Q3 2020 Economic Outlook

By the LNWM Investment Strategy & Research Group

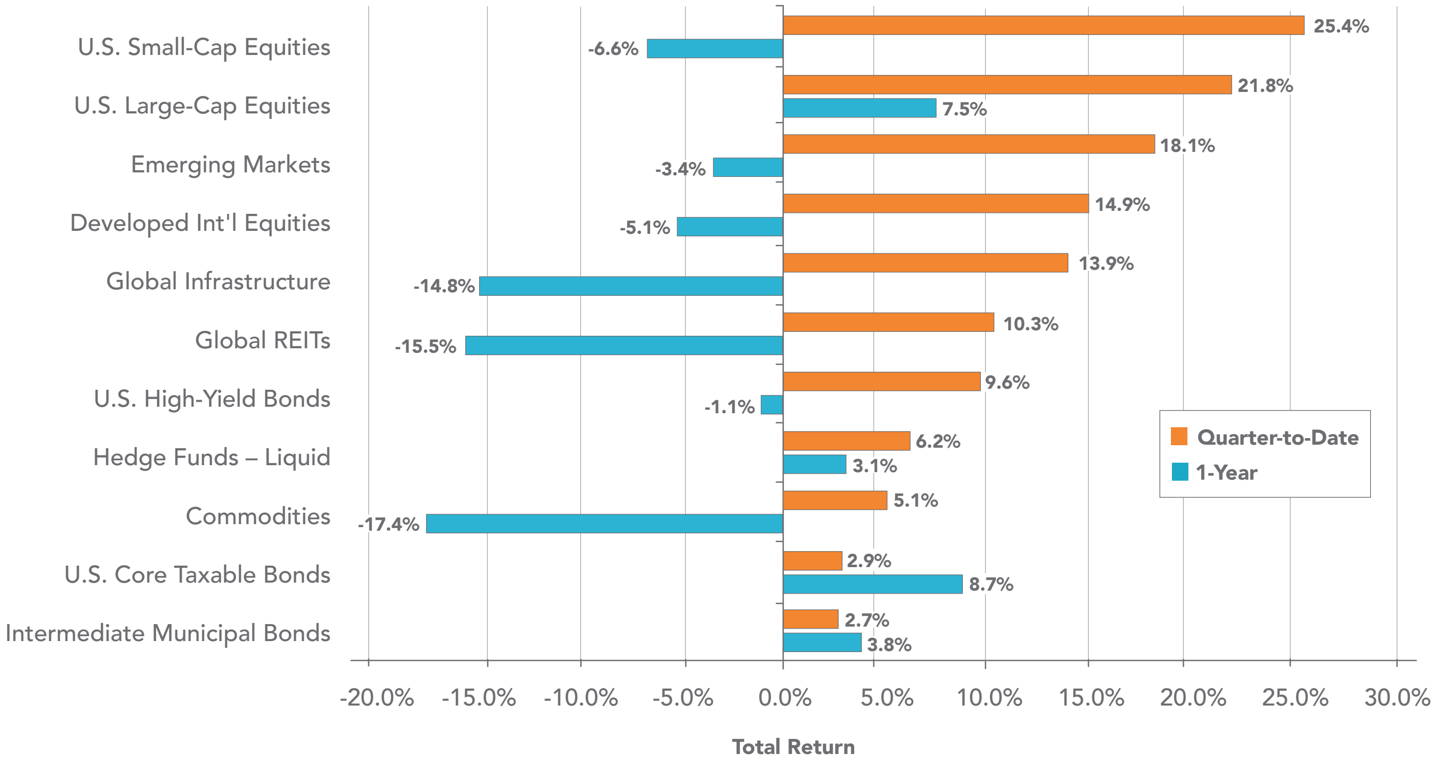
> "Economists are often asked to predict what the economy is going to do. But economic predictions require predicting what politicians are going to do – and nothing is more unpredictable."
>
> **– Thomas Sowell**

SEEING PAST TERRA INCOGNITA

Recently, it seems that each quarter that I write the *Outlook*, I mention that we're in 'unprecedented times.' This time, I mean it. In the past four months, entire societies have been locked down, reopened *partially* and now some are *partially* closing again. Yet, it does not seem we are much closer to containing the cause of the lockdowns, Covid-19.

Initially, financial markets reacted as expected by selling off dramatically only to later rally at a pace few foresaw, mainly supported by government programs with the theme 'do anything it takes.' The big question now is: Where do we go from here, given the ongoing impact from Covid-19?

PERFORMANCE OF ASSET CLASSES 2ND QUARTER AND 1-YEAR
(As of June 30, 2020)



Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

The impact has been unevenly felt, both health-wise and economically, but it has resulted in major shifts that are likely to affect the economy and the markets in the decade to come. Due to necessary Covid-19 relief programs, the US national debt has now surpassed 100% of GDP and continues to increase. From April through June 2020, the US government spent roughly $2 trillion more than it took in, nearly tripling the annual deficit, which had already climbed to nearly $1 trillion prior to Covid-19.

Although millions of people have returned to work as the lockdowns have eased, official US unemployment was recently at 11% and is expected to remain elevated. Adding to the uncertainty is the upcoming US presidential election, which is just beginning to come into focus. While there is much written about Biden vs Trump, few are focused on the high-stakes races in the Senate, which could result in a Democratic majority. Finally, but of equal importance, is the current level of civic unrest across major cities in the US and abroad.

SIGNS OF PROGRESS AND CONCERN

With many major economies now operating closer to normal, the global economic growth rate, we think, has turned positive again. In the event of a second wave of infections, strict social measures are likely, although probably not at the severe levels we saw in March. Western leaders seem to be accepting the trade-off between opening the economy and the subsequent likely increase in Covid-19 infections. Still, millions of people will continue to adhere to social distancing until Covid-19 dissipates through treatment or vaccine. This we think will continue to hinder economic growth this year and into next. We do not expect global output to recover to 2019 levels until the end of 2021.

Between now and then, the markets are anticipating steady improvement in the economy and corporate profits. Disappointment could be destabilizing. Consensus is that the 2nd quarter of 2020 will see the worst results, with things improving from there. Analyst estimates are that S&P 500 earnings will be down a shocking 45% for 2nd quarter 2020 vs. the same quarter in 2019. So the focus now is turning to fundamentals and corporate "guidance," what executives envision for the pace of business for the rest of the year.

