Quarterly Economic Update

December 16, 2020

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

By Michael McNair

Fiscal cliff

The Pandemic Unemployment Assistance (PUA) and Pandemic Emergency Unemployment Compensation (PEUC) is scheduled to expire on December 28th, causing 7-12 million workers to lose all jobless benefits. Another 3 million will shift to state Extended Benefit (EB) programs, which will give workers in certain states another round of regular benefits, typically lasting another 13 weeks.

The expiration of the PUA and PEUC would reduce direct fiscal support by $12-30 billion in Q1, and $23-41 billion in Q2-Q4.

The risk of 15 million Americans losing their jobless benefits has given Congress the impetus to pass a stage 4 fiscal stimulus before the end of the year. We expect that Congress will include some form of PUA & PEUC expansion in a fiscal package passed in Q4 or Q1, lasting between 6-12 months. However, as with prior cliffs, the expiration may occur first before Congress chooses to retroactively revive and extend the programs.

Stage 4 Stimulus

Congress has only days remaining to pass a stage 4 stimulus bill and avoid the expiration of the pandemic relief measures and the resulting fiscal cliff. The current continuing resolution funding the government runs out December 11th but there is a possibility that Congress passes a one-week continuing resolution, making December 18th the effective deadline for a relief bill to pass before various relief measures expire at the end of the year.

Fiscal negotiators have been haggling over a stage 4 stimulus since July. Republicans initially proposed a $1 trillion bill and the Democrats opened with $3.4 trillion. Both sides moved roughly 1/3 and countered with $1.3 trillion and $2.2 trillion for Republicans and Democrats, respectively. Mnuchin's final offer was $1.8 trillion and the parties appeared to be getting closer to a deal until the Treasury ceded control of the stimulus discussions to Mitch McConnell in November. McConnell promptly lowered the Republicans' offer from $1.8 trillion to $500 billion. While the size of the aid package has come down, the sides are fighting over the same three issues that caused the impasse in the summer: state aid, liability protections, and the dollar amount of the bill.

In the first week of December McConnell presented a $900 billion plan. McConnell's plan had several issues that were non-starters for Democrats, including no state fiscal relief, a quick phase-out of unemployment benefits after a one-month extension, and COVID-19 liability relief for businesses. On December 8th, McConnell suggested that he might be willing to set aside the proposed liability shield (a Republican priority) if

Democrats agreed to also set aside state & local aid until next year. This concession increases our odds of a deal getting done, as these were the two most contentious issues. However, we remain cautious as Senate Minority Leader Chuck Schumer has indicated that he is not in favor of dropping state & local aid in this bill.

Further complicating an agreement is a recent push to include a $600 stimulus check in the bill. Another round of stimulus checks has bipartisan support – including President Trump – but the cost would total $150 - 300 billion. The bipartisan framework already in place stands at $908 billion and the inclusion of stimulus checks would put the total cost of the bill over the $1 trillion limit that Republicans are seeking. However, if Democrats agree to postpone state & local aid until next year it would free up $160 billion and allow the inclusion of stimulus checks without exceeding the $1 trillion limit.

The $908 billion, Gang of 8 framework gives us a good Idea of what the stage 4 stimulus bill could entail, even if some of the provisions eventually fail to make the final bill. The $150-300 billion provision for stimulus checks was not included in the framework but look likely to make the final bill.

COVID Emergency Relief Framework

Major Issues	Cost Estimate
State, Local and Tribal Governments	$160 billion
Additional Unemployment Insurance (UI)	$180 billion
Support for small businesses including: Paycheck Protection Program (PPP), EIDL, restaurants, stages and deductibility	$288 billion
CDFI/MDI Community Lender Support	$12 billion
Transportation (Airlines, Airports, Buses, Transit and Amtrak)	$45 billion
Vaccine development and Distribution & Testing and Tracing	$16 billion
Healthcare Provider Relief Fun	$35 billion
Education	$82 billion
Student Loans	$4 billion
Housing Assistance (Rental)	$25 billion
Nutrition/Agriculture	$26 billion
U.S. Postal Service	$10 billion
Childcare	$10 billion
Broadband	$10 billion
Opioid Treatment	$5 billion
Provide short term Federal protection from Coronavirus related lawsuits with the purpose of giving states time to develop their own response.	
Total	**$908 billion**

Source: U.S. Congress and Cowen and Company

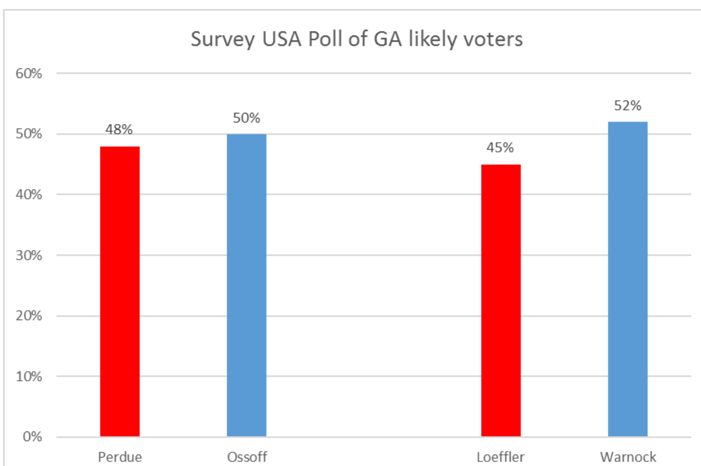
Policymakers are left with 3 possibilities:

1) A > $1 trillion bill which includes $600 stimulus checks, aid to state & local governments, COVID-19 liability protections for businesses, as well as the other provisions listed in the Group of 8 framework.
2) A medium-sized package that excludes aid to state & local governments as well as business liability protections.

