ClearBridge Investments

# Recovery Indicators Update: Rebound Gains Steam

September 1, 2020

## Key Takeaways

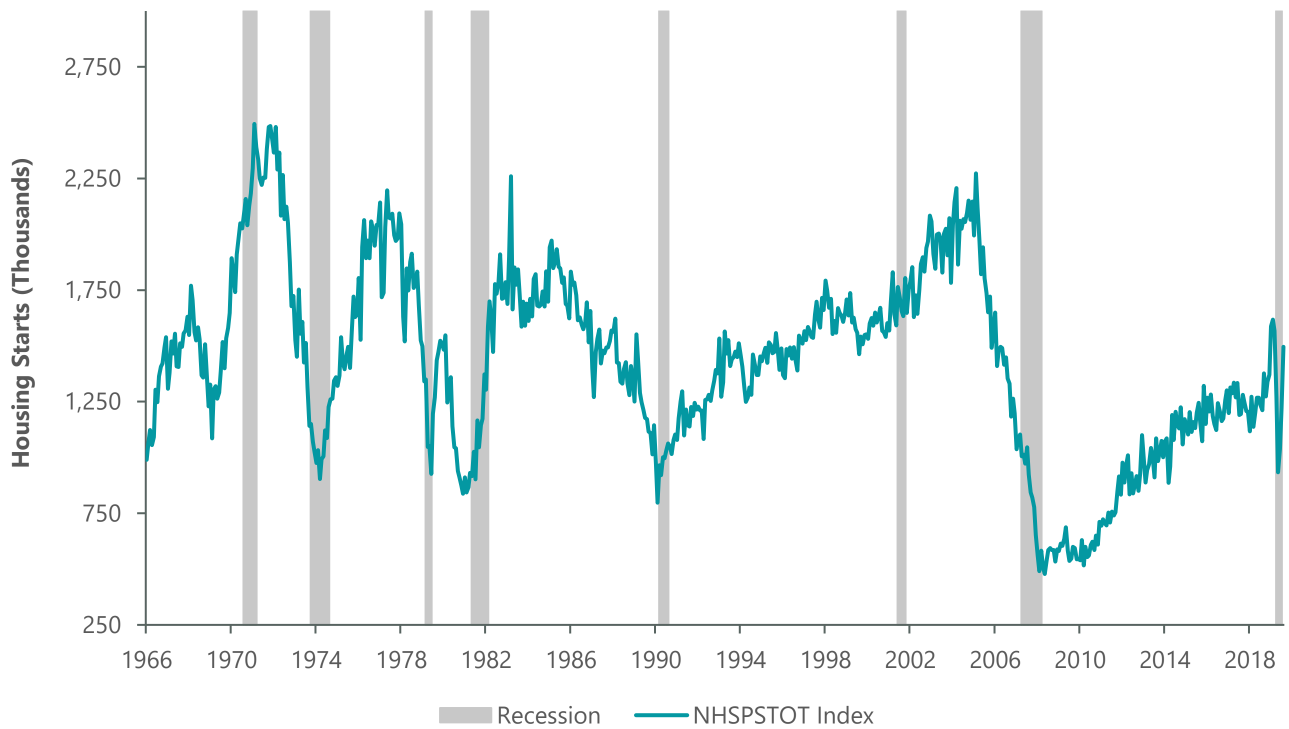
- Two indicator improvements in August further strengthened the overall green signal of the ClearBridge Recovery Dashboard, confirming our view that a durable market and economic bottom has formed.
- The uptick in Housing Starts signifies a healthy housing market which is an important component of the overall economy, with a strong multiplier effect from complementary spending.
- A narrowing of Credit Spreads has bolstered demand for fixed income securities, ensuring the ability of public companies to access capital markets to finance operations.

