INVESTMENT OUTLOOK

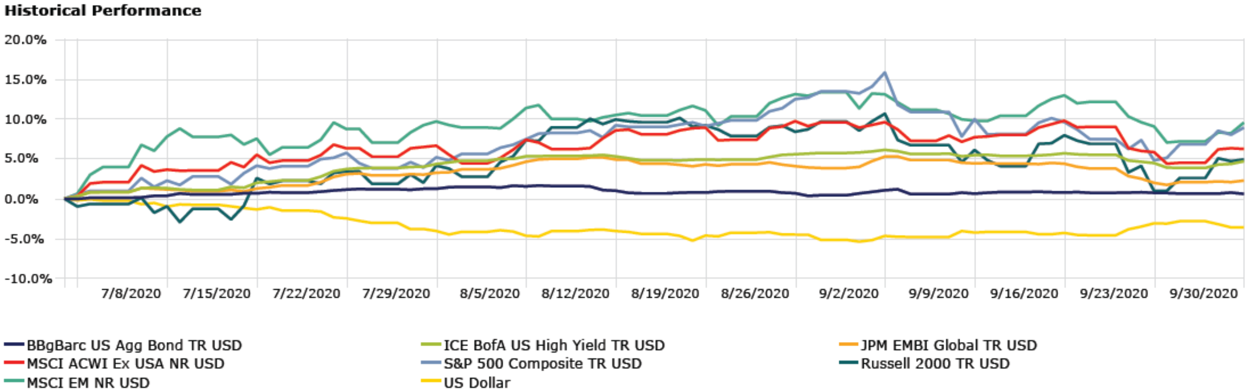
Q3 2020 Market Commentary

As the summer pulls to a close, a global reopening amidst the COVID-19 pandemic has led to a resurgence in case growth and fatalities. The final quarter of the year will witness economies fighting for growth as the winter challenges the pandemic response, as well as the most contentious US election in recent memory.

Global Markets Performance

Per Morningstar, the US stock market, as represented by the S&P 500, finished up 8.93% on the quarter, building on an over 20% return last quarter and posting a net 5.57% on the year so far. Smaller US stocks[1] rose less, up almost 5% for the quarter but are still down -8.69% this year. International stock markets[2] and emerging markets[3] performed similarly to domestic equity markets with returns of 6.25% and 9.56%. On the credit side, core bonds[4] rose 0.62% and high yield bonds[5] rose as well, up 4.71% for the quarter, impacted primarily by moderately tightened spreads[a]. Emerging market (EM) bonds[6] rose as well, up 2.28% on the quarter.