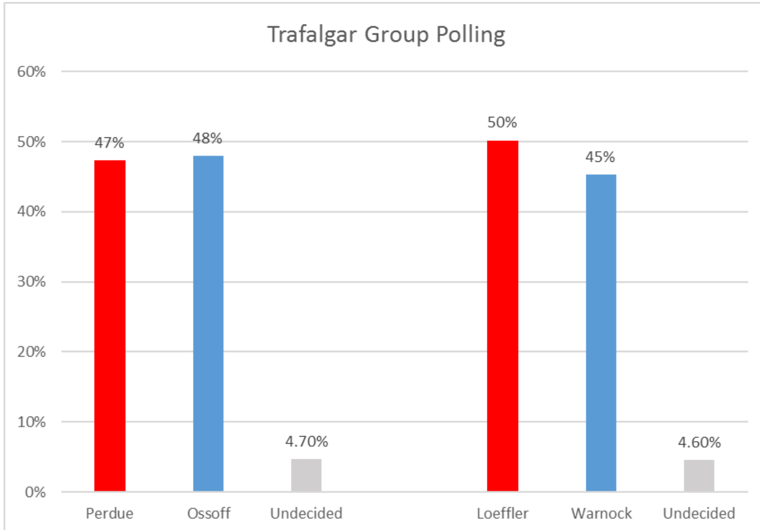
3) A skinny package that only includes vaccine funds, and unemployment extension, the reauthorization of the PPP program, and extension of the eviction moratorium.

The passage of a stage 4 stimulus bill before the end of the year is important to prevent a fiscal cliff that could put the economy into a double-dip recession before the new Congress and President can pass a stimulus package. However, the Georgia Senate race on January 5th is the most important factor determining the level of fiscal stimulus over the next two years. If Democrats win both seats in the run-off the Senate will be split 50-50 but Democrats will have control due to the tie-breaking vote of the Vice-President. It would be a mistake to assume that such a narrow margin will lead to gridlock. We believe that Democrats will be able to push through most of their policy agenda with budget reconciliation, which requires just 51 votes for fiscal policy changes. The budget reconciliation process requires Congress to approve a budget with a specific amount earmarked for spending and revenue changes. The Senate then passes legislation related to those spending and revenue changes without the ability for a Senate filibuster. The result is that legislation can pass with 51 votes instead of the traditional 60. The budget reconciliation process was used by President Obama to pass a portion of the Affordable Care Act and President Trump to pass his 2017 tax cut. The caveat is that the budget reconciliation process can only be fiscal and cannot directly change policy. Yet, the Democrats can use this process to boost spending on climate change, infrastructure, health care, and aid to state & local governments.

The betting odds currently give the Republicans a 65% chance of winning at least one of the Georgia Senate races and maintaining their majority. However, the Republican odds are trending down, as the race has tightened considerably. Recent polling has even shown that the Democrats have the lead.

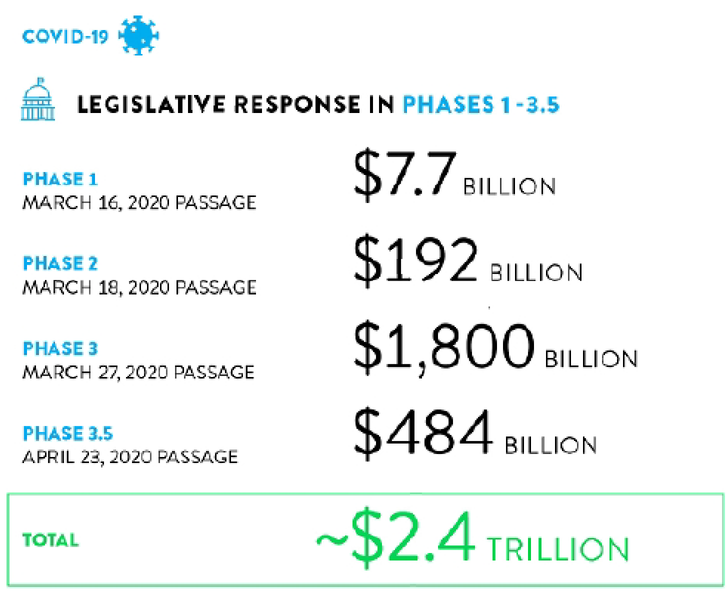


It is easy to dismiss the polls because they have overstated Democratic support throughout this election cycle. However, the Trafalgar polls, which have been labeled as "bad polls" with a Republican bias, have performed well in this cycle. While no poll is perfect, it is interesting to note that even the Trafalgar poll confirms the competitiveness of the two races.



