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MARKET REVIEW
NOVEMBER 2020

SHORT-TERM INTEREST RATES: LOWER FOR LONGER

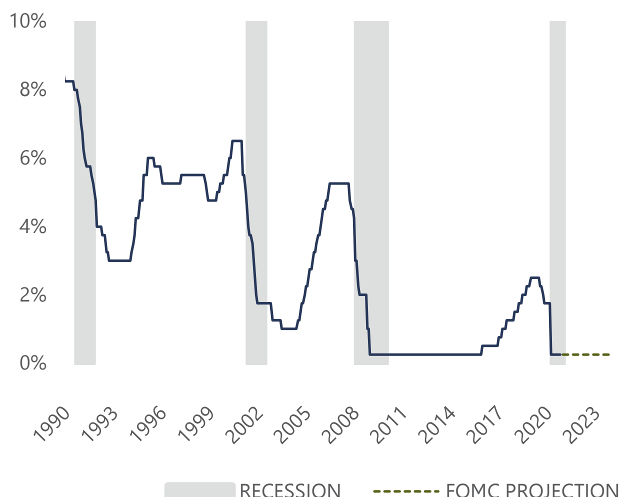
The U.S. economy entered 2020 on seemingly solid ground following a somewhat volatile 2019 highlighted by the trade war with China and a Federal Reserve forced to ease off the gas pedal regarding interest rate hikes. Heading into this year the economic expansion was the longest on record at 126 months, and the unemployment rate was sitting at an impressive 3.5%. The Great Recession and the Federal Reserve's zero interest rate policy in the early half of the 2010s decade were in the rearview mirror and a distant memory, but not forgotten, for many market participants. No one foresaw the coming challenges with the COVID-19 pandemic as the most pessimistic economist projection in February still called for positive U.S. economic growth in 2020. By the end of the first quarter, the global economy had lost all momentum, and the world found itself taking extreme measures, including the near complete closure of some countries' economies, to curb the spread of this unknown virus.

The U.S. was not immune to the pandemic with forced shutdowns in many areas in the spring and summer in an effort to slow the spread of COVID-19. From the onset, unprecedented monetary and fiscal stimulus was implemented to offset the economic effects of the pandemic. These stimulus measures included:

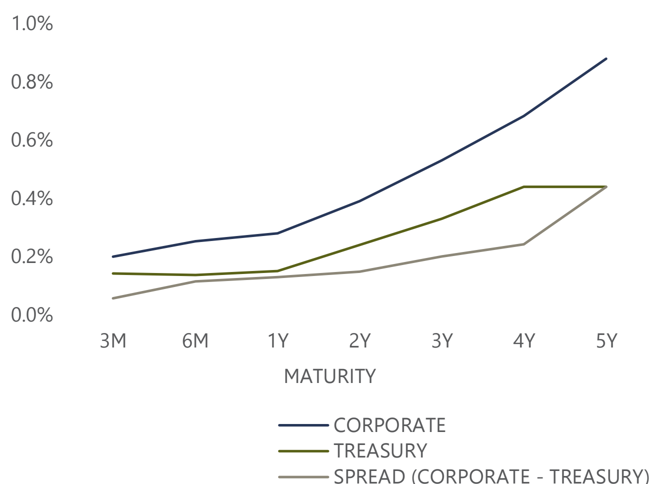
- Federal Reserve immediately cut short-term interest rates to zero
- Congress delivered massive fiscal support through the CARES Act which offered businesses and households temporary relief
- Federal Reserve, under coordinated funding from Congress, adopted various support programs that were unprecedented in size and scope, all aimed at improving liquidity and supporting overall market conditions
- Federal Reserve nearly doubled its balance sheet through Quantitative Easing (QE)