Historical Performance



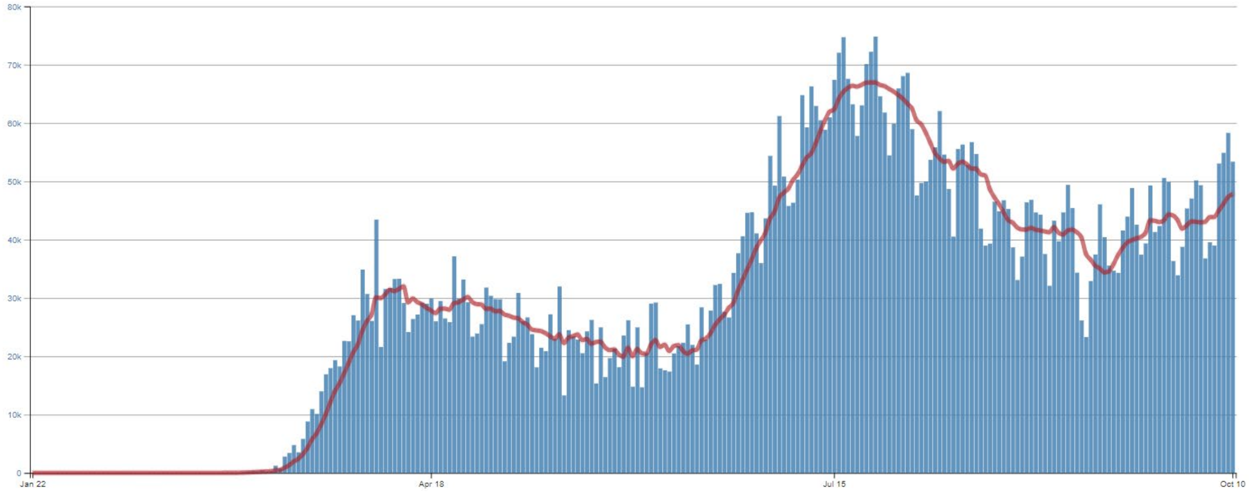
Calendar Year Returns

	YTD	2019	2018	2017	2016	2015
BBgBarc US Agg Bond TR USD	6.79	8.72	0.01	3.54	2.65	0.55
ICE BofA US High Yield TR USD	-0.30	14.41	-2.26	7.48	17.49	-4.64
JPM EMBI Global TR USD	0.37	14.42	-4.61	9.32	10.19	1.23
MSCI ACWI Ex USA NR USD	-5.44	21.51	-14.20	27.19	4.50	-5.66
S&P 500 Composite TR USD	5.57	31.49	-4.38	21.83	11.96	1.38
Russell 2000 TR USD	-8.69	25.52	-11.01	14.65	21.31	-4.41
MSCI EM NR USD	-1.16	18.42	-14.57	37.28	11.19	-14.92
US Dollar	-2.60	0.22	4.40	-9.87	3.63	9.26

Coronavirus Update

Early in the fourth quarter of this year, global cases are approaching 37 million and global deaths have surpassed 1 million. In the US, the case count is now over 7.5 million and the fatalities have surpassed 200 thousand[8]. Based on recent data from the CDC, US cases are rising at an average of between forty and fifty thousand cases per day and the trend is higher[9]. The US continues to rank second globally in terms of total cases (behind only India), but per capita case counts have trended lower over the past few months[8].

Daily Trends in Number of COVID-19 Cases, US



Source: CDC[8].

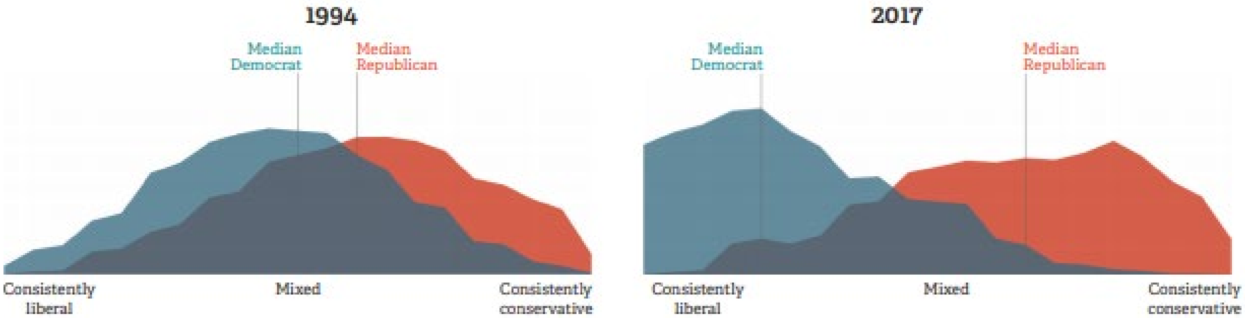
Case count spikes are now occurring in areas of the country that initially avoided a substantial first wave, particularly the Midwest and South[10]. Despite the resurgence in cases, the number of deaths has not risen in the same degree as cases and thus the mortality rate appears to be decreasing. Additionally, the percentage of deaths continues to skew heavily towards the elderly, with those sixty-five and over accounting for nearly 80% of the total deaths in the US[11].

Vote-atility: The US Presidential Election

If you've watched the news at all in the last few months you've undoubtedly been bombarded by mention of the upcoming presidential election. It's nearly impossible to miss across traditional, online, and social media. And while in election years past you may have heard mention that elections have minimal long-term consequences on capital markets, the same cannot be said with such conviction this time around.

