Economic and Market Analysis

# The Light at the End of the Tunnel

**Third Quarter**
**2020**

UMB

UMB Investment Management appreciates this opportunity to share our insight with you.


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## The Light at the End of the Tunnel

The economy continued its reopening process throughout the third quarter. The labor market is healing, workers are being called back to work and the unemployment rate is improving. Consumers were supported by jobs and fiscal stimulus, resulting in robust consumption. The COVID-19 global pandemic continues, but the data suggests there is light at the end of the tunnel. In the second quarter, U.S. GDP contracted by 31%, which was unprecedented — something the economy had not seen in either the Great Recession or the Depression. In the third quarter, we expect to see another unprecedented event, this time a significant recovery, with U.S. GDP up 25% (some estimates are as high as 35%) — again, something the economy had not seen in either the Great Recession or the Depression.

## Economic Data

The third quarter economic data indicates there is light at the end of the tunnel. There are risks that remain, such as COVID-19 outbreaks, the termination of numerous stimulus programs and the uncertainty of new stimulus programs.

- **Economic Activity:** As global economies reopened in Q3 and fiscal stimulus supported consumers' consumption behaviors, economic activity robustly rebounded. We expect Q3 GDP to improve by 25%; the risk could be to the upside. However, if there is a resurgence in COVID-19 cases and stimulus programs are not replaced or extended, a household fiscal cliff may develop and consumption may plateau, putting Q4 GDP in jeopardy.
- **Initial Unemployment Claims:** The labor market, a proxy for economic conditions, is healing. Unemployment peaked in April at 14.7% as economies shut down and swiftly recovered by the end of Q3, down to 7.9%. The initial unemployment claims figure gives us clues to the direction of the future unemployment rate. Claims peaked in late March at 6.6 million and have recovered to approximately 850,000, still at an elevated level. To put in perspective, during the Great Recession, initial unemployment claims peaked at 665,000.
- **Consumer Confidence:** Confidence improved across all demographic groups. The Conference Board's Consumer Confidence index jumped in September, the largest improvement since 2003, led by consumer expectations due to an improved outlook in the labor market and business conditions. The increase in confidence and purchasing plans bodes well for consumer spending growth in the near term. Stimulus, stock market gains and housing prices all boosted confidence. As stimulus programs expire and are potentially replaced with less generous plans, confidence may stall. Spiking COVID-19 cases may also curb confidence, yet positive news on a vaccine will stabilize sentiment. Consumer confidence data indicates that perhaps consumers are seeing a light at the end of the tunnel.
- **Monetary and Fiscal Stimulus:** The fiscal response to COVID-19 has been unprecedented as the total fiscal stimulus has amounted to approximately 13% of GDP compared to the great financial crises at around 7% of GDP. Fiscal stimulus has supported consumption in Q3. However, many of the benefits have expired, presenting some risk to the recovery. More stimulus will be required to support growth. Many stimulus beneficiaries increased their savings in Q3, providing liquidity for consumption in the event of no additional stimulus. The Federal Reserve has ensured the public that low interest rates will remain a long-term strategy. Moreover, the Fed has engaged in aggressive quantitative easing, ballooning its balance sheet from approximately $4 trillion in February to just over $7 trillion today, which has helped risk assets.
- **Risks:** Numerous uncertainties remain: the COVID-19 virus, reversing reopening plans, changing stimulus plans, high-unemployment, trade tensions with China, an upcoming Presidential election and dislocations in the financial markets.

## Outlook

Even with a robust recovery in the second half of the year, 2020 annual GDP will contract between 3 and 4%. The economic rebound in the second half of the year is expected to continue into 2021. COVID-19 continues to be a point of uncertainty. We expect the Fed to take no further action in 2020, leaving short rates at virtually zero. We expect the S&P 500 to remain in a trading range between 3200-3600.

The table at right summarizes our 2020 forecasts:

| | |
|---|---|
| U.S. Real GDP Growth Rate | (3)%-(4)% |
| Global Real GDP Growth Rate | (4)-(5)% |
| S&P 500 Price Target | 3,300 |
| S&P 500 Operating EPS Growth | -20.00% |
| Projected 10-Year Treasury Rate | 0.75% |
| Fed Funds | 0.25% |

## Equity Markets – The Light at the End of the Tunnel

### Quarter Recap

In the third quarter, the S&P 500 rose 8.9%, reaching new all time highs. Many of the themes in the second quarter carried over to the third quarter. The market rallied due to the reopening of the economy, the anticipation of continued fiscal stimulus and a potential vaccine/therapeutics on the horizon to combat the virus. Positive vaccine news and a gradual reopening of the economy have given investors increased visibility into a corporate earnings recovery in 2021. The stock market, a leading indicator, clearly sees some light at the end of the tunnel.

### The Presidential Election Impact on the Stock Market

While elections can create short-term volatility in the markets, over the long-term, they have limited impact on returns. Over the last 75 years, the market has returned on average 11% per year and has done well under both Democrat and Republican administrations.

The Democrats' proposal to increase tax rates will negatively impact corporate earnings growth rates. However, the aggressive fiscal stimulus proposal proposed by Democrats should offset some of this earnings impact. So, we believe we may see some volatility in markets if taxes are increased, but longer-term, the benefits of fiscal stimulus will lead to more consumption and higher markets.

The Republican proposal includes lower taxes and less aggressive fiscal stimulus. Again, this perhaps may result in mixed outcomes: lower taxes may be beneficial for corporate earnings, yet without stimulus, consumption may decline in the short term.

### COVID-19 Impact on the Stock Market

COVID-19 still represents a significant risk to earnings and the stock market. However, there is light at the end of the tunnel due to the following: 1) while cases are ticking higher, the increase in hospitalizations and deaths remain under control; and 2) in the short run, better therapeutic options are lowering the death rate and in the longer term, a vaccine is likely to be widely distributed by the middle 2021, which will help the economy return to normal.

### Valuation

Traditional valuation metrics, such as the price to earnings (P/E) ratio, indicate the market is overvalued. The S&P 500 trades at 22x forward earnings vs. a long-term average of 16x. However, the dividend yield on the S&P 500 is 1.7% vs. a 10 year treasury yield of 0.8%, which makes owning equities attractive relative to bonds (a dividend yield higher than the 10 year treasury yield indicates stocks are cheaper than bonds).

### Forecast

Our revised S&P 500 forecast is 3300 for 2020. Our 2020 forecast represents approximately 22 times our 2021 EPS estimate of $150. While a higher multiple is justified due to the Fed and low interest rates, our short-term forecast is for the market to be in a trading range of 3200-3600. Our 2021 S&P 500 price target is 3600.

