2020 Outlook Themes – 9/30/20

Each quarter we review our Macro Economic Strategic Allocation model via the *Outlook.* An important part of the process is the Outlook Themes, where the research team endeavors to put the current market environment in perspective as well as lay out what could be key drivers for the upcoming year.

Q3'20 saw continued momentum from the Q2'20 market recovery. Fiscal and monetary stimulus supported the economy and financial markets, economies continued to re-open, and medical progress to treat the Covid-19 pandemic was made. That said, no new monetary or fiscal stimulus was added, economic re-openings were slowed by resurgent Covid-19 cases, and while medical progress advanced, public policy responses remained mixed.

These developments are addressed via the 2020 Outlook Themes.

Outlook Theme #1: *2020 Vision is Blurry* - Understanding the unique characteristics of the 2020 recession (its speed and the external source of disruption) helped to understand the subsequent recovery. The presidential election is in focus early in Q4'20, after which the market will have a narrower set of policy expectations to price, a potential reduction in uncertainty. At the same time, Q4'20 should see results from multiple Covid-19 studies, which will hopefully confirm the market's optimism that vaccines and treatments will be available in 2021.

Outlook Theme #2: *The Fed and the Treasury Take Aim with the Stimulus Policy Bazooka* - The monetary (Federal Reserve) and fiscal (government programs) policy responses played an important role in countering the short term negative effect of lockdowns and also kept the financial markets from spiraling out of control. During Q3'20 there was no additional ammo supplied, as the Fed did not add to programs nor did the Federal government pass an additional stimulus program. For much of Q3'20, the market's expectation was that a compromise around $1.5 trillion could be reached, but that ultimately was not the case as the approaching election truncated negotiations. The expectation has now shifted to a post-election program. But as many of the existing programs ended as Q3'30 closed, there is the risk that a delayed action will cause the economic rebound to slow.

Outlook Theme #3: *Will Helicopter Money Rescue the Economy, or Cause Inflation to Take Off?* - The unprecedented Fed monetary and fiscal policies have some of the characteristics of "Helicopter Money". Even though the Fed did not add to its programs, it did change its long term framework to focus on keeping rates low until inflation truly emerges, as opposed to starting to pull back when it sees unemployment getting low. We refer to this as the Fed's "don't fire until you see the whites of their eyes" inflation policy. The plus is that the Fed may find unemployment can reach lower than expected levels. The risk, when the 10 year Treasury yields 0.68%, is that the goal of 2% inflation is realized in full.

As always, feel free to contact us if you have any questions or would like to discuss any aspect of the *2020 Outlook Themes* in further detail.

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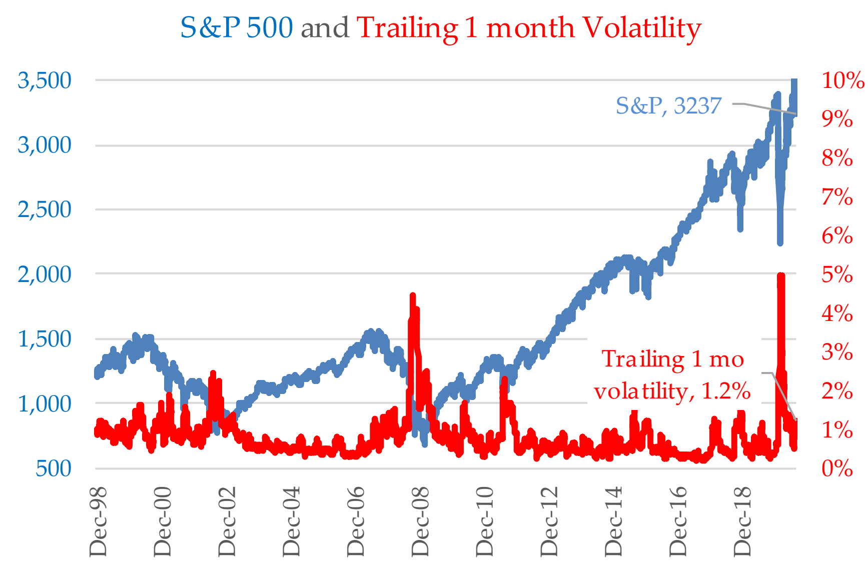
2020 Investment Theme #1: 2020 Vision is Blurry

