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# MARKET REVIEW
DECEMBER 2020

## ECONOMY TO RUN HOTTER WITH NEW FED POLICY

In 1977, Congress modified the Federal Reserve Act of 1913 to create the Federal Reserve's dual mandate of maximum employment and price stability. Since the mid-1990s Fed officials have informally viewed 2% annualized inflation as being consistent with their price stability mandate. In January 2012, the Fed announced it was creating a formal policy of targeting 2% inflation driven by their view that clearly communicating this goal would anchor inflation expectations and help foster price stability.

During the last eight years the Fed has been largely unsuccessful at achieving 2% inflation on a consistent basis, which led the Fed to modify its inflation policy this past August. Last year the Fed began its first comprehensive review of its monetary policy framework to assess areas for improvement. Some market strategists correctly anticipated the Fed would modify its approach to inflation as part of the policy review because inflation undershot their 2% target 75% of the time over the last 20 years, as shown in the accompanying chart. The modified policy switched to targeting an average inflation rate of 2% over time instead an explicit 2% target. This means the Fed will start tolerating inflation above 2% for a period of time to make up for periods when inflation was below 2%. This may sound like a subtle change, but the potential effects on the economy and markets could be significant. Before detailing the potential implications of the policy change, we will review why low inflation is a concern for the Fed.

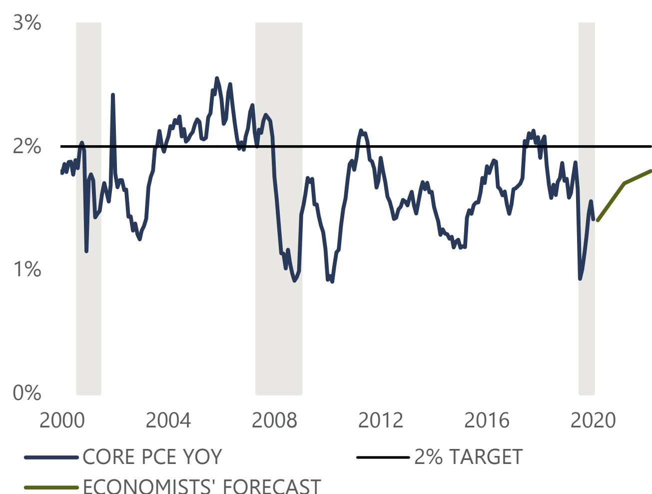
### RISKS OF LOW INFLATION

The Fed's monetary policy review and updated inflation policy was summarized by Fed Chair Jerome Powell at the central bank's annual economic policy symposium in August. During his speech, Powell highlighted the risks of persistently low inflation as a cause for concern. One risk noted by Powell is that persistently low inflation can lead to lower market interest rates which impairs the Fed's ability to reduce its policy rate during economic downturns. Nominal bond yields are viewed as the sum of real yields plus a premium for inflation risk since higher inflation reduces the purchasing power of a bond's coupon payment stream. As inflation falls, bond yields typically also decline as investors demand less compensation for the lower inflation risk. Lower interest rates, in turn, provide the Fed with less space to react to negative economic shocks by cutting rates to stimulate the economy.

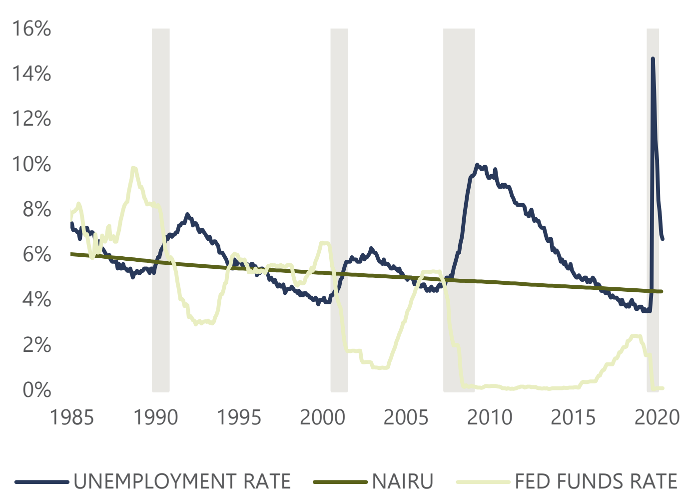
Another risk cited by the European Central Bank (ECB) is that persistent periods of very low inflation can raise the specter of deflation, which occurs when price inflation falls below 0% over a given period. As the experience of the Japanese economy over the past three decades highlights, deflationary pressure presents its own set of pernicious problems for policymakers, businesses and the overall health of a national economy. Following an asset price bubble in the 1980s, Japanese policymakers implemented significant monetary and fiscal policy shifts to counter the excesses of speculation in the country's real estate and stock markets. Many economists suggest that a deflationary mindset took hold across a generation of Japanese consumers beginning in the early 1990s, whereby spending was postponed and savings were increased due to expectations of cheaper prices in the future. A deflationary spiral of sorts ensued in Japan for nearly a decade, as reduced consumer spending caused lower business output, downward pressure on wages and further expectations of lower prices.