## Bond Markets – The Light at the End of the Tunnel

### Quarter Recap

The third quarter was much quieter than the first half of the year. Interest rates moved mostly sideways. The Fed's ongoing pledge to do whatever it takes to keep financial conditions accommodative (see page 9) kept investors hungry for risk assets. This drove up equity prices and kept the tailwind in place for the corporate and high yield sectors. Returns were solid, but have begun to lose momentum as rates have fallen nearly to zero and corporate spreads have made a full recovery.

The Fed has effectively gone "all in" by expressing an intention to hold overnight rates near zero through 2023. They've also hinted that they will use open market purchases to ensure that longer rates remain near the current historical lows. This has pushed mortgage rates to all-time lows — which has helped keep the housing market moving along at a very brisk pace. Additionally, another huge wave of mortgage refinancing has put extra discretionary cash into consumers' pockets, which is clearly some light at the end of the tunnel.

The massive level of Federal stimulus has never been seen before and has resulted in an unprecedented growth in the money supply. Zero rates, massive money supply growth and massive growth in the Federal debt burden have ignited a heated debate over the likelihood and timing of a resurgence in inflation (see page 10). While there are numerous dis-inflationary forces that are keeping headline inflation dormant at this time, we believe that a modest resurgence is likely — albeit at least 2-3 years in the future. The debate will continue to simmer, but the inflation figures are likely to remain subdued for long enough to be outside of the current actionable time horizon (12-24 months).

### High-yield spreads

High yield continued its run of strong performance, spurred onward by ongoing stimulus commitments from the Federal Open Markets Committee (FOMC). With the Fed keeping monetary policy at "full throttle" and Congress assumed to be closing in on another round of Fiscal stimulus, the high yield markets are likely to enjoy enough of a tailwind to help drive a reasonably attractive return stream for the next 6-12 months. As with the rest of the bond market, the return stream is losing momentum, but simply collecting the coupon yield of 4.5% should make it a strong alternative relative to other sectors of the market.

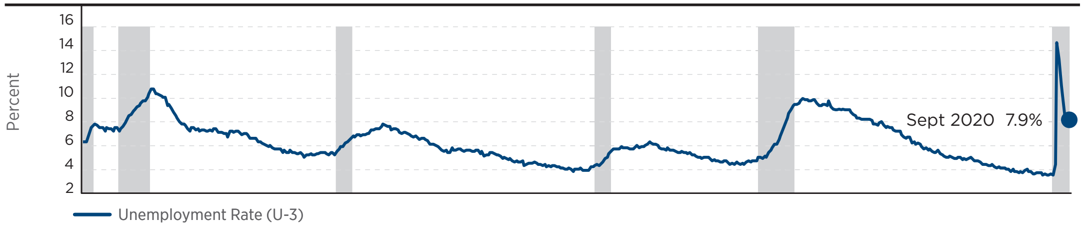
### Forecast

We believe the Fed will stand firm on its pledge to keep rates anchored near zero — at least through 2021, perhaps longer. Given the many uncertainties around the upcoming political environment and the reopening of the economy (post-COVID-19), longer-term rates are unlikely to move meaningfully higher. This should allow fixed income investors to at least collect their portfolio yield. However, this also means that the decades-long run of 5-10% returns from bonds has likely come to a close. We are much more likely to be facing several years of returns in the 1.0% range.

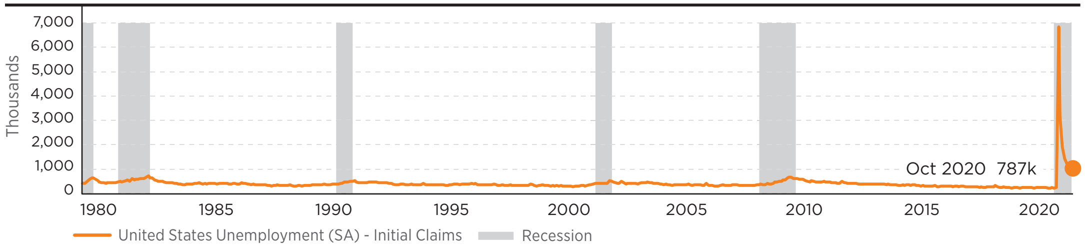
# Economy – Labor Market and Personal Income

## LABOR MARKET

### Unemployment Rate




### Initial Unemployment Claims

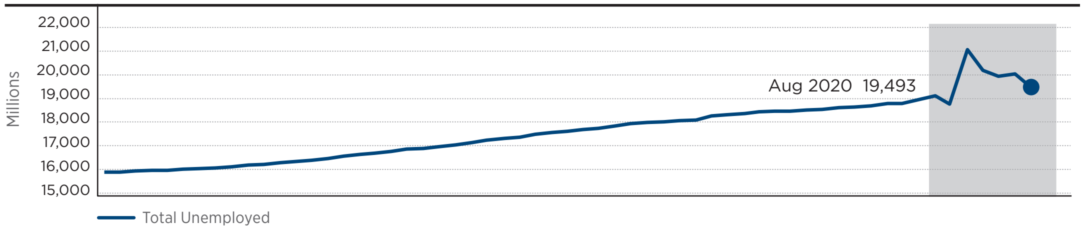



Source for all: Refinitiv Datastream: UMB Investment Management

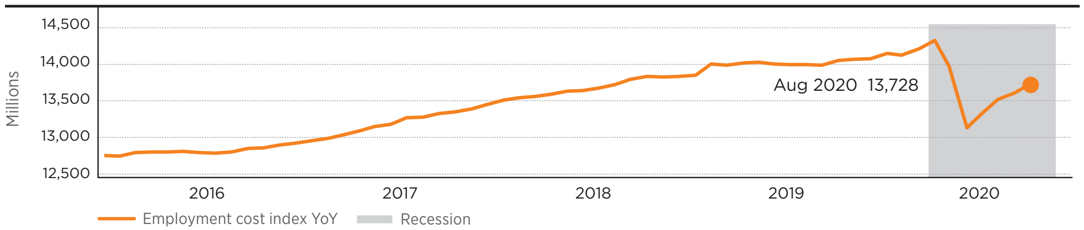
- The headline unemployment rate continues to decline. After peaking at 14.7% in April, the unemployment rate in September was 7.9%. Much of the improvement is due to a decrease in temporary layoffs. Non-farm payroll gains continue to slow gradually, suggesting unemployment may plateau and the economic rebound is entering a weaker phase.
- The initial unemployment claims figure indicates what may happen to the future unemployment rate. Claims have come down over the past several months and are showing signs of stabilization. At the end of the quarter, initial unemployment claims were close to 850,000 per week and continuing claims were 11 million.
- We think the unemployment rate improvement will slow and end the year around 7-8%, much higher than pre-crisis levels of 3.5%.