DEALING WITH COVID-19

Through mid-July 2020, there have been about 13 million confirmed cases of Covid-19 worldwide and over 500,000 deaths. In the US, we are playing a bit of 'whack-a-mole' and attacking hot spots as they arise, i.e. Florida, California and Texas, most recently. We do not yet have a vaccine but based on lower death rates, it seems that treatment and societal reactions are helping and will hopefully only improve. Also, many of those most recently infected are younger and therefore among the less vulnerable.

Because Covid-19 symptoms can surface after one is contagious, the virus is proving extraordinarily difficult to contain; hence, extreme measures of social distancing are required to avoid medical systems becoming overwhelmed. On a positive note, it seems the recent rise in infection rates may not lead to a similar rise in hospitalizations, and we hope this proves true through the winter until we have a viable vaccine.

There is certainly an abundance of empirical evidence from countries that have done a better job containing the virus vs those that have not; we hope world leaders will learn from that. In any case, we think societal norms will change for the foreseeable future, but a second widespread lockdown like we experienced in March/April is less likely.

In the latest issue of *Navigator*, sent out with this Outlook, you will find an article by Senior Investment Analyst Josh Hile, *The World After Covid-19*, which outlines our views on how daily lives are likely to change going forward.

Things could have been much worse. And this is one reason the markets have been so resilient lately. Basically, the Federal Reserve and US government have provided massive, foundational support so the US and global economies can continue to function relatively normally. All of this support – including the first-ever Paycheck Protection Program and the Federal Reserve expanding its asset purchases to include US corporate debt – is larger than QE1, QE2 and QE3 combined (the Fed's three rounds of stimulus after the 2008 crisis).

Ultimately, checks were mailed, tax payments were delayed, and other supports combined to make US government spending 2.5 times (so far) the level it was during the entire 2008 financial crisis. New stimulus programs by the Federal Reserve maintained liquidity in the capital markets, and some call this 'propping up markets,' with which we cannot argue. Unfortunately, despite the heroic efforts of the Federal Reserve and US Treasury, there are many jobs that will be permanently lost as we adjust to new societal norms. The higher level of unemployment is likely to reverse the upward pressure on wages that we saw in 2019 and is likely to keep inflation low for now.

We've consistently focused on the US consumer spending as a key economic driver, and this is one of our main concerns going forward. Spending has been temporarily buoyed by the Paycheck Protection Program and $600 a month in higher unemployment benefits. But these payments are due to expire at the end of July, just as Covid-19 is resurging and Congress is at a standstill, although continuing to debate additional stimulus.

While people will continue returning to work, the unemployment rate is likely to remain close to 10% through this year. If unemployment remains high, particularly among the most economically vulnerable, continued civic unrest is more likely, which we think would be an incredibly unfortunate outcome as nobody wins in that scenario.

POLITICS AND YOUR PORTFOLIO

In just over 100 days, we will have a US presidential election along with several key Senate elections. There is a possibility of a Democratic sweep in November, which we believe markets will begin to assess in the months ahead. Even if the Republicans retain the Senate majority, with Joe Biden as president key policy changes are likely, which we believe will impact financial markets. For one, Biden has already proposed raising the corporate tax rate to 28%, vs. 21% currently but still below the 35% it was pre-2017.

However, the resulting increase in tax revenue is not likely to offset the massive increase in spending, particularly on healthcare. As a result, the national deficit will continue to rise. I've expressed my uneasiness with our national debt many times in the past, which boils down to the 2 things: 1) We can service our debt as long as interest rates stay low, which they are likely to do in the near term; 2) The US needs a plan to begin repaying debt or at least stabilizing the amount.

Estimating the impact of political change is extremely difficult and we fully expect more policy surprises in the months leading up to the elections.

S&P 500 TOTAL RETURN BY COMPANY SIZE (JAN. 1 - JULY 3, 2020)

Company Size	Median Market Cap ($billions)	P/E*	P/S**	P/FCF***	P/B****	Total Return
Top 10	$848.5	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1	13.9	0.8	10.0	1.2	-38.5%
S&P 500		**22.8**	**2.4**	**20.4**	**3.0**	**-2.1%**

*Price-to-Earnings; **Price-to-Sales; ***Price-to-Free Cash Flow; ****Price-to-Book.
Source of Data: Ben Carlson's *A Wealth of Common Sense*, Bloomberg, LNWM.

BIGGER HAS BEEN BETTER

Equity markets have rebounded more than 33% from the lows of March 23, which have left many asking if current valuations are too high. In the US, given the amount of government intervention (most importantly in the high-yield debt market) and very low interest rates, we see current valuations as being fair to rich, although one must look below the index level at which stocks are driving returns.

As the chart above shows, the 10 largest companies in the S&P 500 have kept the entire index (500 names) from turning negative. In other words, the change in index levels masks the dramatic divergence by sector and by market capitalization. If some of the cyclical sectors that have not appreciated as much as the largest names can recover, we think at the index level, there may still be room for upside.

WHAT WE HAVE DONE AND ARE DOING

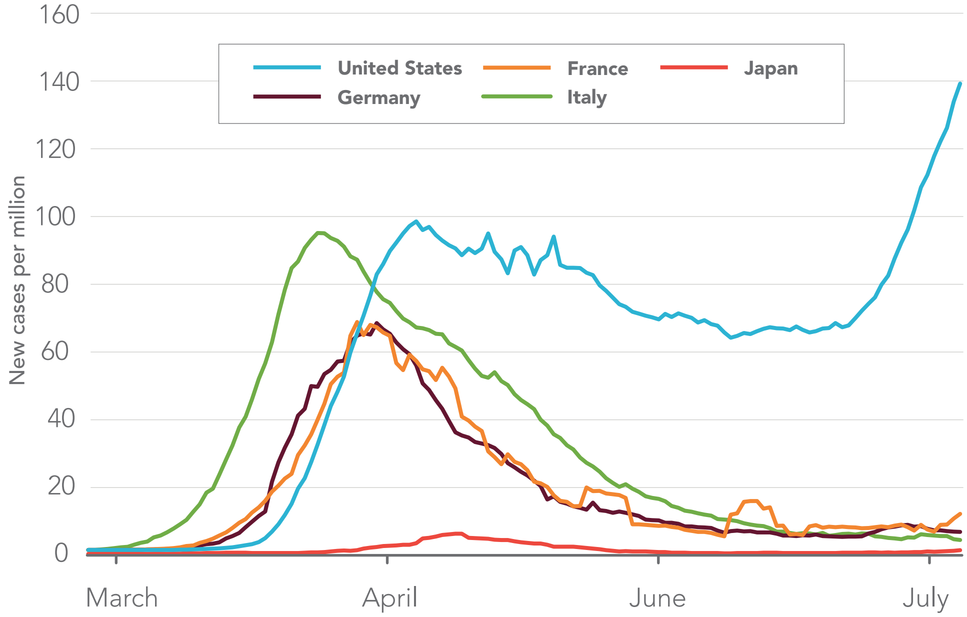
After a relatively active first quarter as the Covid-19 pandemic set in, our trading has been relatively muted with the exception of a small shift from taxable fixed income into municipal bonds. We had already exited our commodity exposure and reduced non-US equities, while increasing our allocation to US large-cap growth. Given the subsequent rebound in US growth stocks (which surprised many), one might say we were more conservative than we needed to be. We maintain, however, that the decrease in risk was prudent given the environment. Further, our increase in exposure to large-cap US growth has been beneficial.