### NEW INFLATION POLICY'S POTENTIAL EFFECTS

Under the old 2% inflation target policy, the Fed had a mostly forward-looking view that sometimes resulted in preemptively raising interest rates to prevent inflation from rising too far above 2%. An important factor in the Fed's forward-looking assessment was based on the Phillips Curve, which states that lower unemployment rates are associated with higher levels of inflation that above-trend economic growth often generates. Lower unemployment rates can lead to higher inflation because strong labor markets typically boost wage growth which influences consumers' demand for goods and services. The Fed utilized the Phillips Curve in combination with comparing the unemployment rate to the non-accelerating inflation rate of unemployment (NAIRU), which is a theoretical long-term unemployment rate that does not cause inflation to increase. After the unemployment rate dips below NAIRU, the labor market is viewed as overheating which tends to lead to stronger wage growth and potentially higher inflation. Raising interest rates partly based on the view that inflation is poised to accelerate when the




Grey shading indicates NBER-designated recessions.
Source: Bloomberg. Past performance does not guarantee future results.




Grey shading indicates NBER-designated recessions. Source: Federal Reserve Bank of St. Louis. Past performance does not guarantee future results.

unemployment rate falls below NAIRU led the Fed to arguably tighten monetary policy prematurely at various times over the last 12 years. This, in turn, created an environment where inflation often undershot the Fed's target. Some investors view late 2016 and 2017 as an example of premature tightening. The Fed began raising rates in December 2016 and continued hiking rates in the first half of 2017 as the unemployment rate moved below NAIRU in March 2017. Meanwhile, GDP growth and inflation slowed from 2.5% and 1.8%, respectively, in late 2016 to 1.7% and 1.5% by mid-2017.

The Fed's updated policy suggests it will put less emphasis on their forward-looking models and place more importance on the recent history of realized inflation. This will likely result in policymakers waiting for inflation data to sustain a higher level for a period of time before raising interest rates instead of doing so in anticipation of stronger inflation as they had in the past. If the Fed adopted this new framework earlier and calculated average inflation over a one-year period, the first rate hike after the Global Financial Crisis would have occurred in 2018 instead of 2015, if at all, since annualized inflation based on the Fed's preferred measure peaked at only 2.1% in 2018. However, inflation may have been higher if the Fed did not raise rates back then.

A more patient Fed will likely allow the labor market and economy to run hotter than in the past in order to generate higher inflation. Under this scenario short-term interest rates would remain lower for longer, chances would increase for longer economic expansions, and the probability of slowdowns caused by tighter monetary policy would be reduced. Longer expansions with the economy running hotter would influence the investment landscape. First, this type of environment would be supportive of risk assets, such as equities and corporate credit, and could potentially lead to longer periods of outperformance for risk assets relative to lower risk assets. Second, the U.S. Treasury yield curve could steepen as the Fed keeps short-term yields anchored and longer-term yields move upward amid strengthening economic growth and inflation. Also, investors may require a larger premium for inflation risk because the subjective nature of the Fed's modified policy increases uncertainty about future inflation.