## PERSONAL INCOME

### U.S. Personal Income




### U.S. Personal Income Less Transfer Payments

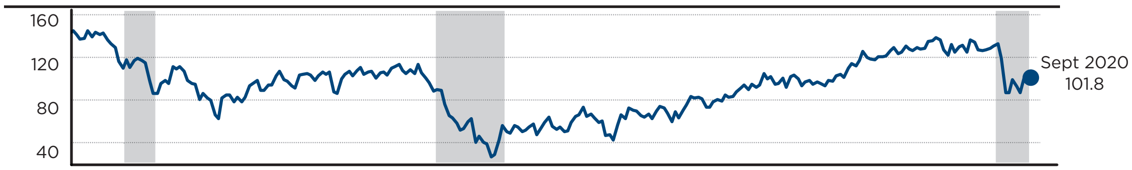



Source for all: Refinitiv Datastream: UMB Investment Management

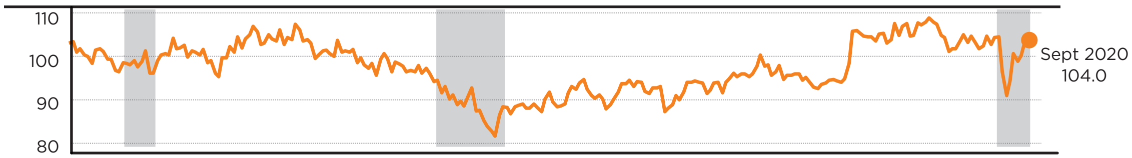
- Fiscal stimulus programs such as extended unemployment benefits and direct payments to consumers boosted personal income. Unfortunately, many fiscal stimulus programs expired in the third quarter and personal incomes are now declining.
- Personal income fell 2.7% in August, down in three of the past four months. Government transfer payments dropped 21.2%, mostly due to the expiration of the $600/week unemployment benefit.
- The personal saving rate fell to 14.1% in August from a high of 33.6% in April. However, it is still nearly double its pre-pandemic level, and close to the highest it has been since 1975, indicating the consumer is still in a solid financial position.

## CONSUMER AND BUSINESS CONFIDENCE

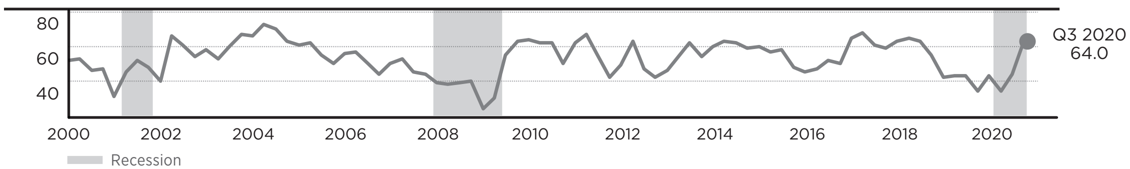
### Consumer Confidence - Conference Board




### NFIB Small Business Optimism




### CEO Confidence

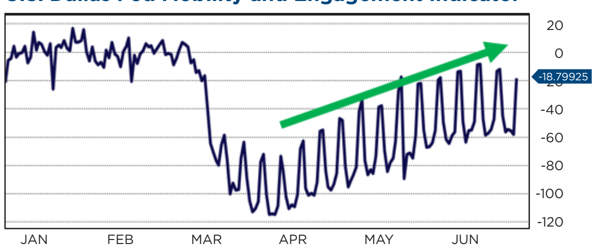



Source for all: Refinitiv Datastream: UMB Investment Management

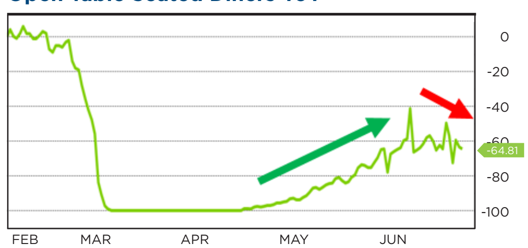
- Consumers and business owners see the light at the end of the tunnel. Confidence is critical for economic growth. The most recent readings have recovered nicely following the sharp contraction earlier this year.
- Despite consumer confidence still being well off its level from earlier this year, the recent month-over-month improvement of 15.5 points to the current level of 101.8 in consumer confidence was the best monthly change since April 2003.
- Businesses, both small and large, also saw a rebound in confidence.
- For the rebound in confidence to be sustainable, consumers need the following to boost confidence: 1) COVID-19 vaccine, 2) a treatment, 3) hospital capacity, 4) wide-spreading testing, 5) a stable labor market and 6) continued fiscal policy support from the government.

## 2020 HIGH FREQUENCY ECONOMIC INDICATORS

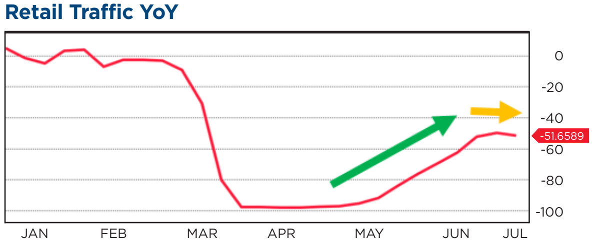
### U.S. Dallas Fed Mobility and Engagement Indicator



