Economic Overview

Steve Scranton, CFA, Chief Investment Officer and Economist

The 3rd quarter saw the process of an economic recovery begin. As it stands now, forecasts for 3rd quarter GDP are for a rebound of 25-35%. We will get the first estimate of 3rd quarter GDP on October 29th. Even with this rebound, GDP will be below the level that existed at the end of 2019. Although the recovery is in its early stages, the pattern emerging is that this is a tale of two recoveries. What type of job you have and where you live matters greatly.

Goods Producing Sector vs Service Sector

- Most goods producing industries did not suffer a full shutdown and were reopened fairly quickly. Even though many people were working from home, they still needed to buy goods. As a result, that side of the economy has rebounded faster.
- The service side of the economy suffered the biggest hit from the lockdowns. Leisure & Hospitality was the worst hit and has the most uncertain future as it continues to be in the most restrictive operating mode.

Remote Work vs Physical Work

- Within the service side of the economy, those industries that are more traditionally classified as "white collar" jobs were able to equip their employees with the hardware and software that allowed them to continuing operating by working from home. The traditional "blue collar" industries that require a physical presence to provide the service were unable to have employees work from home and thus were forced to furlough, layoff or terminate their employees.

Big Business vs Small Business

- Big businesses have been able to access the financial markets to either issue low cost corporate bonds or borrow directly from the Federal Reserve. This allowed them to continue operating by obtaining bridge financing.
- Small businesses do not have access to the financial markets. They borrow from their local financial institution. Unfortunately, data from the Federal Reserve shows that over 70% of financial institutions have tightened their lending standards. As a result, small businesses are the forgotten victim of this crisis. Individuals had their income replaced via the CARES Act and big businesses were able to borrow to stay afloat while small businesses received virtually no financial aid.

Open States vs Restricted States

- It mattered what state you lived or operated in as it relates to the 3rd quarter rebound. States that have lifted restrictions faster have seen jobs recovery and economic growth occur faster. States that are still in more restrictive modes of operation saw slower jobs recovery and economic growth. **NOTE:** this is not a comment on the medical risks of these decisions since this is an economic discussion.

The rebound in growth in the 3rd quarter can also be attributed to the vast financial aid that has been provided to the unemployed via Congressional action. Unfortunately, that aid began to decline at the end of July and will continue to decline until the aid runs out at the end of the year. Unless Congress passes new aid legislation or states reopen their economies more, we may find that the 3rd quarter was the peak period of the rebound.

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Alternative Strategies

Rick Cloutier, PhD, CFA, Chief Investment Strategist

During the quarter, equity markets continued to rise from their March lows as lockdown restrictions eased and the economy continued to recover. **The S&P 500 returned 8.9% for the quarter and, through the first nine months of 2020, is up 5.6%.**

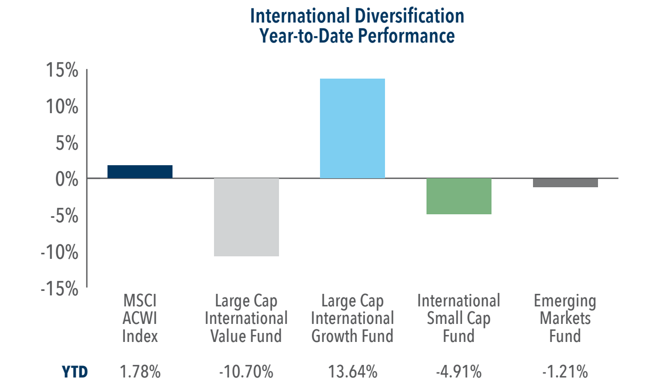
With so much uncertainty, the S&P's rise has surprised many. However, although the S&P 500 is reaching new highs, the breadth of the rally has been narrow, with about 90% of the stocks down for the year. Many industries like airlines, hotels, travel, and retailers are off, which seems reasonable given the negative effects the lockdown has caused for their businesses. But many technology stocks have done well as their businesses have been boosted by the lockdown. This schism is manifested in the huge discrepancy in returns, about 30 percentage points, between large cap growth stocks and large cap value stocks. Given the change in fortunes that the lockdown has created, this dichotomy seems to makes sense.