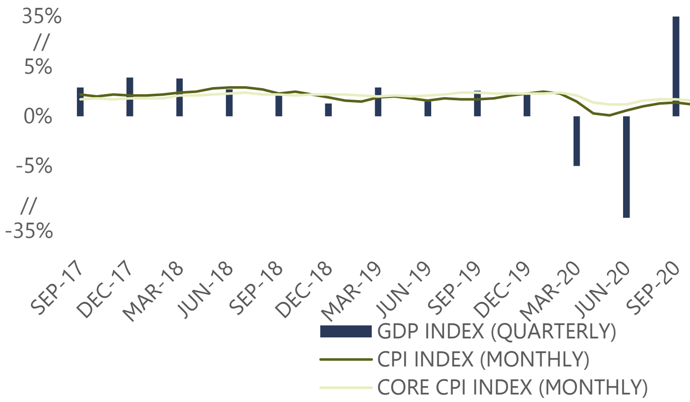
Providing the economy with more runway before tightening monetary policy also comes with risks that will need to be monitored. Extended risk asset valuations could become more common as the Fed stays on the sidelines longer while letting the economy run its course. If inflation remains subdued while valuations get excessive, the Fed may intervene by hiking rates to reduce the risk of an asset bubble threatening the economy or financial system stability. This seems like a plausible scenario given the two most recent recessions prior to 2020 were precipitated by asset bubbles, and the Fed's Statement on Longer-Run Goals and Monetary Policy Strategy indicates "achieving maximum employment and price stability depends on a stable financial system."

## CONCLUSION

The Fed's modified inflation targeting policy could materially affect the economy and markets. Potential effects include a more favorable environment for equities and corporate credit as economic cycles lengthen and the economy runs hotter. Additionally, the U.S. Treasury yield curve could steepen. However, there remains some uncertainty regarding how the Fed will respond in future situations given this policy change provides the Fed with more flexibility and makes their decisions more subjective. In addition, the median economists' projection shows it could take a few years from now for inflation to rise above 2% on a consistent basis and test the Fed's willingness to tolerate inflation above 2%.

## ECONOMY

### GDP AND CONSUMER PRICES
SEPTEMBER 2017 THROUGH OCTOBER 2020



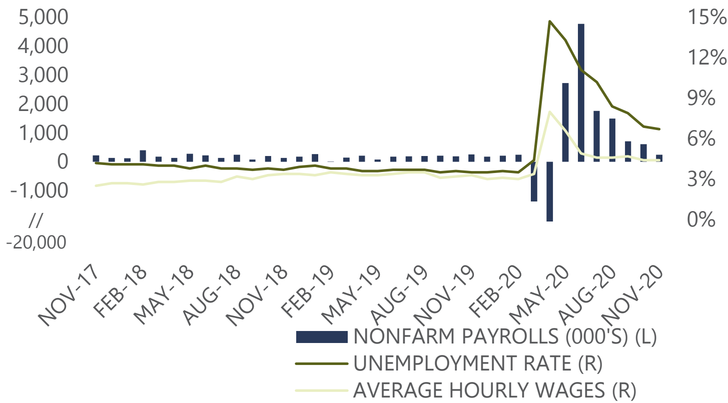

Source: Bloomberg

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.

The ongoing efforts to reopen businesses and resume activities that were postponed due to the pandemic drove the sharp increase in GDP. Economists project fourth quarter GDP will increase by 4.0%, resulting in full year 2020 GDP contracting 3.6%.

The Consumer Price Index (CPI) was unchanged in October from the previous month, indicating subdued inflation as the pandemic drags on. The year-over-year Core CPI reading, which excludes volatile food and energy costs, decelerated to 1.6% from 1.7% in September.

### LABOR MARKET
NOVEMBER 2017 THROUGH NOVEMBER 2020



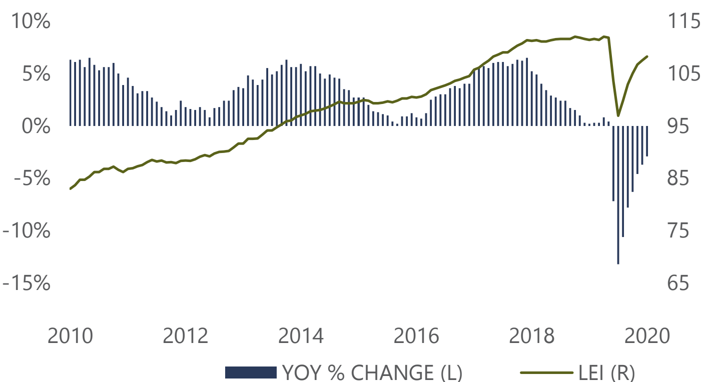

Source: Bloomberg

The resurgence of COVID-19 cases throughout the U.S. resulted in weaker-than-expected job gains in November. The U.S. economy added 245,000 jobs during the month which was less than half of the 610,000 jobs added in October. November was the weakest month of jobs gains since the recovery began in May. The unemployment rate inched down to 6.7% from 6.9%.

