MARKET COMMENTARY

Feast or Famine

Q3, 2020

- COVID-19 remains a critical health issue that is creating an uneven recovery across the U.S. economy and capital markets.
- The Federal Reserve, Treasury, and federal government are making policy decisions that are dictating crucial capital flows, creating an abundance for some and a dearth for others.
- Given the past few weeks, especially the first Presidential debate, the election appears to be heading towards a decisive victory for Democrats.
- Even though equity valuations remain high and bonds yields low, a renewed commitment by monetary and fiscal policymakers will continue to flood the markets and economy with money, which should continue to support markets, but there will be winners and losers.

Overview

After two radically different and extreme quarters to start the year, returns settled down in the third quarter to post gains that resembled a more normal, albeit optimistic, environment. The S&P 500 Index, a proxy for U.S. stocks, rose by 9% while a broad measure of taxable fixed income securities, the Bloomberg Barclays U.S. Aggregate Bond Index, gained 0.6%. Year to date, the S&P 500 is up 6%.

In the third quarter, the S&P 500 rose by 9% while the Bloomberg Barclays U.S. Aggregate Bond Index gained 0.6%. These returns were relatively normal when compared to the two radically different quarters we had to start the year.

On the surface, these relatively mundane returns were surprising, considering that the underlying economy remains incredibly uneven. However, in terms of sector returns, this year has been feast or famine. On the feast side, the technology sector, which represents approximately one-quarter of the S&P 500, is up 29% year to date. Conversely, the energy and financial sectors, which combine to represent a smaller, but still significant, 15% of the index, are down 48% and 20%, respectively. The spread between the best and worst performing sectors is 78%—the highest it's been since 2000 when utilities were up 51% and materials were down 31%. Given the wide dispersion of sector returns, the considerable disparity between growth and value stock returns is unsurprising. So far in 2020, large cap growth stocks, as measured by the Russell 1000 Growth Index, are higher by 24% while the Russell 1000 Value Index is down 12%. Similarly, the spread between small cap growth stocks, as measured by the Russell 2000 Growth Index, and small cap value stocks, as measured by the Russell 2000 Value Index, is 26%. To provide some context, at the height of the tech bubble in 1999, the difference between large cap growth and value stock returns was 20%. In 1999, large cap growth stocks outperformed small cap value stocks by 35%, but year to date, that spread is 46%, as small cap value stocks are down 22%.

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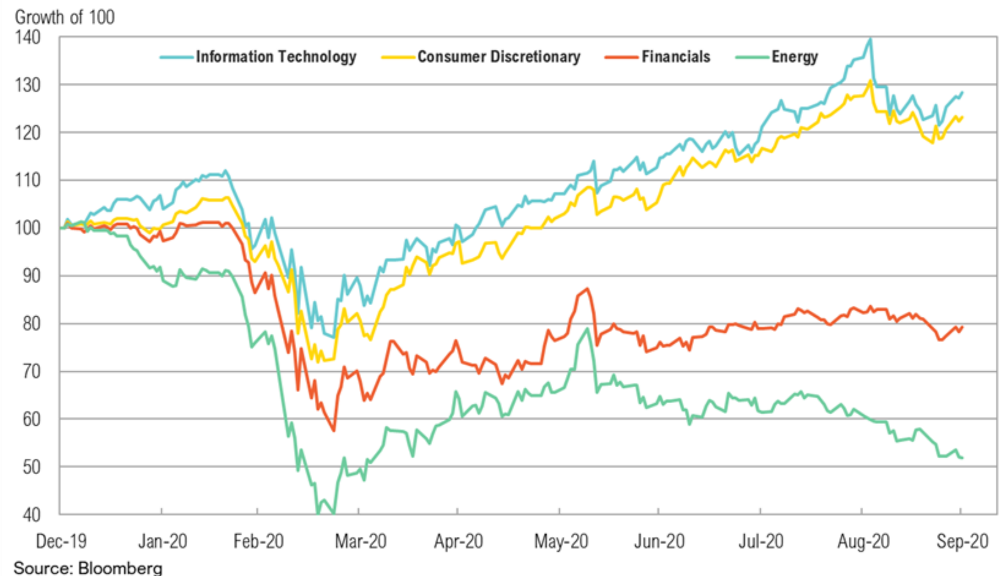

Source: Bloomberg

While air travel remains lower by nearly 70% year over year, full-time employment at airlines was down just 6% this year. This disconnect is the result of government loans suspending the fallout.

