All Eyes on the Consumer

"Consumer balance sheets were strong heading into the COVID-19 market shock—the counter-cyclical fiscal stimulus will provide a bridge to help them emerge in better shape than is the case in a traditional recession once the lock-downs are gradually lifted and the economy begins to re-engage."

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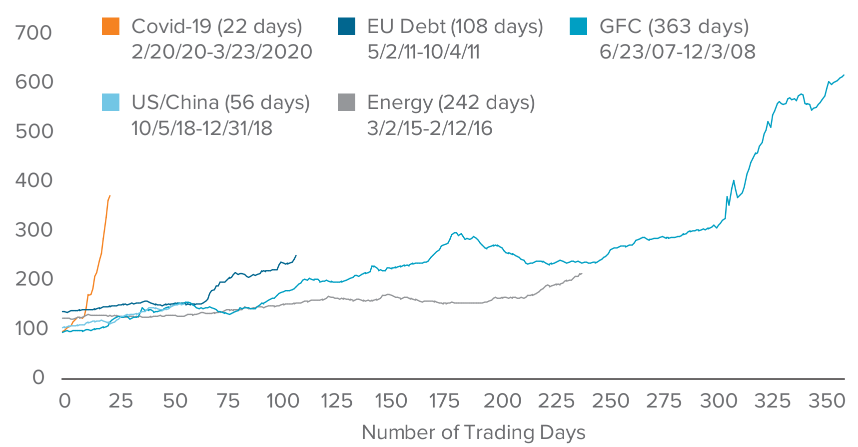
The Velocity of the COVID-19 Market Shock Was Unparalleled

The COVID-19 global pandemic has had a deep and profound effect on virtually every economy across the world. From a capital markets perspective, most headlines have focused on equities, but the real story is what happened in fixed income during the first quarter. The dislocation in the fixed-income arena left credit spreads wider and prices lower, at levels last seen in the 2008 crisis (over an extremely compressed time frame). While the magnitude of price moves is comparable to the 2008 crisis, the velocity greatly outpaced it (Figure 1). This reflects the forced selling and technical nature of the move, rather than a repricing that has emerged from real fundamental risk, which tends to come from more visible developments over longer time periods. Selling pressure is responsible for the majority of the move. As access to cash collapsed, willing buyers disappeared amid the unprecedented volatility and the broker-dealer community proved hamstrung and did not moderate the imbalance.

Figure 1. The unprecedented velocity of recent spread widening

Investment Grade Spreads



As of March 31, 2020. Source: BloombergBarclays and Voya Investment Management. Investment Grade Spreads as represented by the BloombergBarclays US Aggregate Corporate Bond Index OAS.

Don't Forget Where We Were Before COVID-19

Prior to COVID-19, there was only one consumer-led recession in the last 30 years—this was during the 2008 crisis. While there are many parallels to draw between the current crisis and 2008, the fundamental economic backdrop that preceded COVID-19 was starkly different than the economic environment that preceded the 2008 crisis.

Heading into this market shock, there was a lot of momentum in the global economy: Global PMIs had hit an important bottom in August, trade concerns had subsided, manufacturing activity was accelerating, and the U.S. stock market was setting all-time highs. Additionally, consumers had been in a fortified position for several years with a strong labor market and robust household balance sheets, which was not the case during the last bear market in 2007-2008.

In addition, there are differences in the U.S. housing market, which was a severe pain point during the 2008 crisis. However, fast forward to over the last ten years, and mortgage debt has steadily declined as a percentage of GDP (mortgage debt represents the most sizeable line item on the balance sheets of most consumers). Households also had much more home equity today than they did at the start of the 2008 crisis, further indicating the strength of the consumer before businesses began to temporarily close in response to the COVID-19 pandemic. With high capital ratios, the banking system is more fundamentally sound, another key difference between today and 2008.

"Heading into this market shock, consumers were de-leveraging and the banking system was fundamentally sound with high capital ratios."