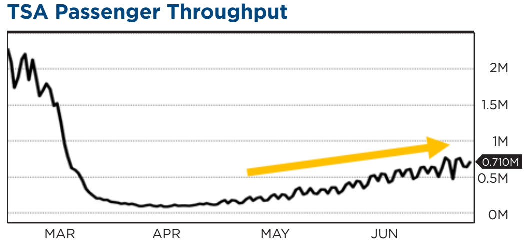

### Open Table Seated Diners YoY




### Retail Traffic YoY




### TSA Passenger Throughput

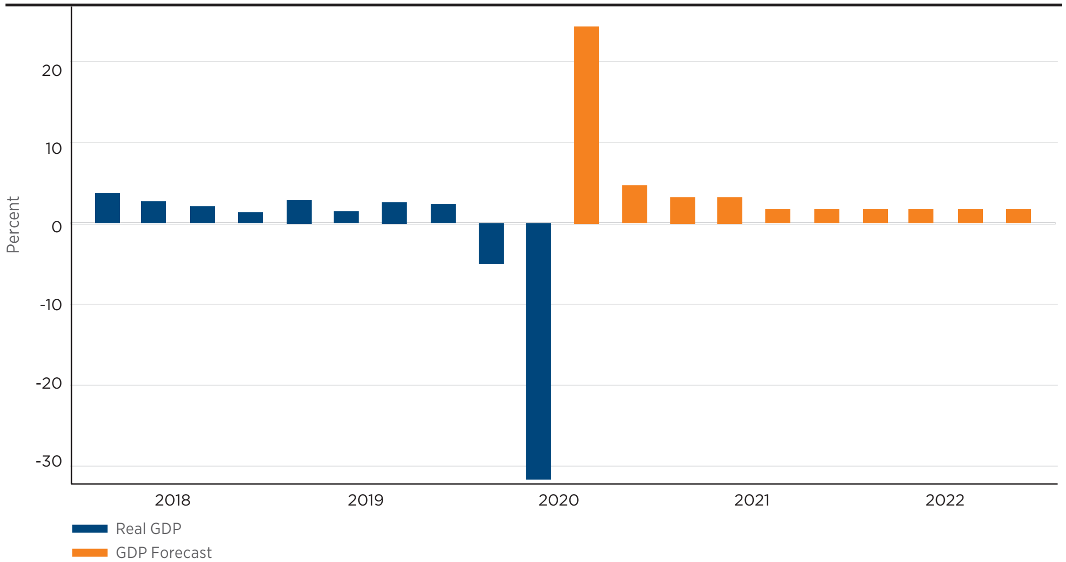



Source for all: Bloomberg; UMB Investment Management

- Most economic datapoints are lagging in nature; we receive the economic data one to two months after the reference month. Given the speed at which economic conditions are changing due to COVID-19 and to better assess the recovery, it is critical to analyze real-time, or high-frequency, data.
- There are a number of daily mobility indicators, such as traffic and restaurant reservations. The high-frequency data has confirmed a sharp rebound from March-April, but due to the recent surge in COVID-19 across the U.S., many of the high-frequency datapoints have begun to plateau in June.
- This confirms our view that in order to see a sustainable rebound in the economy, the consumer requires a safe, convenient and familiar environment.

# Economy – Real GDP and Fiscal Stimulus

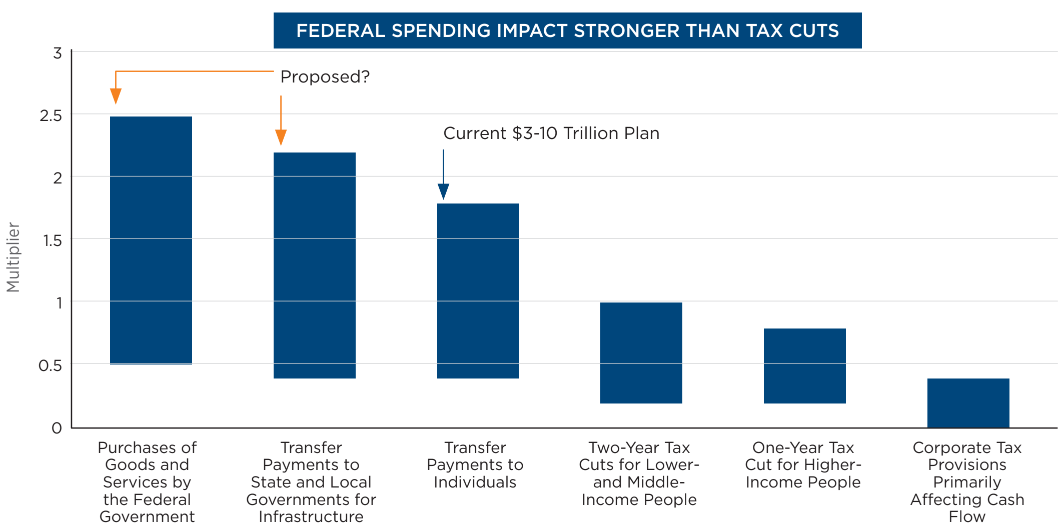
## Real GDP – Quarter over Quarter Seasonally Adjusted Annual Rate (QoQ SAAR)




Source: Refinitiv Datastream: UMB Investment Management

- We expect third quarter GDP to robustly rebound by 25-30% on an annualized basis. There is a large variance in Q3 forecasts, with the Atlanta Fed is estimating 35.3% and the New York Fed predicting 13.8%.
- Fourth quarter GDP hangs in the balance. According to the Congressional Budget Office, GDP growth without prior fiscal support would contract by 7%, creating a double dip recession. We do expect additional stimulus to be passed in Q4, making our GDP forecast for Q4 4.7%.
- Global economies have weathered the pandemic storm, aided by government support and consumers and businesses adapting to a new way of life due to the virus. Future sustainable economic growth will be slower than it was pre-crisis. We estimate that an additional $2 trillion stimulus plan is required to get back to pre-crisis economic activity levels.

## Fiscal Stimulus Multiplier Effect

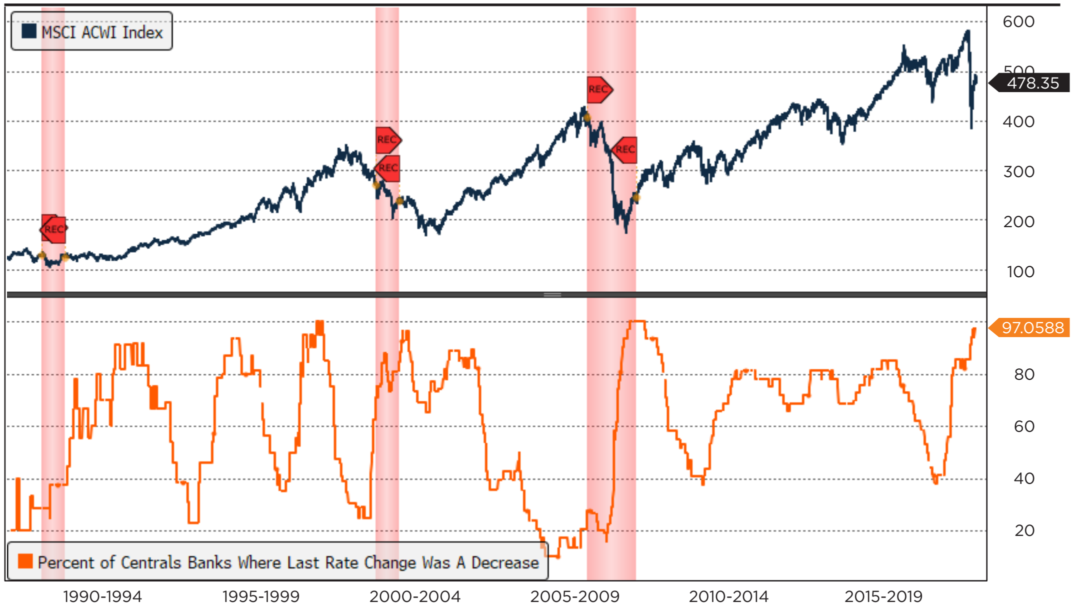



Source: Congressional Budget Office

- To combat the economic slowdown caused by the spread of COVID-19, the government passed the CARES act, a $2.2 trillion stimulus bill that provided direct relief to consumers and businesses.
- The fiscal multiplier effect measures how effective fiscal stimulus is in stimulating GDP growth. A fiscal multiplier greater than 1 means that each $1 in fiscal stimulus generates more than $1 in GDP. Transfer payments to individuals tends to be highly effective in stimulating economic growth.
- There is a high probability that additional stimulus via an infrastructure spending package will be discussed on Capitol Hill.

