# Investment Perspective

Why did the financial markets rally in the face of such economic hardship?

Expect the unexpected — one of the golden rules of investing. This year reminded us of that rule. In January, we did not expect a pandemic to cause the most severe global recession since the 1930s. The stock market tumbled at a terrifying pace because of this devastation. We did not expect a market decline of 35% in five weeks, a recovery of 55% in five months and a new market high in September. Why did the financial markets rally in the face of such economic hardship? The primary reasons were massive central bank liquidity, fiscal stimulus, the temporary nature of quarantine measures and the prospects for a vaccine. However, there was another major development that was unexpected. The Covid-19 pandemic accelerated technological shifts already underway for more than a decade. The need for innovative solutions in response to the pandemic's disruption amplified these positive secular trends, leading to the outperformance of many technology companies across all market spectrums.

Generally, stock markets have recovered as investors gain confidence. The virus's impact is not as bad as originally feared and corporate earnings have been better than expected. In fact, the S&P 500 hit a new high on September 2, marking one of the fastest market recoveries in history during a recession. This recovery took only six months compared to an average of three years during recessionary periods. We expect the market to strengthen further during the fourth quarter as November to April is historically the best seasonal period for the markets. But we also expect continued high volatility due to economic uncertainties associated with Covid-19, the presidential election, future fiscal stimulus, vaccine developments and the trajectory of corporate earnings. A summary of year-to-date index returns through September 30, 2020 is as follows:

All major regions resumed growth in the third quarter as a positive inflection began during the summer months. Economists now expect a rebound in worldwide growth of 5.8% in 2021

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| Dow Jones Industrials | -0.9% | Russell 2500 | -5.8% |
| MSCI EAFE | -7.1% | S&P 500 | +5.6% |
| NASDAQ Composite | +25.3% | Wilshire 5000 | +6.3% |

## GLOBAL ECONOMY

The world economy entered a severe recession with GDP (ex. U.S.) expected to decline 3.9% this year due to the pandemic caused by Covid-19. Each major region suffered a dramatic decline in growth during the first half of the year with Europe experiencing the sharpest downturn. Least impacted was China which may grow 2% this year after a sharp first quarter downturn followed by a strong recovery due to effective virus containment. All major regions resumed growth in the third quarter as a positive inflection began during the summer months. Economists now expect a rebound in worldwide growth of 5.8% in 2021. In total, the developed and emerging markets are spending 15% of GDP on fiscal stimulus.

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These efforts are significant when combined with central bank actions, but unprecedented times call for extraordinary solutions. A key risk to the outlook is slower economic growth because of the accelerating virus infections in Europe and the U.S.

Growth is being supported by consumer spending, capital expenditures, housing, information technology, inventory rebuilding and the expectation of another large government stimulus plan

In the U.S., the economy is expected to decline 3.6% this year followed by a recovery of 4.5% in 2021. Growth is being supported by consumer spending, capital expenditures, housing, information technology, inventory rebuilding and the expectation of another large government stimulus plan. On an annualized basis, GDP declined 31% in the second quarter and rebounded 33% in the third quarter with further modest strength expected through year-end. Positively, many businesses and consumers are gradually resuming activity as the environment appears less risky, but rising virus infections will impact this trend. Working remotely is proving to be a viable solution with many industries experiencing productivity increases. The unemployment rate improved to 8.8% in the third quarter from 13% in the second quarter and further job gains are expected in coming months. Many businesses are experiencing staff shortages and backlogs due to the pace of recovery, but state layoffs are expected because of the cash crisis caused by reduced tax revenues. In addition, housing is serving as a source of growth after being a drag over the past two years. New mortgage applications are increasing with the 30-year fixed rate mortgage at 2.80% and a 30-year Treasury yield of 1.61%. Corporate investments in information technology (IT) are also strengthening. The pace of IT modernization accelerated in response to the disruption caused by the virus crisis. In addition, inventories need to be rebuilt after major drawdowns in the first half. But the pandemic has had a severe negative impact on many service-oriented segments of the economy (e.g. airlines, hotels, restaurants, theaters and other leisure-related businesses.) In 2021, we expect the recovery to gradually broaden into these service industries. Importantly, the virus has not destroyed the economic means of production and idle capacity is waiting to resume growth. The worst appears behind us. Wide-scale closures are unlikely at this stage given the ramp-up in test and trace capacity which enables targeting clusters for quarantine measures. Furthermore, there are reasonable expectations for improved drug treatments and vaccines to be deployed in the first half of 2021. These are positive developments.

