# FINANCIAL MARKETS COMMENTARY

## 3RD QUARTER, 2020

TELEMUS®

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# THIRD QUARTER HIGHLIGHTS

- We are starting to see a slowing in the rate of advancement of economic conditions as the impact from both stimulus measures and reopening efforts are beginning to stall out. The economy will eventually need to shed its reliance on stimulus and stand on its own two feet. Over the near-term, the path of the economy will be highly dependent on the course of the coronavirus.
- The unprecedented amount of stimulus have been key to helping to weather the COVID-19 pandemic. The size of U.S. government debt is on pace to hit 100% of GDP in 2021. Concerns around this debt burden could eventually impact interest rates or the value of the Dollar. The U.S. has experienced this level of government indebtedness before, but it is an effect of pandemic economics that bears monitoring over time.
- Stocks continued to rally with results being more narrowly focused on larger and growth-oriented companies. Year-to-date only 36% of stocks have performed better than S&P 500 in aggregate.
- Returns to fixed income were modest as interest rates continue to trade in a tight range. Compressing yields on corporate bonds helped to propel high yield bond returns this quarter.
- Commodities generally performed well, although asset prices remain volatile. Gold hit an all time high, while agricultural commodities benefited from Chinese demand. The dollar faced pressure, depreciating in the quarter.
- We see the bulk of the economic rebound priced into stocks. Going forward we would expect security selection to play a greater role in driving portfolio returns.

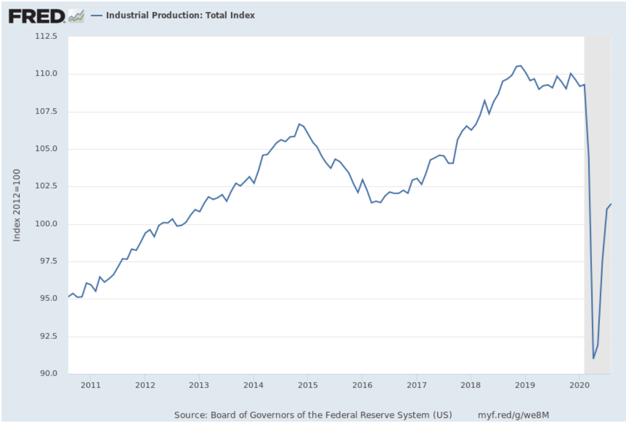
# ECONOMY

## ECONOMIC CONDITIONS

The U.S. economy continued its positive trajectory in rebounding from the COVID-19 pandemic. Consumer spending, which makes up nearly 70% of the U.S. economy, was particularly strong as excess unemployment benefits and stimulus checks flowed through the economy. Reduced restrictions around social distancing and the ability to consume more goods and services in outdoor settings further supported the economy enabling it to recover faster than expected. What was particularly impressive was the positive trajectory of the recovery despite a mid-summer surge of coronavirus cases in the sunbelt region.

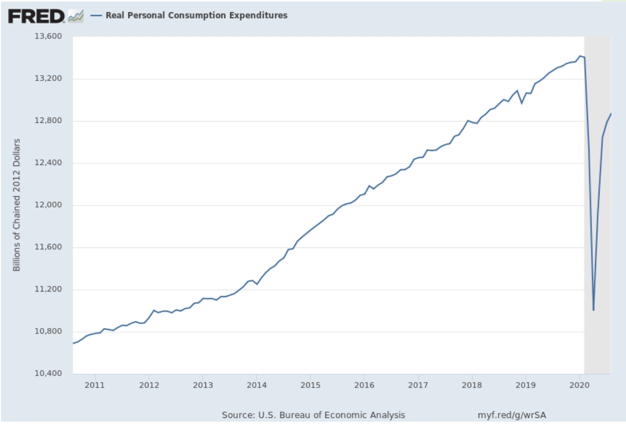
The charts below show U.S. industrial production and real (inflation adjusted) consumer spending. They provide a good visual depiction of what we see occurring with the economy. There was an unprecedented and sharp decline in March and April, and since then a significant rebound. Both measures also convey that while the economy continues to show improvement, we are seeing a slowing pace of advancement as the impact from both stimulus measures and reopening efforts are beginning to stall out. A key positive for the economy at this stage is high consumer savings rates, which could offer momentum to consumption going forward.