# Equity Market – Don’t Fight the Fed and Valuation

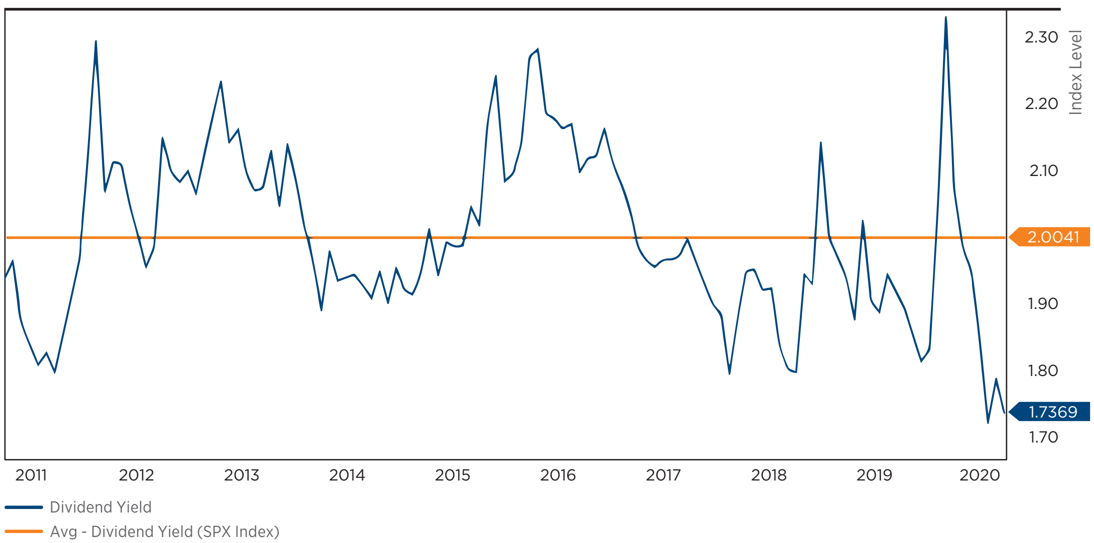
## Don’t Fight the Fed




Source: Bloomberg; UMB Investment Management

- “Don’t fight the Fed” is an old adage on Wall Street — meaning when the Fed is easing, you want to buy stocks and when the Fed is tightening, you want to sell stocks. Historically, this has proven to be very sage advice.
- The Fed has engaged in unprecedented monetary policy in an effort to support both the economy and financial markets through the COVID-19 crisis. This highly accommodative monetary policy has resulted in tremendous amounts of liquidity in the financial system and cash on the sidelines ready and willing to support financial markets.
- As the chart to the left shows, when central banks are cutting interest rates, it tends to bode well for future stock market returns. Today, nearly all of the central banks around the world are cutting interest rates. Many, like the Fed, are going further, engaging in unconventional policy.

## S&P 500 Dividend Yield

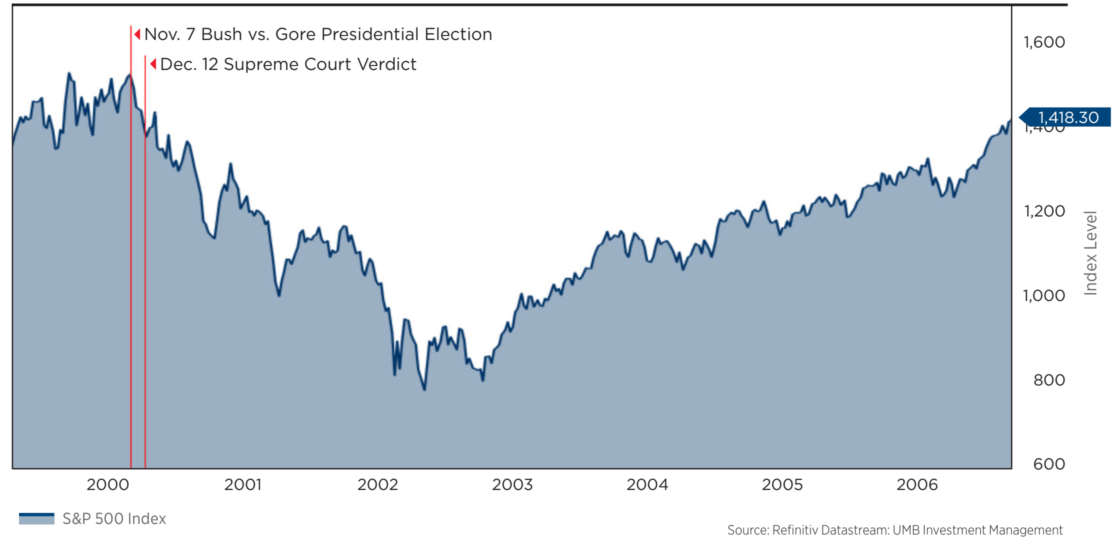



Source: Bloomberg; UMB Investment Management

- One valuation metric is to examine the dividend yield of the S&P 500 and compare it to the yield on bonds.
- These low interest rates on bonds is the reason for the saying known as TINA — “there is no alternative” right now other than stocks.
- The current dividend yield on the S&P 500 is 1.7% vs 0.8% for the 10-year treasury bond. A dividend yield higher than the 10-year treasury yield means that stocks are cheap relative to bonds.