In terms of new opportunities for qualified investors, on July 1 we launched an allocation to a new hedge fund structured as a Limited Partnership. After many months of research, we moved forward with what we believe will be the most efficient vehicle for our clients to access an asset class that should reduce volatility and provide uncorrelated sources of return. I encourage you to discuss this further with your advisor. Looking forward, we will continue to evaluate opportunities that will likely increase risk when appropriate. Given the low expected returns on stocks and bonds in the coming years, we expect to increase our allocation to private, less liquid investments.

KEY ECONOMIC DRIVERS

- **Covid-19** – As we continue to learn more about the virus and how it spreads, I believe we can establish three scenarios: (1) Downside: we have a second wave that causes lockdowns throughout the country; we believe there is low probability of this as most of the country (and world) have begun to adjust to new norms that minimize the spread. (2) Base case: we continue to have outbreaks in different areas throughout the world, which can be managed. In this case, growth remains muted as travel is restricted along with large gatherings. (3) Upside: we return to normal later this year or early next year. For this third scenario, we will need significant advances in treatments and potentially a viable vaccine, on which it appears progress is being steadily made.
- **Corporate Earnings** – While current earnings are always important, we are most focused on forward guidance. We are at the outset of Q2 earnings announcements and have already seen some of the country's largest banks set aside record amounts for loan-loss provisions while also expressing concern that the current stimulus is hiding the impact of the recession, which will likely be seen later on.
- **Fiscal/Monetary Policy** – In reality, we are concerned with how our economy and capital markets will transition from the current state of dependence on government stimulus. Congress has already begun debating more Covid-19 relief, which we think will heat up as supplemental unemployment benefits expire at the end of July.
- **Inflation Rate** – We believe there will continue to be risk of higher inflation given the high level of government spending around the globe. In fact, this is not about runaway inflation; rather, it can be a level of inflation greater than financial markets are currently discounting. This is not a near-term risk but something that we are beginning to focus on now to prepare our portfolio positioning over the coming decade.
- **US Elections** – Unfortunately, the current pandemic and civic unrest have become political issues. We believe that will hinder resolution of both problems, particularly as we get closer to November. Regardless of the victor, taxes are most likely moving higher. The increasing odds of a Democratic sweep in November will come with new policy implications that investors will need to price in.

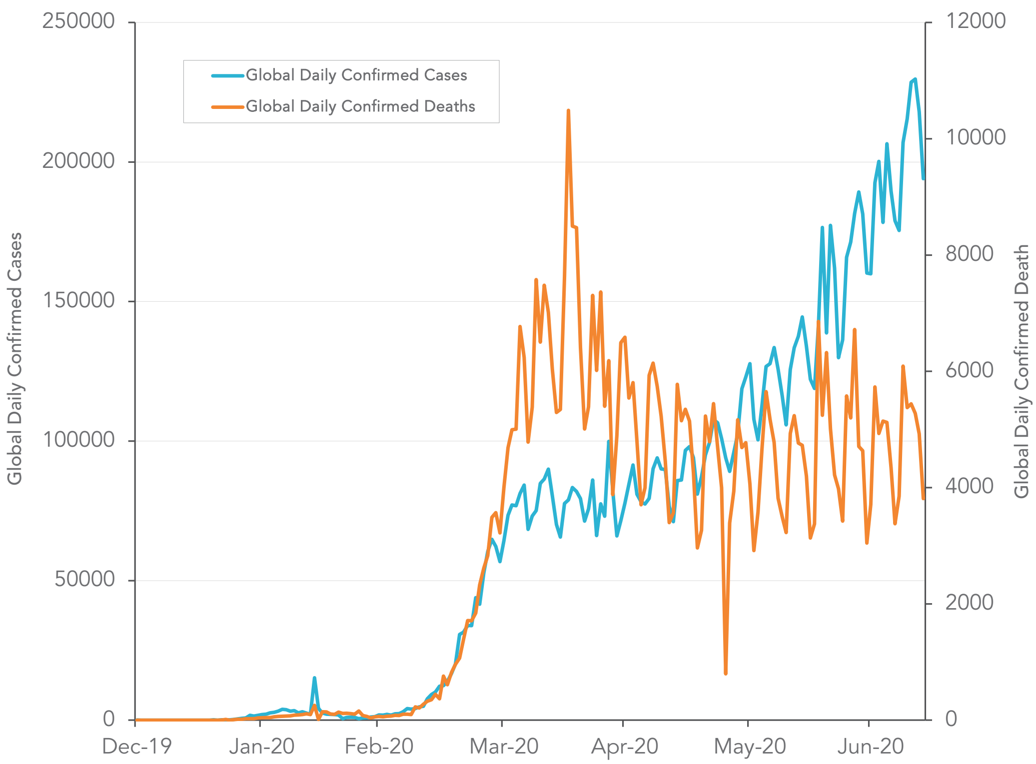
US IN THE LEAD: NEW COVID-19 CASES PER 1 MILLION IN POPULATION



Source of Data: BlackRock Investment Institute.

Cases of Covid-19 in most major developed economies, including the Eurozone and Japan, plateaued in March/April and have declined to low levels. Meanwhile, US cases have been rising dramatically since the end of June, following somewhat of a plateau. The US uptick has mostly been the result of differences in social distancing policies and practices, compliance, as well as more widespread testing.