The pandemic has introduced a new lifestyle preference that is shifting homeownership away from densely populated urban centers to more suburban and rural areas

## HOUSING & REAL ESTATE

The housing sector is experiencing a renewed period of growth in response to lower interest rates and changing consumer preferences because of Covid-19. This will generate rising spending on home renovations in the future. Housing starts are expected to increase 6% this year to 1.37 million followed by a 10% gain in 2021. Permits for new home construction are at a 13-year high. For many years, household formation has been outpacing housing growth (especially single-family homes) as younger generations rented in urban environments. Now, the pandemic has introduced a new lifestyle preference that is shifting homeownership away from densely populated urban centers to more suburban and rural areas. The current demand/supply dynamic suggests continued upward pressure on home and lumber prices along with supply chains and labor. Existing home sales rose 20.9% y/y to a 6.0 million annual rate and gained 9.4% in September to a 14- year high.

Inventories of unsold homes are low — at a three-months' supply — and it will take time for commercial builders to construct new homes. As a result, home prices are rising across the nation. The median existing single-family home price was $315,000 in August, up 11.7% from August 2019. Despite uncertainty in other parts of the economy, there are clear signs of immediate improvement in housing that appears sustainable given the combination of changing lifestyle preferences, demographics, diminished supply, low mortgage rates and affordability enabled by work-from-home trends.

The nation is navigating through this pandemic with an inconsistent approach to official guidelines with the expectation that therapeutics and vaccines will arrive shortly to help society return to normal

## CORONAVIRUS UPDATE

The U.S. is experiencing a rising spread of the coronavirus across the country as cases per day reached a new high of approximately 90,000. Since the beginning of the pandemic, a total of 9 million Americans have been infected with almost 230,000 deaths. Today, approximately 1.4 million people are tested daily and about 6% are positive. Testing capacity is growing rapidly with the capability to test larger and asymptomatic segments (show no symptoms) of the population. The population needs to follow the mask and social distancing guidelines. This is key to helping contain spread of the virus and increasing confidence to further reopen the economy. Importantly, the pace of deaths has slowed with approximately 1000 daily deaths compared to over 2000 in early April, but the pace is rising again. The mortality rates of the disease are improving as the most vulnerable people seek greater protection, the treatment regime improves and the less vulnerable segments of the population account for a higher proportion of infections due to engagement in higher risk activities. The nation is navigating through this pandemic with an inconsistent approach to official guidelines with the expectation that therapeutics and vaccines will arrive shortly to help society return to normal. Accordingly, eliminating the risk of contagion seems unlikely and we need to proceed cautiously as we resume activities. This is likely to be a difficult winter as the population exhibits pandemic fatigue and Covid-19 gets worse before it gets better.

The Fed modified its policy framework after a comprehensive 18-month review of monetary policy. The Fed has now adopted "average inflation targeting"

## MONETARY POLICY

The Federal Reserve forcefully stabilized the economy with significant unconventional measures to provide the banking system and financial markets with capital and liquidity. The Fed's policy continues to do "whatever it takes" for as long as necessary. Chairman Powell said that "we will not run out of ammunition." In addition, the Fed modified its policy framework after a comprehensive 18-month review of monetary policy. The Fed has now adopted "average inflation targeting." The objective is to achieve inflation moderately above 2% for some time so that inflation averages 2% over time allowing for broad-based employment gains. Low unemployment need not induce policy tightening if inflation remains close to the 2% target. The central bank is also comfortable with inflation above 2% for short periods of time in order to retain the ability to use interest rate management as opposed to quantitative easing as policy tool. The Fed does not want to employ negative interest rates like the European Central Bank has done. Today, inflation is bouncing back moderately from the low levels in the spring. Overall inflation is 1.4% y/y and the core PCE inflation measure has recently firmed up to 1.5% y/y. Energy prices are putting downward pressure on overall inflation while food inflation is trending higher than the overall rate. Used car prices are higher as people look for alternatives to public transit. Overall, interest rates will stay lower for longer and inflation is likely to trend higher in line with the Fed's objectives.