# Equity Market – Election and COVID-19 Trends

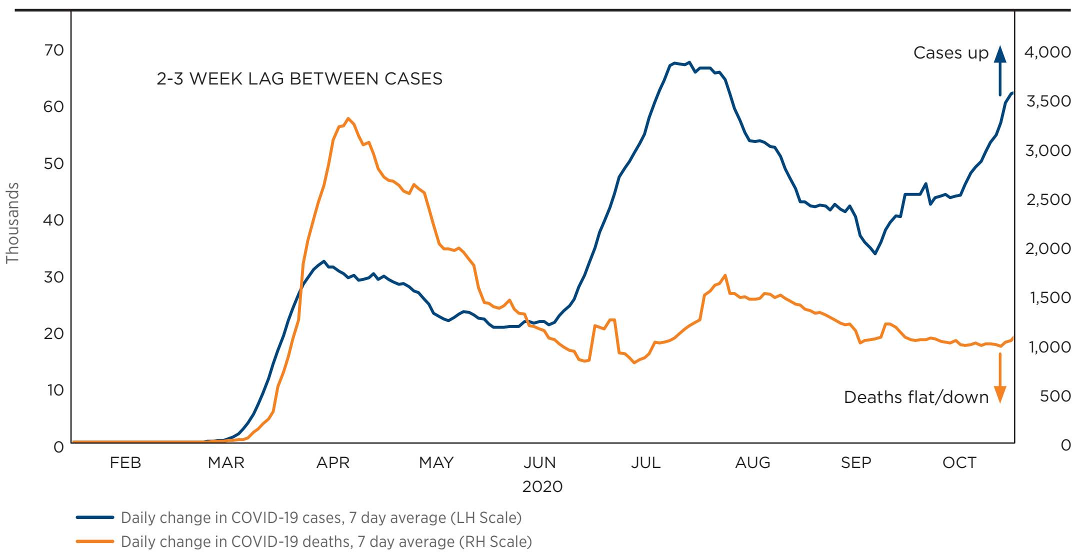
## 2000 Contested Election




Source: Refinitiv Datastream: UMB Investment Management

- There is concern that a contested election will create market volatility. During the 2000 presidential election, which was contested, market volatility increased due to the uncertainty.
- However, we would argue that the market volatility surrounding the 2000 presidential election was driven by a slowing economy and the tech bubble.
- Over the longer term, the market recovered strongly as uncertainty faded and the economy improved.

## U.S. COVID-19 Cases and Deaths

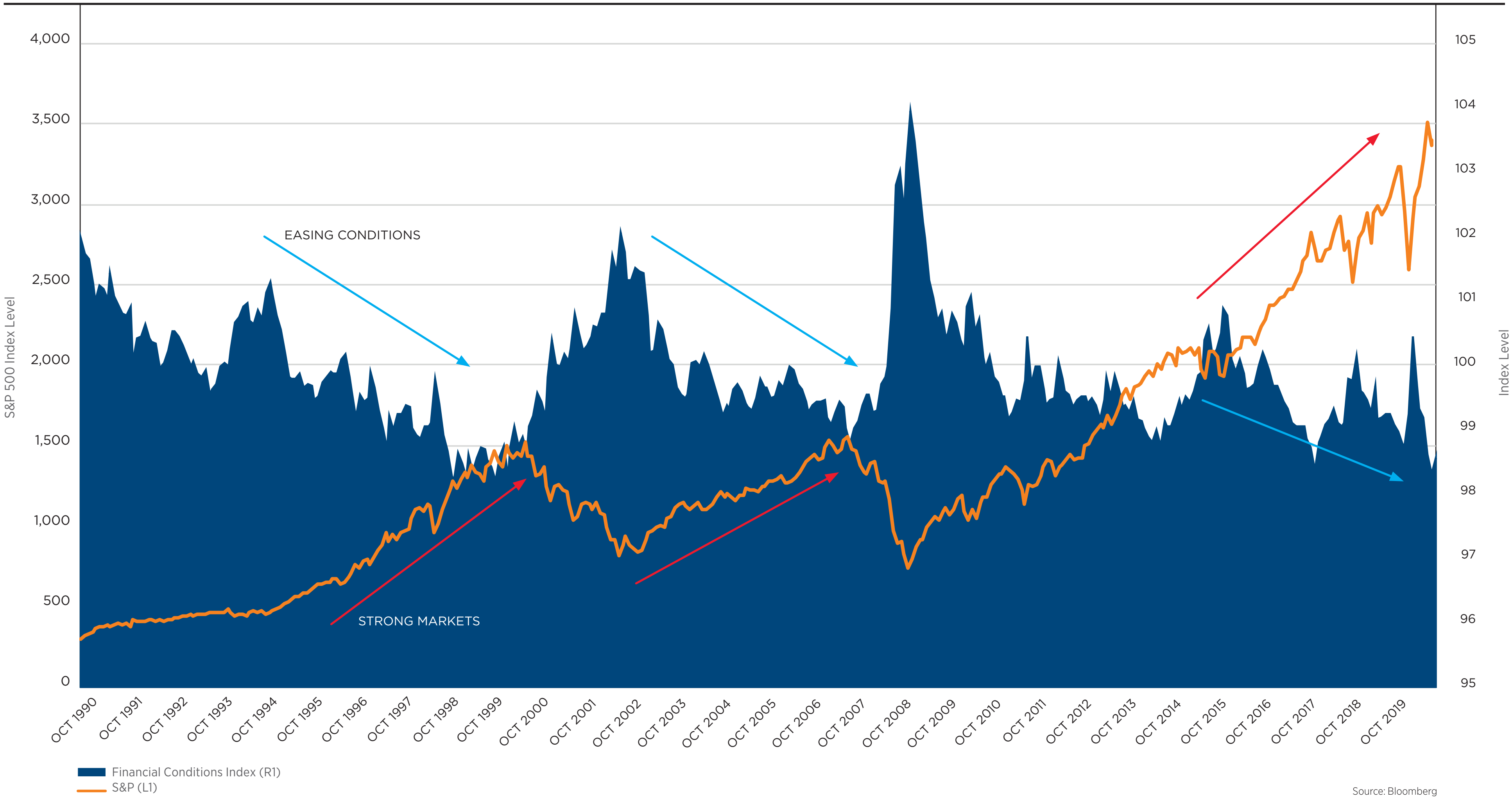



Source: Refinitiv Datastream: UMB Investment Management

- The spread of COVID-19 remains a risk to our equity market forecast. We think the market now responds to the trend in hospitalizations and deaths, not the number of cases.
- Currently, we are seeing a divergence. The number of cases has increased significantly but deaths have remained fairly low. If the number of deaths move higher, we could see economic activity stall, which would hurt earnings and therefore the market. Back in April, there was a 2-3 week lag between cases and deaths. We hope to see the divergence continue.
- Spikes in cases and deaths around the world and news on delays of a vaccine will put downward pressure on equities.