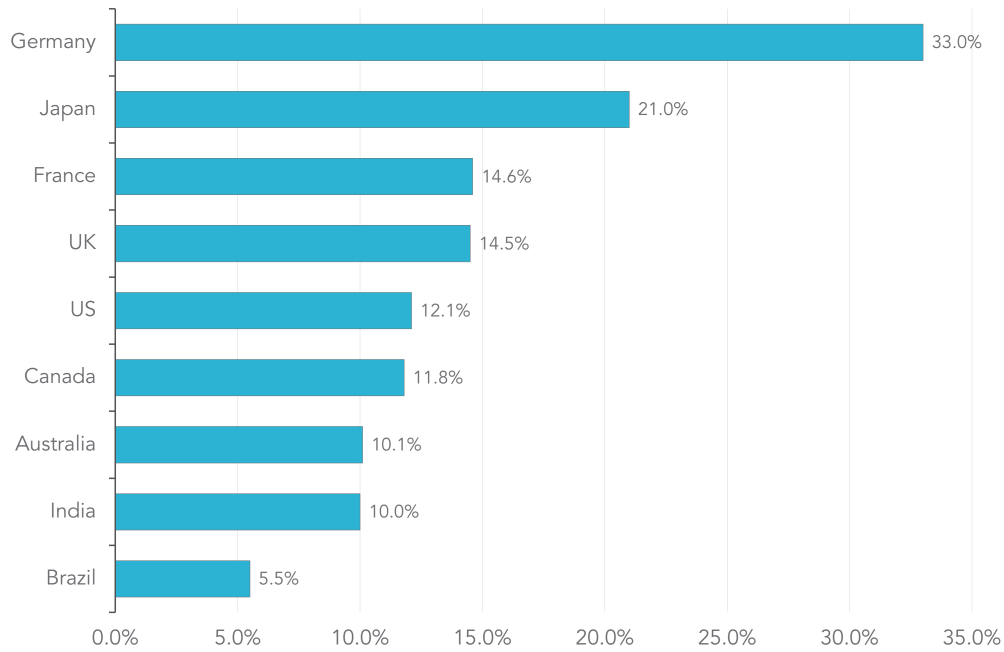
GLOBAL DAILY COVID-19 CASES AND DEATHS



Source of Data: European CDC.

While the number of Covid-19 cases continues to rise and new regions become hot spots, from a global standpoint, the daily number of deaths has fallen and stabilized somewhat. In setting financial market expectations going forward, we think investors will focus less on the spread of the virus and more on the severity of the human and economic consequences.

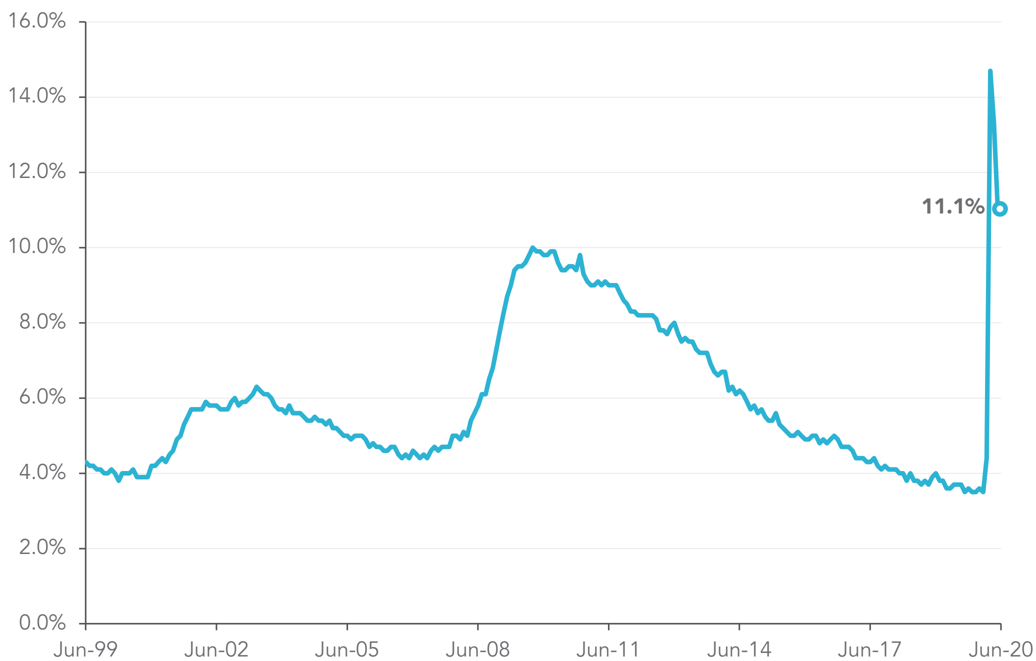
GOVERNMENT COVID-19 RELIEF SPENDING AS % OF GDP



Source of Data: McKinsey & Company, LNWM.

The economic impact of Covid-19 has been unprecedented but so too has been the policy response. The chart at left shows government spending, not including new stimulus programs launched by central banks. As you can see, both developed and emerging market governments have committed significant resources to support their economies, well in excess of what was seen during the 2008 financial crisis. Additional support from the US Congress via a second CARES Act is possible, if not likely, this summer.

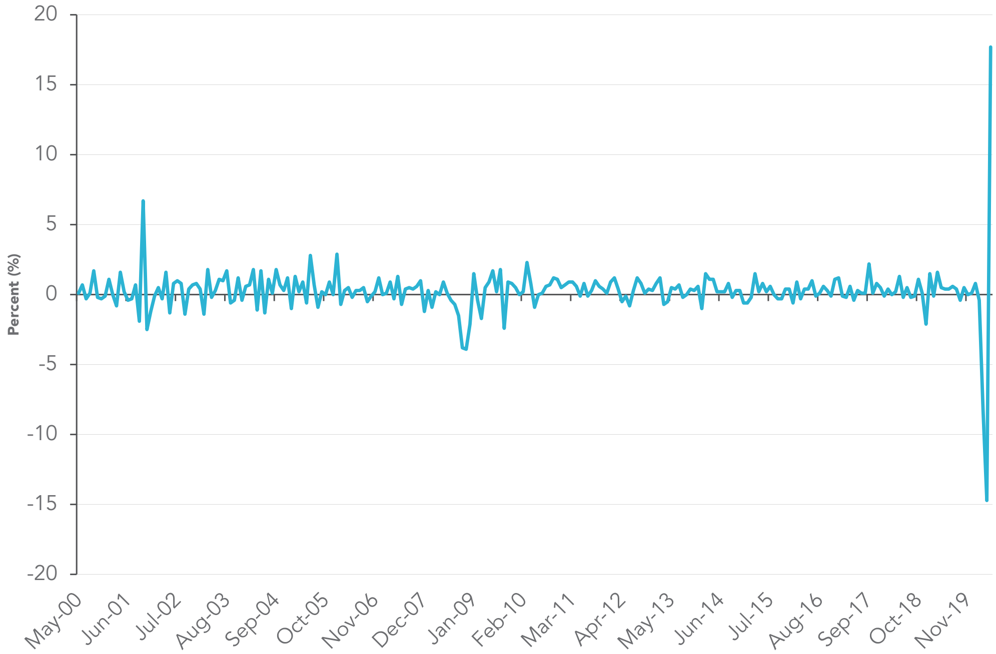
US UNEMPLOYMENT RATE



Source of Data: Bureau of Labor Statistics.