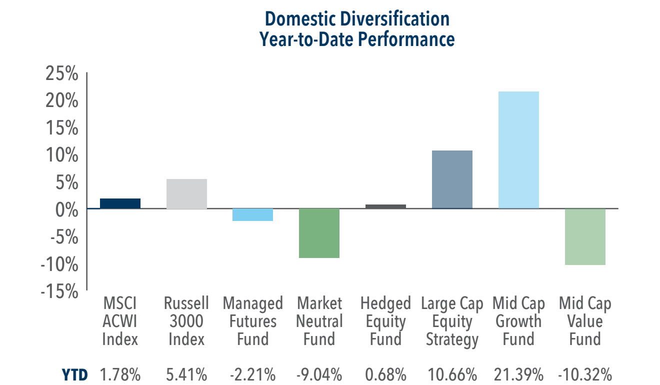
While the rise in other stock indices was similarly impressive for the quarter, many remain underwater year to date. **So far this year, the Russell Mid Cap Index is down 2.35%, the MSCI EAFE Index is off 8.92%, the EAFE Small Cap Index has lost 5.71%, and the MSCI Emerging Market Index has declined 1.16%.**

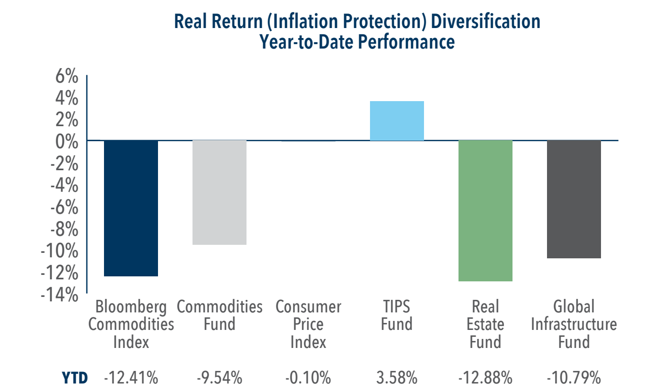
Yields remained low and returns on high quality bonds generally fell below 1%. **High Yield and emerging market bonds fared better, returning 4.9% and 2.3%, respectively. Despite the muted returns on government bonds, inflation protected bonds performed well, returning a little over 3% for the quarter.** Some of this outperformance can be attributed to investor fears of future inflation stemming from the outsized stimulus, but most can be ascribed to the Fed's mandate change. During the quarter the Fed moved from an inflation target of 2% to an inflation target averaging 2%. This change means that the Fed could let inflation run above 2% before reducing expansionary policies.

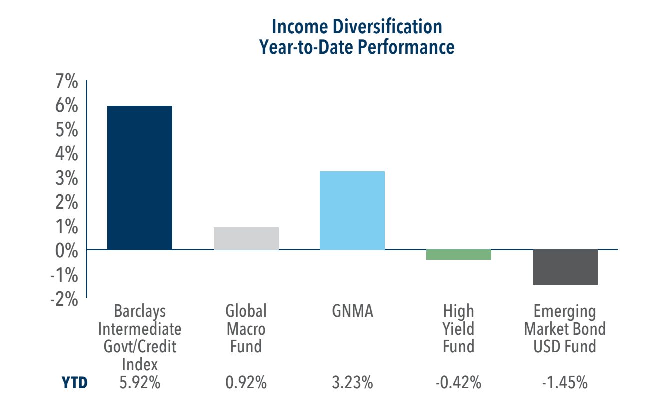
Returns for many alternatives fell between the returns of stocks and bonds; however, commodities had an outstanding quarter, gaining over 9%.

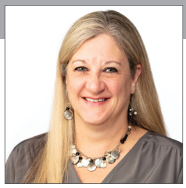
Given the number of uncertainties, we expect volatility to remain high as heightened market risk persists.











Domestic Equities

Gayle Sprute, Senior Portfolio Manager

After a precipitous 1st quarter drop and sharp 2nd quarter rebound, equities delivered a surprisingly strong 3rd quarter. **The consecutive 2nd and 3rd quarter rallies are the strongest since 2009. Stocks staged robust gains in the face of continued challenges as optimism and hopefulness remained elevated.** Although economic data improved from the lows in March and April, there is still much needed in the way of recovery and "repair" — from the perspectives of employment, business re-openings, resumption of "normal" consumer behaviors, COVID-19 vaccines/treatments, and improving manufacturing activity, among others. The continued prevalence of COVID-19 cases makes it difficult to see a linear path through this difficult pandemic.

Sentiment during the 3rd quarter was bolstered by fiscal and monetary support. The Federal Reserve (Fed) continually messaged that it remains committed to doing what it can, for as long as it takes, to support economic improvement. Congress initially came together to pass fiscal stimulus packages. However, the much desired "fifth" fiscal support bill struggled to progress during the quarter. Hope ebbed and flowed as Democrats and Republicans argued on the size and scope of the potential fiscal aid. The quarter closed with hope diminishing for a compromise before the November elections, even though the nation is still very much in need of additional fiscal stimulus.