The labor report showed that the restaurant industry lost jobs for the first time since April. Additionally, employment fell in other industries including retailers, public schools and nursing homes.

One positive takeaway from November's weaker employment report is that it may give Congress more incentive to reach a deal on another stimulus package to help the economy.

### LEADING ECONOMIC INDICATORS
OCTOBER 2010 THROUGH OCTOBER 2020




Source: Bloomberg

The Conference Board Leading Economic Index (LEI) for the U.S. climbed to 108.2 in October from 107.5 the previous month. The 0.7% monthly gain marked the fifth consecutive month the index increased.

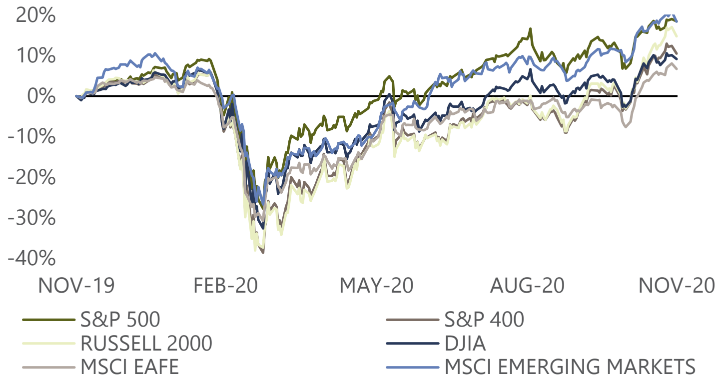
Weakness was seen in housing permits and consumers' outlook for economic conditions; however, strength among the leading indicators has become more widespread.

For the six-month period ending in October, the LEI increased 11.7%, a strong improvement from the 3.9% growth for the six-month period ending in September. Despite the continued increase, the pace of improvements has been decelerating from the initial rebound earlier in the pandemic recovery.

# EQUITY

## TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, NOVEMBER 2019 THROUGH NOVEMBER 2020




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

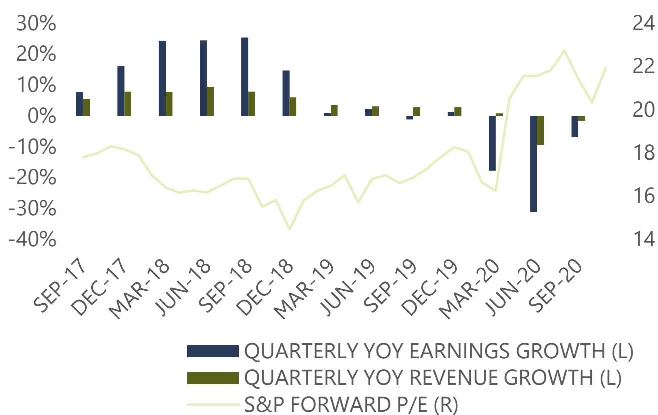
Global equities surged higher with most major indexes rising double digits in response to positive vaccine news. Positive vaccine clinical trial data released from Pfizer, Moderna, and AstraZeneca spurred hopes for a return to normalcy next year.

The most economically sensitive areas of the stock market performed the best. Small cap stocks led with the Russell 2000 posting a record monthly gain of 18.43%. Mid cap also outperformed large cap as the S&P 400 rose 14.28%, its best monthly return since the beginning of the post-Global Financial Crisis market recovery in the spring of 2009.

Foreign developed stocks outperformed U.S. large cap. Europe performed particularly well since its higher exposure to global trade makes it more cyclical.

## S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, SEPTEMBER 2017 THROUGH NOVEMBER 2020




Source: Bloomberg

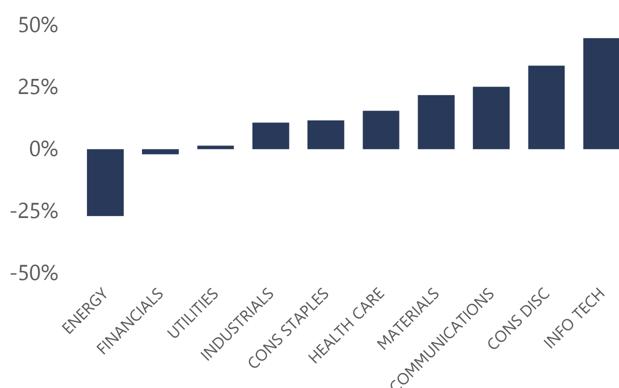
Third quarter earnings reporting season is mostly wrapped up with results reported from 99% of S&P 500 companies. S&P 500 earnings are recovering quicker from COVID-19 shutdowns than analysts projected. Earnings are on track for a 6.91% year-over-year decline compared to analysts' initial estimate for a 21.48% decline.