Fast forward seven months and the U.S. economy is left with a recession that is on track to be classified as the deepest but shortest in history. The swift monetary and fiscal actions have put the U.S. economy on track for a largely V-shaped recovery with a degree of government dependence and amid fears over additional waves of new COVID-19 cases. The Fed has reiterated its commitment to seeing this recovery through, as evidenced by its "lower for longer" policy and a new approach to monetary policy released in late August. The Fed's most recent interest rate projection as shown in the chart on the next page indicates a forecast of zero Fed Funds rate through the end of 2023. In addition, the Fed will support growth in an attempt to increase the inflation rate back toward its 2% target and, for a time, tolerate inflation above 2%. In essence, the Fed adopted an outcome-based forward guidance that delays interest rate liftoff until the economy achieves both full employment and an average 2% inflation instead of preemptively raising rates. Additional targeted fiscal support appears necessary to further the economic recovery, particularly for the consumer, impacted industries, and state and local governments, but the next installment may prove more challenging and politically charged amid a pivotal election year. In any event, the Fed remains at the ready to do whatever is necessary to achieve maximum employment with or without the assistance from Congress.

It is amazing that a mere 12 months ago we were discussing an inverted yield curve, and now the spread between the 10-year and 2-year Treasury yields has widened to over 0.7% with a bias to go higher. The shift has been completely dominated by rising long-term rates as short-term rates have remained anchored near zero, taking their cue from a Fed that has repeatedly communicated this zero interest rate policy for the foreseeable future. The steeper yield curve is consistent with the Fed's new policy approach to allow for higher average inflation prior to raising rates, and a solid bounce in the economy after the second quarter's sharp contraction adds to the conviction that long-term rates will likely rise into 2021. In addition, the precipitous decline in the dollar has also been a factor as a weaker currency provides a significant degree of protection from global deflation risks. The Fed has a vested interest in seeing further economic recovery, which can be ultimately attained by maintaining highly accommodative financial conditions with interest rates at these relatively low levels. The Fed also has additional tools in its arsenal if they feel rates are rising too quickly, such as shifting the focus of their bond purchases to longer duration or absolute yield curve control. The bond purchase program is currently $120 billion per month in Treasury and mortgage securities based on a preannounced duration schedule.



Source: Bloomberg.
Past performance does not guarantee future results.



Source: Bloomberg
Past performance does not guarantee future results.

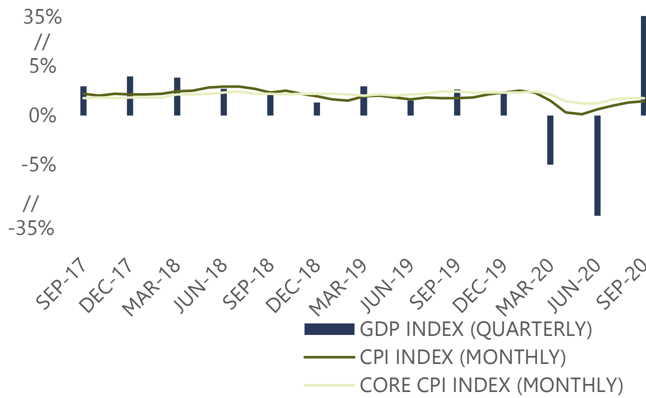
While the domestic economy may realize a V-shaped recovery, the yield curve may not reflect that reality as quickly as it may have coming out of past periods of slowdowns. The Fed's commitment to lower for longer has dragged yields for the entire short-term fixed income universe lower. However, opportunities still exist for investors. The events of this spring may have, rightfully so, spooked investors, and interest rate spreads, or compensation for risk, in the corporate market and other spread markets reflected this concern. Dispersion between high- and low-quality names remains quite large, and as a result, quality over yield may be more prudent with increased focus on sector and credit selection. But given the magnitude of monetary and fiscal support over the last 9 months, spreads have recovered a large portion of spread widening realized in the first half of the year. The graph above (right) displays corporate securities' yield advantage over and above that of risk-free securities. While the long-term implications on certain sectors are still being digested, investors can have greater confidence in the stability of short-term interest rates and the overall credit market due to the unwavering support the Fed has demonstrated and communicated over the last seven months.