As we enter the final three months of this unprecedented year, upcoming 3rd quarter earnings will bring a much needed update from corporate America. **After COVID-19-affected 2nd quarter earnings declined by 31.8% year/year for the S&P 500 companies, the current 3rd quarter expectation is for an earnings decline of 21.0%. This is better than the estimate of -25.3% at the beginning of the quarter and demonstrates progress from the 2nd quarter.** Nevertheless, this is still down significantly from the high-water mark in the 4th quarter of 2019. Investors will be listening to management outlooks for 2021, particularly relating to COVID-19 related impacts. In addition, uncertainty remains elevated regarding whether President Trump or former Vice President Biden will prevail in the November presidential election — and whether Republicans or Democrats will come away with the Senate majority.

Fixed Income

Brian Brill, CFA, Senior Portfolio Manager

At first glance, the 3rd quarter of 2020 was incredibly stable. Looking closer, however, you will find the foundation for major changes for possibly years to come.

Based on the MOVE index, a common measure of volatility in the US Treasury market, volatility has never been so low. From an outright yield change perspective, five year Treasury securities traded in just a 12 basis point range all quarter. Even tighter for the 2-year Treasury note with a 6 basis point range.

This tight lid on yields is all due to massive intervention by the Federal Reserve (Fed) and a great desire by investors to hold safe assets due to the consequences of the ongoing COVID-19 pandemic.

But the somnambulant Treasury market is masking an event that happened this quarter that could affect monetary policy for years to come. Fed officials formalized a change to their dual mandate of fostering economic conditions that achieve both stable prices and maximum sustainable employment. This dual mandate historically led them to tighten monetary policy by raising interest rates as the economy approached full employment as they believed full employment would lead to higher inflation. As a result they would begin to tighten conditions well before their 2% inflation target for fear that they would lose control if they did not act preemptively. **The Fed's new policy now seeks to achieve inflation that averages 2% over time and states that following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time.** As it pertains to employment, the Fed will now focus on "shortfalls" rather than "deviations" from maximum employment. This means that they will respond if employment is too low but ignore it when it's too high. The Fed no longer believes that a tight labor market is inflationary and is willing to let it run hot at least until inflation overshoots by too much.

Given this new policy and sanguine economic projections, the Fed projects to be on hold through 2023, but the changes made to the inflation mandate could lead to higher rates over the long term.

Third Quarter 2020 – Wealth Management Insights

International Review

Derrick Wilson, Portfolio Manager

Global equity markets rose over the course of the quarter, albeit with some bouts of volatility. Through the summer months, Europe and Asia seemed to make some progress concerning the virus and economic activity. Also in the mix were ongoing geopolitical tensions.

Throughout the quarter, the back-and-forth between the US and China continued. July saw the closing of consulates in each country. In August, the US imposed sanctions against specific Chinese and Hong Kong officials for their involvement in the new national security law over Hong Kong. China retaliated by imposing sanctions against certain US individuals. More recently was the battle over a forced sale of the US business unit of Chinese internet sensation TikTok imposed by President Trump.

China has seen improvement in economic measures as both manufacturing and non-manufacturing (services) industry activity have remained in expansionary territory. Adding to this, consumers appear to be coming back as the latest retail sales report shows a slight increase over the year prior. This improving data was reflected in the Chinese equity market as it returned a little over 13% during the quarter. Broader emerging markets were up over 8%.

European Union leaders spent most of the quarter in discussions to work out a financial rescue package for member countries. The key issues were the balance between loans and grants and how this would be distributed or shared among the members. Eventually, an agreement was reached.

On the virus front, Europe was on alert as virus cases began climbing again in recent months. France and Spain were the first to see increasingly rising cases. The UK, Italy, and, to a lesser extent, Germany all were experiencing a pickup in cases as well. Renewed and additional restrictions have been implemented by local governments to prevent further spread of COVID-19.

European equity markets continued to lag the global markets. Brexit still remained unresolved, which caused the UK to be the laggard within Europe. **European equities returned just over 3%, whereas equities in Britain finished slightly negative, down 0.50% during the 3rd quarter.**

As we head into the home stretch of what has certainly been a tumultuous year for the world, the search for an effective (and safe) vaccine continues. The US presidential election is a global focus. Market volatility remains elevated, and at this time we would anticipate that will persist.

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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