Furthering the odds of a Democratic sweep is the apparent enthusiasm gap among Georgia Republicans. A recent Survey USA poll showed that 25% of Georgia Republicans stated that they “aren’t that interested” in the run-off election, compared to just 11% of Democrats. The reason for the apathy likely is a result of Republican’s distrust of the voting process. 20% of Georgia Republicans stated that they believe the voting process is rigged, compared to just 7% of Democrats.

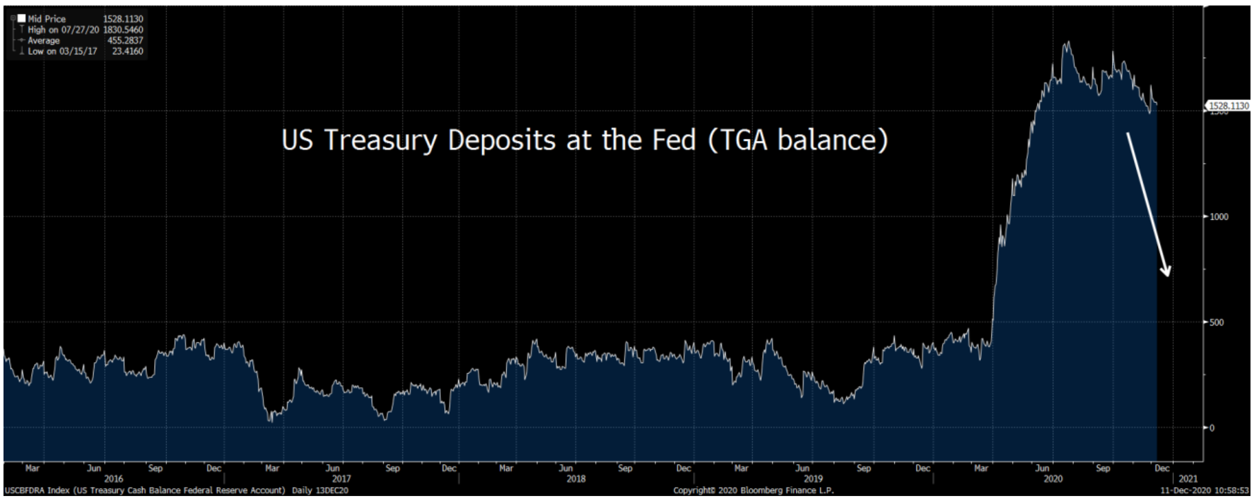
If the Democrats win both Georgia Senate seats, we expect a fiscal stimulus package of at least $3 trillion to be passed in early 2021. To put $3 trillion into context, the combined size of the previous four relief packages is $2.4 trillion.



Source: Cowen and Company

Even under a split government scenario, we expect fiscal policy to be highly stimulative in 2021. We believe the odds are over 50% for a stage 4 relief package in the $900 billion range passing before year-end. We also believe that once the new administration gets into office, they will be quick to pass another relief package in early 2021. Further adding to the stimulus, the Treasury has committed to drawing down the Treasury General Account (TGA) to $800 billion to fund the stimulus.

The TGA balance increases when the Treasury issues more bonds than they spend. Critically, the TGA cash sits at the Fed and cannot be lent out to the commercial banking system. It is the functional equivalent of stuffing cash under the mattress. Since the start of the year, the TGA balance has increased by $1.4 trillion. However, the drawdown of the TGA balance is now set to return $725 billion to the commercial banking system, raising deposits and money supply by 8% in the first half of 2021. It is no wonder the reflation trade has gained momentum. It is likely just getting started.