According to Pew Research, a non-partisan think tank, Americans are more polarized now than they have been in at least the last twenty years. That polarization has led to, or been derived from, more extreme positions on both sides of the aisle[12]. Thus, both the Republican and Democratic platforms are substantially more conservative and progressive, respectively, and the outcome of the upcoming election has both a wider range of potential policies and increased uncertainty.

Political Polarization, 1994-2017



Source: Pew Research Center[12].

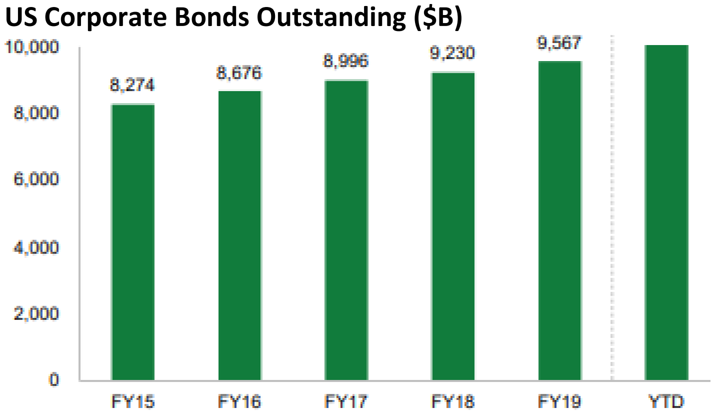
In addition, betting markets are currently predicting a 'blue wave', or a democratic sweep of the presidency, a majority in the Senate, and a majority in the House of Representatives[13]. This is important because, according to economists at Morgan Stanley, a unified government has historically led to greater policy change than divided government, which is more likely to lead to gridlock[14]. Thus, should the democratic party sweep, it is plausible that more transformative economic policy could prevail than in a typical election year.

Wrapping up all of these ideas, over the past few weeks numerous US banks have cautioned for increased volatility as we approach and move past November 3rd. With the contentiousness of the election, the probable increase of mail-in ballot voting, and the large number of Wall Street traders still working from home, some banks are preparing for trading volumes to spike as much as eight times higher than average levels on election night[15].

Debt Issue, Rates Tissue

As we've touched on in previous missives, corporate debt issuance so far this year has been nothing short of extraordinary. At of the end of the first quarter (the most recent quarter for which we have data thus far), G4 non-financial corporate debt[b] is on pace for an annualized total of $3.5 trillion, according to analysts at J.P. Morgan[16]. If that were to occur, that would be the highest level on record, and US corporations already owe over $10 trillion[17].

US Corporate Bonds Outstanding ($B)



Source: SIFMA[18].

In tandem with this record issuance has been a dramatic drop in interest rates on both the shorter and longer terms. From the end of January through the end of September, three-month US government interest rates dropped by over 93%, while ten-year rates dropped by over 54%[19]. Those lower rates have made it easier and cheaper for companies to issue debt as the relative interest burden for issuing debt is now substantially lower, all else equal.

If rates continue to stay low it is likely that issuance could remain elevated. Negative economic impacts from the pandemic add further incentive to increase cash levels by issuing debt cheaply.

Looking Forward

While large swaths of the population will continue to stay home as the pandemic endures, the final quarter of this year has the potential to be one of the most volatile in years in both the markets and the world itself. To come are the results of the US presidential election as well as the initial results from Phase Three trials[c] of some of the leading COVID-19 vaccine candidates. In terms of the latter, it is possible we may see results as soon as the end of October[20].

The developments of these two events as we move through the quarter could add significant volatility as the markets parse policy initiatives and the potential of a return to normality in our daily lives. As always, it's important to remember that markets will move in anticipation of these events and adjust on an ongoing basis as each situation becomes clearer.

In the absence of a crystal ball, it's essential that investors review their financial plans to align with their financial goals. While the headlines will rage and markets will move, volatility is a normal process within markets and not necessarily an impetus to alter your investment strategy. If your financial condition has changed or you'd like to discuss the outlook in greater detail, please reach out to your financial advisor.

As of September 30, 2020.

References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index

Core intermediate bonds[4] – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds[5] – as represented by the ICE BofAML US High Yield Index

Emerging market bonds[6] – as represented by JPM Emerging Market Bond (EMB) Global Index.

