HIGHTOWER
Westchester

# Market Commentary Q3 2020

2020 continues to surprise. A pandemic, the shutdown of the global economy, the deepest recession since the 1930s, a global equity market collapse and now, record highs for the U.S. equity market. The upcoming U.S. election is shaping up to be a tight contest, with the potential for more surprises and market volatility.

We're in the early recovery phase of the cycle following the COVID-19 recession. This implies an extended period of low-inflation and low-interest-rate growth, an environment that usually favors equities over bonds. But after such a rapid rebound, an equity market pullback and further volatility, would not be surprising. Technology stock valuations are elevated, and the U.S. federal elections create uncertainty around tax changes, government regulations and the re-escalation of U.S./ China trade tensions.

COVID-19 has been center stage for most of 2020, but we expect that election buzz will steal some of the limelight during the fourth quarter. The main items on our radar for the remainder of 2020 are the election, rising wave of northern hemisphere COVID-19 cases going into the Fall, encouraging progress on the vaccine front and the ongoing negotiations around a new fiscal stimulus package.

Overall, equity markets had a strong third quarter with the S&P 500 index rising +8.9% bringing its YTD return into the green with a +5.6% return.[1] In mid-August, the S&P 500 set its first all-time high since February.[1] The market continued to power higher until early September when valuation concerns drove a shift in performance between growth and value and market volatility increased.

The strong quarterly performance wasn't isolated to just U.S. markets. Emerging market equities outperformed the S&P 500 Index with a quarterly return of +9.6%, bringing their YTD total return to -1.2%.[1] Developed international markets also had a good quarter returning 4.9% and -7.1% in Q3 and YTD, respectively.[1] During the September selloff, international markets generally held up better than U.S. equity markets and long-duration Treasuries provided some shelter. Overall, risk on sentiment remained the dominant force throughout the quarter and this dampened the performance of the Bloomberg Barclays Aggregate Bond Index, which returned +0.6% for the quarter.[1]

Fixed income markets experienced positive performance in the third quarter of 2020, mainly due to the Federal Reserve's pledge to keep interest rates low through 2023 and continued central bank support of many fixed income asset classes.

The 10-year U.S. Treasury ("UST") Note, a bell-weather measure used in the fixed income markets, ended Q3 2020 with a yield of 0.68% compared to 0.66% at the end of the second quarter.[1] Generally, Treasuries traded in a narrow range during the quarter, although the 10-year UST did briefly touch a record low yield of 0.51% on August 4, 2020.[1] In addition, the UST yield curve "steepened" slightly during the quarter as short-term yields dropped more than longer-term yields.[1]

Since mid-June, the Federal Reserve has purchased $80 billion a month in U.S. Treasuries and $40 billion a month in mortgage-backed bonds, down from even larger amounts in the Spring, as the FOMC worked overtime to support key fixed income markets.[1] Very low interest rates attracted near record amounts of corporate bond issuance during the third quarter as companies in all credit sectors accessed seemingly voracious investor demand for cash flow. As an example, year to date issuance of high yield debt has already surpassed amounts issued during all of 2019.[1] The U.S. High Yield Index was the best performing major fixed income index during Q3.[1]

The municipal ("muni") market was nearly stagnant in September, with the S&P Municipal Bond Index returning just 0.02% for the month.[1] Muni supply remained robust with issuance at $52 billion, the largest amount on record for the month of September.[1] Uncertainty around fiscal policy and the pending U.S. presidential election left investors reluctant to put their cash to work in the muni market. Performance was relatively strong in muni bonds with short and intermediate duration (i.e., low to medium levels of interest rate risk) and barbell credit strategies (i.e., exposure to both low- and high-quality bonds). Year-to-date, the asset class has gained 3.18%.[1]

As said numerous times before, these are very unusual times in the financial markets. An unprecedented amount of central bank intervention with historically low (and even negative nominal) interest rates is a challenging environment for fixed income investors. That said, the number of fixed income strategies, both conservative and more opportunistic, which we currently deploy along with our core allocations, are a means of enhancing cash flow, preserving capital, and pursuing positive risk-adjusted returns.

As previously mentioned, we expect the Presidential election to be the focus in the coming weeks. We know this isn't your typical election cycle, with COVID-19 still being a tail risk in the U.S. and concerns about the type of recovery we can expect across the global economy. Things to consider include the shape of the U.S. economic recovery, the policy by the Federal Reserve, fiscal stimulus and the current valuations of markets. We continue to believe the current investment landscape is unusual and while we wait for the outcome of the election, both parties have and will continue to embrace deficit spending, which is likely the only way through.

