Economic & Investment Perspectives

Figure 1: Returns – 10/31/2020 (Source: Yahoo Finance)
Conditional formatting: green (high) to red (low) for each time period;

Bonds	ETF	MTD	YTD	Max Draw Down	Current vs. 52-wk High	Current vs. 52-wk Low	% of loss recovered
US Aggregate Fixed Income	AGG	-0.6%	6.1%	-11.5%	-2.1%	11.0%	85%
Non-US Fixed Income	BNDX	0.3%	3.9%	-9.1%	-0.5%	8.3%	83%
High Yield	HYG	0.4%	-0.9%	-23.7%	-5.3%	24.2%	78%
Global Equity							
ACWI Global Equity	ACWI	-2.2%	-0.6%	-34.8%	-7.1%	46.6%	87%
United States	VTI	-1.9%	3.5%	-36.5%	-8.1%	52.5%	91%
International Developed	EFA	-3.6%	-10.4%	-35.1%	-12.8%	34.2%	63%
Emerging Markets	EEM	1.3%	0.1%	-35.0%	-3.6%	48.4%	90%
Equity by Region							
United States	VTI	-1.9%	3.5%	-36.5%	-8.1%	52.5%	91%
Europe	IEUR	-5.2%	-13.8%	-38.5%	-15.7%	37.1%	59%
Asia ex-Japan	AAXJ	1.9%	7.3%	-30.7%	-3.0%	48.4%	109%
China	MCHI	4.8%	21.7%	-26.3%	-2.1%	55.4%	155%
Japan	EWJ	-1.4%	-0.9%	-31.5%	-4.1%	40.0%	87%
Latin America	ILF	0.0%	-37.3%	-56.0%	-39.6%	35.5%	28%
US Equity							
US S&P 500	IVV	-2.5%	2.9%	-35.3%	-9.0%	48.8%	89%
NASDAQ 100 QQQ	QQQ	-3.0%	27.2%	-30.5%	-11.2%	63.3%	144%
US Large Growth	IWF	-3.4%	20.0%	-33.5%	-10.5%	63.4%	126%
US Large Value	IWD	-1.2%	-12.7%	-39.4%	-15.9%	38.8%	60%
US Eqwt S&P 500	RSP	-0.6%	-5.8%	-40.7%	-9.6%	52.4%	76%
US Mid Cap	IJH	2.2%	-6.6%	-44.1%	-10.1%	60.7%	77%
US Small Cap	VTWO	2.3%	-6.5%	-43.8%	-9.6%	60.8%	78%

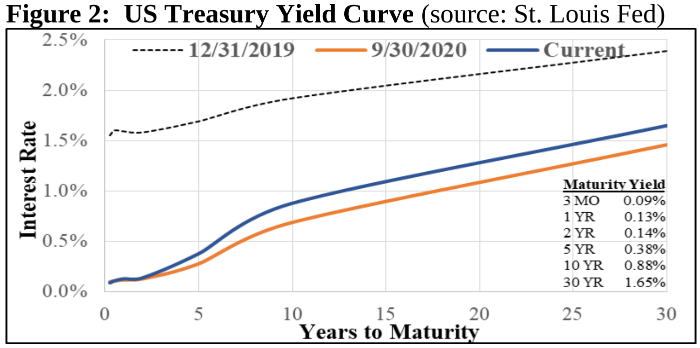
After setting new all-time highs in early September, global equities slumped in October, falling below pre-pandemic highs. The resurgence of the virus in the US (record daily cases) and Europe (new lockdowns in England; rising cases in Germany, France and Italy) led investors to question the strength and durability of the global economic rebound. Looming US election uncertainty added to the skittish market tone. Performance highlights for the month and year-to-date (YTD) include the following (Figure 1):

