Q4 Outlook: The Storm Before the Calm - The Sequel

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Executive summary

- A forecaster's nightmare: with no shortage of obstacles, misdirection and confusion, we dive deep in order to form a reasonable capital markets outlook
- Context is key; the economic pendulum has swung from one extreme to the other, and appears to be swinging back again
- The monetary and fiscal responses were the "triage needed to save the (economic) patient" but partial reopening is preventing the patient from fully healing
- The Fed's biggest move since the "Volker Shock", what will be the FAIT of inflation?
- Investors must plan for self-sustaining portfolios and not depend on Federal Bailouts

This is a forecaster's nightmare. There is no shortage of obstacles, zigs and zags, misdirection and plain old confusion that must be overcome to form a reasonable capital markets forecast over the next ten weeks. OK, now the difficult becomes impossible... or does it? We will investigate this and more in order to see through to the end of the year, but keep in mind, it is the "fundamentals that drive markets".

Context is always important, but this is especially true when the pendulum swings from one extreme to the other. At the beginning of 2020 the United States' longest expansion in recorded history was still, by and large, chugging along: unemployment was hovering around 50-year lows, real wage gains were accelerating in lower paying jobs, and the benefits of growth were being more widely shared. However, there were some signs that raised concern, such as manufacturing and corporate earnings growth turning negative, but by-and-large few foresaw the cataclysmic Bear Market on the horizon.

Then the pandemic reared its ugly head in mid-February and global economies shutdown like dominoes. Real GDP in the United States fell 31% in the second quarter; payrolls were slashed by 22 million; and Great Depression-like drive-up food lines were evident – scary indeed.

The fundamentals rebound valiantly

Seven months later and we are in the *fastest recovery in history*. Let's review some of the pertinent economic data:

- Jobs surged: payrolls recovered half of their losses; the unemployment rate improved to 7.9% by the end of September from the 14.7% high in April.
- ISM manufacturing and services indexes trended up four straight months through September.
- Housing is booming: existing and new home sales rose to 14-year highs by September
- Q3 2020 GDP is expected to be 31% verses Q2 2020 GDP of minus 31%.
- Real consumer spending is expected to surge 38% in Q3 after a minus 33.2% plunge in Q2.

Economic data provided by ActionEconomics! LLC.

All good news indeed as the U.S. digs out of a big hole. Fortunately, the U.S. Federal Reserve and the U.S. Government acted quickly enough to shore up the financial system. Unfortunately, they didn't solve the problem. Although the historic level of stimulus injected into the markets and the economy was the "triage needed to save the patient", the economy cannot fully heal while only partially reopened. While medical issues certainly need to be considered and the experts need to be consulted, being too careful risks reversing the gains made thus far.

Not opening the economy fully is like heating a house in the winter when the front door is open, or more pertinently, like giving PPP loans to restaurants but limiting the number of patrons needed to sustain the business. A goal of eliminating contagion will lead to policies that result in the loss of jobs, loss of income, loss of education and loss of purpose. For many people, these hardships could significantly lessen their standard of livings and impact them adversely in a way that is difficult to quantify.

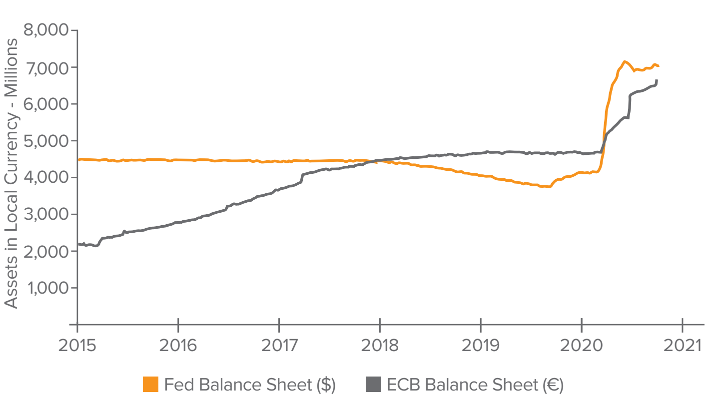
The forecast obstacles are formidable, and each point or subpoint could derail any end-of-year prognostication. Here are the highlights for each potential trigger, all of which need little explanation:

- **The Political:** U.S. Presidency, U.S. Congress, and Supreme Court.
- **The Economic:** Jobs, Capital Investment, Monetary & Fiscal Stimulus, Corporate Earnings
- **The Pandemic:** Reopen America, Vaccine, New COVID Cases, Sweden
- **The Geopolitical:** Brexit, China, Iran, Russia, Middle East

The Fed's biggest move since the "Volker Shock"

The 1980 "Volker Shock" raised the Fed Funds rate to its highest point in history, taking it from 10.25% to 20% in March of that year. It caused a brutal recession, but ultimately broke the back of inflation and kicked off one of the greatest economic periods in U.S. history. We have been benefiting from declining inflation ever since former Fed Chairman Volker's iconic move. Current Federal Reserve Chairman Jerome Powell may have just announced an equally epic, yet diametrically opposed feat by instead *stoking* inflation.

Figure 1. The U.S. Federal Reserve and other Central Banks are Again Expanding Their Balance Sheet



Source: FactSet, Voya Investment Management, as of 10/02/20. ECB = European Central Bank.

Fed Chairman Powell, in his October 6, 2020 speech "Recent Economic Developments and Challenges Ahead" announced the Federal Open Market Committee's adoption of a *flexible average inflation-targeting regime* (my own nickname for it is "FAIT"). He said that "the FOMC will aim to achieve inflation moderately above 2%for some time so that inflation averages 2% percent over time and longer-term inflation expectations remain well anchored at 2%." In other words, he tacitly admitted that the Fed raising interest rates at nearly every meeting from December 2016 through March 2018 went too far – at a minimum – and over time derailed an accelerating economy.

Well, better late than never, as FAIT should be very bullish for stocks over the long term. This means that the next time the economy surges the FOMC will not put its foot on the brake, and instead allow unemployment to continue to drop and inflation to rise beyond its 2% mandate for some time. This represents the most significant move since the "Volker Shock" in that the Fed takes out the major policy risk of tightening too quickly. Now, for the first time, the Fed won't *take the punch bowl away* when the party is picking up steam.

Investing with a plan beats hoping for the best

There is a hard line between what is difficult and what is impossible. The solution for the investor begins with a plan. Of course, the exponential outcomes that could occur are daunting, and investors do not have an unlimited "risk-budget" to protect against every scenario. So, we follow the approach that is analogous to building a sailboat to withstand hurricanes which first takes the experience of sailing in hurricanes and a plan robust enough to make it through and to carry on. This may include a multiple ton lead keel; complex curved skeleton design; specially designed sails along with the experience of how to sail through the battering of wind, waves and worse.

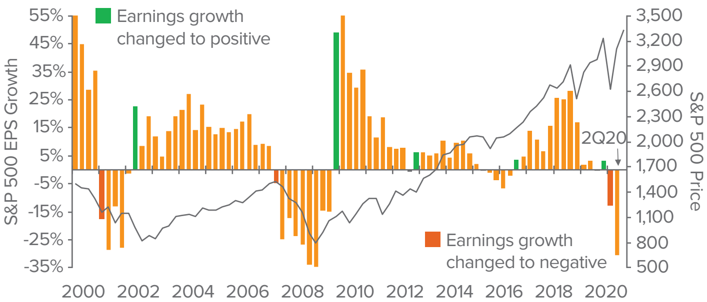
The building of robust portfolios requires the same planning and experience. After three sudden and raging Bear Markets it is time to change the old investment adage of "Stay the Course", which implies heading directly into the hurricane hoping for the best. Instead, how about "hurricane-proof" the investment process with a plan? A robust investment process should cast a wide net, use a range of asset classes, not be overly concentrated, avoid trading during market turmoil, and – in more sophisticated cases – tack around the storm.

