City National Rochdale®

AN RBC/CITY NATIONAL COMPANY

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# On the Radar

FAQS ON THE MARKETS AND ECONOMY

## Where are we in the economic reopening?

Economic conditions have improved notably from the April lows, with recent data coming in much better than expected. The combination of the incremental reopening of the economy and government stimulus has supported a healthy rebound in spending, which could produce a record increase in U.S. GDP over the third quarter.

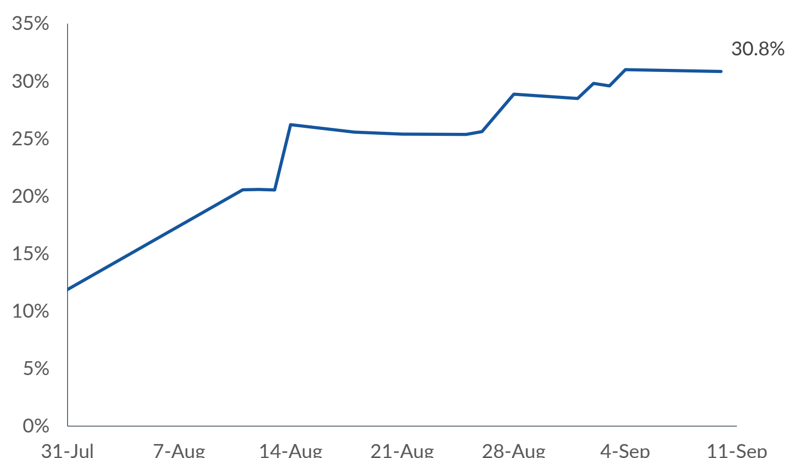
After this initial rebound, we think the economy will continue to expand, but at a much more gradual pace, as pent-up demand from lockdowns fade, social distance measures linger and consumer confidence gradually rebuilds. Indeed, a return to full normalization and prior GDP levels is unlikely until the second half of 2021.

The economy is a long way from firing on all cylinders. Spending on consumer goods has rebounded strongly in recent months. On the other hand, the services side of the economy is yet to fully come back online. State economies continue to cautiously push forward with reopenings, but over 80% of the country remains under some restrictions from the COVID-19 outbreak.

Strange as it might sound, the easy part of recovery is likely over. Most of the jobs that were going to come back right away have already come back, and most of the companies that are still around and capable of reopening have reopened.

Looking ahead, the list of challenges that will ultimately determine the shape of recovery is long and daunting, including the appropriate level of governmental constraints on economic activity, vaccine progress, school reopenings, state/local aid, and further federal support for struggling businesses and the still 13 million Americans unemployed.

**Evolution of Atlanta Fed GDPnow Estimate for Q3 GDP**




Source: Atlanta Fed as of September 10, 2020.

Above all, the path forward will follow the path of the coronavirus, efforts to contain the virus' spread and the success of governmental officials in managing the tension between the public health and the health of the economy.

**KEY QUESTIONS**

How strong was the recent labor report?

Is the recent increase in CPI a cause of concern?

What do rising COVID-19 cases at U.S. colleges and universities mean for their bond credit quality?

Should investors be concerned about the market sell-off?

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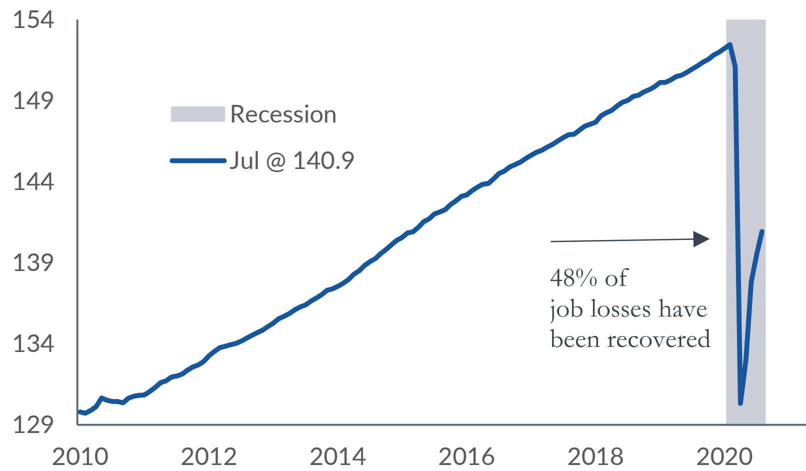
# How strong was the recent labor report?

The job market continues to heal. Interestingly, in the August report, the household survey (unemployment rate) was stronger than expected, and the establishment survey (nonfarm payrolls) was weaker than expected.