This feast-or-famine narrative applies across the U.S. economy. Struggling with the combined impact of the COVID-19 crisis and the subsequent response from policymakers, the airline industry has been one of the hardest hit. Using TSA travel checkpoint data as a proxy for air travel shows just how devastating the crisis has been. After collapsing to virtually no activity in March and April, the airline industry is still reeling. In the last week of September, activity remains lower by nearly 70% relative to the same week one year ago.[1]

Even with those distressing numbers, the airline industry remains nearly fully employed. Through August, full-time employment was down just 6% compared to the start of the year.[2] This disconnect is the result of government loans suspending the fallout. It also underscores something the Federal Reserve has keyed in on in its recent shift away from a focus on its dual mandate of “maximum employment and price stability”.[3] At its virtual “Jackson Hole” Economic Policy Symposium, the Federal Reserve formalized a policy position that is more tolerant of overheating markets and inflation levels above 2%. The Fed also gave itself an additional mandate, financial stability.[4] The vagueness of this mandate increases the Fed’s power.

There are nearly 25 million Americans receiving government support as a result of job losses as permanent job losses increase at a faster rate than during the prior two recessions.

Whether justified or not, the Fed has scaled up its already far-reaching power in proportion to the size of the pandemic. It has also explicitly called for further fiscal stimulus, focusing especially on a labor market that remains in distress, even as headline jobs numbers have improved. Continuing jobless claims have moved lower off all-time highs, dropping from nearly 25 million to 11 million.[5] The unemployment rate has improved from 15% to 8%.[6] However, if you include all of the assistance programs launched during the pandemic, the number of Americans receiving government support as a result of job losses is close to 25 million, approximately 15% of the 160 million people in the workforce.[5,7] Permanent job losses—a specific point of concern for policymakers—are also increasing at a faster rate than during the prior two recessions.[8] Layoffs in industries such as airlines, which are inevitable without further government support, would only push the permanent job loss number higher.

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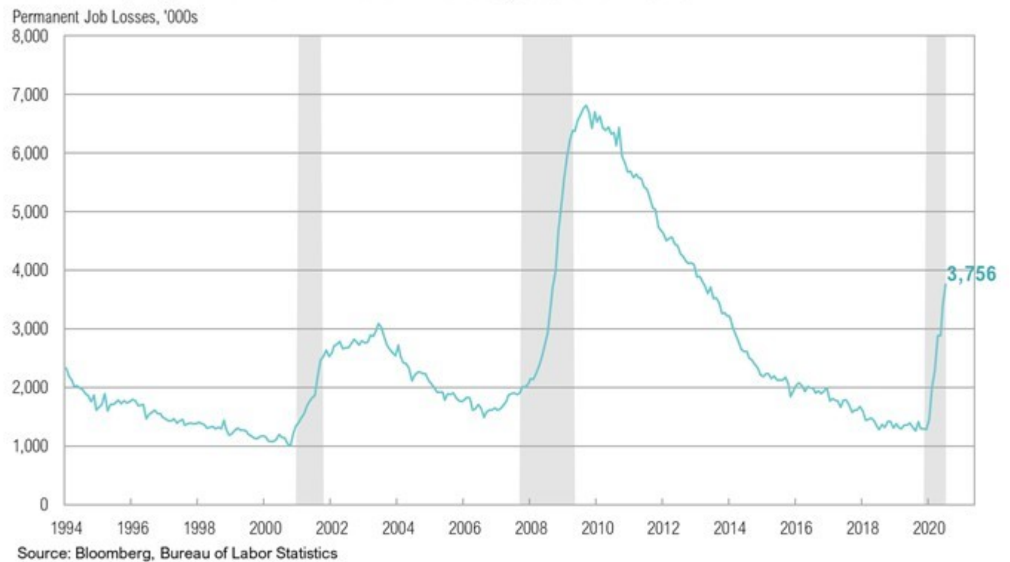

Given the labor market conditions, Fed Chairman Jerome Powell told the National Association for Business Economics that the risks of overdoing economic support seem less than doing too little to support the economy.