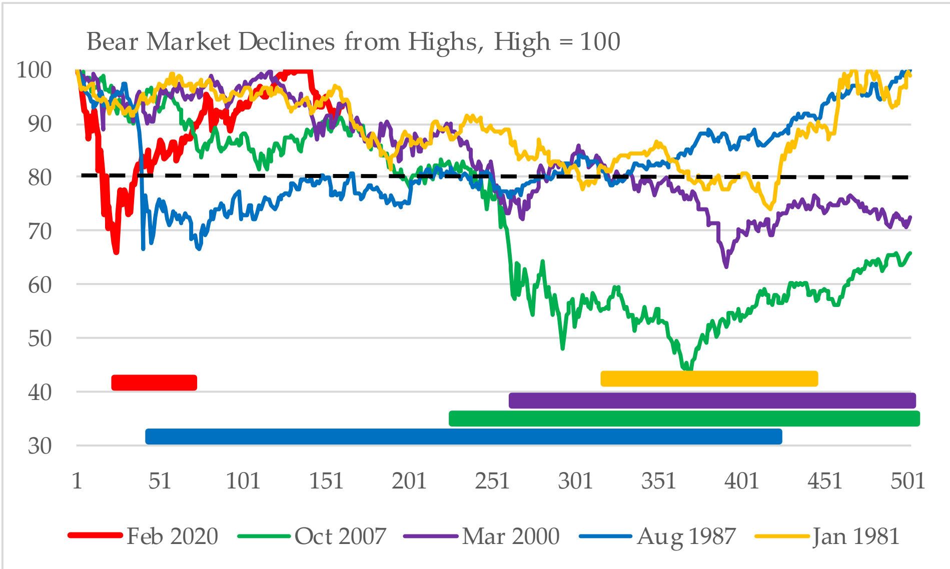
Unpredictability and uncertainty have been the theme of 2020, far more than when we observed on 12/31/19:

Market forecasting is always difficult and uncertain. The combination of recency bias (what just happened gets extrapolated), return focus (observers focus on returns, which are volatile, as opposed to valuation or other more stable metrics), group think (analysts don't want to stray too far from the pack), and discerning priced info from what will be the marginal new info (new news will move markets, but forecasts tend to center on narratives already in place) creates many opportunities for error. On top of that, financial markets are massively complicated and interlinked systems and future events are unpredictable.

Volatility is the financial market's manifestation of uncertainty, as investors with a wide range of possible outcomes will have a wider disparity in the price of assets. Q1'20 experienced record levels of market volatility, as the Covid-19 pandemic and, more importantly for the markets, the economic impact of the healthcare policy response of lockdowns and social distancing, drove the markets. As the chart shows, trailing one month volatility hit a record high of 5% at the end of March, then dropped as the market recovered, reaching a low of 0.5% on 8/28/20, coinciding with the market's high. From that point, volatility has risen as the market pulled back in September, and reached 1.2% on 9/30/20. The drop from record volatility shows uncertainty has been reduced. But the still elevated level shows it has not been eliminated.



One of the main drivers for the market's elevated volatility is the speed of the slowdown. On 3/31/20, we noted: *The 2020 economic impact will be unusual for several reasons. The first is the speed of the stock market decline, the speed of the pending recession, and the speed of the policy response. Events that usually take place over months are happening in weeks, and those that usually take weeks, are happening in days. The market crash, recession and policy response seem to be running in fast forward.*



The speed of this market cycle remained its key characteristic. As the chart shows, the 2020 stock market decline into a bear market (down 20%) was the fastest on record. It exceeded both the Global Financial Crisis (GFC) market in late 2008 and even the Black Monday Crash in 1987 (which featured a one day 20% drop). Since that point, the speed of the market developments were illustrated by the rapidity of the recovery. The colored horizontal lines indicate the period between these market declines reaching -20% and then returning to 90% of their initial high. As the short red bar shows, the 2020 cycle was notable not only for the speed of decline, but the pace of the recovery.

During Q3'20, the market continued to exhibit record speed in its cycle by returning to its prior high in record time. On 8/18/20, the S&P returned to its prior high from 2/19/20, completing its peak to trough to peak cycle in 6 months, or 128 trading days. The 2020 decline completed its round trip before three of the four others even hit their 20% decline. The other four declines had an average cycle length of 985 days, or four years. In fact, the two most recent, March 2000 (1715 days, or 6.5 years) and October 2007 (1257 days, or 5 years), were both more than 10 times longer.