### U.S. INDUSTRIAL PRODUCTION




Source: Federal Reserve Bank of St. Louis. FRED Database

### REAL PERSONAL CONSUMPTION

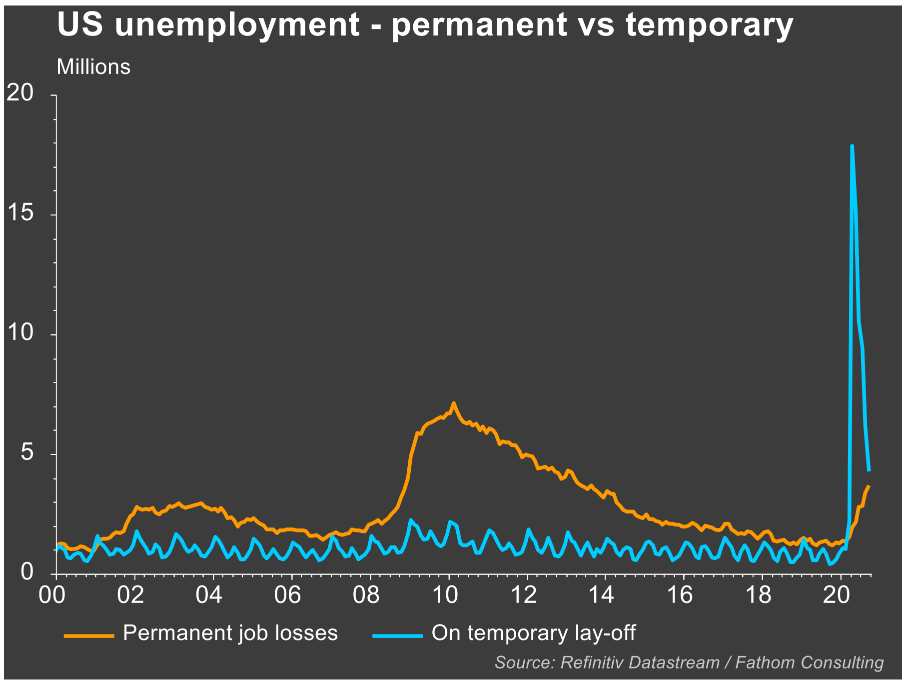



Source: Federal Reserve Bank of St. Louis. FRED Database

The challenges from the coronavirus led to U.S. GDP declining at a seasonally adjusted annualize pace of -31.4% in the second quarter. Third quarter GDP will not be reported until late October but is forecast to rebound at roughly a +25% annualized pace. Current economic consensus expectations call for the U.S. economy to contract by -4.5% this year. This compares to the International Monetary Fund's forecast of a -4.9% contraction for the global economy. The IMF's forecast was revised down this past quarter from its April projection of -3.0%.

# ECONOMY

U.S. unemployment rates have declined from 14.7% in April to 7.9% in September, however, the pace of improvement slowed later in the quarter. As the chart below highlights, while we have retraced half of the roughly 20 million jobs that were lost in March and April, they have largely come from individuals that were temporarily laid off returning to work. The level of permanent layoffs remains elevated and continues to grind higher.



# ECONOMY

## FISCAL POLICY

The effect of the $2.2 Trillion CARES Act was much more significant than most had anticipated. Its shear size equated to 10% of annual GDP and many of its benefits (payroll protection program, stimulus checks and excess unemployment benefits) all hit the economy in a fairly short period of time. It was effective medicine for the economy. In fact a working paper by the National Bureau of Economic Research suggests that the Payroll Protection Program helped anywhere from 14%-30% of small businesses to survive through the pandemic.

