Economic & Investment Perspectives

Figure 1: Returns – 9/30/2020 (Source: Bloomberg, Yahoo!)

Note: Conditional formatting within periods – Green (highest) to Red (Lowest). Returns for periods greater than one year are annualized.

Bonds	ETF	SEP	Q3	YTD	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low	% of loss recovered
US Aggregate Fixed Income	AGG	-0.1%	0.4%	6.7%	-11.5%	-1.4%	11.8%	91%
Non-US Fixed Income	BNDX	0.9%	1.0%	3.5%	-9.1%	-1.3%	8.0%	80%
High Yield	HYG	-0.9%	4.1%	-1.3%	-23.7%	-5.2%	24.3%	78%
Global Equity								
ACWI Global Equity	ACWI	-3.0%	8.4%	1.7%	-34.8%	-5.0%	49.9%	94%
United States	VTI	-3.5%	9.2%	5.5%	-36.5%	-6.3%	55.5%	96%
International Developed	EFA	-2.1%	4.5%	-7.1%	-35.1%	-9.7%	39.1%	72%
Emerging Markets	EEM	-1.1%	10.2%	-1.2%	-35.0%	-4.9%	46.4%	86%
Equity by Region								
United States	VTI	-3.5%	9.2%	5.5%	-36.5%	-6.3%	55.5%	96%
Europe	IEUR	-3.3%	4.6%	-9.1%	-38.5%	-11.1%	44.6%	71%
Asia ex-Japan	AAXJ	-0.8%	11.6%	5.4%	-30.7%	-2.8%	45.7%	103%
China	MCHI	-2.0%	13.3%	16.2%	-26.3%	-4.6%	48.3%	135%
Japan	EWJ	1.8%	7.5%	0.5%	-31.5%	-2.8%	41.9%	91%
Latin America	ILF	-4.6%	-2.4%	-37.3%	-56.0%	-39.5%	35.5%	28%
US Equity								
US S&P 500	IVV	-3.9%	8.9%	5.4%	-35.3%	-6.8%	52.4%	96%
NASDAQ 100 QQQ	QQQ	-5.8%	12.2%	31.2%	-30.5%	-8.5%	68.5%	156%
US Large Growth	IWF	-4.6%	13.2%	24.2%	-33.5%	-7.4%	69.1%	137%
US Large Value	IWD	-2.5%	5.5%	-11.6%	-39.4%	-14.9%	40.4%	62%
US Eqwt S&P 500	RSP	-3.0%	6.2%	-5.3%	-40.7%	-9.1%	53.2%	78%
US Mid Cap	IJH	-3.3%	4.7%	-8.7%	-44.1%	-12.1%	57.2%	73%
US Small Cap	VTWO	-3.3%	5.1%	-8.5%	-43.8%	-11.6%	57.2%	74%

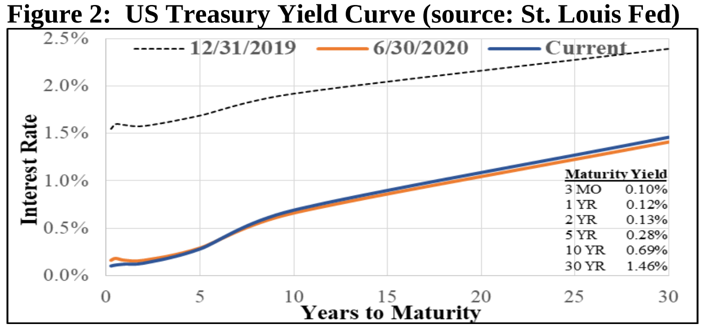
Despite a weak September, global equities logged a strong third quarter and continued to recover from the pandemic-related market meltdown earlier in the year. Even as the virus spread and infection rate remained elevated in the US and abroad, markets rallied on the back of trillions of dollars injected into the economy and markets by the Federal Reserve (Fed), Congress, global governments and central banks. Markets faltered for most of September, with the S&P 500 briefly falling into correction (-10% from previous high) before recovering to end the month down 3.9%. Figure 1 (above) lists returns for various markets. Performance notes for the quarter include the following highlights:

- Global stocks (ACWI): -3.0% in September; +8.4% in Q3.
- US Equity: The broad market (VTI) fell 3.5% for the month but rose 9.2% in Q3. Despite falling 3.9% in September the S&P 500 (IVV) rose 8.9% in Q3. Small stocks (VTWO) and mid-cap stocks (IJH) fared better last month but lagged in Q3, returning +5.1% and +4.7%, respectively. Within the US, large growth stocks (IWF) logged rare under-performance in September but continued to beat value stocks (IWD) by a wide margin in Q3 (+13.2% vs. +5.5%, respectively), widening the growth/value disparity year-to-date (YTD +24.2% vs. -11.6%).
- Non-US Equity: International developed markets (EFA) fell 2.1% in September (+4.5% in Q3), and Emerging Markets (EEM) lost 1.1% for the month (+10.2% in Q3).
- Bonds: The Barclays US Aggregate index (AGG) fell slightly in September but was +0.4% for the quarter. High Yield bonds (HYG) were down 0.9% last month but gained 4.1% in Q3. Non-US bonds (BNDX) rose 0.9% last month and 1.0% in Q3.