# Financial Conditions Support the Markets

## Softening Financial Conditions Support Economy and Markets

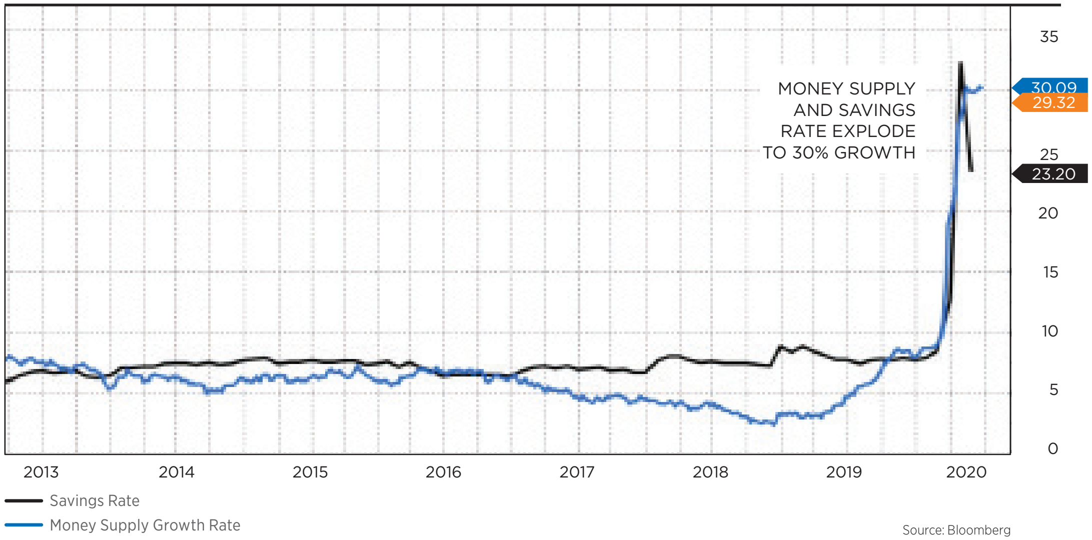



Source: Bloomberg

- Financial conditions are a combination of interest rates, availability of credit, asset valuations and exchange rates.
- Easing financial conditions consistently help drive the economy and markets higher.
- The various recent initiatives of the FOMC are part of a broad commitment to maintain easy financial conditions for the foreseeable future.
- Soft financial conditions should be supportive of at least a moderately positive outlook for both the economy and markets.

# Bond Market – Money Supply and Inflation

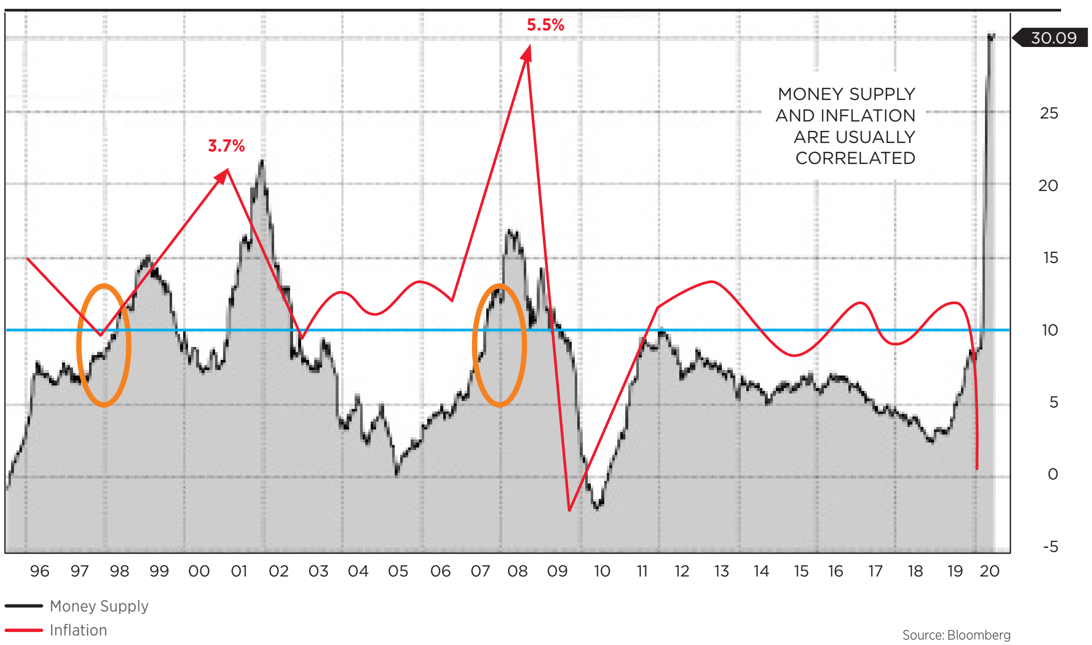
## Money Supply and Savings




Source: Bloomberg

- The Fed stimulus programs have pumped trillions of dollars into the pockets of consumers and businesses.
- This has resulted in an unprecedented explosion in money supply growth.
- When the economy is shut down, the stimulus cannot be spent. Therefore, we've seen a huge accumulation of savings — skyrocketing the savings rate.
- Once consumers are able to deploy the stimulus dollars, the velocity of money will increase, igniting a concern about inflation.

## Money Supply and Inflation




Source: Bloomberg

- Rapid expansion of the money supply (above 10%) has typically been correlated with a spike in Inflation.
- The money supply is currently unprecedented in its expansion rate, but it is trapped in savings.
- If the pandemic drags on, and Fed stimulus is expanded, the money supply will expand further.
- Once stimulus money starts to flow (meaning that the velocity of money increases), the debate about Inflation threats will be ignited.

# U.S. Market Performance – Equity and Fixed Income

## Equity Market Performance

| Equity Index/Sector | Total Return % as of 9/30/2020 1 Month | 3 Month | YTD | 1 Year |
|---|---|---|---|---|
| S&P 500 | **-3.80** | **8.93** | **5.57** | **15.14** |
| Information Technology | -5.37 | 11.95 | **28.69** | 47.23 |
| Consumer Discretionary | -3.62 | 15.06 | **23.38** | 28.89 |
| Communication Services | -6.47 | 8.94 | **8.60** | 18.37 |
| Materials | 1.34 | 13.31 | **5.47** | 12.19 |
| Health Care | -2.15 | 5.87 | **5.01** | 20.11 |
| Consumer Staples | -1.48 | 10.38 | **4.13** | 7.79 |
| Industrials | -0.76 | 12.47 | **-3.99** | 1.29 |
| Utilities | 1.13 | 6.14 | **-5.68** | -4.97 |
| Real Estate | -2.04 | 1.92 | **-6.77** | -7.28 |
| Financials | -3.48 | 4.44 | **-20.25** | -11.93 |
| Energy | -14.51 | -19.72 | **-48.09** | -45.24 |

- The S&P 500 rose 8.9% in Q3 due to the reopening of the economy, vaccine hopes and anticipation of fiscal stimulus.
- The stock market is signaling an economic recovery. This is evidenced by the strong gains in cyclical sectors, which are dependent on an improving economy. The consumer discretionary, materials and the industrial sectors were up 15.1%, 13.3%, and 12.5% in the third quarter, respectively.
- While still bullish on the tech sector, outperforming the market by nearly 23% YTD, this part of the market needs a short-term breather.