The path to recovery from the pandemic-induced slowdown can take various forms. The base case remains lower for longer short-term interest rates, not only due to the Fed's new mandate that stresses patience, but also behind the belief that structural issues in the economy will take longer to overcome than past slowdowns. As with every outlook, there are some risks to the expectation for a continuation in low short-term rates, but the risks appear to have a low probability. Recent optimism surrounding a vaccine is certainly encouraging, and in the event the vaccine clears the last regulatory hurdles with no hiccups, the Fed could be faced with improving economic conditions at a faster pace than forecast. In the meantime, we are experiencing a resurgence in virus cases that will most likely slow the momentum of the economic recovery until the time a vaccine is released to the general public. With the potential of a faster recovery, the U.S. Treasury yield curve may reflect a more positive outlook via higher yields, and potentially force the Fed's hand to raise its short-term target rate so as not to be viewed as being behind the curve. And let's not forget, current Fed Chair Jerome Powell's term ends in 2022, so there is the possibility the incoming administration nominates a more progressive chair who takes a different approach to overall Fed policy. Finally, with the anticipated change in Washington, the risk of greater and ongoing fiscal stimulus becomes a stronger possibility. The need to finance ballooning fiscal spending tends to be inflationary and while the Fed's new mandate allows for inflation to run above its 2% target for a time, we could find out just how high they'll let average inflation run.

ECONOMY

GDP AND CONSUMER PRICES

SEPTEMBER 2017 THROUGH SEPTEMBER 2020

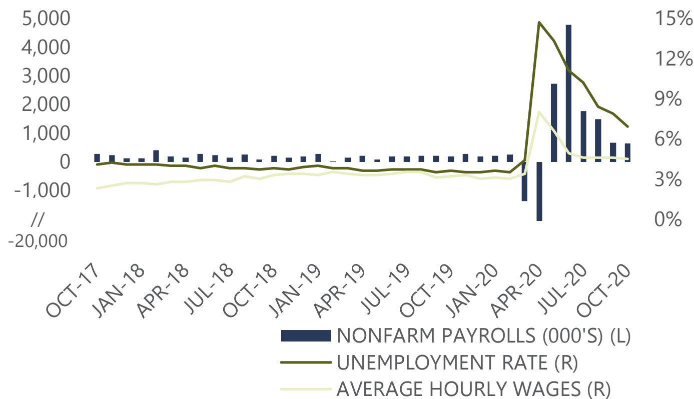


Source: Bloomberg

- U.S. economic activity in the third quarter rebounded at an astonishing annualized growth rate of 33.1%. This was the strongest quarter in U.S. history, following the worst quarterly contraction of 31.4% in the prior quarter.
- Economic growth expectations for the coming quarters have been tempered as a handful of the fiscal stimulus programs that provided support earlier in the year have expired or will be expiring soon. Economists forecast economic growth to be between 3% and 4% in the next few quarters, resulting in forecasts of 3.8% growth in 2021 after falling by 3.9% in 2020.
- U.S. consumer prices climbed for a fourth straight month in September with prices up 0.2% from the prior month and up 1.4% from a year ago.

LABOR MARKET

OCTOBER 2017 THROUGH OCTOBER 2020

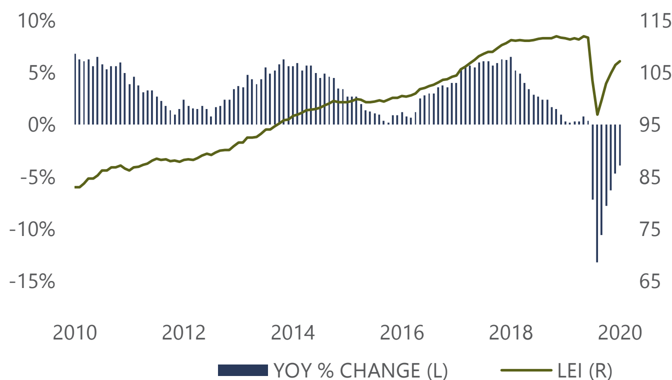


Source: Bloomberg

- The labor market recovery continued in October as U.S. employers added more jobs than expected for the fifth time since April. Nonfarm payrolls increased by 638,000 last month, surpassing economists' consensus estimate of 580,000. Jobs gains in September and August were both revised higher to 672,000 and 1.493 million, respectively. Encouragingly, the leisure and hospitality sectors, which were the hardest hit industries from COVID-19, saw the largest job gains.
- The unemployment rate moved lower, to 6.9%, also beating economists' expectations of 7.9%. Lower unemployment occurred while the participation rate increased by 0.3% to 61.8%. Average hourly earnings rose 4.5% year over year in October, down from 4.7% in the prior month.