## Equity Markets Recoup Losses in Rapid Fashion

The S&P 500 Index completed the recovery of its coronavirus losses in August, meaning equities have now fully rebounded from their 34% drop in just under five months. This meteoric rebound from a recessionary trough is one of the fastest in modern history, proving the old adage to "not fight the Fed" still very much applies today. While many risks remain, incoming data over the last month has further bolstered our view that a durable economic and market bottom has been formed. The ClearBridge Recovery Dashboard continues to flash an overall green expansionary signal, reinforced by two additional positive signal changes this month.

The first positive signal change is Housing Starts, which has improved to green following last month's upgrade to yellow. Housing is an important part of the U.S. economy (15%+ of GDP according to the National Association of Homebuilders), with a strong multiplier effect. When a new home is constructed, it creates a great deal of associated economic activity beyond the actual construction, such as the purchase of appliances and furnishings. In the wake of the housing-led global financial crisis, starts were sluggish given excess supply built during the prior cycle. New construction only began to exceed ClearBridge's estimate of baseline demand (1.3 million per year) in late 2019, before peaking in January 2020 just above an annualized pace of 1.6 million.

Exhibit 1: Housing Starts Bouncing Back



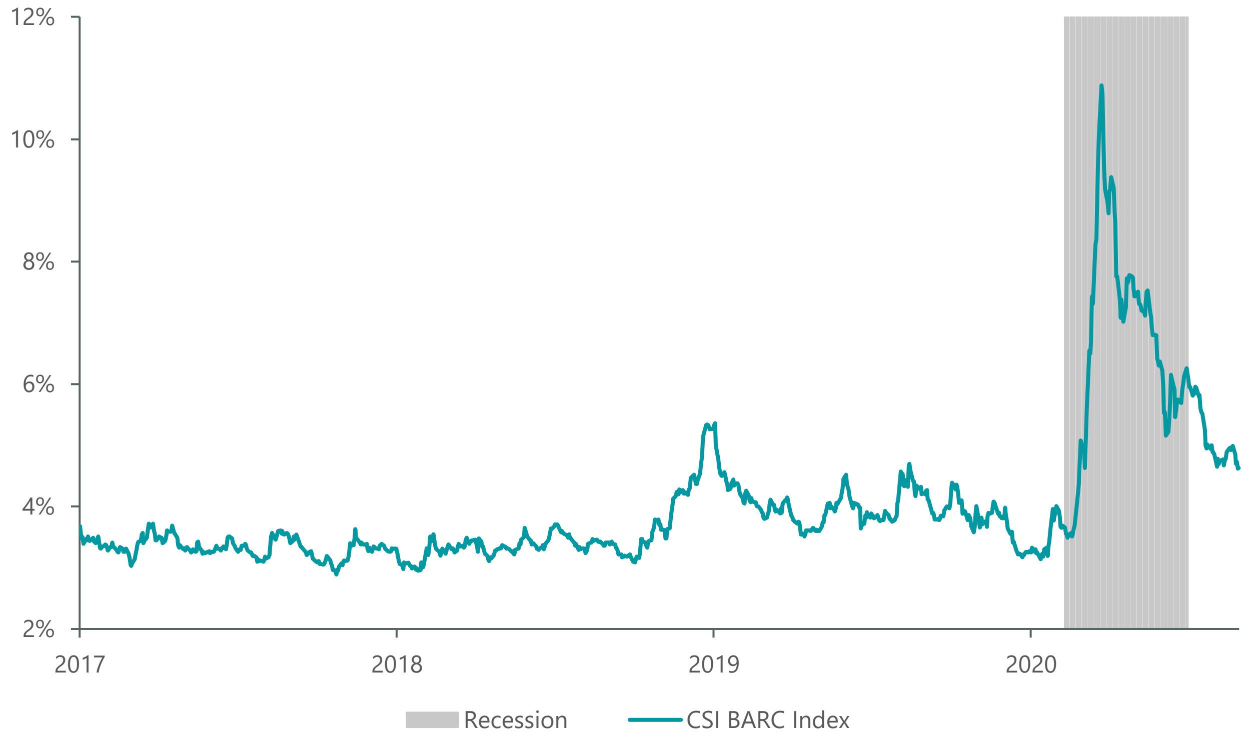

Data as of July 31, 2020. Source: Bloomberg. The NHSPSTOT index measures U.S. new privately-owned housing units started by structure total at a seasonally-adjusted annual rate.