3rd quarter review

The 3Q20 equity rally was explosive but didn't feel that way, as its August peak melted away. Emerging Markets equities lead the way, followed closely by U.S. Large Cap. After that, it wasn't even close as International, U.S. Mid Cap, and U.S. Small Cap equities performed in descending order with all equity asset classes posting gains. While stocks beat bonds, High Yield ran away with the fixed income prize. Still the other bond asset classes did their job by holding onto positive gains, for the most part, with just 20-year U.S. Treasury maturities and longer marginally negative. The volatility index (VIX) was in a downtrend for the quarter, going from roughly 30 to 26 while 10-year Treasury yields marginally increased to 0.66%, and oil prices close near $40 per barrel, all of which were constructive for the markets.

Figure 2. Fundamentals Drive Markets

Earnings growth of the S&P500 is a key indicator of health for the overall stock market



Source: Refinitiv – Thomson Reuters and FactSet, Voya Investment Management. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. The S&P 500 index is a gauge of the U.S. stock market that includes 500 leading companies in major industries of the U.S. economy. **Past performance is no guarantee of future results. Indices are unmanaged and not available for direct investment.**

There has been a significant change in the microstructure of the markets. The most esteemed and widely followed "diversified" index in the world—the Standard & Poor's 500—has a concentration in the Technology sector that has surged in recent years. In fact, the two largest sector weightings in 2017's third quarter was Technology and Financials at 17.15% and 13.79%, respectively. In 2020's third quarter technology was at a whopping 27.5% while financials dropped to a meager 9.87%. In three short years the spread in weightings of Technology over Financials has increased by more than five times and bears pointing out.

Figure 3. Global Effective Diversification has Beaten the S&P 500 over a Long Period of Time

Index	Q3 2020	YTD	3 years	5 years	10 years	20 years
Equity						
S&P 500	8.9	5.6	12.3	14.1	9.2	6.4
S&P Midcap	4.8	-8.6	2.9	8.1	8.2	7.9
S&P Smallcap	3.2	-15.2	-0.3	7.2	7.5	8.4
Global REITs	2.3	-19.1	-0.5	3.0	4.6	7.6
EAFE	4.9	-6.7	1.1	5.8	4.2	4.0
Emerging Mkts	9.7	-0.9	2.8	9.4	6.2	8.2
Average	5.6	-7.5	3.0	7.9	6.6	7.1
Fixed Income						
Corporate	1.5	6.6	6.4	6.0	5.1	6.1
U.S. Treasury 20+	0.1	21.8	12.1	8.4	7.5	7.9
Global Aggregate	2.7	5.7	4.1	3.9	2.4	4.8
High Yield	4.6	0.6	4.2	6.8	6.5	7.2
Average	2.2	8.7	6.7	6.3	5.4	6.5
Overall Average	4.3	-1.0	4.5	7.3	7	6.9

Source: FactSet, FTSE NAREIT, Voya Investment Management. The Overall Average model allocation includes 10 asset classes, equally weighted: S&P 500, S&P 400 Midcap, S&P 600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Bloomberg Barclays U.S. Corporate Bonds, Bloomberg Barclays U.S. Treasury Bonds, Bloomberg Barclays Global Aggregate Bonds, Bloomberg Barclays U.S. High Yield Bonds. Returns are annualized for periods longer than one year. Past performance is no guarantee of future results. An investment cannot be made in an index.

Conclusion and forecast

This too shall pass. Vaccines will emerge, the population will adjust, and business will travel again. But the damage has been done. With scars from the Great Recession of 2008 still visible when the COVID-19 shock hit, it will take a long time for investors to adapt to the fact that significant wealth destruction during this bear market unfolded in a matter of weeks.

So, what are the next few weeks through to the end of this tumultuous year looking like? My 10-week forecast pertinent to the markets is that the government will pass another substantial stimulus relief bill and the Federal Reserve will continue to keep the pedal to the metal with its own stimulus program. Good news indeed for the markets, but this government bailout is tantamount to a U.S. Coast Guard ocean rescue, and should not be celebrated by the crew as seamanship. We believe fundamentals drive markets and our plan is to prepare for the worst and expect the best.

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