As we write this commentary, Washington D.C. is seeking to find a solution on another round of stimulus. The fact that both parties agree further stimulus is needed, with the size and scope being open for debate, is a strong indication there will be another round of fiscal stimulus. It's focus and impact, however, will likely have some differences versus the initial CARES Act.

Eventually the U.S. economy will need to wane itself off stimulus and be able to stand on its own two feet. We see the current economy as being artificially propped up by stimulus, which was the government's aim and has been effective to date. At some point segments facing challenges such as select municipalities, retail strip malls or hotel operators, will ultimately have to face the reality of the deteriorating fundamental conditions that were brought on by the coronavirus pandemic.

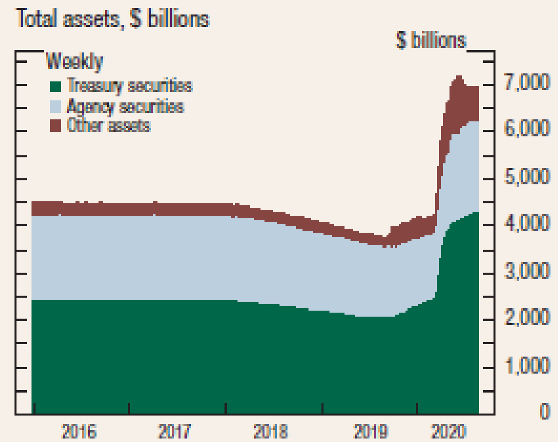
# ECONOMY

### MONETARY POLICY

The Federal Reserve continues to maintain a highly accommodative posture, while also acknowledging there is little else they can do to accelerate the economy. Chairman Powell has explicitly called out the need for further fiscal stimulus to ease any looming pressures on the economy.

The notable shift in monetary policy this quarter was the Federal Reserve's official acknowledgment at their annual Jackson Hole conference that they will target an average inflation rate of 2%, preferring to let inflation run higher than 2% before taking action. The impact from this was further confirmation that the Federal Reserve will not raise short-term interest rates for some time, with Federal Open Market Committee (FOMC) participants projecting that the federal funds rate will remain at its effective lower bound of 0%-0.25% through 2023.

The Fed remains active with its Quantitative Easing (QE) program, targeting to purchase at least $120 billion worth of Treasury and mortgaged backed securities each month. The Fed has become a significant player in these markets, thus pushing investors into other sectors or asset classes in search for yield and return. In fact, per the August 12, 2020 Report on the Federal Reserve's Balance Sheet, the Fed disclosed it held 22% of all outstanding Treasury securities, up from 15% in March. The chart below highlights the swift increase and composition of assets on the Federal Reserve's balance sheet.