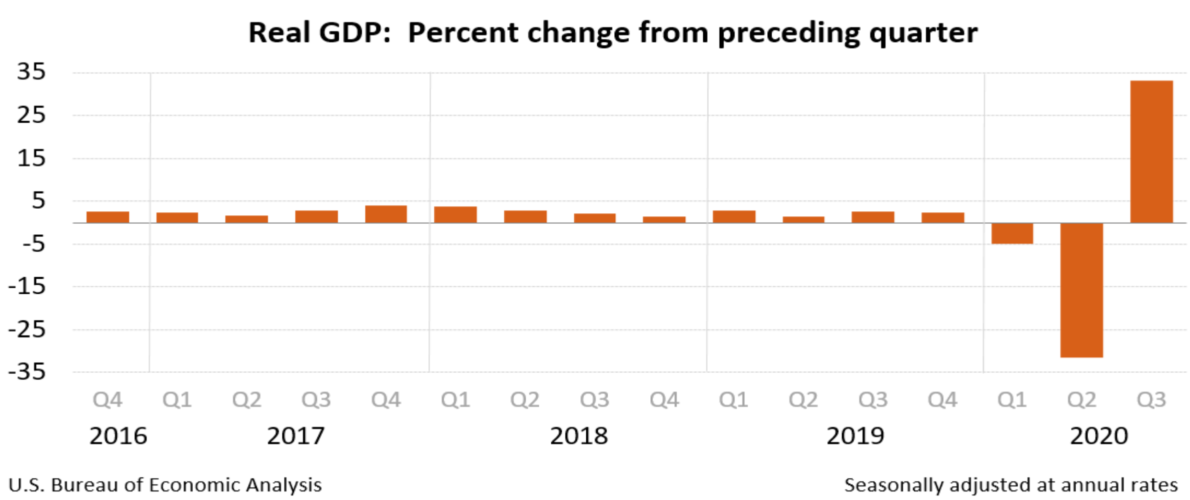


Economic Outlook

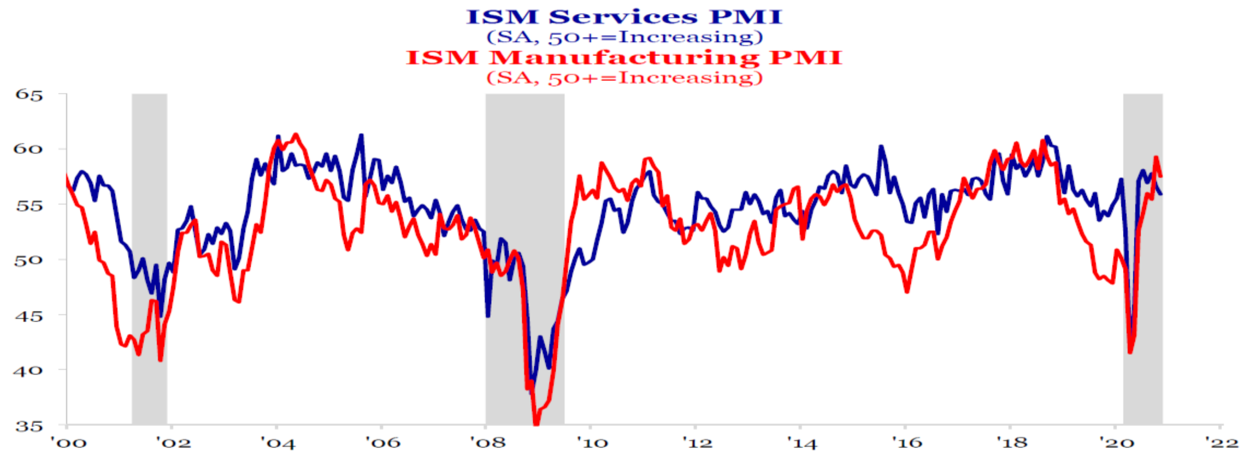
By Bobby Long

Despite the challenges 2020 has brought, the economy has shown itself to be fairly resilient with a strong rebound in economic activity and consumer spending following the brief COVID-19 induced recession we experienced earlier in the year. As mandatory lockdowns and social distancing restrictions have been eased, activity has returned as consumers and businesses have adjusted to this new environment. Some areas of the economy have been able to adjust much easier than others, while many hospitality and leisure related businesses have continued to struggle as restrictions and reduced mobility have severely disrupted these business models. Online retail has benefited at the expense of traditional retail, accelerating the existing trend and leaving many small retail businesses challenged. Air travel has picked up some, but is still significantly depressed with leisure and business travel slow to return. Regional differences have persisted as well, with central business districts and the surrounding small businesses that thrive off them struggling as workers have stayed away from offices. Housing has remained strong and the residential construction industry has been a big support to the recovering economy. Monetary policy remains supportive and low interest rates available to those able to borrow. Fiscal stimulus and government assistance for unemployed individuals and COVID impacted businesses has provided needed support to economic conditions until we gain control over the virus. As sharp as the drop off in economic activity and employment was following the initial lockdowns earlier this year, the rebound in activity has also been remarkably strong.

Gross Domestic Product (GDP) fell -5% in 1Q20 and then -31.4% in 2Q20 as widespread lockdowns and restrictions were put into place. As a result of halting large portions of the economy and then restarting them, expectations were for 3Q20 economic data to rebound significantly and it did with 3Q20 GDP coming in at +33.1%. Economic data has remained supportive with activity indicating 4Q20 GDP growth will likely come in at a healthy rate. GDPNow, the Federal Reserve Bank of Atlanta's running estimate for GDP growth is currently forecasting 11.2%.