Congress is discussing another plan (CARES2.0) to add more fiscal aid to the mix, but political disagreements have delayed progress

## FISCAL STIMULUS

From a fiscal perspective, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provides enhanced unemployment benefits and subsidized payroll loans for businesses. The $2.2 trillion stimulus bill was the largest stimulus package in U.S. history representing approximately 11% of GDP. This fiscal package played a large role in helping the economy rebound faster than expected with consumer spending rebounding to approximately 80% of its prior level. As a result, the Federal Reserve has encouraged legislators to add more fiscal spending to support growth. Today, Congress is discussing another plan (CARES2.0) to add more fiscal aid to the mix, but political disagreements have delayed progress. For context, the federal budget deficit, measured on a 12-month cumulative basis, was running at $2.92 trillion through August, compared to $948 billion one year earlier. Consensus estimates show a FY2020 budget deficit of $3.58 trillion and a smaller $2.19 trillion gap in FY2021. Broadly speaking, massive policy responses helped create a strong economic recovery and further fiscal measures are needed to sustain the advance so the economy can reduce its dependence on accommodative monetary policy. We expect more fiscal stimulus.

Economic and earnings reports have been surprisingly positive and this momentum is likely to continue for the foreseeable future

## INVESTMENT OUTLOOK

The global economy and stock markets are staging an impressive recovery from the depths of the coronavirus recession. Economic and earnings reports have been surprisingly positive and this momentum is likely to continue for the foreseeable future. Positively, there is substantial firepower with cash in money funds at 16% of the equity market's total capitalization. Monetary policy has served as a "firehose" of support for the stock and bond markets. Both have healed due to this ample liquidity. Fiscal policy has helped the consumer and select industries. Additional fiscal support is expected in the near term. Interestingly, the massive disruption caused by the pandemic has caused a reallocation of capital as certain sectors and companies have become more in demand. We continue to see beneficiaries of secular growth trends experience an acceleration of favorable trends due to the faster adoption of key solutions.

We assume S&P operating earnings will likely decline 20% in 2020 to approximately $131 per share and rebound 27% to $166 in 2021, which would approximate the level of earnings in 2019. The second quarter earnings cycle delivered many "beat-and-raise" reports and this momentum is continuing in the third quarter reporting cycle. Investors are looking over the valley and focusing on the pace of recovery over the next two years. Assuming S&P operating earnings of $166 next year, the stock market is selling at 19.8x earnings – an above-average but reasonable valuation considering the 10-year Treasury yield at 0.77% with core PCE inflation at 1.5%. A moderate risk to equities is a sharp upward drift in interest rates which may occur as economic activity strengthens, and the Fed begins to remove some of its massive monetary accommodation.

The amount of capital raised by the financial markets has been remarkable given the caution evident in the business world

Capital markets have been thriving aided by low yields on corporate bonds and a strong stock market. The amount of capital raised by the financial markets has been remarkable given the caution evident in the business world. The Fed and other major central banks have successfully engineered an environment where companies can access the private markets for their financing needs. For example, funds raised for new ventures increased 71% to $24 billion so far this year. High-grade corporate debt issuance of $1.7 trillion is at record levels and total corporate debt outstanding is up 17% y/y. In addition, secondary equity offerings, initial-public-offerings (IPOs) and special-purpose-acquisition-companies (SPACs) are setting records for issuance. The financial markets are awash with liquidity and cheaper sources of capital. Furthermore, corporations have slowed the return of capital to shareholders to build cash. Stock buybacks are down 46% this year and approximately 13% of dividend paying companies in the S&P 500 have cut their dividend.

Smaller capitalization companies are starting to exhibit leadership

Technically, the stock market appears to be establishing a bullish breakout from the March 23 lows. We experienced a breadth thrust with solid confirmation in measures of breadth, momentum and volume. For example, smaller capitalization companies are starting to exhibit leadership. Merrill Lynch views the new high in the advance-decline ratio as a bullish leading indicator. The broader-based NYSE advance-decline line also hit a new high recently. The percentage of SPX companies above the 200-day moving average moved beyond the June peak of 69% to 75% in October. Historically, we are entering the best six-month season for the stock market from November to April with an average return of 5%. More importantly, the S&P 500 recently experienced a "breadth thrust" when advancing stocks outnumber decliners by at least 2-to-1 over 10 days. This occurred 29 times since 1990, signals heavy buying pressure and produced a higher market in 12 months 96% of the time with an average gain of 13%.

Investors have little experience with a global pandemic of this scale which adds to the challenge and uncertainty. Positive surprises may emerge with the development of drugs and vaccines to treat and prevent the virus. However, a second wave of infections, fear of additional quarantines and lingering long-term side-effects from the infection create concern. We remain alert for developments that may improve or worsen the investment landscape. However, the probabilities favor higher stock prices over the intermediate term. Periods like this support our view that time in the market is more important than timing the market. We continue to believe the current market environment will prove to be an outstanding opportunity to accumulate quality growth investments for above-average returns in the years ahead.