Prior to the COVID-19 pandemic, the decline in global short-term interest rates was an important source of steam for the global economic engine. In addition to the strength of consumer balance sheets heading into this market shock, the speed and magnitude of the federal policy response is the primary reason why we believe that, while spending will certainly dip, most of the job market should hold up and consumers should remain more resilient than in other recessionary periods.

The Government Response During the COVID-19 Pandemic Has Been Far Swifter Than 2008

To date, the breadth, scope, scale and size of the government's response to COVID-19 has been enormous. To bolster financial market liquidity, the Fed cut its target rate to a range of 0.00-0.25%, dropped required reserves to zero, increased U.S. dollar swap lines and initiated an unlimited asset purchase program with an expanded list of eligible securities. In total, the Federal Reserve has extended its balance sheet by approximately $4-5 trillion since the pandemic started.

"Before the COVID-19 pandemic, our 2020 outlook focused on the monetary policy response that unfolded in 2019 as the Federal Reserve provided a couple of doses of rate cuts that appeared to be laying the groundwork for a pickup in growth."

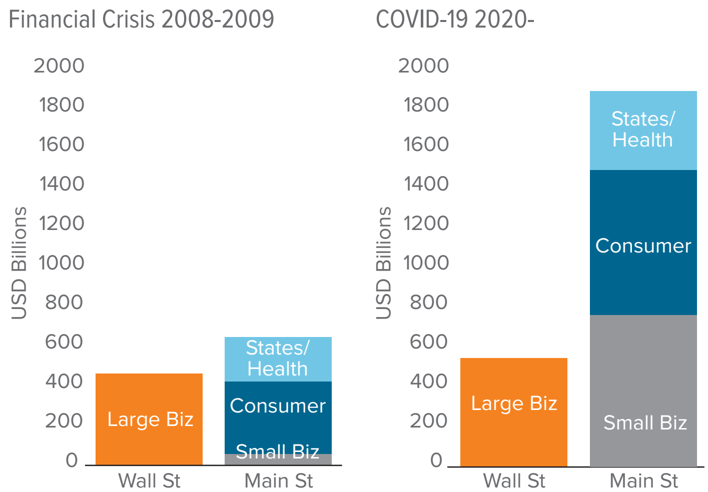
The U.S. government passed the CARES Act, a ~$2.2 trillion fiscal package aimed at supporting individuals, businesses, and the healthcare system. This is equivalent to almost 7% of GDP, which makes it far and away the largest fiscal package ever passed in U.S. history. Additionally, a second version of the successful 2008/2009 Term Asset-Backed Securities Loan Facility (TALF) program was announced. This emergency facility primarily targets the new issuance asset-backed securities (ABS) market and plans to use $100 billion to purchase securities backed by consumer loans and small business, including student loans, auto loans and leases, credit card receivables, and some small business loans.

When the issuance of new asset-backed securities stalls, borrowing costs rise, and consumers and small businesses have less access to loans. To stop this from happening, the Fed is stepping in as a primary lender and market marker of last resort in the ABS market where the amount of private investment capital has greatly diminished.

What is striking is the swiftness of the Fed's response. For example, TALF 2.0 was announced within four weeks of market dislocations. This is less than half the time that lapsed from the Lehman Bankruptcy to the launch of TALF 1.0 in March 2009.

Unlike the response in 2008 (later dubbed a "Wall Street bailout"), the stimulus in response to COVID-19 has been heavily tilted towards the hardest hit segment of the economy, consumers and small businesses (Figure 2).

Figure 2. Stimulus is Heavily Tilted Towards the Consumer



As of May 6, 2020. Source: CARES Act, Los Angeles Times, and Voya Investment Management. Financial Crisis Categories: Large Biz as defined by Federal Government commitments under the Troubled Asset Relief Program (TARP), Small Biz as defined by small business loans, Consumer as defined by relief for families, States/Health as defined by Healthcare payments, Education and Infrastructure. Covid-19 Fiscal Categories: Large Biz as defined by Corporate Loans + Airline & Cargo Loans/Grants, Small Biz as defined by small business loans, Consumer as defined by household payments, Unemployment Insurance and Tax Deferrals and Deadline Extensions, States/Health includes aid to states, hospitals & veterans care.

