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OUTLOOKS

September 2020

ECONOMIC OUTLOOK

Summary

While monetary and fiscal stimuli have been major influences behind the economic rebound we are experiencing in the second half of 2020, their impact tends to be short- to medium-term in nature. However, the Federal Reserve did announce some longer-lasting policy changes in late August that could extend future economic expansions.

The Fed has a dual mandate; their goal is to optimize economic conditions so that price inflation remains stable while also allowing for maximum sustainable employment. They traditionally have monitored inflation with a "target" of 2% per annum, but in reality, it has acted more as a limit since they have not allowed it to go above that level. They have also measured deviations in employment trends, both positive and negative, from what the Fed has estimated to be "full employment."

The Fed viewed these mandates through the lens of various economic models, primarily the Phillips Curve - which is the inverse relationship between the rate of unemployment and the increase in wages in the economy. The Phillips Curve was used to determine if current monetary policy was too restrictive or accommodative, even though the Fed had long ago admitted that it was "broken" since inflationary pressures appear less responsive to low unemployment than they used to be. Even so, it continued to influence their policy decisions.

Finally, in late August, the Fed seemed to abandon the model and other similar views that had been in place for decades. In a fairly major policy shift, it was determined that a symmetric target for inflation would be more appropriate, which would allow for a true 2% average over time, rather than a 2% limit. Additionally, instead of viewing the deviations from maximum employment, they will now focus only on the shortfalls – a switch to a more asymmetric view.

Why does any of this matter? Due to the traditional relationship of low unemployment leading to higher inflation, the Fed has gravitated toward being preemptively restrictive at times in order to engineer higher unemployment and lower inflation expectations. But if inflation hasn't been a problem, then the Fed has been predisposed to unnecessarily increase rates and threaten economic prosperity for no real reason. By waiting to see the actual impact on inflation, the Fed will now err toward a predisposition of accommodative policy. Given the current unemployment rate, this won't have an immediate impact on policy but it is a clear indication that the Fed is willing to "permit" long-lasting economic growth well into the future.

Positives

Personal spending remains elevated (1.9% vs 1.6% estimate)

Durable goods orders up double digits (11.2% vs 4.8% estimate)

Home sales continue to exceed expectations

Negatives

Congress hasn't been able to work out a deal on additional fiscal stimulus

Consumer confidence is well below expectations (84.8 vs 93.0 estimate)

Initial unemployment claims remain elevated (22 of the past 23 weeks have been above 1MM)

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OUTLOOKS

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EQUITY OUTLOOK

Summary

After falling 34% from peak to trough, the S&P 500 rallied to a fresh all-time high in August. It is notable given the size of the decline that it took only 5 months for the index to recover the losses. It's also notable the market's recovery has been fueled by very few companies. Roughly 5% of the S&P 500 constituents trade at or near their all-time highs, depending on the specific day. Leadership has been narrow.

While value stocks did participate in the rally, they continue to underperform their growth peers. The Russell 1000 Growth Index climbed 10.3% over the course of the month while the Russell 1000 Value Index was up just 4.1%. Mid-cap and small-cap companies also failed to keep pace. Their respective Russell Midcap Index and Russell 2000 Index rose 5.6% and 3.5% underperforming the S&P 500.

Market sentiment with regard to the global pandemic has shifted from absolute fear, to signs of hope and reopening, and now into a completely new stage. Society seems to be learning to cope alongside the virus. We continue to see the green shoots of an economic recovery and the stock market continues to focus on these more optimistic signals. The threat of new waves of COVID-19 cases has been muted given improved treatment protocols and the looming potential for multiple vaccines.

Accommodative Fed policy, a lack of attractive investment alternatives and the FOMO (fear of missing out) trade has propelled the stock market recovery. These themes continue to remain in place and there are few reasons to doubt that the market's momentum will stop anytime soon. While September has historically been a challenging month for stocks, we remain constructive on equity markets as we continue through an overly-eventful 2020.

Positives

- Medical breakthroughs concerning the COVID-19 outbreak
- Savings rate is high-could fuel purchases
- Accommodative Federal Reserve and global central bank policy

Negatives

- Rising geopolitical tensions
- Layoffs continue

Unknowns

- Market's response to the election with polls now tightening

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FIXED INCOME OUTLOOK

Summary

The downward trend in interest rates continued into the first few days of August as talks stalled over the next round of government stimulus needed to combat the economic fallout of the coronavirus. The 2-year and the 10-year Treasury notes both reached new closing lows at 0.17% and 0.51%, respectively. Yields then moved up swiftly over the next 10 days with the release of a July's stronger-than-expected payroll report and indications of inflation actually ticking upwards. The final push upwards came late in the month when the Federal Reserve Chairman presented his virtual address at the Kansas City Fed's Jackson Hole Economic Policy Symposium. Through his speech Chair Powell discussed the findings of the Fed's yearlong listening tour which was originated to help the Fed better understand inflation and inflationary expectations.

While anticipated by some, the takeaways from the speech were nothing short of monumental for the way that monetary policy will be conducted in the future. The Fed acknowledged the breakdown in the relationship between employment and inflation. Therefore, they will no longer consider low levels of unemployment automatically lead to higher inflation and indicate that they should tighten policy. They will now only look at the inflationary statistics as an indication that policy is too easy and conditions should firm. On the other hand, they will consider any slack in labor market from recent trends as an indication that policy might be too restrictive.

On the inflation front, the Fed's established target of 2% will no longer be looked at as a cap but rather a level to be achieved over time. This means that they will let inflation run above the 2% level to make up for periods when inflation is below that level. Considering that the core PCE, the Fed's favored measure, has run below their target for the vast majority of the past 25 years, we believe it is unlikely they will feel the need to increase the overnight rate above the ZIRP (Zero Interest Rate Policy) anytime in the next five years or more.

Given the Fed's fresh look at the conducting of monetary policy, it makes sense that the markets are now expecting slightly higher inflation over the next five to 10 years. It also makes sense that longer rates moved upwards after the speech while short rates remained anchored. For the month of August, the 2-year increased less than 3 basis points (bps) while the 10-year increased by nearly 18 bps to close at 0.13% and 0.71%, respectively. We believe that the longer maturity part of the curve can still see higher rates with this new Fed perspective, but with short rates staying firmly in the middle of the Fed's 0 bps to 25 bps overnight range, any increase is limited. Bond investors understand that as the slope of the yield curve increases, the appreciation generated by bonds aging or "rolling" down the curve increases as well. As the one free lunch still available to bond holders, this slope will cap any increase in longer rates.

Positives

With the change in the Fed's thinking, short rates are unlikely to change for years

The return from the "roll" will cap the slope of the curve

Investment-grade corporate bond supply likely to slow from a record pace

Negatives

Federal debt to grow by trillions with record supply on the horizon

Most investment-grade corporate yields are below the rate of inflation

Unknowns

Containment of coronavirus and progress toward a vaccine

Election outcome