LEADING ECONOMIC INDICATORS

SEPTEMBER 2010 THROUGH SEPTEMBER 2020



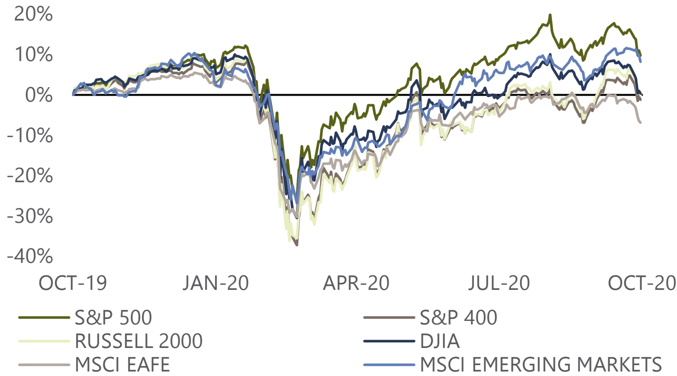
Source: Bloomberg

- The strong rebound in the Conference Board's Leading Economic Index (LEI) extended for a fourth consecutive month in September. LEI's 0.7% monthly gain was driven by contributions from initial jobless claims, building permits, and the interest rate spread.
- LEI over the six-month period ending September increased 3.6%, marking a big improvement from the 8.4% decline over the six-month period ending June 2020.
- Strength among the LEI components has started becoming more widespread over the last few months as the economic recovery continues.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, OCTOBER 2019 THROUGH OCTOBER 2020

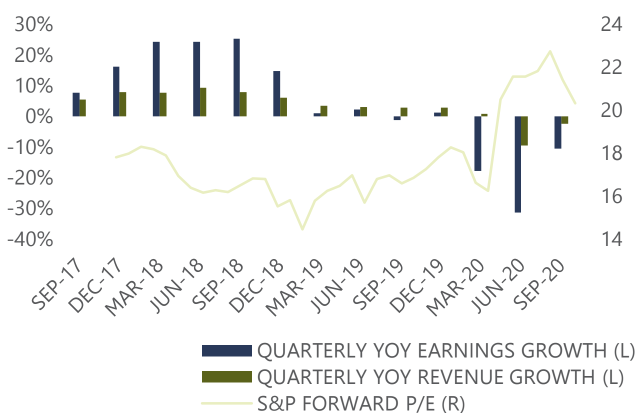


Source: Bloomberg. Past performance is no guarantee of future results.

- After a strong start to October, developed market stocks gave up their gains in the second half of the month amid the latest resurgence in COVID-19 cases, lack of progress on additional fiscal stimulus, and uncertainty over the U.S. presidential election. Renewed virus concerns led some European countries to reintroduce lockdown measures.
- The S&P 500 closed out the month with its worst weekly decline since March and ended the month down 2.66%. September and October were the first consecutive monthly losses since February and March.
- Emerging markets posted a solid gain in the month, led by MSCI China's 5.29% monthly return. China benefited from improving economic data. Biden's lead over Trump in the polls spurred hopes for thawing trade tension with the U.S.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2017 THROUGH OCTOBER 2020