The spread of COVID-19 quickly ground activity to a halt, with starts falling below 1.0 million in April. However, as stay-at-home restrictions have eased, housing has bounced back, particularly in suburban areas that had seen a more challenging market over the past decade. Starts have now recovered to a nearly 1.5 million annual pace (Exhibit 1). While the pace of growth may moderate in the coming months as an initial wave of pent-up demand peters out, this surge from the low is a strong sign that the economy has turned the corner. Furthermore, as these construction projects are completed in the coming months, there will be a shot of adrenaline into the economy from complementary home-related purchasing activity. This spending should further bolster GDP growth and offset the eventual waning impulse from pent-up demand.

## Credit Flowing Again to Corporate Borrowers

The second positive signal change is Credit Spreads, which have also improved to green from yellow. Credit Spreads are one way to evaluate returning investor demand for fixed income, with wider spreads equating to a higher required return in order to compensate for higher perceived risk. In the depths of the COVID-19 crisis, investors demanded nearly 11% on top of the 10-year U.S. Treasury yield to invest in high-yield bonds, about 3.5x as much as at the start of the year.

Exhibit 2: High Yield Credit Spreads Have Narrowed




Data as of Aug. 28, 2020. Source: Bloomberg.

At these punitive spreads, credit issuance ground to a halt in March. This, in turn, further exacerbated the volatility in equity markets as investors called into question a company's ability to rollover existing debt or raise additional capital. However, the quick and decisive actions taken by the Federal Reserve were in part targeted to support the flow of credit and ease this pressure point. These programs have largely been successful, allowing corporate bond issuance to come roaring back. Volatility has receded alongside the premiums fixed income investors are demanding to take on credit risk. While Credit Spreads have not fully recovered to their pre-coronavirus lows, they have narrowed considerably, retracing over 80% of their move from earlier this year (Exhibit 2). At current levels, Credit Spreads are consistent with a green signal on the dashboard.

With these two additional signal changes, the ClearBridge Recovery Dashboard is solidly in green territory. Seven of nine signals are now green, including all three in the Financial section. As noted last month, this is consistent with a recovery taking hold on Wall Street to a greater degree than Main Street.

Exhibit 3: ClearBridge Recovery Dashboard

| | | August 31, 2020 | July 31, 2020 | June 30, 2020 |
|---|---|---|---|---|
| Confidence | Consumer Confidence | ⬆ | ⬆ | ⬆ |
| | Business Confidence (ISM) | ⬆ | ⬆ | ⬆ |
| | Investor Sentiment | ✖ | ✖ | ✖ |
| Economic | Housing Starts | ⬆ | ● | ✖ |
| | Initial Jobless Claims | ● | ● | ● |
| | Philly Fed | ⬆ | ⬆ | ⬆ |
| Financial | Credit Spreads | ⬆ | ● | ● |
| | Fed Policy | ⬆ | ⬆ | ⬆ |
| | Financial Conditions | ⬆ | ⬆ | ● |
| | **Overall Signal** | ⬆ | ⬆ | ⬆ |

⬆ Expansion ● Improvement ✖ Recession

Source: ClearBridge Investments.

While the broad economic picture continues to brighten, we do not believe the remaining signals on the dashboard are likely to improve in the coming months. Incoming data is likely to be somewhat mixed as the initial wave of post-lockdown demand ebbs. However, it is important for investors still on the sidelines or looking to take on more risk to realize that a durable economic and market bottom has likely formed. Equities have erased their year-to-date losses and the consensus of forecasters expects GDP to rebound 20% in the third quarter. As such, we believe investors would be well-served to begin to re-frame their mindset away from the recently-ended recession and towards the incipient economic expansion now underway.

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