Around 85% of companies reported earnings above analysts' estimates. This is the highest earnings beat percent in Bloomberg's 30 years of data and well above the 63% long-term average.

Analysts continue to upwardly revise earnings expectations for coming quarters. Earnings are projected to decline 9.98% in the fourth quarter followed by growth of 14.98% and 44.19% in first and second quarters next year, respectively.

## S&P 500 SECTORS 12-MONTH PRICE RETURNS

NOVEMBER 2019 THROUGH NOVEMBER 2020




Source: Bloomberg

The positive vaccine trial data and hopes for a return to normalcy next year spurred a change in market leadership. Sectors with greater economic sensitivity such as financials, energy, and industrials, led in November with each sector rising over 15%.

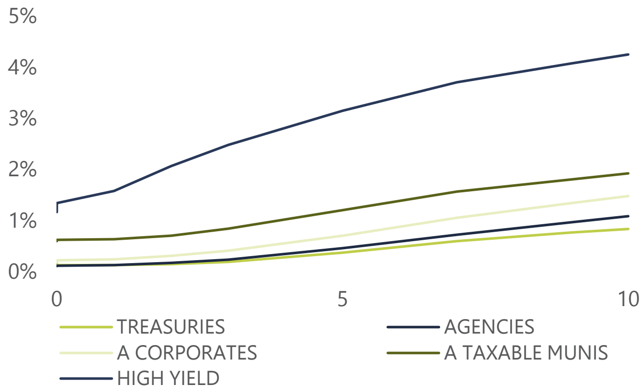
The rotation to cyclical stocks also resulted in the S&P 500 Value index outperforming the S&P 500 Growth index by over 3%.

After leading during most of the rally earlier in the year, the technology sector was the worst performing sector over the last three months as momentum eased for work-from-home beneficiaries and higher growth stocks. Technology remains the leader year to date by a wide margin with its 36.08% return.

# FIXED INCOME

## CURRENT YIELD CURVES

YIELD CURVES AS OF NOVEMBER 2020




Source: Bloomberg

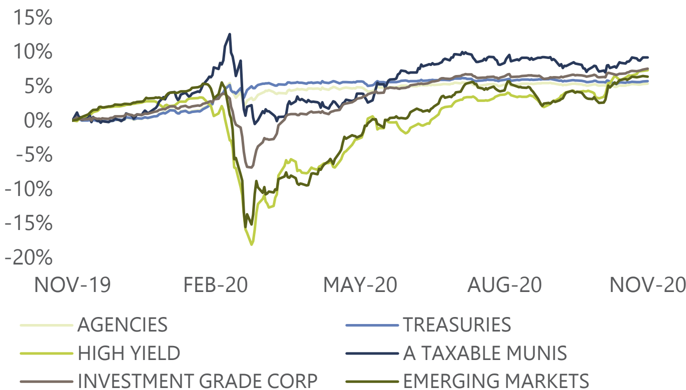
Large parts of the U.S. Treasury yield curve were relatively unchanged in November after steepening significantly from August through October. The difference in yields between the three-month and 10-year U.S. Treasury notes stands at 0.76% on November 30 compared to 0.43% on July 31.

Shorter dated U.S. Treasury yields remained anchored at historically low levels driven by indications from Federal Reserve officials that the central bank's policy rate will stay at the zero bound for the foreseeable future.

In late November, the difference in yields between a representative 10-year A-rated U.S. corporate index and the 10-year U.S. Treasury note reached its lowest level in the pandemic era.

## 12-MONTH RETURNS, TAXABLE BOND SEGMENTS

NOVEMBER 2019 THROUGH NOVEMBER 2020




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

High yield and emerging market bonds experienced the sharpest recoveries in performance from March lows amid building expectations for a robust global economic recovery in 2021. Emerging markets bonds benefitted in recent months from a bout of significant U.S. dollar weakness.