The US unemployment rate spiked above 14% in March/April but has since fallen to around 11% as businesses reopen and more workers return to their jobs. Still, some 18 million more people are jobless now than in February 2020. Continued improvement in the job market, if only slight in the grand scheme of things, will be one the primary drivers of consumer confidence and spending.

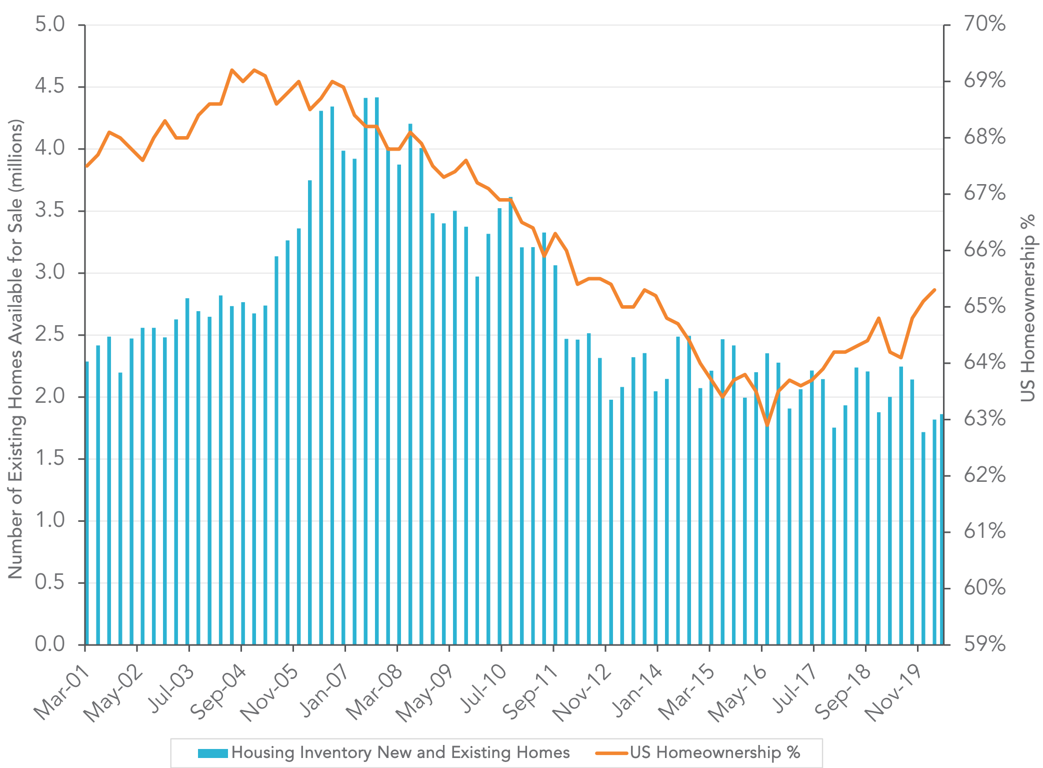
US RETAIL SALES (MONTHLY CHANGE)



Source of Data: Bloomberg.

US retail sales, which are normally relatively stable month-to-month, dropped dramatically this past spring and have since posted an impressive but partial recovery, reflecting improving consumer sentiment about the job market and the boost from government stimulus payments. While more stimulus is likely, the size and scope are uncertain. The chart suggests, though, that when consumers get support payments they will increase spending due to pent-up demand.

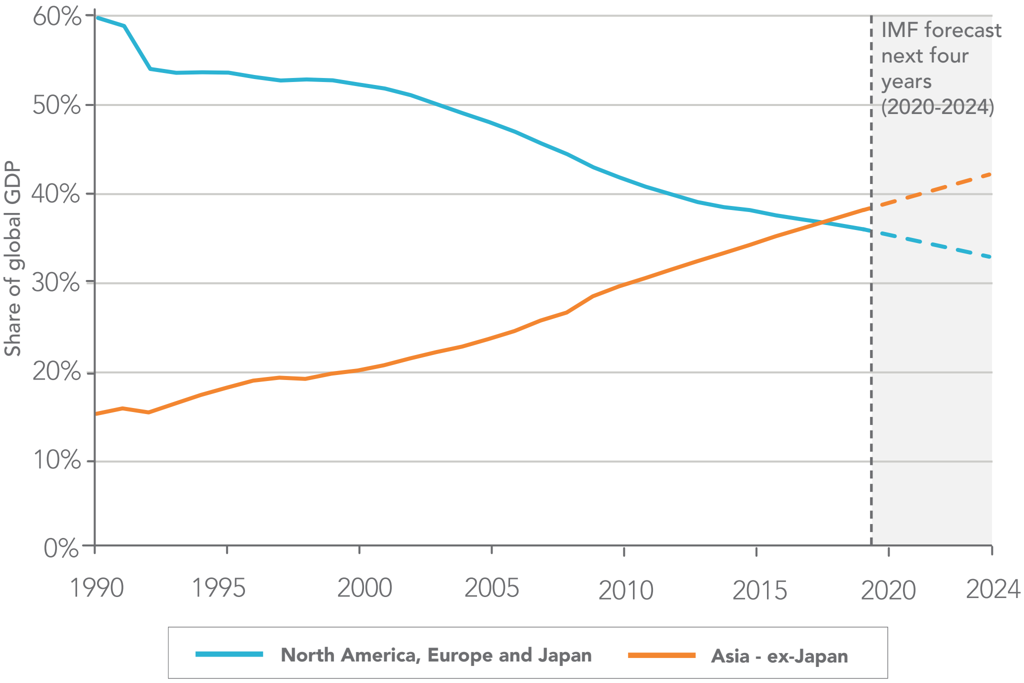
US HOUSING FOR SALE VS HOMEOWNERSHIP RATE



Source of Data: Bloomberg, US Census Bureau.