Given these conditions, on October 6, Fed Chairman Jerome Powell told the National Association for Business Economics that "too little support would lead to a weak recovery." He added that the risks of "overdoing it" seem less than doing too little.[9] This is not the first time the Fed has tried to dictate economic outcomes by influencing capital markets, but it is being more brazen about it. In November 2010, then Fed Chairman Ben Bernanke wrote an op-ed piece in the *Washington Post* that explained the rationale behind the Fed's second quantitative easing program: "[Quantitative easing] eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."[10]

In response to the pandemic, earlier this year, the Fed implemented the Secondary Market Corporate Credit Facility and purchased billions of dollars of fixed income exchange-traded funds (including funds that hold high-yield bonds) and the bonds of corporations such as Alphabet, Amazon, Apple, Toyota, and Walmart.[11] These purchases enabled investment-grade companies to issue $1.6 trillion in new bonds in 2020—an astounding 72% increase relative to last year.[12] Even companies with below investment-grade credit ratings have been able to access capital markets. Companies with junk ratings have issued $325 billion in new bonds this year, a 57% increase relative to last year.[12] This theme is not limited to the U.S. In September alone, corporate bond sales globally totaled $434 billion, the largest monthly issuance ever.[13] Meanwhile, the Main Street Lending Program has disbursed just $2 billion with the first deployments occurring in July, nearly four months after the aforementioned program began buying securities.[14]

It appears the Secondary Market Corporate Credit Facility and quantitative easing programs will be sufficient to achieve the Fed's stated goal of supporting asset prices. As of October 7, the 10-year Treasury note yielded 0.8%, and investment-grade corporate bond spreads hit 101 basis points, both near all-time lows. Similarly, the S&P 500 is near

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an all-time high, despite trading near the high end of its historical valuation range. The one-year forward price-to-earnings ratio for the index sits at nearly 22 times, which is not far from the Tech Bubble high of 26 times.[15] Although the Fed may be able to support asset prices, there is only so far that monetary policy can go. For instance, the number of Americans who need the Supplemental Nutrition Assistance Program (SNAP) jumped 16% in just three months through May and it now includes 43 million people.[16] Unfortunately, while investors have feasted, a non-trivial number of people need help putting food on the table.

Capital markets seem willing to tolerate significant federal debt issuance.

The structural economic damage inflicted by COVID-19 appears daunting, but it may be promising that the capital markets seem willing to tolerate massive amounts of federal debt issuance and monetization of that debt. Indeed, inflation remains contained, and the U.S. dollar has been range-bound for the past six years. Looking ahead, the Fed's willingness to tolerate higher inflation—thereby lowering the real (inflation-adjusted) return for investment assets—will be most obvious in the fixed income markets. As investors absorb this reality, they may move away from these securities in search of a higher interest rate to compensate them for this risk. If that occurs, the Fed can assuage those higher yields (and lower prices) with increased asset purchases.

Election

Over the summer, it looked like the U.S. election would come down to the president's ability to get control of the pandemic and to Joe Biden's performance in the debates. Another factor was whether the silent vote, which pollsters failed to capture in 2016, would boost the president out of his several-point deficit in the polls. Before the first presidential debate on September 30, Biden was leading the president by about 6%, according to an aggregate of national polls, and betting market PredictIt gave Biden a 57% chance of winning.[17] On the heels of a rancorous first debate, the outcome of the election now seems more certain. On October 7, national polls showed Biden's lead increasing to 10%.[17] PredictIt increased Biden's chance of winning to 67%—a whopping 8% increase since the debate. In addition, the number of new COVID-19 cases per day remains high, hovering above 40,000, which also hurts the president's chances.[18] Control of both the House of Representatives and Senate also appears to be favoring Democrats. Prior to the first debate, the odds of a so-called "blue sweep" were 50%. That number has since jumped to 62%, according to PredictIt.

Before the first presidential debate, Biden was leading President Trump by about 6% according to national polls. On October 7, after a rancorous debate and hospitalization of President Trump due to COVID-19, national polls showed Biden's lead increasing to 10%.