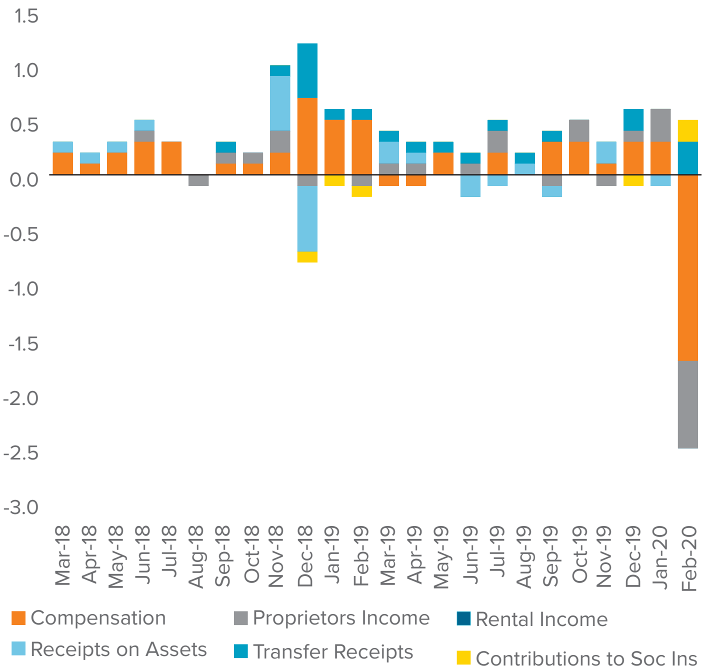
Risks to Monitor: Trappings of a Two-Speed Recovery

While there are many dark forecasts regarding the length and depth of the recession, our central case remains that government efforts will be enough to help consumers endure this storm. Once the economy begins to slowly reopen, we believe consumers will emerge in better shape than previous recessions. However, as Figure 3 clearly highlights, the immediate impact to consumers has been extraordinarily painful. The latest month-over-month data shows that compensation has plummeted by almost 2%. Transfer receipts, which include unemployment benefits, have helped offset some of this loss but not completely. A lot will depend on the "known unknowns" like how long it will take for businesses to reopen and re-engage furloughed workers.

While the decrease in compensation is bleak, it's important to remember that in addition to stimulus, the government's relief package also includes measures like forbearance, which allows consumers to temporarily reduce or stop mortgage payments. For most consumers, mortgage payments represent their largest fixed monthly cost, which means forbearance should also help soften the blow from the decrease in compensation. It is important to note that mortgage holders will eventually need to repay forborne amounts, which could lead to a future drag in consumption. However, the length of the forbearance period (i.e., initially six months with the potential for one year) is also notable, as borrowers should have ample time to recover as businesses reopen and incomes normalize.

Figure 3. While the Data is Bleak, Support for the Consumer Comes in Many Forms

Contributions to Personal Income Growth (Excluding Contributions to Social Insurance)



As of March 31, 2020. Source: Wells Fargo and Voya Investment Management.

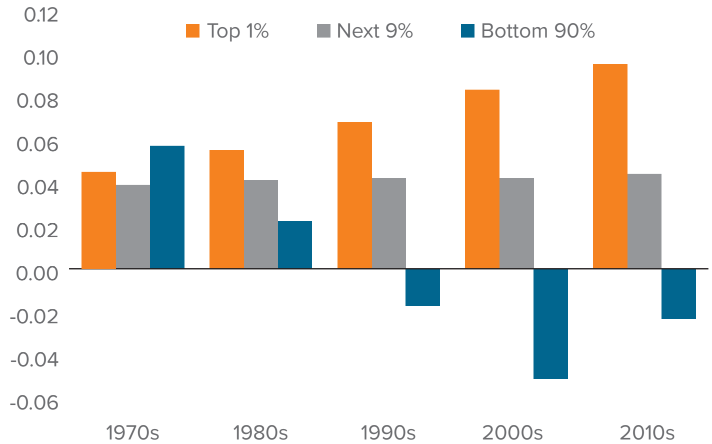
While the magnitude of the policy response has been appropriately sized and swift, it does not come without consequences. With the exceptions of airlines and a few critical industries, most large business aid is in the form of debt. Unlike mortgage debt, corporate debt–as a percentage of GDP–has grown significantly since 2008. This means large businesses will emerge with even higher debt loads and many small businesses will as well.