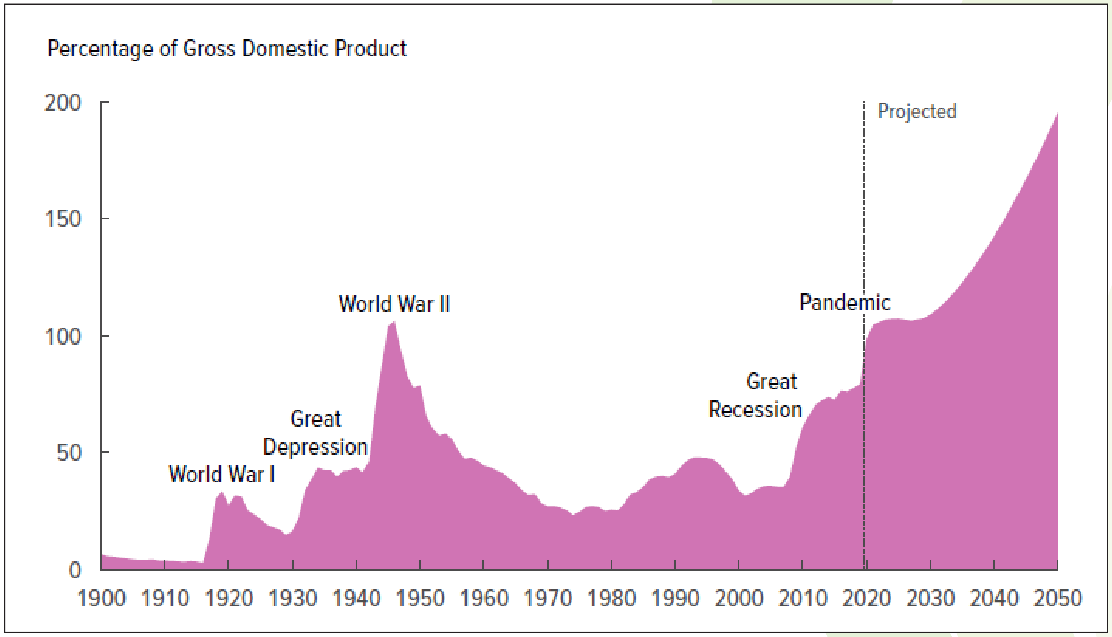
Note: Other assets includes swaps, repos, loans, and liquidity and credit facility LLCs.
Source: Federal Reserve Board.

# ECONOMY

## PERSPECTIVE

The size and speed of both fiscal and monetary stimulus has fueled a quicker and better than expected rebound in economic conditions than might have been expected given the severity of the COVID-19 pandemic. As the quarter progressed, we began to see signs that the rate of improvement in economic conditions was beginning to slow. Another looming round of fiscal stimulus is likely to help further the recovery in the short-term. However, at some point businesses, municipalities and consumers will need to a make a go of things on their own, as there will be a limit on the amount of fiscal policy that can be undertaken before the market grows concerned.

The U.S. is now forecast to have a debt-to-GDP ratio in excess of 100% by 2021. This artificial line of demarcation has been crossed by the U.S. government before, coming out of World War II. Over the subsequent 30 years the U.S. was able to reduce its debt burden to approximately 25% of GDP. In the present case, lower for longer interest rates should help ease the debt service burden of the additional debt. Moreover, if the Fed is able to foster higher inflation, this could serve as an added measure to increase nominal GDP . The notion of more highly leveraged government is a long-term challenge we are actively watching and considering.




Source: Congressional Budget Office. The 2020 Long-Term Budget Outlook.

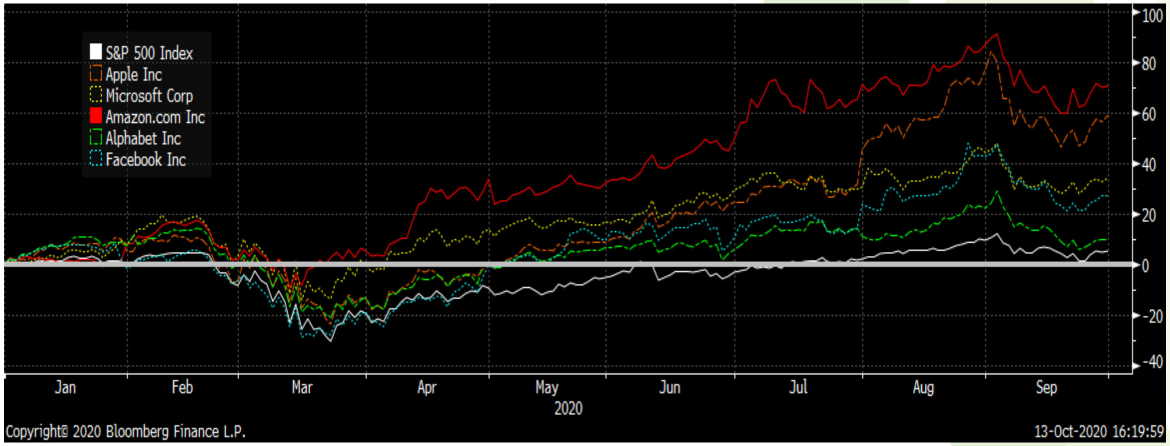
# EQUITIES

Despite a moderate pullback in September, stocks rebounded in the third quarter in reaction to a quicker and better than expected rebound in the economy. Large cap stocks now show positive results for the year, as market records set intra-quarter exceeded the levels set prior to the pandemic.