An unusual predicament awaits the inbound government: a weak economy, yet broad-based political will to deliver more support. Further, the Treasury currently holds a cash position of more than $1.6 trillion.[19] This is due to the massive amount of issuance after the initial COVID-19 "shutdown" and the lack of disbursements from certain pandemic-related relief programs. While support for the economy may be good for markets, it is unclear which sectors will win and which will lose. Along these lines, it will be interesting to see how new government leaders approach key issues, like the recently released House Judiciary Committee's antitrust report on digital marketplaces. The Democratic report—which focuses on Amazon, Apple, Facebook, and Google—portrays these companies as too powerful.[20] Collectively, these companies represent 17% of the S&P 500 Index, have over $109 billion in cash on their balance sheets, and enjoyed earnings growth of 6% over the past year.[21]

Markets

The S&P 500 rose by a robust 9% during the third quarter and continues to climb higher despite a tepid earnings environment. During the most recent earnings season, companies in the S&P 500 announced operating earnings that were down 33% year-over-year. For the first half of 2020, earnings were down 40% relative to the first half of 2019. Given what has occurred thus far and expectations for the rest of this year, the S&P 500 is on pace to experience a decline in earnings of 28%.[22]

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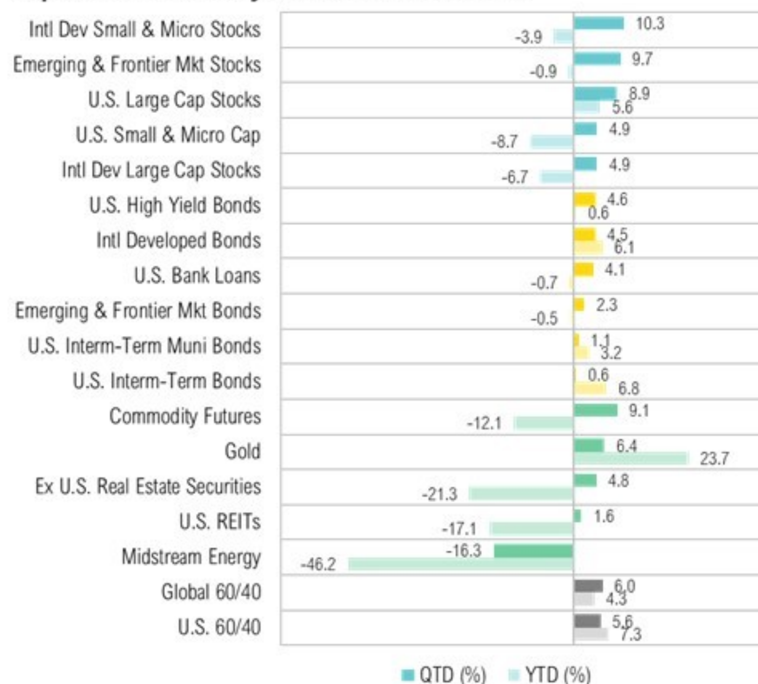
Fixed income markets reflected underlying optimism and the benefits of continued Fed support. As a result, lower quality fixed income sectors outperformed investment-grade securities while generating equity-like returns and erasing losses for the year. High-yield bonds were up more than 4% during the quarter, leaving them up 0.6% for the year. Similarly, bank loans gained 4% and are now down less than 1% in 2020. Intermediate-term municipal bonds were up 1% in the quarter, leaving them up just over 3% for the year. The 10-year Treasury yield traded within a remarkably narrow range of 22 basis points, ending the quarter at 0.69%, just three basis points higher from where it started the quarter.[23]

Equities outside the U.S. also generated positive returns in the quarter, and developing markets outperformed developed markets. However, on a year-to-date basis, returns are still negative. In U.S. dollar terms, the MSCI Emerging Markets Index increased by almost 10% and is now down less than 1% for the year. For the quarter, the MSCI EAFE Index gained 5%, but remains down nearly 7% for the year.

September 2020 Key Market Total Returns



Source: Bloomberg

Looking Forward

With every presidential election, it's tempting to look to history for clues about how markets will perform. But if 2020 has taught us anything, it is that the future is uncertain. There is simply no precedent for what the world is going through today. Instead, we have a mashup of some of the worst and best episodes in market history. Examining the whole,

we believe heightened volatility is possible in the coming months as the transition of power in Washington unfolds, the new composition of government starts to spend money, and the Fed right-sizes its asset purchase program to deal with the onslaught of Treasury issuance. However, we also believe that there will be massive amounts of fiscal and monetary support, which would render economic and market fundamentals less relevant. Our goal in this feast-or-famine environment is to remain diversified and to continue to be incremental—buying what may become relatively cheap and trimming what may become expensive. As always, we will be vigilant in our assessment of opportunities and risks.

Finally, we continue to be grateful for the many workers who do not have the luxury to work remotely and have to risk their health and safety in order to provide the services that keep our society functioning.

Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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