> "Prior to COVID-19, consumers on the lower end of the income bracket were supported primarily by low unemployment—will recent stimulus provide affected workers with enough liquidity to weather this storm?"

From this perspective, we expect the divergence between consumer and corporate balance sheets to continue. In addition, although consumer balance sheets were broadly robust heading into this market shock, a closer look at savings rates by income bracket reveals a more nuanced picture (Figure 4). Consumers on the lower end of the income bracket were in good shape primarily because of low unemployment (which provided cash flow liquidity), not necessarily because of asset growth or declining leverage.

Figure 4. Savings Rates by Income Bracket Show Wide Dispersion

Net Saving Rates Across The Income Distribution



Source: *The Saving Glut of the Rich and the Rise in Household Debt, March 2020*, Atif Mian, Ludwig Straub, and Amir Suf. Note: The saving of the top 1% is defined to be the after-tax income of the top 1% of the income distribution minus personal consumption of the top 1% of the income distribution, scaled by national income. Net saving of the other two groups is similarly defined. Averages for the decades are shown.

In our 2020 outlook, we highlighted populism as a growing force of uncertainty with the potential to pull the global economy in new directions. As demonstrated earlier in Figure 2, policy measures to combat COVID-19 are heavily skewed towards consumers and small businesses.

> "From an investment perspective, the dispersion among consumers supports our view that the best way to access attractive consumer fundamentals is through higher-quality investments."

However, while the stimulus is certainly directed to these consumers more so than during the 2008 crisis, it is more of a loss mitigation than an outright economic boost. Although our expectation is that the overall unemployment rate will drop quickly from historic extremes, we also believe that there will be lingering damage on consumers in lower income brackets. For this reason, we expect the unemployment rate to remain above pre-crisis levels. Given what is likely to be an uneven recovery, the soil that helped sow the seeds for populism's rise will become even more fertile as we emerge on the other side of the COVID-19 pandemic.

The Path Forward: Prepare for ZIRP

There is no denying that the short-term economic impact from efforts to combat the COVID-19 pandemic has been enormous. In the span of just six weeks, more than 30 million people filed for unemployment. However, we believe that ultimately, the COVID-19 outbreak will prove to be a temporary shock, inducing a technical recession but not fundamentally impairing productive capacity.

Overall, we believe the second quarter will be more transitional from the COVID-19 fallout, therefore setting up the third quarter–when growth should begin to accelerate aggressively–through to the end of the fourth quarter when we believe we will start to see a more normal rate of employment and economic growth.

In our January outlook, one of our key themes was our view that the upside for interest rates was capped. At that time, we believed that rates were unlikely to get anywhere near our 10-year fair value estimate. While much uncertainty remains, one aspect of the COVID-19 market shock is clear: The Fed will not stand in the way of the economic recovery. This means the world is headed for a prolonged period of zero interest rate policy also known as "ZIRP."

From an investment perspective, the dispersion among consumers supports our view that the best way to access attractive consumer fundamentals is through higher-quality securitized investments. Tactically, there is also an opportunity to capitalize on dislocation in the high-yield market where spreads widened to over 1000 basis points for the first time since the 2008 crisis.

In equities, small-cap companies have significantly underperformed their large-cap counterparts. We believe this dispersion represents a tactical opportunity for small-cap stocks in the short term. More broadly, the extreme widening of valuation spreads has created significant stock picking opportunities for active investors.