| | Q3 2020 | Year-to-Date |
|---|---|---|
| S&P 500 | 8.9% | 5.6% |
| NASDAQ | 11.2% | 25.3% |
| Dow Jones Industrial Average | 8.2% | -0.9% |
| Russell 2000 | 4.9% | -8.6% |
| MSCI EAFE | 4.8% | -7.1% |
| MSCI Emerging Markets | 9.6% | -1.2% |

Returns for the quarter were driven by large cap growth stocks whose performance stood out as particularly strong relative to the rest of the broad market. Large cap growth, as measured by the Russell 1000 Growth index, gained +13.2% on the quarter. This compares to a more modest +5.6% for the Russell 1000 Value index. Over the past year, the difference in return between growth and value stocks is over 40 percentage points, a record spread. Lower interest rates has made longer duration assets, such as companies with higher long-term earnings expectations, more attractive. In addition, many of the companies that have experienced outsized performance both in the quarter and on the year, are those whose businesses models have become more advantaged as a result of the pandemic.

The preference for growth is understandable, however, the narrowness in the market's focus has been unusual. Through September, only 36% of companies in the S&P 500 have outpaced the broader index. This limited number of outperformers was last seen during the technology bubble. What has compounded the 'have' and 'have not' nature of the S&P 500 is the unusual top heaviness of the S&P 500. Currently the top 5 stocks compose 22% of the S&P, with the top 10 accounting for 29%. In an environment where the top 5 stocks (Apple, Microsoft, Amazon, Alphabet, Facebook) are coupled to similar themes, it has only helped to fuel the narrow distortion to the market today.




Source: Bloomberg

# EQUITIES

During the quarter, there was some migration back into more cyclical companies such as materials and industrials. Energy stocks fell as investors have become more concerned by the fact that demand remains well below pre-COVID levels and visibility remains uncertain. Returns for the sectors within the S&P 500 are depicted below.

### S&P 500 3RD QUARTER SECTOR RETURNS

A lack of growth companies outside of the U.S. led to less robust returns from developed market international equities, which gained +4.8%. Emerging market stocks did well in July as the dollar began to weaken and ended up outpacing U.S. stocks by gaining +9.6%. Inside of emerging market equities, Asian equities outperformed Latin America given the improving recovery from the virus in Asia.


Source: Bloomberg

Having fully recovered from the COVID pandemic, the U.S. market is now trading at a P/E ratio of 21.5x forecasted earnings. This compares to the 25-year average P/E ratio of 16.5x, or a 30% premium to the long-term average. In our view, the impact of lower interest rates has resulted in market participants willingness to pay higher multiples and effectively pull forward future returns into 2020.

What we have seen occur in equity markets this year in a general market (beta) rally that has been concentrated in specific styles (growth and larger capitalization) and sectors (technology, consumer discretionary). Given the potential for post-election positioning and a reaction to any additional fiscal stimulus measures, we believe the broad-based rebound is likely to moderate. Going forward, security selection is likely to be of greater importance. This environment is likely to be beneficial for active strategies that seek to add value from stock picking.