Understanding the speed of the cycle and the nature of the slowdown compared to a typical recession was key to understanding how 2020 has unfolded. On 3/31/20 we noted: *Recessions do not simply drop out of the sky. They are typically preceded by some form of deterioration in the data. Conversely, this recession is emerging literally out of nowhere.*

Recessions typically occur as the correction for a misallocation of resources in the economy. A bubble builds as a certain asset (telecom equipment in 2000, mortgages / real estate in 2008) creates over excitement and over investment. The 2020 recession is not that. There is not a misallocation of resources to correct. Businesses are not closing because the activity in which they are engaged is not productive, nor are workers being fired because their contribution to the economy is no longer needed. Rather, activity is being deliberately shuttered to prevent the spread of Covid-19 and thus the timing of the economic recovery is dictated by an external, or exogenous, driver.

Due to both the speed of the shutdown and the exogenous driver, the challenge, then, is interpreting the data. Almost every economic statistic, from GDP to manufacturing surveys to unemployment, will show off the charts deterioration in speed and magnitude, as well as carry a different meaning than normal. Looking at unemployment as an example, furloughed workers will be listed as unemployed, they are not workers in need of a new job and retraining. They are resources temporarily idled until the all clear allows them to return. For example, in 2008/2009, payrolls declined by 8.7 million over the course of twelve months. In 2020, this number will likely be exceeded in just one or two months. The historically fast rise in unemployment could also see a historically fast decline. Although, like normal cycles, the decline will still take longer than the increase.

This view from 3/31 can be seen in the subsequent data. Looking at the labor market, payrolls dropped 20.5m in April, then rose 10.6m from May to August. Unemployment behaved similarly, jumping from 3.5% in February to 14.7% in April, then reversing course and declining by 6.3% in just four months to 8.4% in August. This recovery is unquestionably a positive development and speaks to the temporary nature of many of the job losses. This optimism is tempered, however, by the fact that an unemployment rate of 8.4%, while less the GFC peak of 10%, is still above the cycle peaks of every other recession since 1983.

In other words, it's great that the labor market is no longer headed toward depression era levels (April's jump to 15% fed concerns of reaching 20% depression era levels by May), nor as high as the GFC peak in early 2009 (10%), but it's still on par with any other recession peak. While the labor market should continue to recover at a faster than normal pace, the low hanging fruit has been picked already in the first 6% decline (or 10.6m payrolls added), but it needs to be considered relative to the 22.2m payroll decline in March and April. Businesses that face more significant return to work challenges will remain impaired (and not hiring) until the virus is under control.

While there was a surge in cases over the summer, the risk of a true "second wave" of cases as fall weather pushes people into more transmissible indoor activities, runs the risk of disrupting the economic recovery, either by causing policymakers to delay or reverse re-opening steps or, just as economically damaging, consumers responding to this risk by retrenching on their own. Conversely, the rise in cases could spur better adoption of the simple, low cost mitigation steps of wearing masks when appropriate and social distancing. For example, the July "second peak" spurred national retail chains to adopt mask wearing policies, helping to set a standard across the country. While such steps are inconvenient, they are much more preferable (and less economically damaging) than the lockdowns that were needed to bring early outbreaks under control.

A final source of uncertainty heading into Q4 is the presidential election. Political headlines garner more market attention than is justifiable. However, one area of growing uncertainty can be seen in the financial markets: post-election volatility. Both S&P futures (and the related VIX index) and foreign exchange markets have seen traders take on positions that price a jump in volatility after the election. Part of the reason for this is that traders were caught off guard four years ago by the election outcome, and this time around may be over prepared. But the other possibility being considered is an "undecided" election. Since the electoral college decides the election via state by state results, there are in theory 50 opportunities to have a close state vote (though in reality 10 or so swing states) hold the overall election in the balance due to a close electoral college count. While this seems like more 2020 paranoia, such an outcome occurred as recently as the 2000 election, when the result of the Florida ballot count was needed to determine the electoral college victor. A 500 vote margin determined the outcome, but that came after recounts and a legal challenge up to the US Supreme court, ultimately concluding on 12/12 that a recount of 70,000 rejected votes would not be made. Taking a similar situation and placing it into today's more heated political environment could certainly spur a bout of volatility until the official result is known. But even in such an event, an outcome would still be reached and the markets would return to focusing on the fundamentals of the economy and profits of businesses, the primary long term drivers of financial market performance.