Morningstar performance data[7] – sourced from Morningstar Direct, 2020.

Global and US coronavirus data[8] – sourced from Johns Hopkins University of Medicine Coronavirus Resource Center, 9 October 2020. https://coronavirus.jhu.edu/.

CDC coronavirus data[9] – sourced from Centers for Disease Control and Prevention, "Coronavirus Disease 2019 (COVID-19)", 9 October 2020. https://covid.cdc.gov/covid-data-tracker/#trends_dailytrends.

CDC coronavirus data[10] – sourced from Centers for Disease Control and Prevention, "Coronavirus Disease 2019 (COVID-19)", 11 October 2020. https://covid.cdc.gov/covid-data-tracker/#cases_casesinlast7days.

CDC coronavirus data[11] – sourced from Centers for Disease Control and Prevention, "Coronavirus Disease 2019 (COVID-19)", 11 October 2020. https://covid.cdc.gov/covid-data-tracker/#demographics.

Pew Research data[12] – sourced from Pew Research Center, "The shift in the American public's political values, Political Polarization, 1994-2017," 20 October 2017. https://www.pewresearch.org/politics/interactives/political-polarization-1994-2017/.

Election betting odds[13] – sourced from The Sports Geek, "2020 Election Props – Will the Democratic Party Sweep the Election," 1 October 2020. https://www.thesportsgeek.com/blog/2020-election-props-will-the-democratic-party-sweep-the-election/.

Morgan Stanley unified/divided government policy[14] – sourced from Morgan Stanley, "2020 US Election: A Revised Guide to Economic Policy Paths & Market Impacts," 8 June 2020.

Election volatility[15] – sourced from Bloomberg Markets, "Wall Street Prepares Systems for Election Night Trading Surge," 25 September 2020. https://www.bloomberg.com/news/articles/2020-09-25/wall-street-prepares-systems-for-election-night-trading-surge?sref=G07EOM5V.

Corporate debt issuance[16] – sourced from J.P. Morgan, "Flows & Liquidity: Corporate debt surges," by Nikolaos Panigirtzoglou, 6 October 2020.

US corporate debt levels[17] – sourced from Newsweek, "A $10 Trillion Corporate Debt Bomb Is Waiting to Explode the U.S. Economy," 29 July 2020. https://www.newsweek.com/coronavirus-corporate-debt-covid-19-bonds-federal-reserve-1521219#:~:text=U.S.%20corporate%20debt%20stands%20at,of%20International%20Finance%20%5BIIF%5D.

Corporate bonds outstanding [18] – sourced from SIFMA, "SIFMA Research Quarterly – 2Q20, US Fixed Income Markets – Outstanding," September 2020. https://www.sifma.org/wp-content/uploads/2020/09/US-Research-Quarterly-Fixed-Income-Outstanding-2020-09-24-SIFMA.pdf.

US government rates[19] – sourced from US Department of the Treasury, "Daily Treasury Yield Curve Rates," 1 October 2020. https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2020.

Vaccine results[20] – sourced from Nature, "COVID-vaccine results are on the way – and scientists' concerns are growing," 25 September 2020. https://www.nature.com/articles/d41586-020-02706-6.

Glossary:

Spreads[a] – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

G4 non-financial corporate debt[b] – debt issued by corporations not operating within the financial sector, e.g. banks. G4 refers to the US, the Euro area, the UK, and Japan.

Phase Three trials[c] – per the CDC, in Phase 3 the vaccines are "given to thousands of people and tested for efficacy and safety." After Phase Three trials are approved, vaccines can be issued to the general public.

Options – a contract that gives the buyer the right, but not the obligation, to buy or sell the underlying asset at a specified price prior to a specified date

Blue chip – typically large capitalization, well-known brands.

Fiscal spending & budget deficits – fiscal spending relates to all government expenses, and a budget deficit implies a government is spending more than it is receiving from taxes, interest, etc.

Liquidity vs Solvency – liquidity relates to having enough cash on hand to continue operating in the short term, while solvency relates to the long-term and whether or not equity is sufficient to continue operating.

Repos (repurchase agreements) – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that's neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.