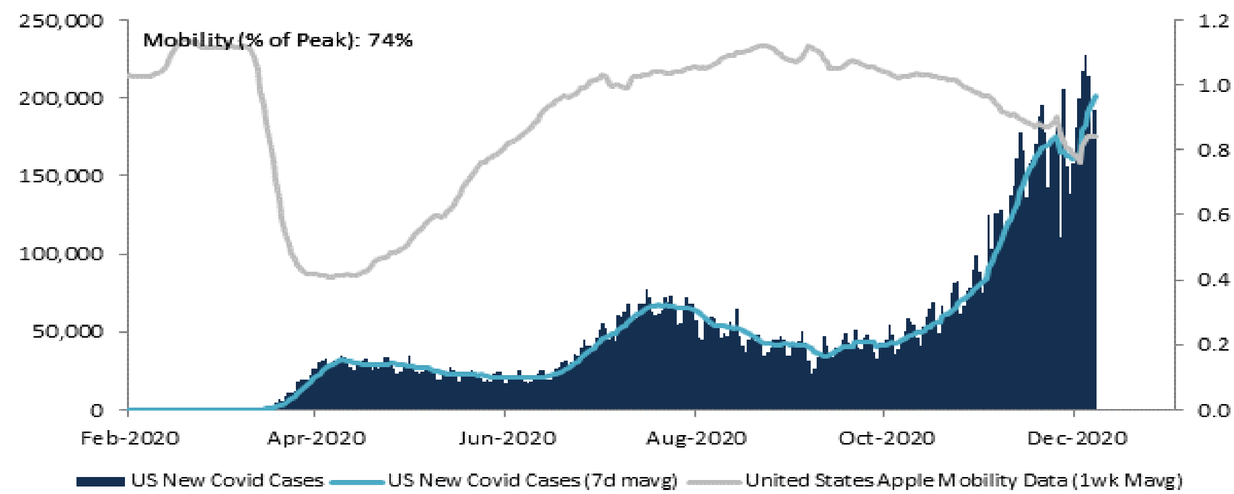


The Institute for Supply Management's Services and Manufacturing Purchasing Managers Index both registered favorable business activity for the month of November. After dropping earlier in the year, both composite indices have shown expansionary growth over the past six months. The Manufacturing PMI has shown broad growth across manufacturing industries. The Services PMI has shown relatively broad growth across industries as well, with contractions reported in the most recent survey in Arts, Entertainment & Recreation; Real Estate, Rental & Leasing; and Educational Services.



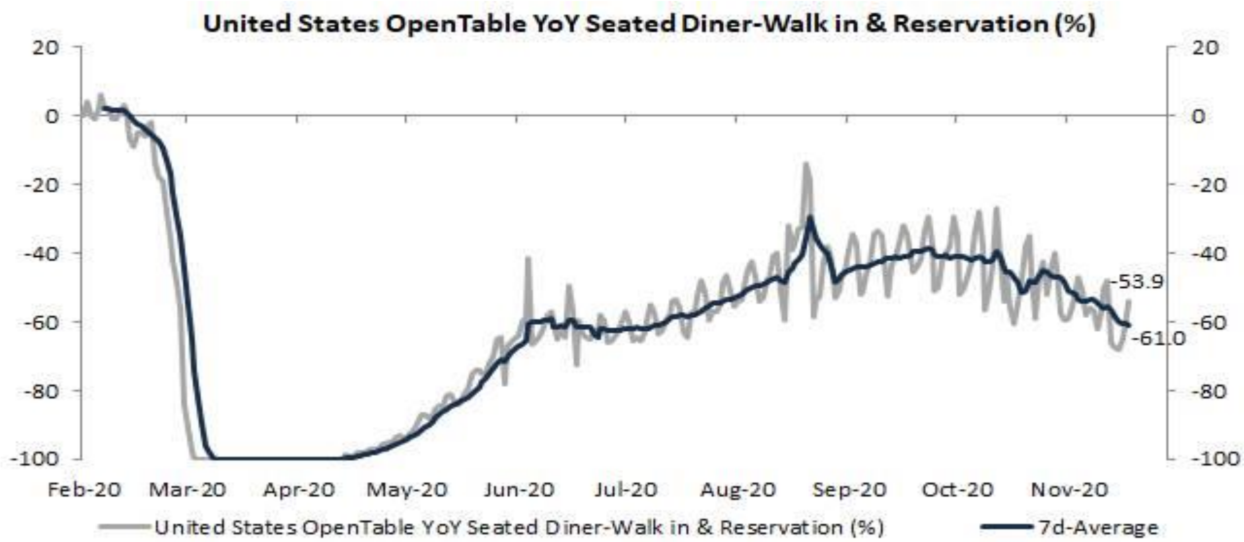
Source: Strategas Securities, LLC

While economic activity has been healthy for the past several months, rising COVID cases along with increased restrictions in some areas of the country could weigh on growth as we move through the end of the year and into 1Q21. Rising cases will most likely not lead to widespread lockdowns like we saw earlier this year, but as cases and hospitalizations rise and more people have direct connections with others who experience serious illness, it will likely serve to depress activity. The chart below shows how the recent rise in cases has been correlated with a decline in the Apple mobility data trends.



