Market Update from Thrivent

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April Fool's Day Markets

As mentioned in previous postings, investors should be fully prepared for a period of extreme volatility. And thus, April Fool's Day seems an appropriate day for the market to again behave erratically. Over the last few weeks, and certainly today, the current "fool's dunce cap" is being shown to be worn by any segment of the market, participants or security structures that employed leverage (borrowing) to magnify returns.

Borrowing is a double-edged sword

Leverage is a two-edged sword that can magnify losses. Historically, leverage—or debt in the financial system—was found predominantly in the regulated banking system. But as regulations were put on banks to mitigate leverage risk after the last financial crisis, leverage has found its way into other sectors of finance and investment vehicles. These include some securitized asset structures, REITS, Business Development Companies and leveraged Exchange Traded Funds (ETFs), to name a few. Collectively these are referred to as the "shadow banking" system. As market volatility increases, leveraged structures or investors are exposed to the risk of being required to liquidate positions to satisfy lenders. This leverage issue is nowhere near the extensive problem it was during the financial crisis, but it once again is adding to volatility.

When an investor buys an asset or accumulates assets using borrowed money, the investor is required by the lender to keep some level of equity, or "skin in the game." For assets traded in the market, when the price of those assets goes below a certain level, the lender issues a "margin call" for the investor to either come up with more cash, or to sell the asset and satisfy the outstanding loan. During periods of extreme stress and volatility, price discovery for less liquid assets become challenging, triggering a vicious cycle of selling. Although not the problem it was during the financial crisis, the negative consequences of leverage seem to be popping up again.

Real estate and energy segments affected

The real estate and energy segments of the market have traditionally used leverage. These two areas have experienced more pronounced volatility and price declines as a result. The real estate market, both residential and commercial, is affected by the uncertainty of rent payments. $81 billion dollars of rent payments are due across the county on April 1. With business shut down and individuals being furloughed, it's unclear how these obligations will be covered. This uncertainty is cascading into the mortgage market, as uncertainty builds over how mortgages will be serviced if cash flow is temporarily disrupted. Market prices for REITS, especially mortgage and office property REITS, which traditionally use leverage, have been hit particularly hard.

Congress passes CARES Act

Fortunately, the immense CARES act has been passed by the federal government and will provide some relief to the problem. This huge bill seems to provide for well-targeted relief to specific areas of the economy. The market responded favorably to the passage of this bill last week, but today the immediate question of rental payment and debt service seems more acute. It will take a few weeks to get specific elements of this legislation up and running, and cash into people's hands.

In summary, don't be surprised as markets lurch up and down due to uncertainty, the unwinding of leverage and the continued rush for cash. Although this is an extraordinary time, this process is not, as the market goes through a protracted bottoming process. And stay tuned for the next market update which will take a closer look at the energy sector.

All information and representations herein are as of April 1, 2020 unless otherwise noted.

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