Some day in the future, we are going to look back on 2020 and reflect on how the world and our lives changed. The spread of COVID-19 has infiltrated every aspect of our lives leaving many unemployed, threatening small and large businesses alike, and forcing many of us to remain sheltered in our homes. By estimations reported in the media, we have yet to reach the height of this calamity. The more protracted these events are, the deeper the impact to the economy. Fortunately, the monetary and fiscal response has been swift and significant, even unprecedented, to provide help and support to those that need it most. Capital markets were not spared, with the S&P 500 falling 20% during the quarter while the Bloomberg Barclays U.S. Aggregate Bond Index returned 3.15%, though this number masks the stress experienced outside of the Treasury sector. Stripping away the benefits of rates falling to all-time lows, this fixed income benchmark would have returned -4.15% for the quarter.

Economic data yet to reflect reality

Prior to virus containment efforts, the U.S. economy was rebounding from trade tensions with a “Phase One” deal signed with China and a resolution on the trade agreement between Canada and Mexico. Manufacturing and non-manufacturing surveys were bouncing back from their late 2019 levels while unemployment hugged 3.5% as job growth remained robust. With the help of Joe Biden taking the lead position as the Democratic nominee, the S&P 500 was able to reach an all-time high on February 19th. Although only a few short weeks ago, it feels like an eternity with how quickly events have transpired. Since late February, governments have called for non-essential businesses to close, the travel and leisure industries have come to a grinding halt, sporting events have been delayed or canceled, and schools are attempting remote learning. If this wasn’t enough, Saudi Arabia and Russia started a price war driving the price of oil down 66%.

Exhibit 1: The change in March non-farm payrolls was significant, but does not fully represent the magnitude of COVID-19

Source: Bureau of Labor Statistics

We have yet to see the full extent the carnage will have on economic data, but we are beginning to see glimpses. Published by the Department of Labor, U.S. initial jobless claims for the week ending March 21st were released showing a record increase of 3.3 million, shattering the previous high of 695,000 set during 1982. This figure again rose the following week to 6.6 million. Non-farm payrolls declined by a staggering 701,000 for March, with data that mainly covered the early part of the month before government-mandated shutdowns took hold. The unemployment rate moved up to 4.4% in March as a result and is expected to climb further, possibly reaching 30% by the end
of the second quarter. Estimates for second quarter GDP growth are also startling, with expectations for a drop of 30% or more on an annualized basis.

The silver lining, though difficult to see, is that despite once unfathomable economic numbers, expectations are for the economy to recover. Market practitioners are currently debating whether there will be a “U” or “V” shaped recovery, but the shape is irrelevant for long-term investors and the focus should be on the return to growth. Preceding the outbreak, the economy was exhibiting strength, and with the lack of a structural imbalance needing to be corrected, expansion should resume once the virus is under control.

**The great response**

As the COVID-19 situation unfolded and investors began to understand the gravity of the situation, selling pressures accelerated to Great Financial Crisis (GFC) levels in a matter of days. Many technical records were smashed: time from peak to bear market, size of daily price moves, supply levels, and fund flows. No asset class was left unscathed. Even Treasuries, arguably the most liquid market in the world, succumbed to liquidity challenges. The simple explanation for the rout on financial assets is that money managers and investors were selling their most liquid assets. The complex reasoning introduces the mechanics of ETFs, the unwinding of complex investment strategies, algorithmic trading, and diminished balance sheet capacity of financial institutions. It was clear that markets were no longer functioning properly.

**Exhibit 2:** After hitting a record high of 3,386 on February 19, the S&P 500 experienced violent price swings not seen since the Great Financial Crisis triggering circuit breakers multiple times

![S&P 500 Daily % Change](chart)

Source: Bloomberg, S&P, Opus

**Exhibit 3 and 4:** As evidenced by the iShares Short-Term Corporate Bond ETF (IGSB), fixed income ETFs experienced significant outflows resulting in sizable discounts to NAV and further compounding stresses in the bond markets

![Fund Flows and Cumulative Fund Flows](chart)

Source: Bloomberg, Opus

![Premium to NAV](chart)
The Federal Reserve acted twice to calm markets by cutting rates 50 basis points on March 3rd and again on March 15th, this time down to zero. On the 15th, it also announced the return of quantitative easing (QE) in the form of $500 billion of Treasury and $200 billion of agency mortgage-backed purchases. Failing to assuage market panic, the Fed pulled out all the stops before the market opened on the 23rd, announcing unlimited QE for Treasury and agency mortgage-backed securities, now including agency commercial mortgage-backed bonds, restarted liquidity programs from the GFC aimed at buying asset-backed securities and providing relief to money market mutual funds, and announced the formation of two new facilities to buy newly issued and existing corporate bonds. This marks the first time the Fed has stepped in to support corporate debt in the hopes of keeping financing open during this critical time. Lastly, the Fed opened lines of liquidity through short-term lending programs and currency swap lines for foreign central banks. This is a substantial response by the Fed, and as of early April, the Fed’s balance sheet had swelled to $5.8 trillion with further growth expected. This is $1.6 trillion higher than early March and beyond the $4.5 trillion achieved during previous rounds of QE.

It took two months to provide a fiscal stimulus package during the GFC; this latest package came to fruition in roughly one week. The $2 trillion package includes loans to industries, loans to small business, direct cash transfers to individuals, tax benefits to businesses maintaining payrolls, a boost to unemployment benefits, aid to state and local governments, and food and education assistance. As part of the measures, $454 billion is earmarked for the Fed’s bond buying facilities, which could create $4.5 trillion of liquidity if the Fed maintains historical leverage ratios. This package amounts to about 9% of GDP, without consideration of leveraging effects, and is greater than programs enacted during the GFC.

With what’s at stake, policy responses have been coordinated across the globe with central banks easing monetary policy. Many policy rates are back to, or even below, levels last seen during the GFC and the main central banks have all announced QE programs injecting liquidity into the markets. Although the immediate outlook is uncertain, the size, speed, and coordination of these actions has, at a minimum, alleviated the technical stresses in the market.

As we adjust to our new lives created by the COVID-19 outbreak and witness the turmoil inflicted upon the businesses we took for granted in our daily routines, it is difficult to look beyond the short-term challenges we face. The days are numbered for the longest running expansion in U.S. history, with a sharp recession almost certain, but we are hopeful that the monetary and fiscal response will support the economy until the threat has passed. In China, total confirmed cases have leveled off, factories have reopened, and consumers are slowly beginning to spend. This will be the case for the rest of the world as measures to contain the virus take hold.

Even with the short-term outlook uncertain, we find valuations compelling given the unprecedented policy response and our belief that the economy will eventually recover. With the Fed’s actions, the debt markets have recovered from the lows and large, highly-rated companies have been able to issue bonds at attractive levels for investors. For many quarters we have written about stable growth prospects and uninspiring valuations leading us to take a more defensive stance in our portfolios. Today, we are beginning to selectively unwind this positioning to take advantage of current investment opportunities. As we invest, we will maintain our fundamental research discipline to identify the securities we believe have the best risk/reward tradeoff.

As always, thank you for your continued confidence in Opus Investment Management. We hope that you and your families stay healthy.

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