Interest Rates and the Economy

US interest rates remain near historic lows amid continued health and economic uncertainty. The Fed cut interest rates to near zero in March, and bond yields sank as investors retreated to the safety of US Treasuries, driving prices up and yields down. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Rates are well below 2019 levels but have remained steady since June 30. The Fed's stated intention to keep interest rates low even if inflation rises above their target of 2% continues to support rising stock prices.

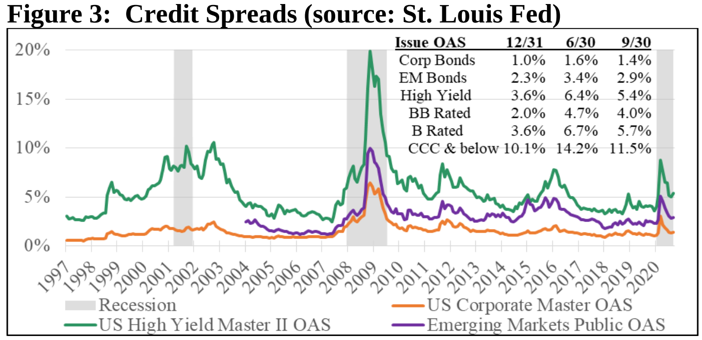
Figure 2: US Treasury Yield Curve (source: St. Louis Fed)



For bonds other than US Treasuries, we focus on the option-adjusted spread (OAS) between various bond yields and comparable US Treasuries rather than the absolute yields. High spreads signal fear or risk aversion, as investors demand higher yields on riskier assets. Credit spreads (Figure 3) spiked to panic levels in March but moderated after the Fed injected trillions of dollars, buying individual bonds and credit ETFs. Spreads remain higher than year-end levels but declined during the third quarter (despite a modest uptick this month as equity markets sold off).

- Investment-grade US corporate bonds currently carry a 1.4% yield premium over Treasuries, down from 1.6% on 6/30.
- High yield bond (non-investment-grade) spreads are now 5.4%, down from 6.4% three months ago; the riskiest bonds (rated CCC & below) still carry an 11.5% yield premium.
- Emerging market credit spreads declined from 3.4% to 2.9%.

Figure 3: Credit Spreads (source: St. Louis Fed)



The Economy vs. The Stock Market

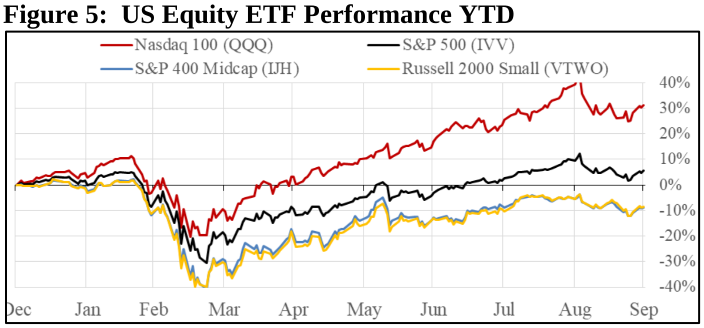
According to the US Bureau of Economic Analysis, US real GDP growth in Q2 was -31.4%, the worst quarterly contraction on record. (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the US, adjusted for inflation; data goes back to 1947.) According to the Atlanta Fed, growth for Q3 is expected to be +32% (annualized), the best quarter in history. As discussed here previously, these numbers are misleading; the US economy did not actually decline by nearly one-third in Q2 and grow by nearly one-third in Q3. The reported numbers are annualized growth rates that assume the economy rose or fell by the same rate for four consecutive quarters. The actual, quarter-over-quarter real GDP growth was -9.0% in Q2 and is expected to be +7.2% in Q3. Figure 4 lists recent reported and actual real GDP growth rates.

Figure 4: US Real GDP Growth (source: St. Louis Fed)

Quarter	Real GDP $Billions	Reported% Annualized	%Change Qtr/Qtr	%Change Year/Year	%Change since 12/31
2019 Q4	$ 19,253.96	2.4%	0.6%	2.3%	na
2020 Q1	$ 19,010.85	-5.0%	-1.3%	0.3%	-1.3%
2020 Q2	$ 17,302.51	-31.4%	-9.0%	-9.0%	-10.1%
2020 Q3 est.	*$ 18,546.10*	*32.0%*	*7.2%*	*-3.1%*	*-3.7%*