The real estate housing market has been a source of concern for investors. As the chart shows, housing inventory for sale has been dropping steadily since the 2008 financial crisis, and was recently below 2001 levels. Meanwhile, the homeownership rate has yet to rebound to its peak in 2006. With federal efforts to support borrowers and lenders alike, we believe the housing market will remain on relatively stable footing.

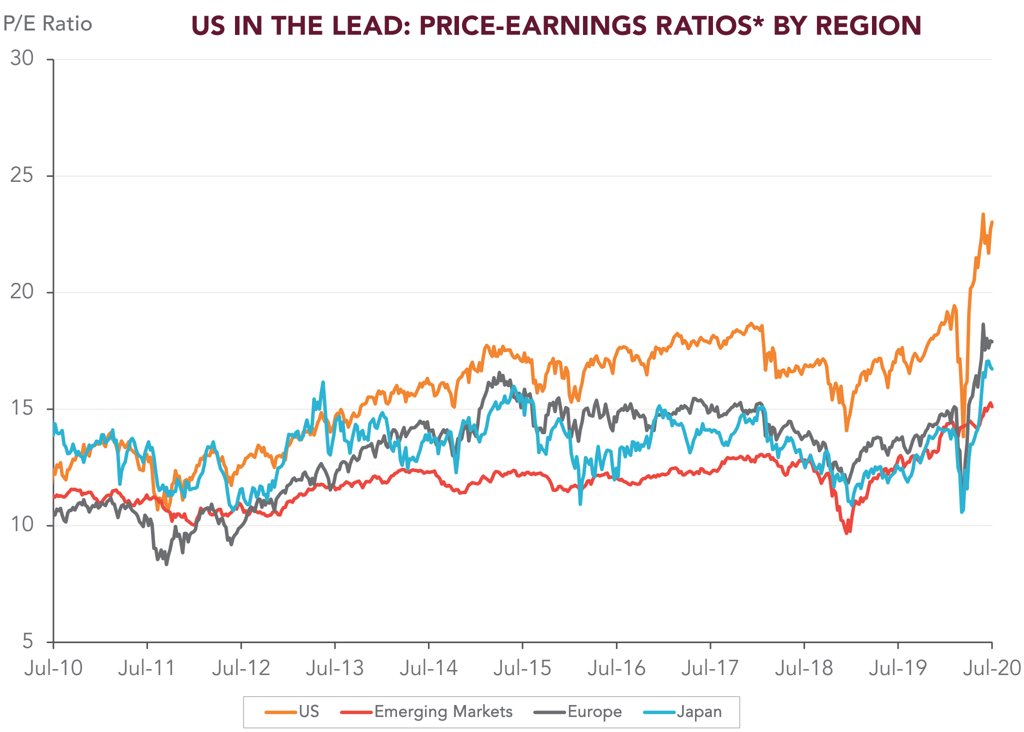
A TIPPING POINT: SHARES OF GLOBAL GDP



Source of Data: BlackRock Investment Institute.

As the chart at left shows, Asia ex-Japan is expected to garner most of the gains in global GDP growth for the foreseeable future. Meanwhile, North America, Europe and Japan collectively are expected to make up a relatively smaller share of global GDP, given these regions' low growth rates and aging populations.

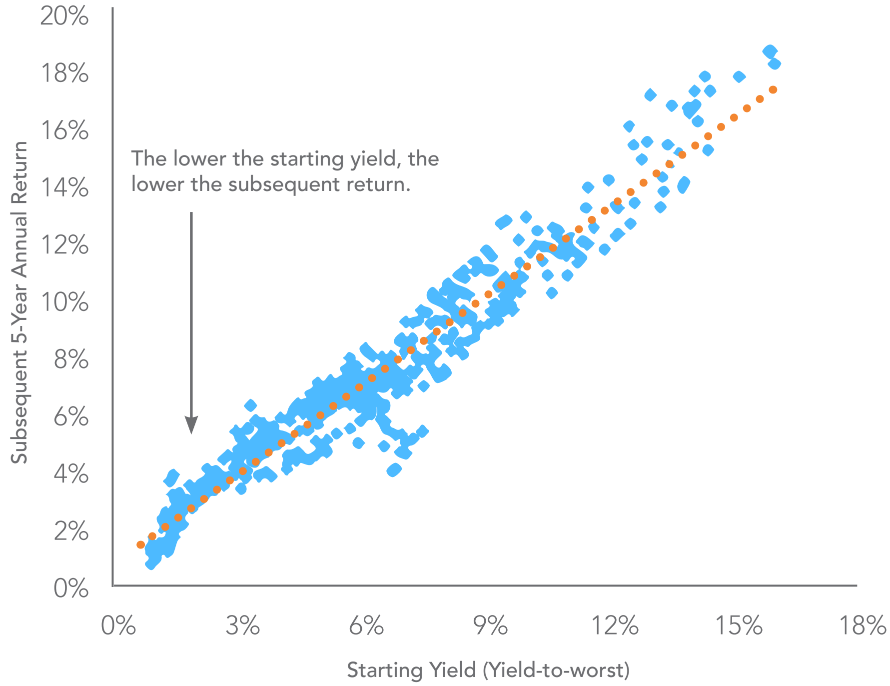
US IN THE LEAD: PRICE-EARNINGS RATIOS* BY REGION



*Based on 12-month forward consensus earnings estimates.
Source of Data: Bloomberg, MSCI.

Equity valuations have bounced back dramatically throughout the world, with the US leading the rebound. Emerging markets (EM) continue to look relatively cheap. We think this is driven by investor concerns about how certain countries, such as Brazil, are dealing with Covid-19, and this has clouded return expectations. The broad-brush treatment -- many EM countries do have Covid-19 under control -- is creating opportunities for our EM asset managers.

