Global Economic and Market Commentary

Summary:

- The magnitude of the recovery has surprised to the upside, especially in the US. Business survey, consumption and housing data strengthened through September, despite an increase in COVID-19 cases.

- Congressional disagreement, the SCOTUS appointment and election campaigns have postponed approval of another round of fiscal stimulus until after the November elections. Growth will suffer in Q4 but rebound in Q1 and Q2 2021.

- If Biden wins the presidency and the Democrats win a majority in the Senate, there is likely to be multiple compression and greater volatility in the markets as a result of policy uncertainty, higher long term interest rates and the prospect of higher corporate and capital gains taxes.

- Equity valuations, especially in the US, are pricing in a V-shaped earnings recovery in 2021. We expect global equities to be supported by the lack of investment opportunities in a zero and negative interest rate environment. Further upside in equity markets will need progress towards a vaccine and/or further stimulus. Cyclical sectors will likely outperform in the next 12 months.

- The Fed’s “flexible average” inflation targeting (FAIT) strategy translates into keeping its policy rate at 0% through 2023-2025. This will avoid the upward pressure on interest rates which usually accompanies fiscal expansion. For this reason, the Fed’s policy enhances the effectiveness of fiscal policy at a low cost although it constrains monetary policy. Global central bank asset purchase programs created a backstop for credit markets and we foresee stability going forward.

- Uncertainty surrounding the US elections will be the key theme for markets in Q4. The next six months present upside and downside risks associated with renewed US-China tensions, a second wave of COVID-19 cases, Brexit negotiations and policy decisions.

Exhibit 1: Q3 2020 and YTD Asset Class Returns through September 30, 2020

Source: Bloomberg
- Global business surveys reflect optimism in the current recovery. New orders and exports are improving and we expect acceleration in global trade volumes.

- Further fiscal stimulus and successful progress toward a vaccine and effective therapeutics should boost business and consumer confidence, as well as spending which will benefit more cyclical parts of global economies.

- Developed economies and China are in better shape than non-China emerging markets which have suffered from less flexible monetary and fiscal policy and diminished external capital flows.

- The S&P 500 is near all time highs. The 12 month forward P/E ratio of 21.4x is at the highest level since the tech bubble. US Treasury yields are also expensive with yields near all time lows.

- Equities continue to be attractive relative to bonds. The forward equity risk premium (12 month forward S&P 500 earnings yield minus the 10 year US Treasury yield) is cheap relative to the 30 year average. See Exhibit 3.

- Mega cap technology stocks have skewed the valuation of the S&P 500 higher. The ERP of non-US equities and small cap US companies is materially higher than the S&P 500 but with increased risk. We expect certain non-FAAMG* stocks to outperform in the future. These stocks have equally compelling forecasted secular growth.

- The S&P 500 has become concentrated in the top five names which represent 23% of the index. In 2000, the prior valuation peak, the top 5 names were only 18% of the S&P 500.

- The Equal Weight S&P 500 Index has underperformed since 2016 as seen in Exhibit 4 and leadership has narrowed into the mega cap technology companies. Since 1990, the Equal Weight S&P 500 Index has outperformed the market cap weighted S&P 500 Index after a recession.

- Value outperformed growth in September, but the high weighting in technology in the growth index has driven performance during the "stay at home" phase. In the next 12 months, GDP growth acceleration and progress towards economic reopening should benefit large cap cycicals and smaller companies with lower valuations.

*FAAMG – Facebook, Apple, Amazon, Microsoft and Google
The recovery in the US will slow in the fourth quarter and reacceleration will depend upon additional government transfers and state economies reopening.

The Fed's commitment to asset purchase programs in the bond and funding markets has reduced volatility and led to record bond issuance.

A robust stimulus package is needed to deepen the recovery by lowering unemployment and boosting small businesses.

PM Suga replaced former PM Abe in September. He has pledged to keep many of Abe's policies in place.

The recovery in Japan has lagged the US and parts of Europe. Following a strong Q3 and Q4, growth is expected to slow to below 2.5%.

Governance continues to improve in Japan with more outside directors named to corporate boards in 2020. Despite disappointing economic growth prospects, Japanese equities may outperform.