## Bond Market Performance

| Fixed Income Index/Sector | Total Return % as of 9/30/2020 1 Month | 3 Month | YTD | 1 Year |
|---|---|---|---|---|
| Intermediate Gov Credit | -0.01 | 0.61 | **5.92** | 6.32 |
| Intermediate Aggregate | -0.03 | 0.48 | **5.16** | 5.66 |
| US Treasury Long | 0.38 | 0.12 | **21.35** | 16.34 |
| U.S. Treasury | 0.14 | 0.17 | **8.90** | 8.04 |
| Corporate Long | -0.47 | 1.91 | **8.36** | 9.81 |
| U.S. Gov/Credit | -0.05 | 0.78 | **8.04** | 8.03 |
| A | -0.28 | 1.18 | **7.64** | 8.42 |
| Aa | -0.05 | 0.91 | **6.99** | 6.95 |
| U.S. Aggregate | -0.05 | 0.62 | **6.79** | 6.98 |
| US Treasury Intermediate | 0.07 | 0.19 | **6.02** | 6.03 |
| Baa | -0.34 | 2.11 | **5.18** | 6.96 |
| US Agency Intermediate | 0.11 | 0.28 | **4.01** | 4.34 |
| MBS Fixed Rate | -0.11 | 0.11 | **3.62** | 4.36 |

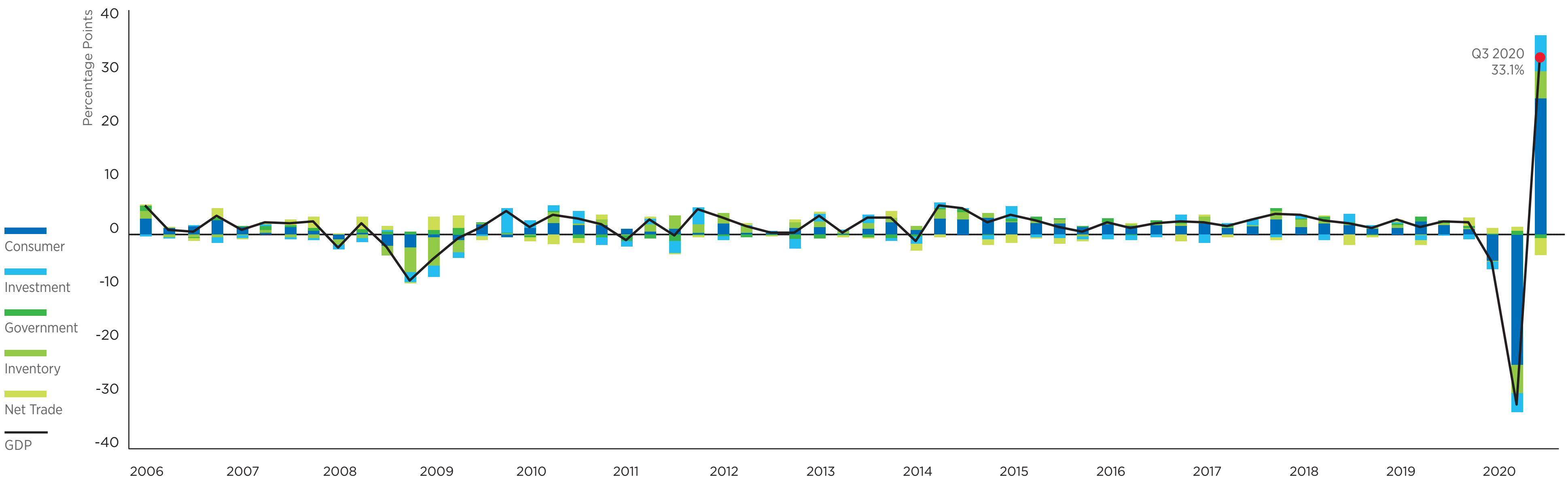
Green = YTD outperformance
Blue = YTD underperformance

Source: Bloomberg

- Continued flows into risk assets resulted in the credit (corporate) sectors again posting the top performance for the quarter.
- Interest rates were largely unchanged.
- Fixed income returns for the quarter and year-to-date continue to be outstanding, although the momentum is tapering off.
- Going forward, returns are likely to taper down to yield collection — in the 1.00% range.

# Real Gross Domestic Product (GDP)

## U.S. Contributions to GDP Growth




Source: Refinitiv Datastream; UMB Investment Management

## % Contribution to GDP by Quarter

| Component | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 |
|---|---|---|---|---|---|---|
| Consumption | 3.0 | 2.1 | 1.2 | -4.8 | -24.0 | 25.3 |
| Investment | -1.2 | -0.2 | -1.1 | -1.5 | -8.8 | 11.6 |
| Net Exports | -0.6 | -0.1 | 1.5 | 1.1 | 0.6 | -3.1 |
| Government | 0.8 | 0.3 | 0.5 | 0.2 | 0.8 | -0.7 |
| **Total** | **2.0** | **2.1** | **2.1** | **-5.0** | **-31.4** | **33.1** |

Source: Thomson Reuters Datastream; UMB Investment Management

## UMB GDP Forecast*

| Year | Q1 | Q2 | Q3 | Q4 | Year |
|---|---|---|---|---|---|
| **2017** | 2.3 (A) | 2.2 (A) | 3.2 (A) | 3.5 (A) | 2.4 (A) |
| **2018** | 2.5 (A) | 3.5 (A) | 2.9 (A) | 1.1 (A) | 2.9 (A) |
| **2019** | 3.1 (A) | 2.0 (A) | 2.1 (A) | 2.1 (A) | 2.3 (A) |
| **2020** | -5.0 (A) | -31.4 (A) | 33.1 (A) | 4.7 (E) | -3.4 (E) |

(A) = Actual, (E) = Estimate

Source: UMB Investment Management

*Quarter over Quarter Seasonally Adjusted Annual Rate

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