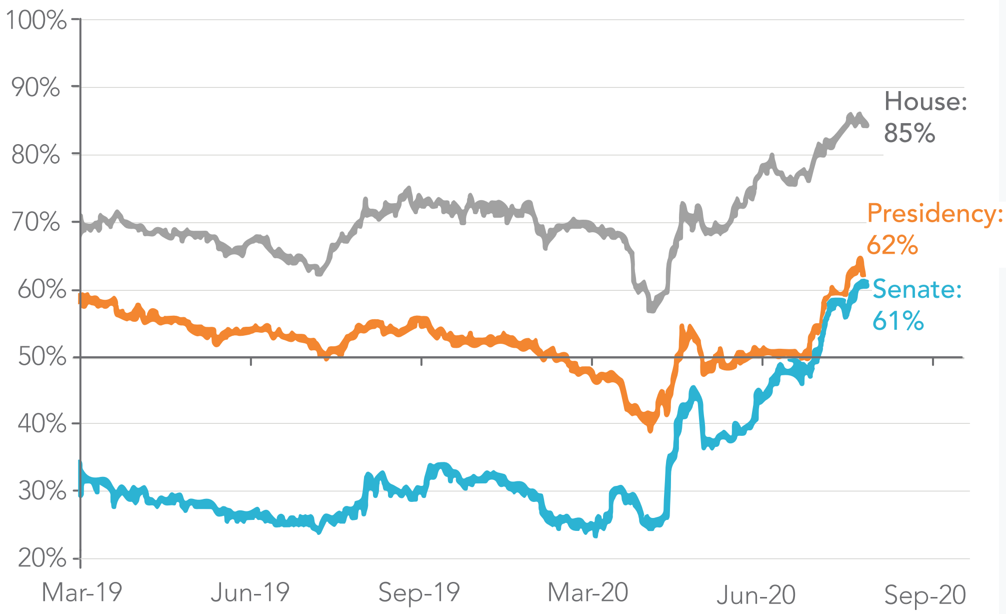
US TREASURY BOND YIELDS* VS SUBSEQUENT 5-YEAR ANNUALIZED RETURNS, 1976 - APRIL 2020



*Yield on Bloomberg Barclays US Treasury Index.
Source of Data: Barclays US Treasury Index, Bloomberg.

The lower the yield on bonds, the lower the subsequent total return is likely to be, the chart at left shows. With the yield on 10-year Treasury bonds around 0.67% recently -- a historically low level -- the implication for investors is that returns are likely to be low in the bond market in the coming decade. Diversifying into higher-risk/ higher-return assets such as stocks and alternatives may be necessary to achieve portfolio objectives.

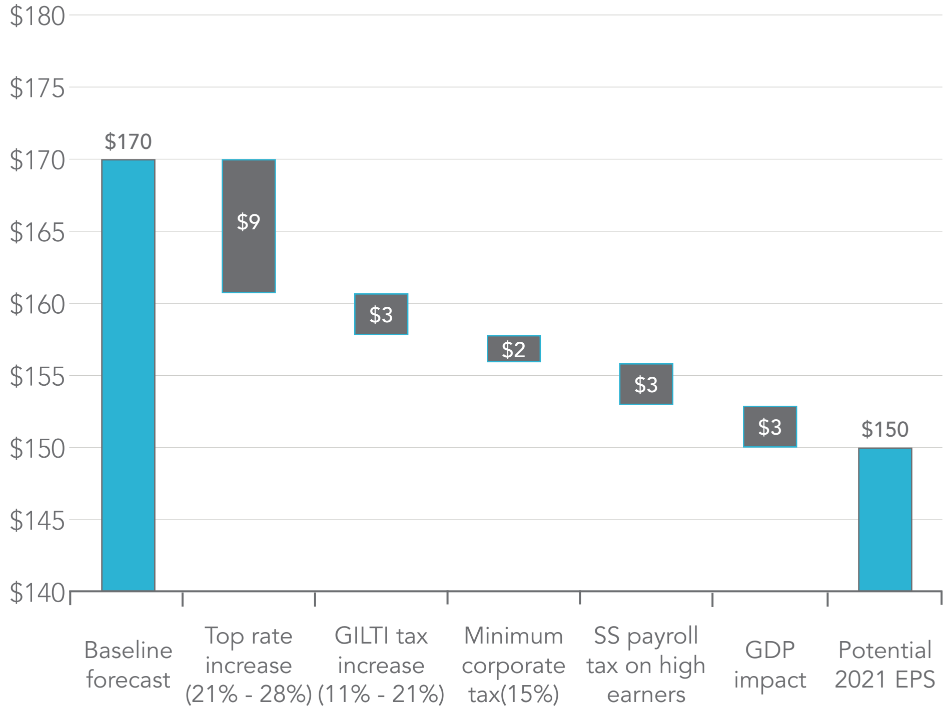
POLLS SHOW RISING PROBABILITY DEMOCRATS WILL CONTROL WHITE HOUSE AND CONGRESS



Source of Data: Goldman Sachs Investment Research.

The probability that Democrats will control both the White House and the Congress has increased dramatically since March. This shift in power, if it happens, could have major implications for tax and economic policy, as well as the markets. For one, tax rates are likely to rise on corporations and the wealthy under Democratic leadership. But higher spending on infrastructure and other programs could provide a boost for companies in many different sectors.

POTENTIAL IMPACT OF TAX REFORM ON S&P 500 EARNINGS PER SHARE FOR 2021



Source of Data: Goldman Sachs Investment Research.

If the November elections lead to a Democratic sweep (control of the White House and Congress), taxes on corporations are likely to rise in a variety of ways. This includes the highest corporate tax rate rising to 28% (from 21% currently). The combined impact is estimated to reduce 2021 earnings per share for S&P 500 companies to $150 (from $170), a 12% decline, which we don't believe is fully priced in by the markets currently.

THE BENEFITS OF DIVERSIFICATION

Total return by asset category relative to a diversified* allocation.