We expect the ECB to announce clearer language regarding monetary policy, inflation targeting and commitment to asset purchase programs in coming meetings.

Growth in tourism sensitive southern European economies will lag northern countries until a vaccine becomes available.

Fiscal stimulus needs to transition from government transfers to true economic stimulus.

Global consumers shifting from services to goods boosted Chinese exports in Q3. China and Taiwan are some of the only countries with positive GDP growth in 2020.

EM ex-China and Taiwan GDP growth is forecasted to fall -5.4% in 2020. Latin America and India have struggled with containing the virus.

EM economies outside of China and Taiwan will need to increase growth in order to attract capital flows.
**Domestic Equities**

- Our outlook for domestic equities has improved and we favor US equities to non-US developed markets. Also, we continue to prefer equities to core fixed income.
- While valuation of the S&P 500 Index is high, non-mega cap technology stocks offer attractive relative returns.
- Value and small cap companies offer a significant valuation discount relative to growth companies, but we maintain an equal weight due to potential downside risks.

**International Equities**

- Non-US developed market equities are trading at a discount to US equities. Weaker growth outlooks and structural issues have kept us at an underweight.
- EM equities have outperformed non-US developed markets due to a large weight to Chinese equities and technology companies. EM growth companies have outperformed EM value companies by over 26%.
- While the EU has made progress toward a more coordinated fiscal policy, forceful and timely fiscal expansion is unlikely to occur.

**Fixed Income**

- Longer dated US Treasury yields have drifted higher in October, but real yields are still negative. See Exhibit 5. Central bank buying and demand for US dollar assets is unlikely to abate in the near future. A Democratic sweep could put upward pressure on yields later in the year and early 2021. We remain underweight duration relative to the Bloomberg Barclays US Aggregate Index.
- We favor investment grade credit to high yield credit in our allocation. High yield may experience spread widening with increased equity volatility and an increase in the default rate.
- We are maintaining our position as buyers of non-agency RMBS as liquidity returns to those markets. New issuance has continued and many bonds are offering yields in excess of 5%. A strong housing market has helped valuations.

**Alternatives/Real Assets**

- The Fed is not purchasing lower rated corporate bonds and parts of the securitized credit market. These securities are significantly mispriced and offer attractive total returns for investors with 3-4 year time horizons.
- We are evaluating distressed opportunities in leveraged loans, unsecured bonds and real estate for investment in 2021.
- We continue to believe private equity secondary positions will be available at significant discounts in the coming quarters.
All information contained herein is based on past performance and is not intended to be indicative of future results. The indices used are unmanaged and return figures reflect the reinvestment of dividends and earnings. There is no guarantee that historical risk and rate of return will persist in the future.

**Municipal Bonds:** Barclays Municipal Index is an unmanaged index that is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

**US Treasuries:** Barclays US Agg Total Treasury is a subset of the Barclays Aggregate US Bond Index and consists of most US Treasury bonds with a maturity of one year or more. It excludes TIPS and STRIPS.

**High Yield:** Barclays US Corporate High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included.

**Core Taxable Bonds:** Barclays US Aggregate Bond Index, which used to be called the "Lehman Aggregate Bond Index," is a broad base index, maintained by Barclays Capital, represents investment grade bonds being traded in United States.

**Commodities:** Bloomberg Commodity Index is made up for 22 exchange-traded futures on commodities that represent 20 commodities. These commodities are weighted to account for economic significance and market liquidity.

**Emerging Markets:** MSCI Emerging Markets Index is a stock market index that is designed to measure the equity market performance of emerging markets outside developed markets, markets such as Brazil, China, Russia, etc.

**International Equities:** MSCI ACWI ex US Index is a stock market index that is designed to measure the equity market performance of all equity markets excluding the US.

**Europe:** The Euro Stoxx Total Market Index covers 95% of the free-float market cap of the stocks in Europe.

**Japan:** The TOPIX Net Total Return Index includes the stocks traded on the Tokyo Stock Exchange. It has approximately 1700 companies.

**S&P 500 Index** includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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