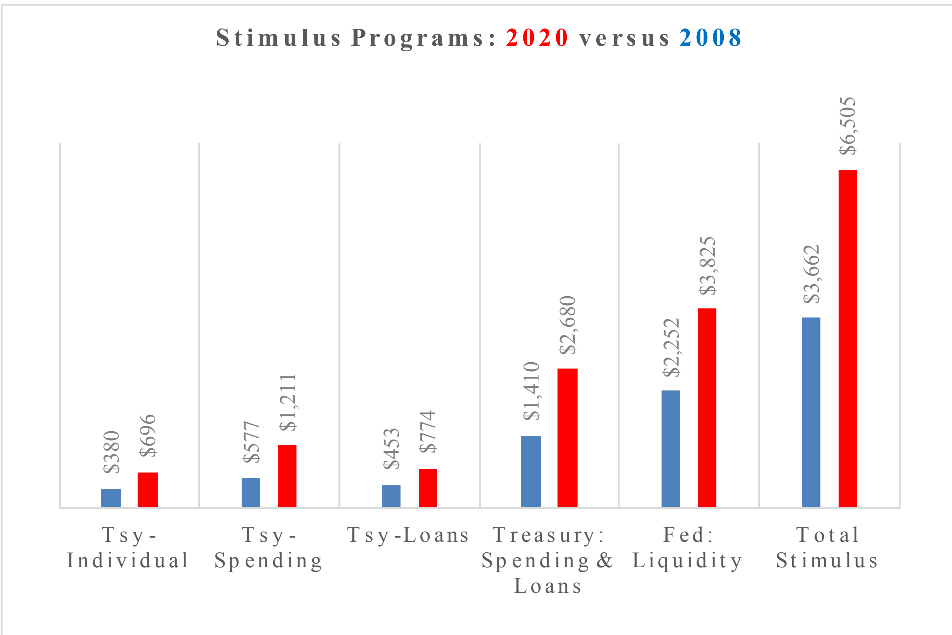
Tying the Covid-19 virus to the election, with multiple studies under way, vaccine results are slated to be reported over the course of Q4. This has long been the timeline, as dictated by the accelerated development, 3 phase testing, and FDA approval process. Developments on this front, as well as improved Covid-19 treatments, have helped to support the market rally. Consequently, the fixed election schedule coincides with the medically driven vaccine schedule, and creates an added level of uncertainty as progress results may or may not come around the date of the election.

This period is unprecedented both in history and in the markets. Volatility was historically high because uncertainty was historically high. The subsequent recovery in both the economy and the markets has also been historically fast, based on the economic disruption being short. The risk is the recovery narrative gets disrupted in Q4 and undermines the market's optimism. Thus it is still the case that the *2020 Vision is Blurry*.

2020 Investment Theme #2: The Fed and the Treasury Take Aim with the Stimulus Policy Bazooka

While stabilization of economic data has certainly been a positive driver for the markets in 2020, the biggest impact thus far has been the fiscal and monetary policy response. Unfortunately, there was no added ammo for the policy bazooka in Q3.

As noted on 3/31/20: *The Federal Reserve (through monetary policy) and the US government (through fiscal policy) are responding to the incredibly fast economic slowdown by running the 2008-2009 playbook at a breakneck pace. The magnitude of the programs is shown below relative to similar programs in 2008/2009 (a more in depth breakdown is in section 2.1d). Such broad based programs are what policy makers refer to as "the bazooka", due to their size relative to typical policy interventions.*



The most important of these programs were the ones targeting market liquidity, and thus the ability for the financial markets to continue functioning despite the stress from the growing pandemic.

First, the Fed rapidly reinstated an array of money market liquidity programs, originally introduced in 2008, to support the functions of the commercial paper market, a key source of short term funding for day to day business operations. It then quickly followed up by announcing two new programs, the PMCCF and SMCCF (the Primary and Secondary Market Corporate Credit Facilities) enabling the Fed to intervene directly with corporate bond and/or bond ETF purchases, as well as to buy bonds directly from issuers. On top of that, the Fed has committed to support small and mid-sized businesses through the Main Street Lending Facility, though program specifics are yet to be announced. These are reflected above as Fed: Liquidity.

Second, the US government passed a total of $2.2 trillion in spending, headlined by the Coronavirus Aid, Relief, and Economic Security Act (CARES), an array of programs from the US Treasury, ranging from $1200 payments to individuals ($300 billion) to $350 billion in Small Business loans to prevent workers form being fired, the Payment Protection Program (PPP).