Best Performance

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD 2020	15-Year Annual-ized Return	15-Year Annual-ized Volatility#
MSCI EM 34.00%	Global REITs 42.35%	MSCI EM 39.42%	10yr Treas 20.06%	MSCI EM 78.51%	US Small Cap 26.85%	10yr Treas 17.15%	Global REITs 28.65%	US Small Cap 38.82%	Global REITs 15.89%	Muni Bonds 2.45%	US Small Cap 21.31%	MSCI EM 37.28%	Muni Bonds 1.64%	US Large Cap 31.43%	10yr Treas 12.68%	US Large Cap 8.91%	MSCI EM 21.84%
COMM. 21.36%	MSCI EM 32.14%	COMM. 16.23%	US Bonds 5.24%	Global REITs 38.26%	Global REITs 20.40%	US Bonds 7.84%	MSCI EM 18.22%	US Large Cap 33.11%	US Large Cap 13.24%	US Large Cap 0.92%	US Large Cap 12.05%	MSCI EAFE 25.03%	US Bonds 0.01%	US Small Cap 25.52%	US Bonds 6.14%	US Small Cap 7.01%	US Small Cap 19.76%
Global REITs 15.35%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	Muni Bonds 4.23%	MSCI EAFE 31.78%	MSCI EM 18.88%	Muni Bonds 7.62%	MSCI EAFE 17.32%	MSCI EAFE 22.78%	10yr Treas 10.72%	10yr Treas 0.91%	COMM. 11.77%	US Large Cap 21.69%	10yr Treas -0.03%	Global REITs 23.06%	Muni Bonds 2.12%	MSCI EM 6.33%	Global REITs 19.64%
MSCI EAFE 13.54%	US Small Cap 18.37%	Diversified 10.91%	Illiquid HF -19.03%	US Large Cap 28.43%	COMM. 16.83%	US Large Cap 1.50%	US Large Cap 16.42%	Diversified 15.60%	US Bonds 5.97%	US Bonds 0.55%	MSCI EM 11.19%	Diversified 17.29%	Global REITs -4.74%	MSCI EAFE 22.01%	Liquid HF -1.09%	Diversified 5.88%	MSCI EAFE 17.01%
Diversified 10.39%	Diversified 17.36%	Illiquid HF 9.95%	Liquid HF -23.25%	Diversified 27.48%	US Large Cap 16.10%	Diversified -3.56%	US Small Cap 16.35%	Illiquid HF 9.14%	US Small Cap 4.89%	Global REITs 0.05%	Diversified 7.11%	US Small Cap 14.65%	Illiquid HF -4.75%	Diversified 19.53%	US Large Cap -2.81%	Global REITs 4.85%	COMM. 16.51%
Illiquid HF 9.27%	US Large Cap 15.46%	10yr Treas 9.76%	Diversified -30.77%	US Small Cap 27.17%	Diversified 12.00%	US Small Cap -4.18%	Diversified 12.54%	Liquid HF 6.73%	Muni Bonds 4.66%	MSCI EAFE -0.81%	Illiquid HF 5.46%	Global REITs 11.42%	US Large Cap -4.78%	MSCI EM 18.42%	Illiquid HF -3.43%	10yr Treas 4.74%	US Large Cap 15.01%
US Large Cap 6.27%	Illiquid HF 12.89%	US Bonds 6.97%	US Small Cap -33.79%	Illiquid HF 20.01%	Illiquid HF 10.24%	Illiquid HF -5.25%	Illiquid HF 6.37%	Global REITs 4.39%	Diversified 3.79%	Illiquid HF -1.11%	Global REITs 4.99%	Illiquid HF 8.58%	Liquid HF -6.74%	Illiquid HF 10.48%	Diversified -5.33%	US Bonds 4.39%	Diversified 11.47%
US Small Cap 4.55%	Liquid HF 9.25%	US Large Cap 5.77%	COMM. -35.65%	COMM. 18.91%	10yr Treas 7.90%	Global REITs -5.82%	US Bonds 4.21%	Muni Bonds -0.32%	Illiquid HF 2.98%	Diversified -2.23%	US Bonds 2.65%	Liquid HF 5.98%	Diversified -7.07%	10yr Treas 8.91%	MSCI EM -9.78%	Illiquid HF 4.22%	10yr Treas 7.01%
Liquid HF 2.72%	US Bonds 4.33%	Muni Bonds 4.79%	US Large Cap -37.60%	Liquid HF 13.40%	MSCI EAFE 7.75%	Liquid HF -8.88%	10yr Treas 4.18%	US Bonds -2.02%	Liquid HF -0.57%	Liquid HF -3.64%	Liquid HF 2.51%	US Bonds 3.54%	US Small Cap -11.01%	US Bonds 8.72%	MSCI EAFE -11.34%	MSCI EAFE 4.09%	Illiquid HF 6.37%
US Bonds 2.43%	Muni Bonds 3.74%	Liquid HF 4.24%	MSCI EAFE -43.38%	Muni Bonds 7.18%	US Bonds 6.54%	MSCI EAFE -12.14%	Muni Bonds 3.56%	MSCI EM -2.60%	MSCI EM -2.19%	US Small Cap -4.41%	MSCI EAFE 1.00%	Muni Bonds 3.49%	COMM. -11.25%	Liquid HF 8.63%	US Small Cap -12.98%	Muni Bonds 3.58%	Liquid HF 5.65%
10yr Treas 1.99%	COMM. 2.07%	US Small Cap -1.57%	Global REITs -47.72%	US Bonds 5.93%	Liquid HF 5.19%	COMM. -13.32%	Liquid HF 3.51%	10yr Treas -7.83%	MSCI EAFE -4.90%	MSCI EM -14.92%	Muni Bonds -0.10%	10yr Treas 2.07%	MSCI EAFE -13.79%	COMM. 7.69%	COMM. -19.40%	Liquid HF 0.90%	US Bonds 3.21%
Muni Bonds 1.67%	10yr Treas 1.36%	Global REITs -6.96%	MSCI EM -53.33%	10yr Treas -9.71%	Muni Bonds 3.13%	MSCI EM -18.42%	COMM. -1.06%	COMM. -9.52%	COMM. -17.01%	COMM. -24.66%	10yr Treas -0.16%	COMM. 1.70%	MSCI EM -14.57%	Muni Bonds 5.63%	Global REITs -20.93%	COMM. -4.34%	Muni Bonds 2.85%
2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD 2020	15-Year Annualized Return	15-Year Annualized Volatility#

Worst Performance

*Diversified asset allocation: 20% U.S. Large Cap Equities; 20% U.S. Municipal Bonds; 20% Hedge Funds (10% Absolute Return, 10% Market Directional); 15% Int'l Developed Equities; 5% U.S. Small Cap Equities; 5% Emerging Markets Equities; 5% Global REITs; 5%, Commodities; 5% Managed Futures.

Past performance is no guarantee of future results. Data as of 6/30/2019. Returns are for period and index indicated (see Disclosures page for index definitions). "Diversified Allocation" returns assume monthly rebalancing.

Source of Data: Morningstar, Hedge Fund Research.

The chart above highlights annual returns on a diversified portfolio consisting of the asset classes noted in the footnote, for each year from 2005 to 2020 (as of June 30, 2020). The last two columns show 15-year annualized returns and price volatility for the diversified portfolio as well as for the asset classes. Sought out as safe havens amid the uncertainty posed by Covid-19, we've seen the dramatic resurgence of large-cap US equities, with the US tech giants leading the way. Meanwhile, most other types of US and foreign stocks have posted negative returns, along with most commodities and other assets. This has resulted in diversified portfolios finishing the first half of 2020 in the red.

ABOUT THE AUTHOR

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