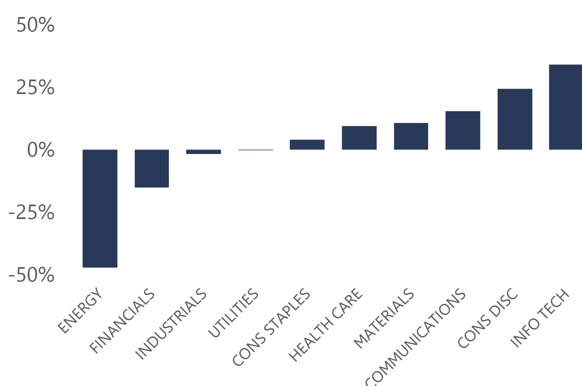


Source: Bloomberg

- Third quarter earnings season is winding down with results reported from nearly 90% of S&P 500 companies. S&P 500 earnings are recovering more quickly from the impact of COVID-19 shutdowns than analysts projected. Earnings are on track for an 8.57% year-over-year decline compared to analysts' initial estimate for a 21.48% decline.
- Around 86% of companies reported earnings above analysts' estimates. This is the highest earnings beat percent in Bloomberg's 30 years of data and is well above the 63% long-term average.
- Analysts revised their earnings expectations upward for the coming quarters. Earnings are projected to decline 10.67% in the fourth quarter followed by growth of 14.50% and 43.58% in the first and second quarters next year, respectively.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

OCTOBER 2019 THROUGH OCTOBER 2020



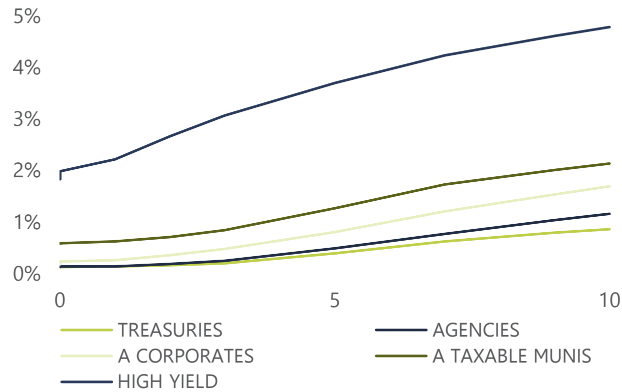
Source: Bloomberg

- The Utilities sector was the top performer in October for the first time since January and one of two sectors with a positive monthly return. The sector's 5.04% return was driven by its defensive nature and some investors anticipating utility stocks would benefit from potential government investment in renewable and carbon-free energy under a Biden presidency.
- Communications was the only other sector with a positive return in the month. Google's parent company, Alphabet, which accounts for around 25% of the sector, rose 10.27% in October amid a strong recovery in advertising revenue which calmed fears about the company's first historical revenue decline in the second quarter.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF OCTOBER 2020



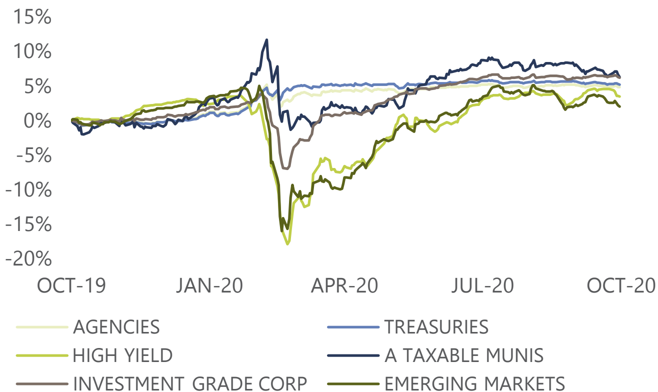
Source: Bloomberg

- The U.S. Treasury yield curve steepened in October. The 1-year, 10-year, and 30-year U.S. Treasuries increased by 0.00%, 0.19% and 0.21%, respectively. Short Treasury yields remained anchored given that Federal Reserve officials expect to keep short-term interest rates low for the next couple of years. Longer duration yields increased as investors anticipate additional fiscal stimulus post-election will likely boost economic growth and inflation.

- Yields on below investment grade bonds have increased more than the other bond segments shown in the accompanying chart amid the COVID-19 pandemic. Economic uncertainty related to lockdown measures led bond investors to favor higher quality corporate credits earlier in the year.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

OCTOBER 2019 THROUGH OCTOBER 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- All of the bond sectors in the accompanying chart generated a return of 2% or higher during the last twelve months. A-rated taxable municipals led the bond market over the last twelve months with a return of 6.3%.