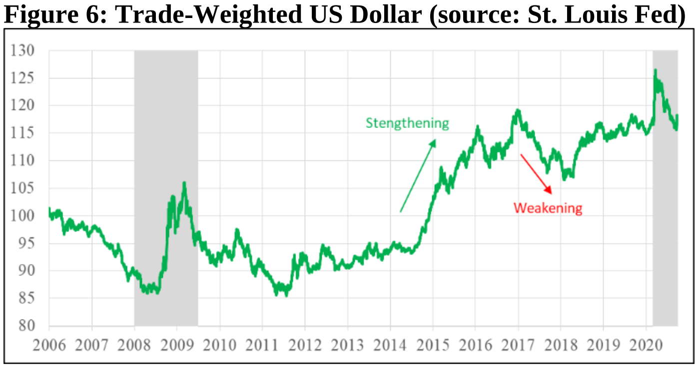
While the speed of the snapback has been impressive, real GDP growth is still -3.7% YTD and -3.1% versus one year ago based on the Atlanta Fed's estimate. By comparison, the worst year-over-year decline during the global financial crisis was -3.9% in the second quarter of 2009. US equity markets have substantially recovered (Figure 5), but the rebound has been disproportionately led by very large tech and internet stocks, which dominate the Nasdaq 100 index (ETF: QQQ +31% YTD). The S&P 500 (IVV) is up 6% this year, but the average stock in the S&P 500 is down 5%, while small (VTWO) and mid-cap stocks (IJH) are down 9%.

Figure 5: US Equity ETF Performance YTD



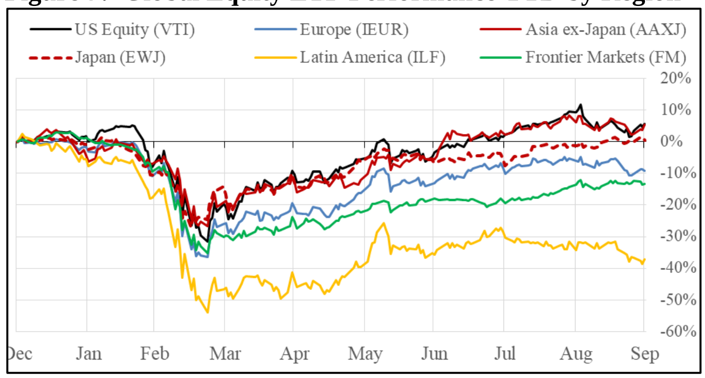
The stock market recovery has been fueled by low interest rates, trillions of dollars of liquidity from the Fed and stimulus from Congress. Eventually, increasing debt and money supply should devalue the dollar, which has retreated since March (Figure 6).

Figure 6: Trade-Weighted US Dollar (source: St. Louis Fed)



A weakening dollar should favor the non-US assets and investment returns due to the currency translation, but YTD global equity returns still favor the US, with Asian stocks close behind (Figure 7). While US stocks (VTI) are up 6% this year, non-US stocks (ACWX) are down 5% so far in 2020 in aggregate. Japanese equities (EWJ) are up 1% and stocks in Asia ex-Japan (AAXJ) are up 5%, led by strong performance from China (MCHI +16%). Meanwhile, European stocks (IEUR) are down 9%; Latin American stocks (ILF) have been crushed by the pandemic, down 37% YTD, under-performing even frontier markets (FM -13%), which include less developed countries and economies in Africa, Eastern Europe and the Middle East.

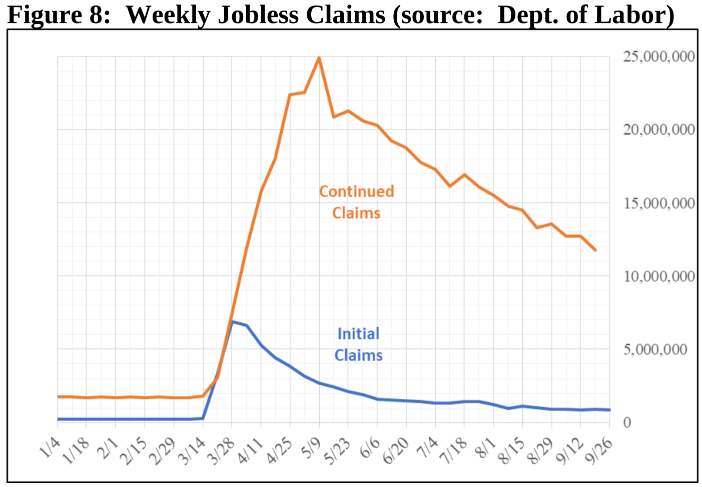
Figure 7: Global Equity ETF Performance YTD by Region



Bottom Line

Global economic prospects are improving from crisis lows but remain below pre-pandemic levels. While the US economy and market has substantially recovered, unemployment remains stubbornly high, as evidenced by this morning's jobless claims data (Figure 8). The employment picture is improving, but there continue to be more than 800,000 first-time unemployment claims each and every week. High profile layoffs announced by Disney, Shell and multiple airlines signal further job losses ahead.

Figure 8: Weekly Jobless Claims (source: Dept. of Labor)



As we have stated previously, full economic recovery will depend on progress against the virus in the form of vaccines and therapeutics which lead to a substantial and sustainable decrease in infection and death rates in the US and abroad. We expect future investment returns to be driven by small and mid-sized US stocks and non-US stocks, which will benefit from global health and economic recovery and a weaker US dollar in the wake of massive US debt and money supply increases.