Although both sides remain in discussions regarding a possible fiscal stimulus package, and there have been hints of optimism over the past few days, it does not look like it will happen prior to the election. The pre-election posturing and a partisan Supreme Court battle now upon us has lowered the probability of reaching an agreement on fiscal stimulus prior to the election.

Our base case scenario is short-term gridlock. While we remain of the view that more fiscal stimulus is likely after the election, there is the risk that the outcome of the election may affect the likelihood of further fiscal stimulus causing gridlock into 2021. Should this occur, it will likely be a negative for the markets. Conversely a stimulus package will likely be a net positive.

Data has been improving, but is it enough? Initially there was a strong recovery in the data as the market began to re-open. That was because there was an "easy recovery" rebound. Going from near zero to something greater than zero was easy and the market reacted positively. Transitioning from the "90% economy" to a full recovery is something quite different. There is reasonable concern that a more sustained recovery will be challenging. Please don't forget why we are here, the virus. COVID-19 constrains re-engagement, especially with the increase in cases around the country and globe. Without new fiscal stimulus, the economic implications of COVID-19 will continue to drag on the recovery.

This has already started to be seen with retail sales growth slowing. Although consumer spending increased 1% in August, lower unemployment assistance resulted in personal income declining 2.7% relative to July.[1] Without the assistance of fiscal stimulus, this has the potential to lower consumer spending during the final quarter of the year which will drag on the economic recovery. While we have seen significant improvement in the employment data, both initial and continuing jobless claims remain stubbornly high. While the Federal Reserve has revised down their expectations for unemployment, we expect the unemployment rate to remain above 5% foreseeable future.

Without further fiscal stimulus or a significant improvement in the labor situation, the consumer story could face serious headwinds.

Globally there are hundreds of COVID-19 vaccines in development with plenty currently in clinical trials, several which are in phase III trials. It is possible that during the next few months, an effective vaccine could start to be distributed. This is a significantly faster schedule than the historical path for most vaccine development. The vast amounts of financial resources going into COVID-19 research has permitted vaccine developers to run stages concurrently without concerns regarding the financial repercussions should any step need to be repeated.

The U.S. Federal Reserve's ("Fed") move to target average inflation is a significant shift. We believe it should lengthen the expansion and delay the day of reckoning for equity markets from higher interest rates. The Fed will now allow an overshoot of its 2% target if inflation dips below the target for some time.

The Fed's preferred measure of inflation, the core personal consumption expenditure deflator, rose 1.3% in the 12-month period through June 30.[1] This measure of inflation has averaged 1.7% over the past five years and 1.6% over the past decade.[1] This gives the Fed plenty of room to leave the Fed funds rate unchanged after inflation starts to pick up. Other central banks are undertaking similar reviews of their respective policy operations and we expect they are likely to reach similar conclusions.

In Europe, economic indicators have rebounded through the third quarter following the easing of lockdowns. Infections have been rising, but hospitalization and death rates remain low due to the shift in infections to younger age groups and more effective treatments. Local targeted restrictions seem more likely than a return to the nationwide shutdowns of March and April. Europe's recovery should continue over coming quarters. It is more exposed to global trade than the U.S. and will be a beneficiary of a rebound in Chinese demand.

U.S./China tensions have escalated with U.S. restrictions on Chinese companies including Huawei and TikTok. Nevertheless, we think the phase one trade deal will remain intact through the U.S. election and have been encouraged by multiple reports of increased Chinese purchases of U.S. agricultural and energy goods.

The Chinese economy has seen significant improvement since the COVID-19 crisis, with many indicators now pointing to growth over the year. The consumer and the services sector have started to catch up to the manufacturing sector. Fiscal policy is set to remain very supportive through the rest of the year and we expect that credit creation will be solid.

So where do we go from here? Volatility is likely to remain elevated during the remainder of the year. Rising COVID cases combined with a very different election cycle are likely to increase volatility during the fourth quarter. And while macroeconomic data has been improving, we could see an uncertain path without taming the virus and additional and much needed fiscal stimulus. The market is telling us that market volatility is expected to remain above its long-term average until there is a viable solution to the pandemic and election uncertainty is behind us.

Within this environment, it is essential to remain ahead of the thematic trends shaping the economy. As such, maintaining a diversified portfolio remains the only free lunch in town. There is as much noise out there as there has been in the last decade, and as we have noted before, make sure to balance fundamentals and noise within portfolios. Improving economic data and a potential vaccine on the horizon help provide some glimmers of hope into the final quarter of 2020 and what would be the strangest start to a new decade in some time.

**To discuss this commentary further, please contact us at 914-825-8630.**

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[1]Morningstar Direct