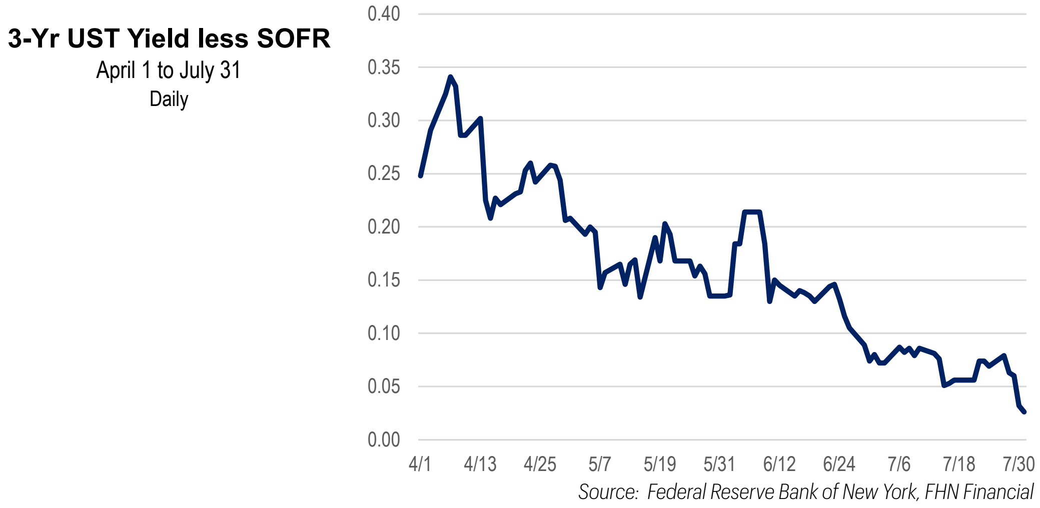
10-Yr Real Treasury Yields + Term Premium
Constant Maturity Basis
July 2019 to Present
Daily

Source: FHN Financial

Four fundamental questions with regard to a sustained increase in real yields that appear just too low for too long:

- Negative short-term rates of -1% make sense within the context of likely Fed policy.
- The uncertain path of both the pandemic and the global recovery to the point where leverage growth can return organically – without central bank accommodation – suggests sufficient risk that keeps 3-yr or 5-yr negative yields at record lows here and in Europe.
- Beyond the middle of the intermediate curve, however, it is the potential of a new QE that could keep real yields on 10-yr UST within a stable range of -.75% to -1.00% or…
- Sizeable credit losses that are nowhere on the radar in current thinking. Today, credit concerns focus on a limited number of industries that have been ravaged by pandemic behavior and regulatory changes.

With few answers on pandemic fundamentals within the 2020 horizon, investors can track real rate sentiment while ignoring inflation expectations and the TIPS cycle. In the middle of more important news, the compression at the short-end of the yield curve has been easy to overlook. This chart of the SOFR/3-yr UST spread, though, has tracked the decline in real rates out the curve, and it is likely to continue to do so.



3-Yr UST Yield less SOFR
April 1 to July 31
Daily

Source: Federal Reserve Bank of New York, FHN Financial

Summary

Trader stubbornness when it comes to Fed reactions makes it both easier and harder to forecast interest rates. Easier, because patterns repeat in predictable fashion. Harder, because those initial reactions fail and force eventual but random corrections.

10-yr UST traded as low as .521% this week. FHN Financial's current short-term expectation is for 10s to test as low as .45% with some hesitation at .50% only because it will be a psychological barrier. Remember, though, .25% was supposed to present the same sort of challenge for 5s and that collapsed quickly.

Trying to figure out potential lows beyond the next move is premature, however. ***The first step is to understand rates are lower for real reasons that will not resolve this quarter.*** We still put low odds on a Congressional failure to extend unemployment benefits, but very high odds for the results to be smaller and for a shorter time period than the support that ends today.

We leave the last words to Chair Powell with regard to labor and inflation:

> But clearly…there will not be much upward pressure on wages and compensation at the aggregate level here in a world where there are just an awful lot of people looking for work.