The unemployment rate is down to 8.4%, a significant decline from 10.2% in July and the peak of 14.7% in April. In August, there was a 3.8 million increase in workers. This big leap probably reflects gig workers (self-employed) who lost their $600/week federal pandemic unemployment benefits when they expired at the end of July and are now getting back to their old jobs. The improvement in the unemployment rate is far more impressive than most assumed back in the spring.

Of the 22.2 million decline in nonfarm payrolls in March and April, 10.6 million (48%) have been hired back (see chart). Still, the goods-producing sectors now stand 5.9% below the February level. This sector is expected to continue to be strong due to demand for goods and low inventory levels. Meanwhile the service sector is 8.7% lower and is still suffering from social distancing rules.

**Nonfarm Payrolls**
*millions, seasonally adjusted*




Source: Bureau of Labor Statistics as of August 2020.

# Is the recent increase in CPI a cause of concern?

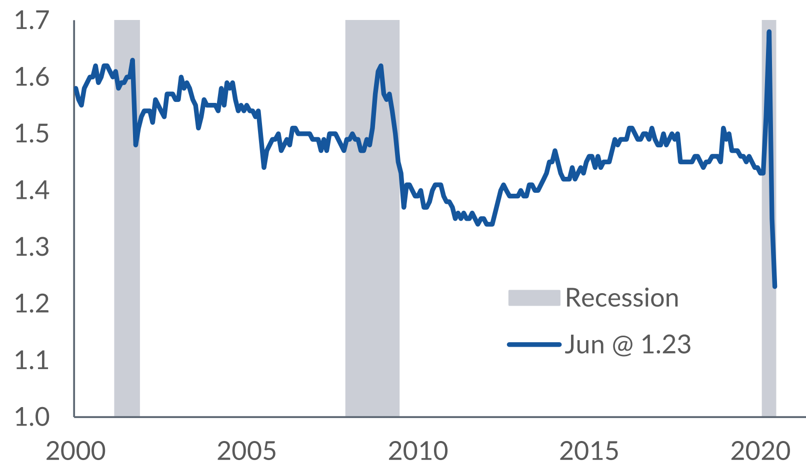
For the past three months, the monthly change in CPI has been positive, and for the past two months, it has been stronger than economic forecasts projected. On a yearly change, CPI stands at 1.3% and core-CPI is at 1.7%.

The recent increase is due to the reopening of the economy, which has caused an unexpected surge in demand. Retailers have not been able to keep up with the demand, and production has been hampered by shortages of supplies due to the lockdown, especially at some ports. The retail sector's inventory-to-sales ratio has fallen sharply; it is down to 1.23, the lowest on record (see chart).

Also, some areas of the economy that had declines in prices this past spring (e.g., vehicle insurance, apparel, and airfares, etc.) have begun to raise prices due to increased usage and demand. Interestingly, college tuition and fees fell 0.7%, the most since 1978, as many schools have transitioned to online learning.

We do not believe the recent price increase is sustainable. We believe supply will increase to meet the need. There is plenty of excess capacity and businesses are primed to start production again.

**Inventories-to-Sales Ratio: Retailers (%)**




Source: U.S. Census Bureau as of June 2020.

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# What do rising COVID-19 cases at U.S. colleges and universities mean for their bond credit quality?

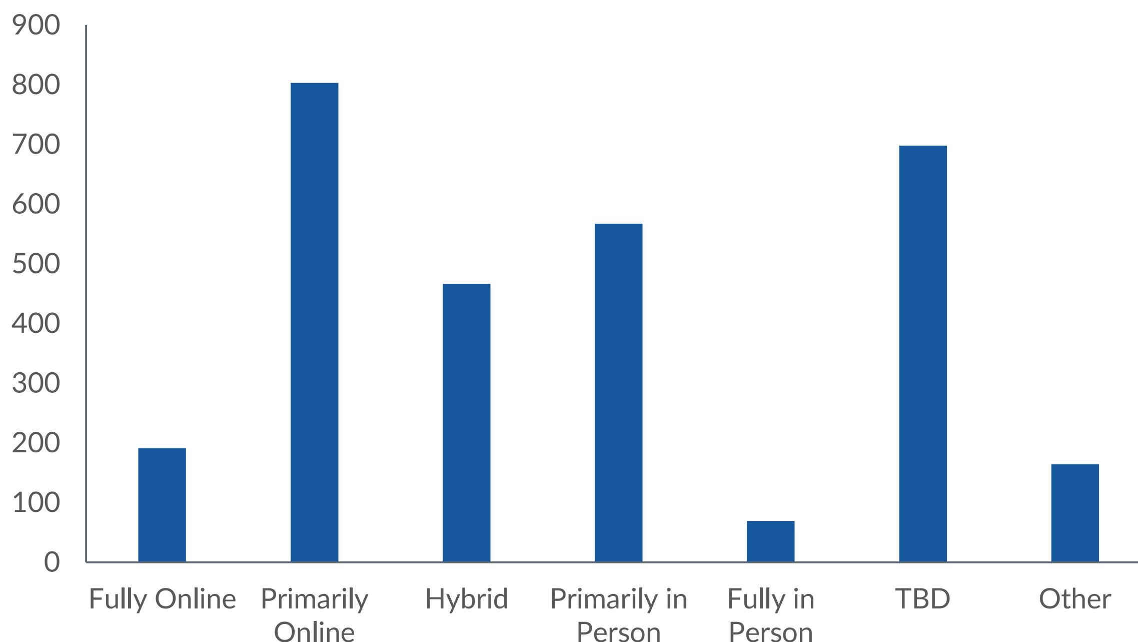
At the onset of the pandemic, institutions of higher education scrambled to shift learning from in-person to remote platforms to help control the spread of disease. Now, as the 2020-2021 academic year gets underway, for those schools that reopened their campuses, the resurgence of COVID threatens to stifle those plans. Despite stringent safety protocols and social distancing measures, in-person and hybrid modes of instruction may revert to fully online classes (now estimated at roughly 60% of colleges and universities across the U.S., per Moody's).