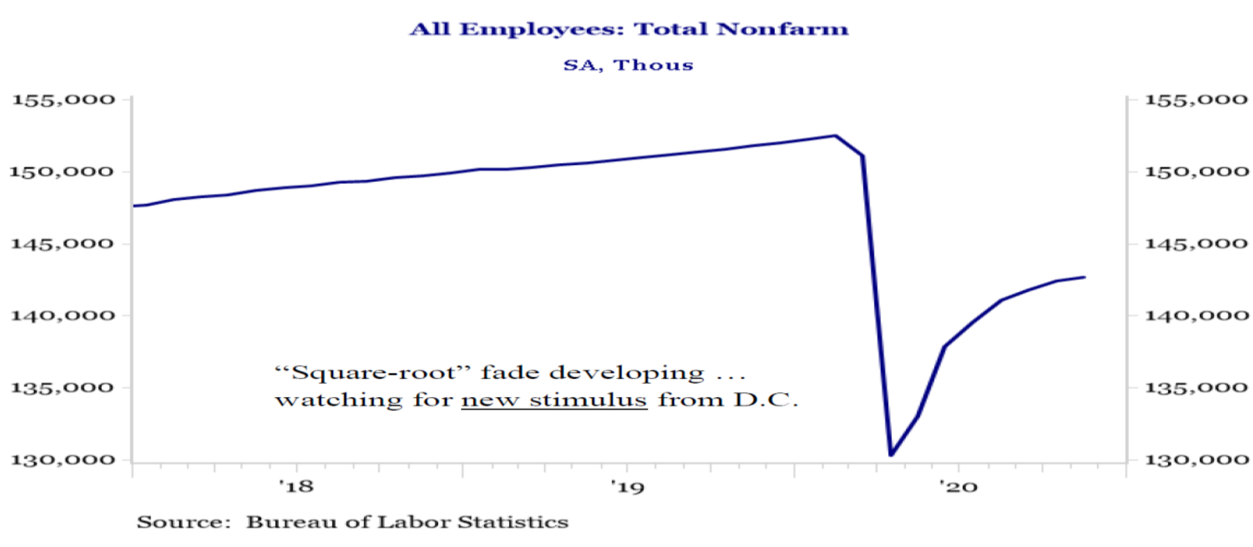
Source: Evercore ISI

Evercore ISI conducts surveys on individuals to measure their comfort levels around various activities such as dining at a restaurant, returning to the workplace, getting on an airplane, taking a taxi, and using public transportation. All have shifted back more negatively as cases have risen recently. Air travel according to TSA Checkpoint data had been modestly trending up over the past several months and saw an uptick into the Thanksgiving holiday but has since fallen back with current traveler throughput at roughly 30% of the previous year's traffic. OpenTable reservations confirm the rising cases do seem to be having a negative impact on activity.

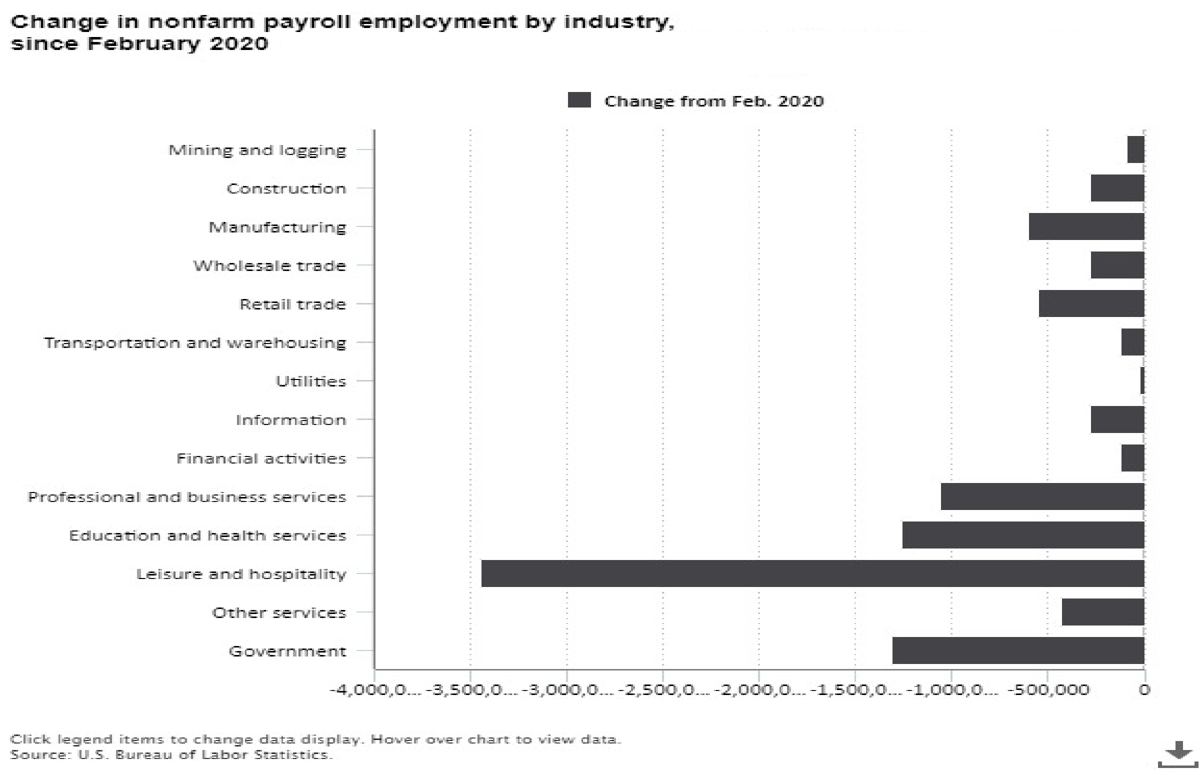


Source: Evercore ISI

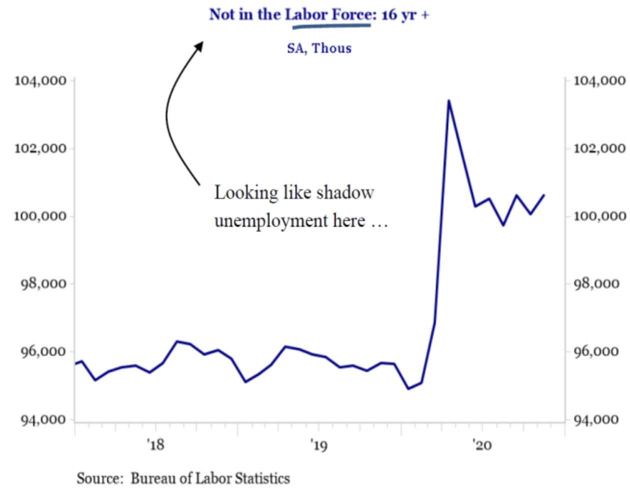
Employment has recovered as restrictions have been eased and the unemployment rate has declined to 6.7% from the 14.7% peak in April. While the rebound has been significant, it is still roughly 10 million jobs shy of the peak and the pace of job gains has started to fade. Initial and continuing jobless claims have come down, but the declines have slowed and are still at levels much too high. This is concerning with COVID cases rising and government support programs expiring.