# FIXED INCOME

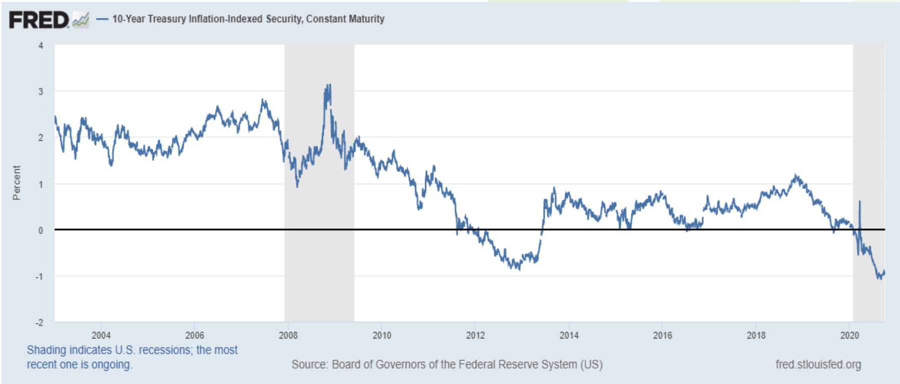
After a notable decline in interest rates fueled returns in the first quarter, and tighter corporate bond spreads helped returns in the second, gains in the third quarter were fairly subdued. Capital continued to flow into the bond market offering demand for what is setting up to be near record levels of corporate, mortgage backed and Treasury bond issuance.

Since falling in February and March, interest rates have remained in a tight trading range. The Federal Reserve's 'dot plot' forecast for interest rates indicates they may remain near zero through 2023. This expectation has anchored rates at the short end of the yield curve. Long-term rates remain tame as well, with the MOVE Index, which measures the implied volatility of Treasury bonds, hitting a record low level in September.

Investors have begun to place greater focus on the sizable uptick in money supply, and its ramifications for inflation as a result of recent fiscal and monetary stimulus. The second quarter consumer price index only fostered the notion of higher inflation in the future after it showed a near-term uptick in prices. The market's higher expectations for inflation, taken in context of what has been fairly flat nominal interest rates, lead to the real (inflation adjusted) yield on Treasury bonds falling just below -1% by quarter's end. Prices of Treasury Inflation Protected Securities (TIPS), which are priced off real yields, benefited from the decline.

Yields on agency mortgage backed securities (MBS) finished the quarter slightly lower. The Fed remains active in purchasing these securities, having increased their holdings of MBS nearly 30% on a year-over-year basis. A strong housing market and record low interest rates have fueled a significant uptick in mortgage activity, leading to a sizable increase in new issuance of MBS.

**REAL YIELDS ON 10-YEAR TREASURY INFLATION PROTECTED SECURITIES (TIPS)**




Source: Federal Reserve Bank of St. Louis (FRED)

# FIXED INCOME

As investors stretched for income, greater demand for corporate bonds pushed the spread, or the difference in yield between corporate bonds and Treasuries, slightly tighter during the quarter. The modestly lower yields on corporate bonds led to positive returns for the sector. High yield bonds faired better than investment grade as spreads compressed by 109 basis points, resulting in a +4.6% return for high yield bonds.

In total, the Bloomberg Barclays U.S. Aggregate Index, the broad-based benchmark for the bond market, gained +0.6% in the quarter. The yield to maturity on the index ended just below 1.2%.

| Index | 3rd Quarter | Year-to-Date |
|---|---|---|
| Bloomberg Barclays U.S. Aggregate | +0.6% | +6.8% |
| Bloomberg Barclays Intermediate Corporate | +1.3% | +5.6% |
| Bloomberg Barclays High Yield | +4.6% | +0.6% |
| Bloomberg Barclays US Mortgage Backed Securities | +0.1% | +3.6% |
| FTSE World Government Bond | +2.9% | +7.1% |
| Bloomberg Barlcays Municpal Bond Index | +1.2% | +3.3% |

Municipal bond returns were more robust than taxable with the Bloomberg Barclays Municipal Bond Index gaining +1.2%. Flows into municipal bonds remain robust, with $20 billion of net flows year-to-date. Investors have been willing to take on greater risk within municipal bonds as state tax receipts have fallen a mere -2.5%, much lower than initially feared back in March. Returns to BBB rated municipal bonds were +3.1% in the quarter, while returns on higher rated AAA credits were +0.8%.