As the chart shows, each of these programs is larger than its GFC precedent. And more importantly, they were deployed quickly, as noted on 3/31/20: *whether you use the July or October start date, it took 4-6 months to deploy all the tools the Fed and Treasury needed to stabilize the economy in 2008. In 2020, the Fed's liquidity programs were all announced from 3/17 to 3/23, and the $2 trillion CARES Act was passed on 3/30. While there will inevitably be adjustments, adaptations, and program growing pains in 2020 (just as in 2008/2009), in this instance the response is taking 4-6 WEEKS instead of 4-6 months.*

During Q2 these programs were deployed and in Q3 they continued to function, but no additional resources were added. On the monetary front, the Fed shifted its framework (addressed in the next section). Beyond that, the Fed has stood pat on policy moves, such as negative interest rates or yield curve control, two added programs that some had hoped for. The Fed has stated its already announced actions have done their job to support the financial markets, and what is needed now is fiscal action (not to mention progress in treating Covid-19).

Despite Fed exhortations and financial market expectations, there still has not been a "CARES 2" Act. The first CARES Act had two shortcomings. First, most of the programs (added unemployment benefits, the PPP hiring extension, airline benefits) were set to run through the end of August or September. With Covid-19 still disrupting large segments of the economy, these programs need some extended resources, even if not in the amount of the original CARES Act. Second, the CARES Act did not offer extensive support to state and local governments, as its priority was economy-wide support. However, states and local municipalities have borne the brunt of Covid-19, with lost revenues from sources like sales and meal taxes, paired with higher expenses for first responders, reopening schools, and other critical services that still are needed, but come with extra costs. As businesses and individuals had less resources, they were prioritized in the first CARES Act. Municipal governments have carried on, but now face budget crises that will both result in firing workers and reducing services.

For much of Q3, the House had a $3.4 trillion bill passed and on the table. The counter proposal from the Republican side was never fully crystallized, as the Senate suggested stripped down $500 billion to $1 trillion concepts, while the White House seemed to endorse an amount closer to $1.5 trillion. And, based on some of the key features, $1.5 to $2 trillion seemed to be the market's expectation, and that supported the stock market rally through Q3. But the end of Q3 has come and gone without a deal, and with just a month to the election, a compromise is unlikely. The hope for the market now has shifted to a post-election deal, though with programs now lapsing, there will be at least some drag on the economy.

So far in 2020, the major response to Covid-19 has been *The Fed and the Treasury Take Aim with the Policy Bazooka.* They seem to have hit the target and supported the economy and markets through Q3, but there was no additional ammo. The Fed did not add a more aggressive program such as yield curve control. Even though fiscal policy was supporting economic activity in Q3, many programs came to a close as Q3 was ending. Thus the impact on the economic data will start to be felt in Q4 even as the market has held up on the hope for eventual fiscal support.

Also of concern is the fiscal "ammo" will eventually be limited by rising budget deficits (the US deficit has risen from $1 trillion to $3 trillion this year), while the monetary "ammo" would require new policies, like yield curve control or negative rates, to give yet another jolt, even though these moves would have diminishing benefits. If either (or both) go too far, then there is the risk of policy side effects.

2020 Investment Theme #3: Will Helicopter Money Rescue the Economy, or Cause Inflation to Take Off?

The primary policy side effect would be inflation. As noted on 3/31/20: *While short term support for the economy and developments on the healthcare policy front are the main focus right now, the longer term question is whether the $6.7 trillion stimulus will be inflationary and what the long term impact on the Federal debt will be. In 2008, the concept of the Federal Reserve buying bonds to keep long term rates down, known as QE, was a largely untested theory put into practice to support the economy. The next step out the theoretical ladder is known as "Helicopter Money", referring to the Fed printing money and figuratively dropping it from helicopters on the economy to spur economic activity and/or inflation should simple QE not work. From a practical standpoint, a rapid ramp in fiscal stimulus including direct payments to individuals paired with the Fed leveraging itself up to buy bonds directly from businesses looks a lot like helicopter money. How it will ultimately end up depends on the nature of the programs: how large they are versus the economic shortfall and whether the programs are permanent or temporary.*

On the fiscal front, Treasury spending is now up to nearly $2 trillion (from $1.6 trillion), while loans are around $774 billion. Assuming the economic disruption is relatively temporary, and thus the surge in fiscal stimulus does not prove to be recurring, this spending serves to offset the lost economic activity. By filling in this lost demand, it prevents DEFLATIONARY forces from taking hold.

For monetary policy, much of the Fed's $3.8 trillion is also not permanent, and thus has far less inflation impact than the very large headline amount suggests. In fact, the SMCFF/PMCFF's mere existence supported the credit markets, even before they were deployed. So not only can Fed programs be pulled back, but they may not even reach close to their stated maximum capacity. This is good as it delivers a benefit with even less long term distortion.

