



# Carte Blanche

August / September 2020

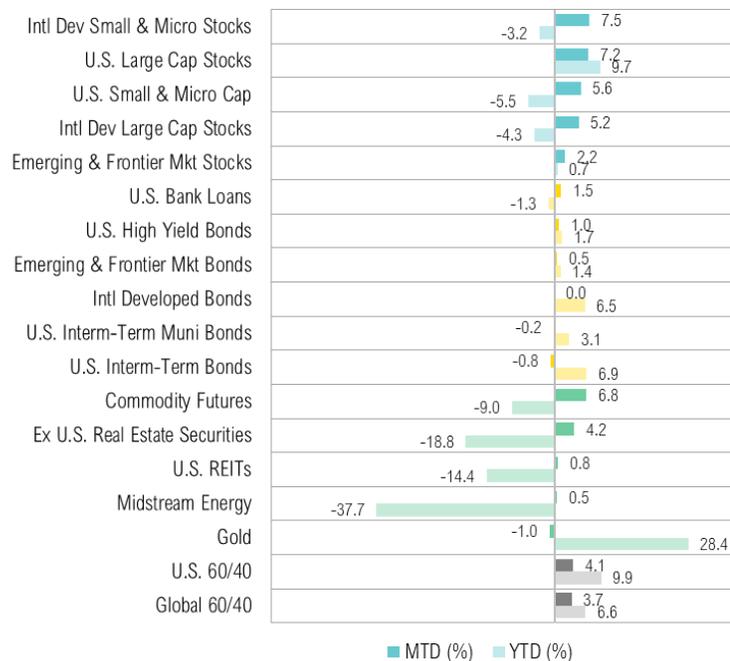
- Markets continued their impressive run through August and into early September before pulling back modestly.
- At its “Jackson Hole” Economic Policy Symposium, the Federal Reserve formalized its shift toward a policy that is more tolerant of overheating markets and inflation levels above 2%.
- The election will increasingly take center stage, but fiscal and monetary support will likely continue regardless, which should help mitigate tail risks but may raise the specter of future inflation.

***In August, the S&P 500 rallied 7.2%, its best August performance in 36 years. Despite those impressive gains, the real star of the show was the tech-focused NASDAQ Composite Index, which rallied 9.7%.***

## Market Update

The combination of a gradual economic recovery, supportive monetary policy and gimmicky stock splits by Apple and Tesla provided the perfect environment for U.S. stocks in August as they continued their march upward. The S&P 500 rallied 7.2%, the best August in 36 years. Despite those impressive gains, the real star of the show was the tech-focused NASDAQ Composite Index, which rallied 9.7%. Even within the NASDAQ, most of the gains were generated by a relatively small group of stocks. The top-performers, all up more than 25%, included Tesla (+74%), Workday (+33%), Zoom (+28%) and Nvidia (+26%). Investment-grade bonds, as measured by the Bloomberg Aggregate Bond Index, declined modestly as interest rates inched higher. High yield corporate bonds rose 1.0% as spreads tightened by 11 basis points and ended the month at 4.77%.

### August 2020 Key Market Total Returns



Source: Bloomberg

**At its annual Economic Policy Symposium, Fed Chairman Jerome Powell emphasized the Fed's willingness to push the policy envelope which could have significant implications for the economy and markets.**

The rally in stocks took a pause as volatility returned on September 3 and 4, with a swift decline in stocks that saw the S&P 500 Index and the NASDAQ 100 both erase the prior eight days of constructive price action.