- Global stocks (ACWI) fell 2.2% and are -0.6% YTD.
- US Equity: The broad market (VTI) fell 1.9% in October but is still +3.5% in 2020. The S&P 500 (IVV) fell 2.5% (+2.9% YTD); the average stock in the S&P 500 lost 0.6% for the month (-5.8% YTD). Mid- and small-cap stocks logged gains during the month: The S&P 400 Midcap (IJH) gained 2.2% (-6.6% YTD) and the Russell 2000 (VTWO) gained 2.3% (-6.5% YTD). At the sector level, technology stocks led the decline (XLK -4.9% in October, +22.3% YTD) while utilities were the only rising sector (XLU +5.1% in October, -0.8% YTD).
- Non-US Equity: Developed market stocks (EFA) fell 3.6% this month (-10.4% YTD), led lower by European equities (IEUR -5.2% in October, -13.8% YTD). Emerging market equities (EEM) rose 1.3% this month (+0.5% YTD) with China (MCHI) up 4.8% (+21.7% YTD) while Latin American stocks (ILF) were flat in October but still -37.3% in 2020.
- Fixed Income: The US Aggregate bond index (AGG) fell 0.6% in October as interest rates (+6.1% YTD). High yield bonds gained 0.4% (-0.9% YTD). Non-US bonds rose slightly.

Interest Rates and the Economy

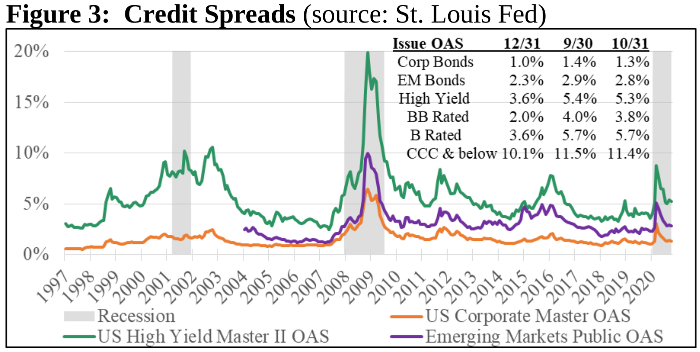
When equity markets fall, investors generally flock to the safety of US Treasuries (causing yields to fall as bond prices rise), but this was not the case in October. Figure 2 graphs the US yield curve, which plots yields (Y-axis) for various maturities (X-axis) of US Treasuries. Short-term yields remained near zero, but longer-term rates rose with expectations of increased government spending in order to stimulate growth and inflation. Regardless of the outcome of the US elections, the Treasury will issue trillions of dollars of debt in coming years to finance tax cuts, economic stimulus and relief, or all of the above. In theory, the rising supply of debt should put upward pressure on interest rates in order to attract sufficient investment demand to absorb the debt.

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 to gauge investor optimism. High spreads signal fear; low spreads signal a strong risk appetite. As illustrated in Figure 3 below, credit spreads spiked in February-March but have erased most of the pandemic fear-related increase, including a marginal decline in October. Corporate bonds now yield just 1.3% over comparable US Treasuries, down from highs of over 3%. Emerging market debt carries a yield premium of 2.8% versus +5% in March. High yield spreads had spiked to almost 9% before falling to +5.3% today, still measurably above 2019 year-end levels (+3.6%) but in-line with long term averages.

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



Record Growth, Elections & the Dollar

The Bureau of Economic Analysis reported that US real GDP grew at an annualized pace of 33.1% in the third quarter (Q3), the best quarterly expansion 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.) This follows on the heels of the worst quarterly economic contraction on record in Q2 (-31.4% annualized). 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 growth was -9.0% in Q2 and +7.4% in Q3. Figure 4 summarizes recently reported and estimated real GDP growth rates.

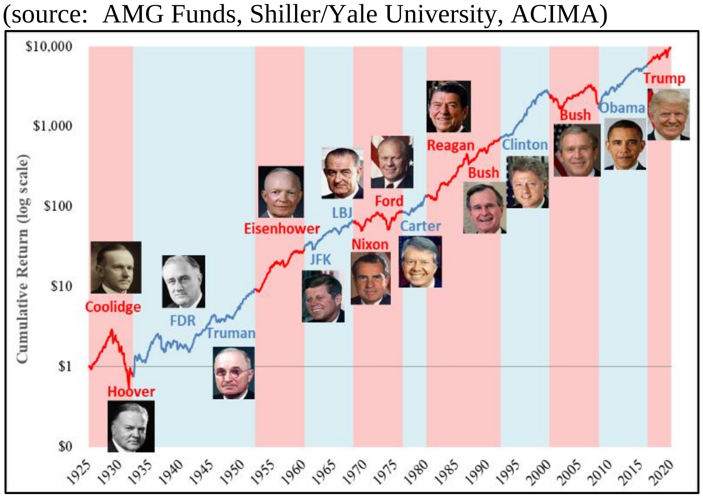
Figure 4: US GDP (source: St. Louis Fed, Blue Chip Survey)