For now, the conclusion remains: *Overall, yes, adding $6.7 trillion stimulus (about 30% of $20 trillion GDP) would be inflationary if the economy was at or near capacity. But if a large portion of that stimulus is temporary and so goes away when no longer needed, and the remaining portion offsets deflationary lost spending, then the inflation impact is less than it might appear.*

There is, however, an inflation consideration beyond the crisis response. During Q3, the Fed made a notable shift to its "policy framework", meaning the how data is considered when setting interest rates. Traditionally, the Federal Reserve has balanced readings on inflation and unemployment, based on the idea that low unemployment will eventually spur inflation, and so when unemployment would get low, the Fed would start to raise rates (or otherwise tighten policy, such as slowing QE). Over the past 10 years, however, inflation has remained at or below the Fed's 2% target. This has raised the question as to whether the Fed has been too quick to raise rates and has prevented unemployment from truly getting low enough.

Consequently, it has changed its framework from anticipating that unemployment is getting too low, to one of "don't fire until you see the whites of their eyes," meaning they will wait until inflation really is lifting off before raising rates. Also, the Fed emphasized it wants inflation to average 2%, not have a 2% ceiling, so inflation of 2.5% is tolerable. With unemployment at 8.4%, the Fed is a good distance away from the 3.5 - 4% range when this policy would actually have an impact on its actions. It might mean, for example, the Fed would think about raising rates in late 2023 instead of late 2022. This will be relevant when that time (and sub 4% unemployment) comes, but for policy actions right now, the impact is minimal.

The Fed has clearly shifted its focus to supporting the economy until the point that inflation is generated. The hope is that this results in unemployment being pushed down to a new, lower, level than was previously thought. The issue is, whether its good inflation or not, that bond yields have reached historic lows thanks to the 20 year drop in inflation. Any form of higher inflation, therefore, could cause this interest rate backdrop to shift. With the 10yr Treasury at just 0.68%, the Fed committing to getting inflation over 2% should raise some concern. Thus it is important to wonder *Will Helicopter Money Rescue the Economy or Cause Inflation to Take Off?*

Conclusion

After the Q1 decline and the Q2 recovery, Q3 was a quarter of inertia: the momentum from Q2 carried into Q3, even though the policy impulse was fading. The good news is that a large amount of economic activity has returned. The challenge is that there is still a lot of ground to make up.

Virus progress and a recovering economy have helped bring expectations into focus, spurring a record market rally that followed the record market decline. Despite this, *The 2020 Vision is Blurry*, with a presidential election, vaccine progress, and questions on fiscal policy remaining. Countries and states have been able to reopen, but these moves have frequently come with a loss of adherence to the very simple mitigation tools, which have in turn spurred Covid-19 cases to rise again. In the US, a second peak in July spurred better adherence and led case growth to subsequently slow. But the concern entering Q4 is that the fall could bring a true second wave, driven by societal factors of cold weather making indoor activity more likely and the viral environment more transmissive.

Countering these risks, *The Fed and Treasury Take Aim with the Policy Bazooka* and certainly hit the target. But they have yet to reload, so the question is: did the first shots do enough? Until the virus is fully under control, there will be a portion of the economy that will not be able to approach normal levels of output. Should the support from policy fall to the wayside, there is a risk of a second wave of unemployment and other key economic metrics deteriorating.

Finally, while the Fed did not enact new tools or add to its QE program, it did adjust its long term framework. That could ultimately answer the question, *Will Helicopter Money Rescue the Economy or Cause Inflation to Take Off?* as the basic policy toward inflation is now "don't fire until you see the whites of their eyes." The Fed plans to keep rates low until sit sees inflation rising, as opposed to moving early in anticipation. When a near record low 0.68% 10yr Treasury yield is underpinning above average valuations for most asset classes, a Fed committed to 2% inflation bears watching.

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-The Standard & Poor's 500 is a market capitalization weighted index of 500 widely held domestic stocks often used as a proxy for the U.S. stock market. The Standard & Poor's 400 is a market capitalization weighted index of 400 mid cap domestic stocks. The Standard & Poor's 600 is a market capitalization weighted index of 600 small cap domestic stocks.

-The NASDAQ Composite Index measures the performance of all issues listed in the NASDAQ stock market, except for rights, warrants, units, and convertible debentures.

-The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.