Enrollment uncertainty already created a complicated budget process for FY 2021 across the sector. In particular, gauging the number of students who chose a gap year or deferred admission and determining how much financial aid to award to incentivize students was also a key risk factor. Tuition pricing will continue to evolve, especially as students become reluctant to pay on-campus tuition rates for online learning. For private institutions, which typically rely on student charges, the risk is more pronounced. Now that COVID is climbing on campuses, if a school decides to close in-person or hybrid instruction or its state mandates its closure (e.g., NYS announced schools must transition to online if their campus exceeds 100 COVID cases), revenue pressure is likely to develop.

Losing students on-campus impacts demand-based services, like dormitory, dining, parking, and sports, among other activities. Moody's reported auxiliary enterprises generated a median of 13% of total revenue sources for their sector credits. The range of dependence varies, however, from less than 5% to more than 30% for some schools. Moreover, the College Board estimates more than half of enrolled students live on-campus at private institutions, versus roughly 30% for their public counterpart. Consequently, the loss of students is more problematic for private colleges and universities, all else equal. For public institutions, they will experience an uncertain state funding environment in the next few years. However, a base level of support is likely given the strategic importance of these schools to economic growth and the development of human capital.

The overall credit impact is uneven and distinct to each college or university. Schools entering the pandemic with already weak student demand or financial cushion are at elevated risk. We expect those schools with healthy balance sheets, a deep student pool (i.e., selectivity), and a greater ability to reduce expenditures in line with revenue performance should weather the impact. Mid- to upper-tier quality college and university bonds will continue to represent sound investments. However, we continue to monitor the sector very closely.

Fall 2020 Plans (as of 8/21/2020)




Source: Davidson College - The College Crisis Initiative.

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# Should investors be concerned about the market sell-off?

After five months of relatively steady advances, U.S. equities have experienced their first signs of turbulence in this new bull market, with strong-performing tech stocks in particular coming under pressure.

Broad valuation concerns, skepticism surrounding the passage of another stimulus package before Election Day, geopolitical tensions and signs of slowing progress in the labor market have all contributed to the shift in investor sentiment.

Still, even the best markets need a breather now and then, and the current pullback appears to us more in line with a healthy consolidation rather than a deterioration in the fundamental outlook. Credit spreads have been generally stable and corporate earnings expectations have not materially changed.

Corrections are normal and often healthy events, helping to eliminate excesses that have built up after extended runs of market optimism and setting a firmer foundation for future gains. Looking at the last six bull market recoveries since 1970, each experienced at least one 5% pullback on their march higher and some even 10%-plus corrections.

The strength of the stock market since March's lows has been supported by aggressive monetary and fiscal stimulus and stronger than expected economic indicators of future growth.

We continue to believe a long term recovery is under way, but going forward stocks are likely to enter a more volatile period with more modest gains than the one experienced during the summer.

| Bear Market Bottom | Number of Pullbacks (1st Year of Bull Market Recovery) | |
|---|---|---|
| | 5-10% | 10+% |
| 1970 | 1 | 1 |
| 1974 | 1 | 2 |
| 1982 | 3 | 0 |
| 1987 | 5 | 0 |
| 2002 | 3 | 1 |
| 2009 | 3 | 0 |
| 2020 | 1 | 0 |

Source: Bloomberg.

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Past performance is no guarantee of future performance.

**Index Definitions**

The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care.

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