While we have seen an uptick in defaults within the bond market, they are more narrowly focused in segments of the economy hardest hit by the pandemic, such as energy or hospitality. The challenge for fixed income investors is that low levels of absolute yield provide little protection against any uptick in defaults. Moreover, the low level of yields are likely to result in a lower benefit to returns from falling rates, should concerns around the economy increase. While we continue to see opportunities for returns in fixed income, investors should expect a more muted return profile from the asset class going forward.

# REAL ASSETS

Real assets had mixed results on the quarter. Commodities stood out as having a particularly strong quarter, gaining +9.1%. However, the Bloomberg Commodity index remains down -12.1% on the year. Precious metals were a key contributor to the index's return, while a rebound in the prices of natural gas, wheat and soybeans also had a positive affect.

| | Q3 2020 | Year-to-Date |
|---|---|---|
| Bloomberg Commodity | 9.1% | -12.1% |
| ICE US Dollar Spot Index | -3.6% | -2.6% |
| Alerian MLP | -16.3% | -46.2% |
| Philadelphia Stock Exchange Gold/Silver | 10.8% | 33.8% |
| MSCI Wold Real Estate | 2.1% | -12.5% |

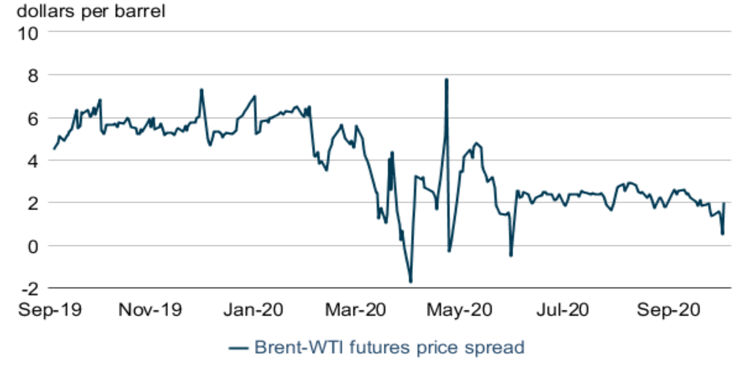
## OIL

Measuring from start to finish, oil appeared to have an uneventful quarter rising just +1.6%. However, the commodity continues to experience pockets of volatility, as evidenced from sixteen percentage point swing between late August and early September. This occurred after an export blockade in Libya was lifted, allowing the country's petroleum production to hit the market.

Oil inventories remain elevated and the combination of high unemployment and a number of Americans continuing to work from home has hindered demand.  In fact oil demand slowed in August and September from early summer levels, according to the Energy Information Administration.

Demand for crude oil has slowed globally. With a glut of supply, the difference in price between the U.S. priced West Texas Intermediate (WTI) crude and OPEC priced Brent was a mere $0.48 at quarter's end. This compares to roughly a $6 premium for Brent crude a year ago.

**Figure 2. Brent–WTI futures price spread**




Source: CME Group and Intercontinental Exchange, as compiled by Bloomberg L.P.
Note: WTI=West Texas Intermediate

