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OUTLOOKS

October 2020

ECONOMIC OUTLOOK

Summary

The final payroll report prior to the 2020 election is in the books and it registered a 7.9% unemployment rate. That is a huge improvement from the 14.7% recorded in April this year but a far cry from the 3.5% rate established in February 2020. The “Lockdown Recession” has also witnessed the largest quarter-over-quarter decline in GDP in Q2 (31.2%) which will almost certainly be followed by the largest increase in U.S. history when the third quarter GDP data is released on October 29. The consensus estimate points to an increase of above 30%, and while that may sound enormous - and it is a big number - the percent increase is from a smaller base and will still leave GDP growth 3 percent to 6 percent below prior year levels.

Expect political partisans and market pundits to have a field day with all this data, spinning it any way that suits their respective constituencies. One important development that is up for less debate comes from the Federal Open Market Committee (FOMC) and it involves more explicit guidance as to the factors related to raising future interest rates. Their new doctrine on average inflation targeting (AIT) lays out a sequential series of milestones that need to be met for the federal funds rate to be adjusted from the zero level.

1) The economy reaches full employment, thereby lifting wages and that in turn, raises inflation.

2) Inflation reaches 2%, not just for a month but on an ongoing basis.

3) The FOMC believes a 2% inflation rate is sustainable and will increase further then consider a hike.

How will we know when we’re getting close to these levels? A few data points should lead the way. First-time unemployment claims will need to approach pre-COVID levels in the 250K range, they are 870K today. More importantly, the unemployment rate will likely need to fall below 4.0%. This is a level reached in two prior expansions that met at least some of the condition mentioned above. At 7.9% today and the fastest portion of job gains behind us, there is a long runway ahead

Positives

ADP National Employment Report came in at 749,000 last month, better than expected and a solid number

Unemployment rate came in at 7.9%, better than forecast of 8.2%

Pending home sales increased 8.8% month-over-month and 20.5% year-over-year

Negatives

Personal income and spending came in below consensus

Durable goods orders rose only 0.4%, down from 11.4% last month

Personal consumption was down 33.2% in Q2 and should rebound nicely in Q3

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OUTLOOKS

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EQUITY OUTLOOK

Summary

The rally in the equity markets paused in September as investors took more of a wait-and-see approach. The S&P 500 shed 3.8% over the month and some of the strongest performing segments of the market, for the year, saw the largest profit taking. The Russell 1000 Growth Index fell 4.7% but remains 24.3% higher year-to-date. By contrast, the Russell 1000 Value Index held up better for the month declining 2.5% but that index is down 11.6% year-to-date.

The top performing economic sectors in the S&P 500 for the year are information technology, consumer discretionary and communication services. Those sectors are respectively higher year-to-date by 28.7%, 23.4% and 8.6%. In September, those specific sectors lost 5.4%, 3.6% and 6.5%.

Perhaps the two largest catalysts for the market's pause in September were the lack of progress on future stimulus and rising political uncertainty. Several weeks ago, it seemed very likely that Congress would eventually get together and agree on an additional round of a much-needed stimulus bill. Partisan bickering and pre-election gamesmanship have significantly narrowed this possibility.

The outcome of the presidential election and balance of power in the senate are still very uncertain. While many polls show Biden with a relatively wide margin over Trump in national polls, the key swing states are much, much closer. A contested election, which could give the stock market heartburn, is also a significant possibility.

It appears that equity market participants recognize the uncertainty that lies ahead over the next couple of months and are willing to step to the sidelines. However, corporate America is very resilient and will adapt to whatever tax or regulatory policy environment is laid out regardless of the election outcome. While it is likely stocks will be volatile as we navigate through the final quarter of 2020, we believe equity markets remain attractive for long-term investors.

Positives

Health care and pharmaceutical industries continue to make medical breakthroughs concerning COVID-19

Many retail investors have been on the sidelines throughout the rally – the pain trade is higher

Accommodative Federal Reserve and global central bank policy

Negatives

Additional economic stimulus bill now seems unlikely prior to the election

Unknowns

Election outcome and market response

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OUTLOOKS

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FIXED INCOME OUTLOOK

Summary

After announcing monumental changes in the way that the Federal Reserve intends on conducting monetary policy going forward, the mid-September meeting of their Federal Open Market Committee (FOMC) was the first opportunity to showcase their new approach in action. With their new asymmetric view of inflation around their 2% target and an abundance of slack in the labor force, the committee did not disappoint. Not only did they confirm that they believe that it will be appropriate to keep the overnight rate at the zero bound but the majority of members extended that outlook from the end of 2022 out to the end of 2023. This would indicate that it is likely that the Fed's targeted overnight lending rate will be 0.00 percent to 0.25 percent for at least three and a half years.

Recalling the last time we had zero interest rate policy (ZIRP), it lasted for seven years. We have long believed that once we dropped back down, it would be a prolonged period before the Fed will increase rates again. As it should, the 2-year Treasury note traded in a 2 basis points (bps) range for the entire month of September and closed during the month at nearly the same level it began at 0.13%.

With no uncertainty as to the path of monetary policy, at least as expressed through the overnight interest rate, all attention turned to additional fiscal stimulus. Yields would creep a few bps higher when there was more optimism that a new bill would be negotiated and would fade as those hopes were dashed. With 10 plus million still unemployed due to COVID-19, there is little debate that some level of additional stimulus is still needed, specifically for small businesses and lower wage workers. But any new aid will need to be financed and the Congressional Budget Office already estimates that the current budget deficit hit $3.3 trillion for the fiscal year just completed. At 16% of GDP, this was the highest level since 1945. The bond market might have a bit of indigestion funding another aid bill if the level reaches somewhere close to $2 trillion.

In September, the 10-year Treasury note ended 2 bps lower for the month at 0.68% after trading in a narrow 8 bps range. We believe the curve can steepen somewhat with short rates anchored at current levels and longer rates increasing modestly but any increase should be limited with the 10-year likely to stay well below 1% for the foreseeable future.

After five months of outperformance, investment-grade corporate bond returns trailed those of comparable Treasury notes as credit spreads moved a few bps wider in aggregate. We look for credit spreads to become a bit volatile with economic and political uncertainties but overall expect that corporate bonds will outperform in the final quarter of the year.

Positives

ZIRP for three plus more years and maybe more

Global search for yield will cap longer rates

Negatives

A new aid/stimulus package will add upwards of $2T in debt to be financed

The entire curve yields less than the targeted inflation rates

Unknowns

Second and third waves of the coronavirus

Election outcome and changes in polices

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