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	$ 18,583.98	33.1%	7.4%	-2.9%	-3.5%
2020 Q4 estimate	$ 18,807.57	4.9%	1.2%	-2.3%	-2.3%
2021 Q1 estimate	$ 19,020.22	4.6%	1.1%	0.0%	-1.2%
2021 Q2 estimate	$ 19,216.87	4.2%	1.0%	11.1%	-0.2%
2021 Q3 estimate	$ 19,410.88	4.1%	1.0%	4.4%	0.8%
2021 Q4 estimate	$ 19,583.27	3.6%	0.9%	4.1%	1.7%

Despite the sharp Q3 recovery, US real GDP is still *down* 3.5% year-to-date and -2.9% versus one year ago. (By comparison, the worst year-over-year decline during the Global Financial Crisis was -3.9% during the second quarter of 2009.) The pace of growth is expected to moderate going forward according to the Blue Chip Survey. Economists expect quarter-over-quarter growth rates of approximately 1% per quarter through the end of 2021. Under these assumptions, the US economy will fully recover to pre-pandemic levels in the third quarter of 2021.

Forecasting economic growth is difficult under any circumstances, especially now given the uncertainty that we face due to the worsening pandemic and pending US elections. But Figure 5 illustrates that, while Republicans (red) and Democrats (blue) may offer differing agendas and approaches to crisis management, stimulus, spending, debt, taxation, etc., the stock market tends to rise regardless of which party wins the White House.

Figure 5: S&P 500 Returns by President – Log Scale
(source: AMG Funds, Shiller/Yale University, ACIMA)



Since 1925, the stock market has risen during every president's tenure, with the exception of Herbert Hoover (Great Depression) and George W. Bush (Global Financial Crisis). Current election uncertainty extends to control of Congress and the implications of unified versus divided government. Data compiled by JP Morgan suggests that since 1947, divided governments (where one party controls the White House and the other controls the Senate, House of Representatives, or both) offer the weakest combination of economic growth and equity returns (Figure 6). Historically, economic and stock market growth have been better under a unified government, with stronger economic growth under Democratic regimes and stronger stock market returns in Republican regimes. Interestingly, stocks have fared better under unified governments, regardless of which party is in control.

Figure 6: GDP and S&P 500 Growth by US Gov. Regime
(source: JP Morgan, St. Louis Fed)

Government Control	% of Years	Average Annual Growth Rate: Real GDP Growth	S&P 500 Price Index
Republican	11%	2.8%	12.9%
Democrat	27%	4.0%	9.8%
Divided Government	62%	2.8%	7.8%
Average	100%	3.2%	8.9%

Bottom Line

Despite the recent equity selloff, global stocks remain within 10% of all-time highs on average, and a foundation for economic recovery and growth remains in place. Interest rates and credit spreads are low. Global central banks have supplied liquidity and support and will likely do whatever is necessary to avert economic calamity. Government relief and stimulus spending has been significant. It is not a question of whether Congress will approve further spending, but rather when and how much.

Some uncertainty will be resolved by US elections in the coming days (or weeks). What can't be known is the ultimate impact of the virus on global health and economies. Infection rates have improved in India and Brazil, but Europe and the US are struggling against a new wave. Full recovery is likely a year away, depending on scientific, medical and social progress against the virus. What we do know is that the US is likely to continue issuing debt and printing money. This should result in a weaker dollar, which benefits US exporters, non-US assets and investments due to the currency translation. Figure 7 graphs the relationship between global equity returns in the context of the US dollar. In past cycles, a weakening dollar has been highly correlated with a negative spread between US and non-US stock returns.

Figure 7: The Dollar and Global Equity Returns