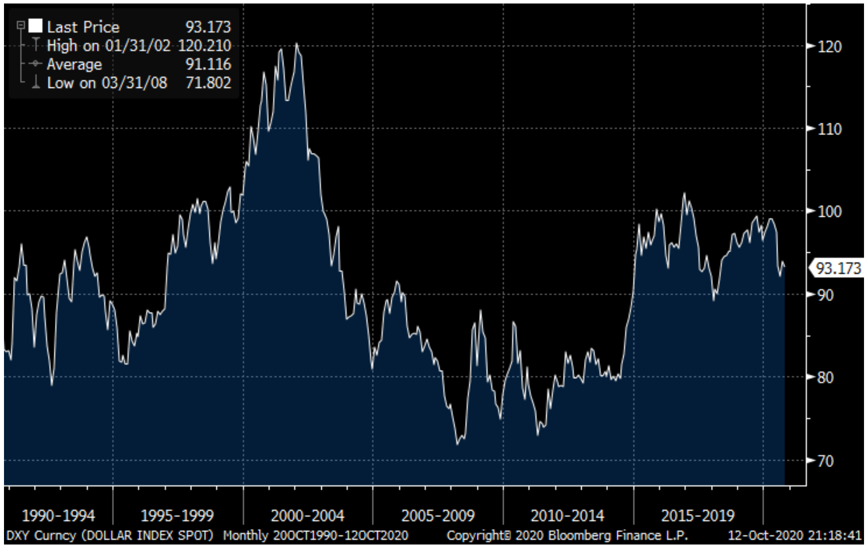
# REAL ASSETS

## CURRENCY

The dollar fell out of favor in the quarter as investors rotated toward other G4 currencies, notably the Euro and Japanese Yen. The dollar also weakened against the Chinese renminbi, which appreciated on better than expected economic data. A combination of factors including the prospect of another round of fiscal spending in the U.S., more attractive relative valuations outside of the U.S., and a lessening yield advantage of U.S. Treasuries over other government bonds drove this shift in positioning.

The dollar has tended to experience prolonged cycles where it has appreciated or depreciated. The dollar has been in a 9-year uptrend and the combination of the factors noted above could serve as a catalyst for a cycle of depreciation in the dollar. At this stage of the economic cycle, a lower value for the dollar could be advantageous in making U.S. goods and services more attractively priced overseas.

### THE U.S. DOLLAR INDEX (PAST 30 YEARS)




Source: Bloomberg

# REAL ASSETS

## GOLD

The price of gold continues its upward trend, appreciating +5.9% to finish the quarter priced just below $1,900/oz. As the dollar declined, gold benefited, hitting an all time (intra-day) high of $2,089 in early August. Gold is sometimes viewed as a hedge against a devaluing of the dollar. As concerns around depreciation in the dollar grew, the price of gold gained.

Gold plays an important role in portfolios today as it can serve as a hedge against higher inflation or a lower dollar. The primary drawback to owning gold as an investment is the lack of income coming from it. In an environment such as the third quarter, where real interest rates went negative, the opportunity cost of holding gold instead of a cash earning asset were negated. This has led to increased investor appetite for the precious metal, as evidenced by the nearly $50 billion of inflows into gold ETFs in 2020.

# LOOKING AHEAD

The economic recovery has been quicker and more robust than we and many had expected back in March. The direct and indirect impact of unprecedented fiscal and monetary stimulus has fostered this rebound. While there is likely to be some level of additional fiscal stimulus to come, eventually the government will have to scale back its impact and the economy will need to stand on its own two feet.  Stimulus measures have helped to lessen the impact across the economy and will likely lead to less severe economic strains, however, we expect the impact from COVID to have an elongated duration.

Returns across asset classes have rebounded sharply from their March lows. As we move beyond near-term uncertainties, such as the election and additional stimulus bills, we would expect less systematic returns to the market, and a greater influence from asset selection. Stock and bond picking will have a bigger outcome on future results than they have had over the past six months.

It seems as if the amount of news flow has only increased since the pandemic began. Markets have reacted to this information; however, a lot still needs to be sorted out. The economic challenges and secular trends that come out of the pandemic are likely to take years to work through, and as a result being conscious of long-term risk and reward potential of investments in our view is the most prudent way forward.

We recognize that during these periods of uncertainty it is only natural to have questions and concerns. Our quest at Telemus is to enrich the lives of our members, and this is of increased importance during times like the present. We aim to keep you informed with a variety of updated information available at **www.telemus.com.** In addition, feel free to reach out to your advisor at any time. For those of you who are not our clients, please feel free to contact us as well.

Telemus Investment Committee

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