Summer Tide Crests But Costs Piling Higher

Note: A briefer update this week as reported data deteriorate during the transition of reporting through the Center for Disease Control to the Department of Health and Human Services. FHN Financial has corrected obvious errors in selected states in assembling the national charts below.

The rapid summer outbreak in three of the largest states in the country is leveling off after six weeks of mayhem. National case statistics are sideways rather than straight up, as a result. Left behind: Rising death tolls that will extend into next month. Coming in September: Sketchy school scheduling and more bitter debates about how and when to reopen regional businesses.

Among the climbing costs that will aggravate the economic slowdown:

- The healthcare burden of treating at least 15,000 more hospitalized patients than in early June.
- The inefficiencies of virtual classes in the fall and the need for fewer school support staff. There is also the threatened loss of teachers at schools that do reopen.
- The toll on smaller businesses that had plans to survive through the first lockdown but do not have the resources to wait for re-openings that actually remain open.
- The further delay in planning and budgeting for 2021 projects as officials and businesses await the outcome of phase 3 vaccine tests.
- Repairing cities (structurally and emotionally) that have been drained by protests fueled in part due to the virus.

Bottom Line: Even the best responses to the pandemic have been assembled on the fly in response to rolling emergencies. Unfortunately, it shows and it's past time to move toward an organized public health effort that requires investment, management and permanence. That means public financing and the cost of incurring the necessary debt.

This week's charts:

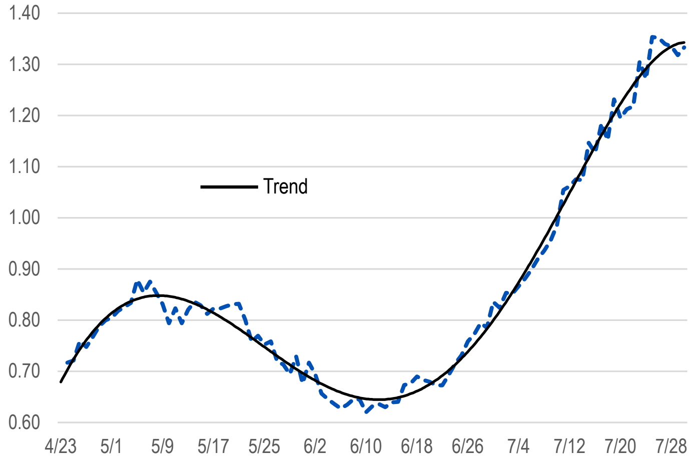
- The number of active cases may have peaked at the first of this week.
- Hospital patient volumes have fallen since July 24.
- Hospitalizations/active cases are falling quickly in the second half of the month, a sign of reduced case severity
- The national positive test ratio peaked two weeks ago, and it never rose significantly in the less impacted states.
- Daily death totals are rising quickly, with this summer's peak likely during the week of August 10. The mortality rate of this summer's cases is unlikely to exceed 2% of those testing positive.

US Active Covid-19 Cases as Adjusted by FHN Financial

April 24 to July 30

Relative to the Number of Tests Previous 3 Wks

Daily (Millions)