Many businesses are likely to taper the pace of hiring if activity is slowing. There are also a lot of small businesses that have only managed to survive the downturn with the help of relief programs. If activity slows again and these businesses do not receive additional support, they may not be able to survive until the virus is brought under control. These businesses are unlikely to bring additional employees back in the current environment and may be forced to cut further. Many restaurant and entertainment businesses are still operating at restricted capacity levels that are unsustainable business models without support. Even if restrictions are lifted, these businesses need activity levels to increase quickly with limited runways to operate in the red for more than a couple months. The chart below shows the jobs lost by industry since February. Many of the jobs lost are in the leisure and hospitality industry, an industry most directly impacted by reduced activity.

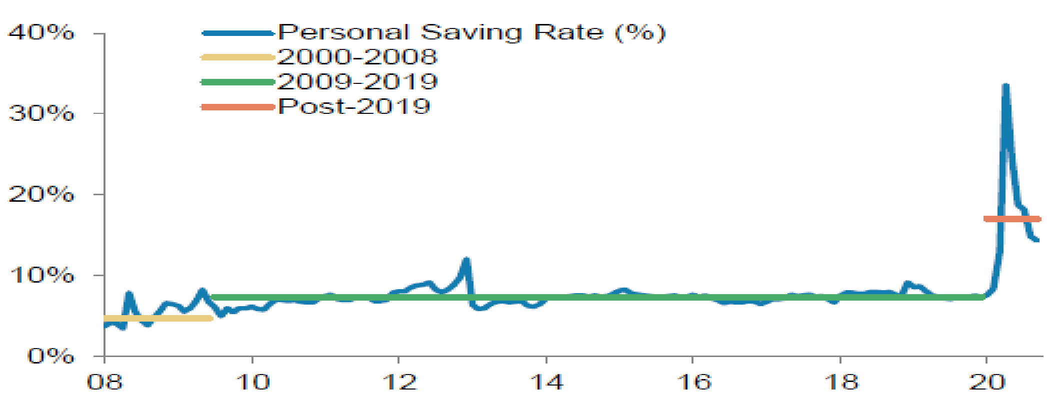


The concern is these employees are at risk of falling out of the workforce. History has shown that the longer an employee is out of work, the higher the risk is they will not return. Skills gaps develop and contacts are lost, leading to permanent unemployment. The two charts below show that there is an elevated number of employees who have been unemployed for more than 27 weeks and an elevated level that is no longer seeking employment. Unemployment claims have also shown that an increasing number of the unemployed are relying on extended benefits. The charts from Strategas Securities, LLC on the following page highlight the risk that these workers become permanently unemployed.



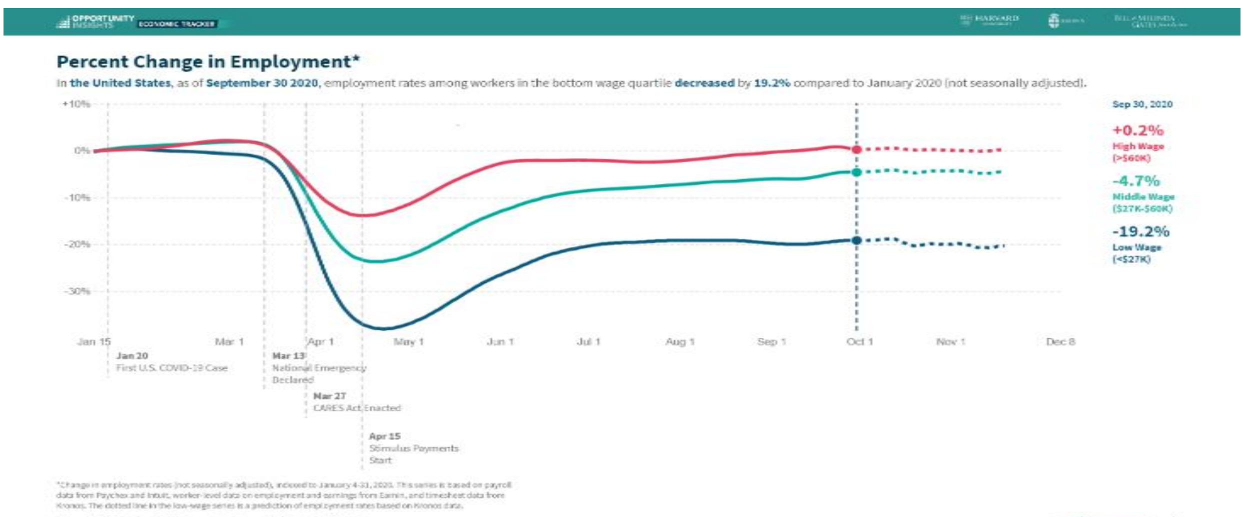
The strength in activity has been supported in large part through government support and relief programs that have been offered to provide continuing incomes to the unemployed and help keep small businesses afloat. This has been an attempt to bridge the gap until restrictions can be lifted and normal mobility resumed. It has helped individuals and families stay in their homes and keep food on the table. It has also helped businesses cover expenses and keep employees on payrolls. The excess benefits have even provided a boost to spending. A large number of individuals are relying on this support that is set to expire. An extension is needed to stabilize the economy until we gain control over the virus. If not and activity has not risen enough to fuel additional job creation, it could weigh on economic conditions as defaults rise and spending from this group drops.