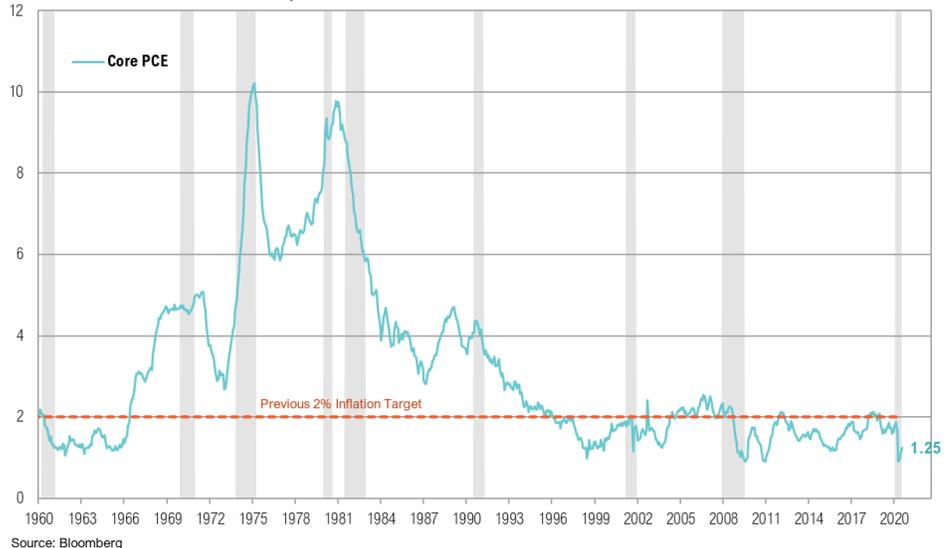
## Carte Blanche for the Fed

On August 27 and 28, the Federal Reserve Bank of Kansas City hosted its annual Economic Policy Symposium. Instead of convening in the picturesque valley of Jackson Hole, Wyoming, this year's event was hosted virtually. The symposium, held every year since 1978, is one of the Federal Reserve's key platforms for communicating its important policy updates. This year was no different. Fed Chairman Jerome Powell emphasized the gravity of the economic situation as well as the Fed's willingness to push the policy envelope. Using words like "profound," "full range of tools," and "robust updating", Powell telegraphed a crucial revision to how the Fed would approach both aspects of its "dual mandate"—maximum employment and stable prices—which could have significant implications for the economy and markets.<sup>2</sup>

The first aspect of the change involves the Fed's goal to achieve stable prices. The Fed has formally moved away from its 2% inflation target (the level first introduced in 1996, but only made public in 2012 by Ben Bernanke<sup>1</sup>) and is instead favoring "average inflation targeting."<sup>2</sup> The move provides cover to allow inflation to run higher than 2% for an undefined period of time. The second change that the Fed revealed was less obvious, though perhaps not less important. It relates to the full employment mandate. The Fed stopped referring to "deviations from full employment" and now discusses "shortfalls"—implying that unemployment can never be too low. While the change may appear subtle, according to the Fed, it reflects their view "that a robust job market can be sustained without causing an outbreak of inflation."<sup>2</sup>

**The Fed communicated two significant changes to its policy approach: 1) the Fed has formally moved away from its 2% inflation target and 2) they now refer to shortfalls in employment, a subtle change that implies a robust job market can be maintained without causing an inflation outbreak.**

**U.S. Core PCE Price Index, Jan-1960 - Jul-2020**



Both of these changes highlight how the Fed has struggled to achieve its inflation goals even with the help of increasingly unorthodox policies. Due to a backdrop of powerful deflationary forces—rising debt levels, improved productivity resulting from advancements in technology, and increasing economic slack—the Fed has had a challenging, arguably impossible, task of delivering inflation. The “Jackson Hole” Symposium in effect doubled down on this goal, signaling its continued willingness to aggressively employ low interest

***While the odds of a “blue sweep” are 52% in betting markets, the lack of clarity from either political party on crucial policy issues makes forecasting the election challenging.***

rates and to extend quantitative easing, seemingly regardless of the collateral damage. With its ambiguous new inflation threshold, the Fed has essentially given itself the ability to purchase unlimited amounts of bonds and appears to be encouraging Congress to pursue aggressive deficit spending.<sup>2</sup>

## **The Election**

With the 59th U.S. presidential election less than two months away, investors are beginning to contemplate potential policy logistics. As of September 9, polls and betting markets anticipate that Biden will win and that Democrats will narrowly take over the Senate and will easily hold onto their majority in the House of Representatives.<sup>5</sup> Based on offshore betting market PredictIt, the odds of a “blue sweep” are 52%—slightly better than a coin toss.<sup>3</sup> That said, details related to several crucial issues are either missing or challenging to forecast. Neither Donald Trump nor Joe Biden have released a formal tax plan, the size and scope of the next round of economic stimulus continues to be hotly debated, and it is still unclear how many Americans will want to, or have the ability to, vote in person versus opting for a mail-in ballot. Making matters worse, a Cato Institute study from July 2020 highlighted the significance of the “silent vote” in 2020 and the folly of relying too heavily on polls. According to the study, more than half (52%) of Democrats and three-quarters (77%) of Republicans, respectively, have political opinions they are afraid to share.<sup>4</sup>

An uncertain election, combined with a Fed committed to monetizing any amount of government spending, creates a fascinating ending to an already surreal year.

## **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.

## **Citations**

1. Federal Reserve: <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120125.pdf>
2. Federal Reserve: <https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm>
3. PredictIt: <https://www.predictit.org/markets/detail/4353/What-will-be-the-balance-of-power-in-Congress-after-the-2020-election>
4. Cato Institute: <https://www.cato.org/publications/survey-reports/poll-62-americans-say-they-have-political-views-theyre-afraid-share>

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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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