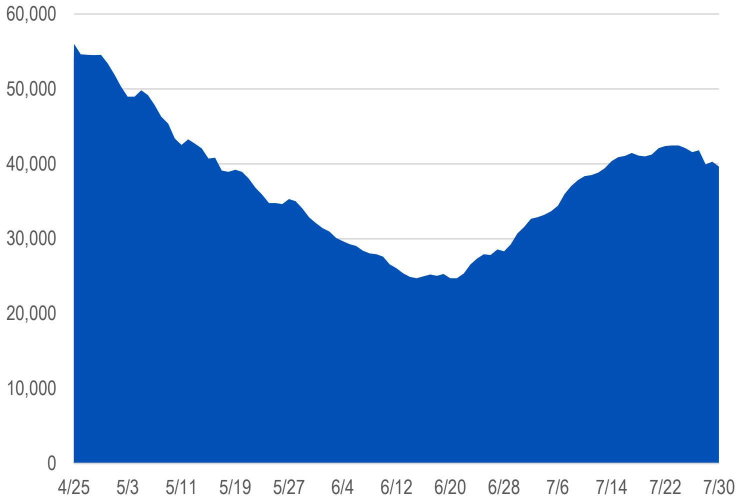
Source: FHN Financial , worldometers

Hospitalized Patients

40 States

Daily

April 25 to July 30

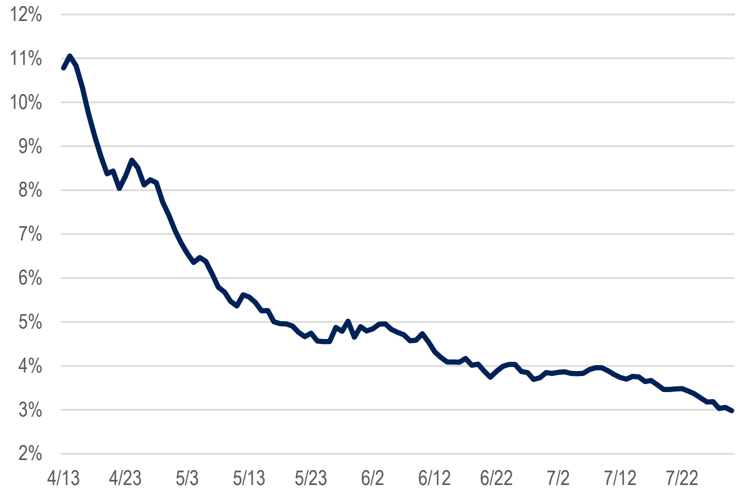


Source: covidtracking.com, FHN Financial

Hospitalizations/ Active Cases

April 13 to July 30

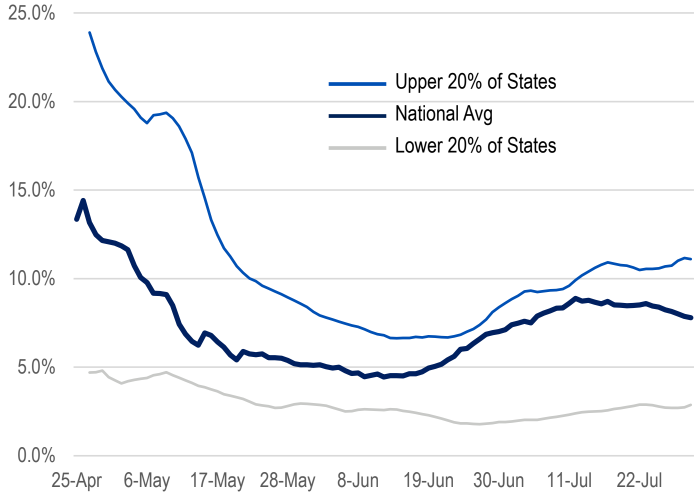
Daily



Source: covidtracking.com, FHN Financial

Positive Tests/Total

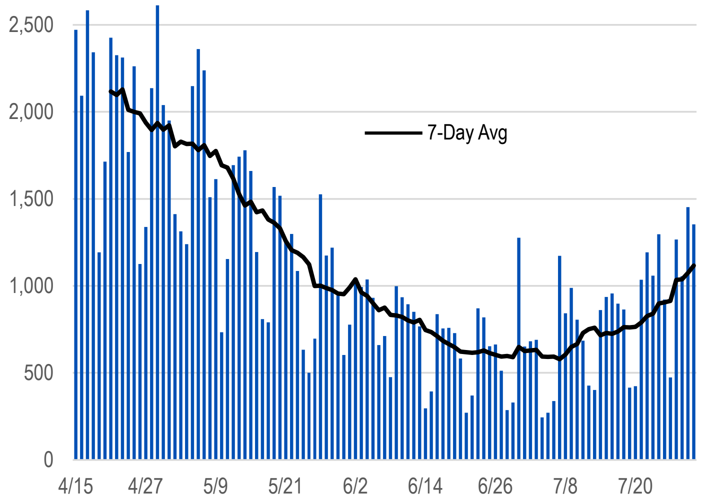
7-Day Moving Averages
April 25 to July 30



Source: covidtracking.com, FHN Financial

Daily Reported Deaths

April 15 to July 30



Source: Bloomberg

Contact FHN Financial for updates on state charts or other national trends not included this week.

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