- Investment grade corporates were the second best performing sector over the last 12 months with a 6.2% return. High yield has significantly narrowed its 12-month underperformance as the economic recovery spurred a sharp reversal in risk sentiment. After falling in the first quarter, investment grade and high yield gained 9.1% and 15.8% since March, respectively. Meanwhile, Treasuries are only up 0.21% since March.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

OCTOBER 2017 THROUGH OCTOBER 2020

Source: Bloomberg

- Agencies, A-rated corporate bonds, and BB-rated corporate bonds experienced spread tightening during October while the other sector shown in the accompanying chart, A-rated taxable municipals, experienced spread widening during the month.

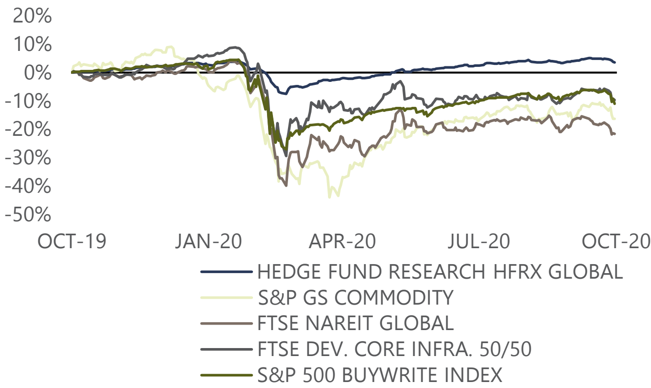
- Of the fixed income sectors shown in the accompanying chart, only BB-rated corporate bond yield spreads over similar maturity Treasuries are above their two-year averages as of the end of October.

- Spreads for all the fixed income sectors shown in the accompanying chart are wider than prior to the beginning of the COVID-19 pandemic. A-rated taxable municipals and BB-rated corporate bond spreads have experienced significantly more spread widening.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

OCTOBER 2019 THROUGH OCTOBER 2020

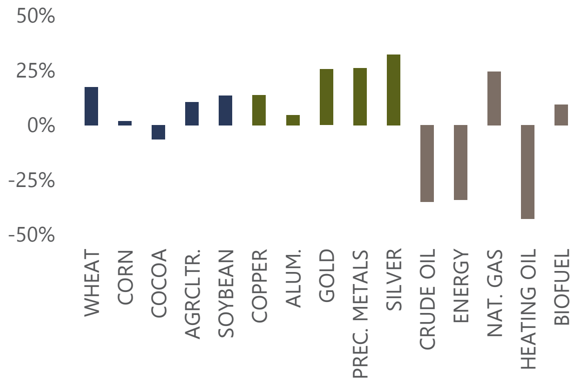


Source: Bloomberg. Past performance is no guarantee of future results.

- The higher beta commodities and real estate indexes shown in the chart at left declined 4.9% and 6.3% from September 1 through October 31 amid equity market weakness driven by increased uncertainty about the path of the pandemic and stalled stimulus negotiations.
- The global hedge fund asset class has navigated the bear market in global stocks and subsequent rally relatively well. The HFRX Global Hedge Fund Index declined 0.2% from the February 19 market peak to October 31 compared to declines of 6.6% and 1.9% for the MSCI All Country World Index ex-U.S. and Russell 3000 Index, respectively.
- Across the hedge fund world, convertible arbitrage, event-driven, relative value arbitrage, and credit-focused strategies have generated the best returns thus far in 2020.

COMMODITIES, 12-MONTH SPOT RETURNS

OCTOBER 2019 THROUGH OCTOBER 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- A roughly 15% drop in U.S. crude oil prices in October dragged down the entire commodities complex in the month. Recent price gains in many agricultural commodities and industrial metals only partly offset oil price weakness driven by expectations for demand destruction over the next several months.
- Recent supply concerns and increases in demand supported October price gains for corn, soybeans and wheat. Meanwhile a cocoa supply glut in the Ivory Coast, the world's largest producer, drove a nearly 10% monthly drop in cocoa prices.
- The performance of gold and silver was lackluster in October, despite a decline in investors' risk appetite related to the long-term policy implications of the global pandemic and uncertainty over the outcome of the U.S. presidential election.

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			