U.S. Treasury and agency bonds generated only very small gains since the end of March, as investors turned their focus to corporate and municipal debt following massive monetary and fiscal stimulus measures provided by the Fed's emergency bond market facilities and the CARES Act.

Heading into 2021, the size and scope of a prospective second wide-ranging congressional stimulus package will likely determine the path of relative performance for U.S. corporate and municipal bonds.

## SPREAD VS. TREASURY LESS 2-YR MOVING AVG

NOVEMBER 2017 THROUGH NOVEMBER 2020

Source: Bloomberg

All four bond market segments shown in the accompanying chart have seen the difference in their respective yields narrow versus similar maturity U.S. Treasury bonds since March. This difference in yields is generally referred to as a "credit spread."

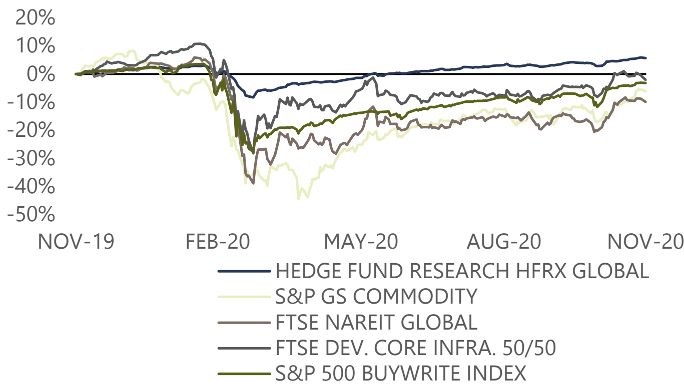
Levels below 0% in the accompanying chart indicate a bond market segment's credit spread is narrower than its two-year moving average.

The broad trend of narrowing credit spreads over the last nine months depicted in the accompanying chart has not been perfectly linear. We can see a widening of corporate BB-rated and municipal A-rated credit spreads in September and October related to increasing uncertainty surrounding congressional stimulus negotiations and the November elections.

# ALTERNATIVES

## ALTERNATIVES, 12-MONTH RETURNS

NOVEMBER 2019 THROUGH NOVEMBER 2020




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

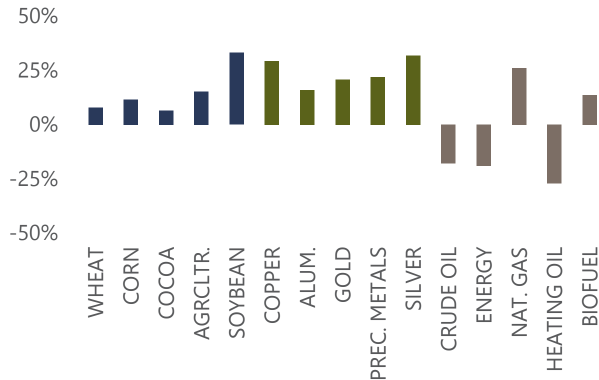
Of the five alternative asset class segments shown in the accompanying chart, the global hedge fund asset class had the strongest performance over the last twelve months both in terms of absolute returns and risk-adjusted returns.

Across the hedge fund world, convertible arbitrage, credit-focused and event-driven special situations strategies have generated the best returns thus far in 2020. Meanwhile, equity market neutral, macro/CTA, and equity market hedge strategies have generated the weakest returns.

The higher beta commodities, real estate and infrastructure indexes shown in the accompanying chart experienced sharp gains in November buoyed by broadly positive risk asset sentiment driven by encouraging COVID-19 vaccine news and reduced uncertainty surrounding the U.S. elections.

## COMMODITIES, 12-MONTH SPOT RETURNS

NOVEMBER 2019 THROUGH NOVEMBER 2020




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

The broad commodities asset class outpaced the S&P 500 and MSCI ACWI indexes in November on the strength of sharp crude oil and industrial metal price gains during the month.

The petroleum complex, copper and iron ore all benefitted from increased optimism for a revival in demand related to a resumption of travel, transport and business activities to pre-pandemic levels assuming successful distribution of COVID-19 vaccines.

Gold prices fell more than 5% in November to close the month near a five-month low, as investors expressed declining interest in safe haven assets. According to S&P Global, net flows into physically backed gold ETFs remained positive in October, the most recent month for which data is available.

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