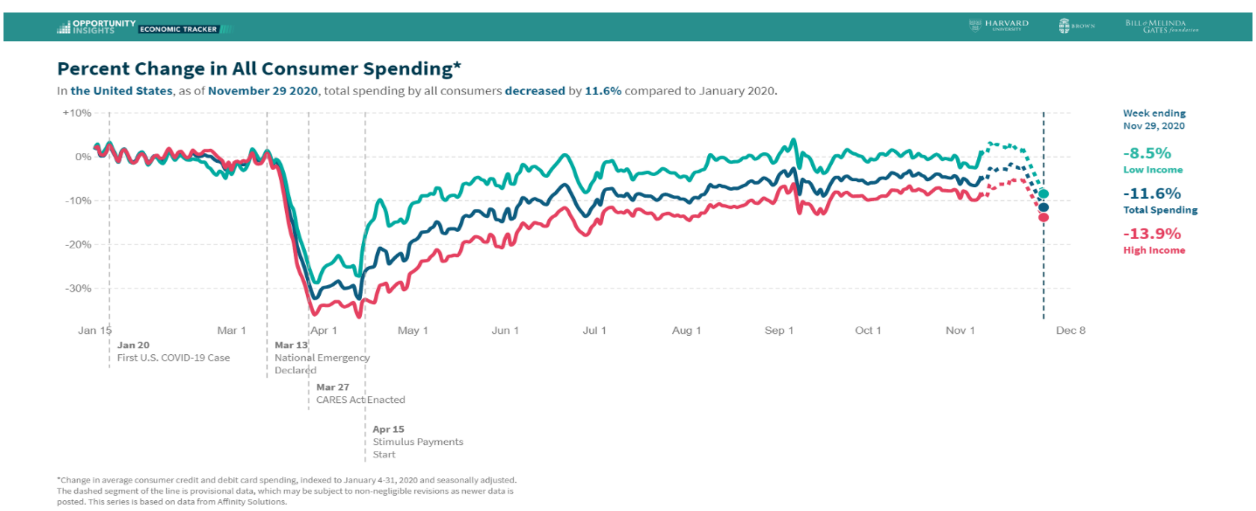
A unique component through this economic cycle has been the dynamics between household savings and consumption. As the chart below shows, the personal savings rate had already averaged higher since the previous financial crises. This left households in a relatively strong position entering the recession. As stay-at-home orders were enacted along with fiscal stimulus and excess benefits, savings rose and consumption fell as consumers spent less on gasoline, travel and leisure, personal services, and other discretionary expenditures. This gap created significant spending potential to fuel activity as the economy has opened back up.



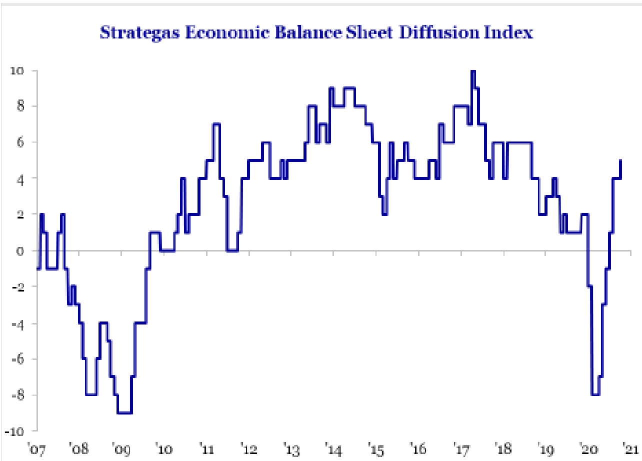
Note: Through October 2020
Source: Bureau of Economic Analysis, Federal Reserve, Morgan Stanley Research

When discussing personal savings and consumer spending, it is important to note the differences between low income and high-income households. Low wage workers have lost jobs at a much higher rate than high wage workers and the low wage workers have been much slower to regain employment. Low wage workers also resumed spending at pre-crisis levels quickly, likely spending much of their combined income and stimulus payments. High wage workers resumed spending but at much lower levels, likely adding to savings and increasing net worth. When we talk about increased savings rates and higher net worth, this serves to increase the wealth gap between upper income and lower income households. Lower income households and the unemployed are still in dire need for assistance and do not have savings or access to credit to support them very long without employment, representing a risk to economic conditions. It should also be noted that the top 20% of income earners do 40% of the spending. With these workers largely employed with increased savings, it represents significant pent-up demand to drive economic activity.





Don Rismiller with Strategas Securities, LLC publishes an Economic Balance Sheet Diffusion Index each month in an attempt to quantify their interpretation of the state of the economy. We have found it to be a good summary and characterization of several broad economic conditions and whether they are currently assets or liabilities to the state of overall economic conditions. As the chart shows below, the index has steadily improved over the past several months as several economic liabilities have shifted to assets supporting the recovery.

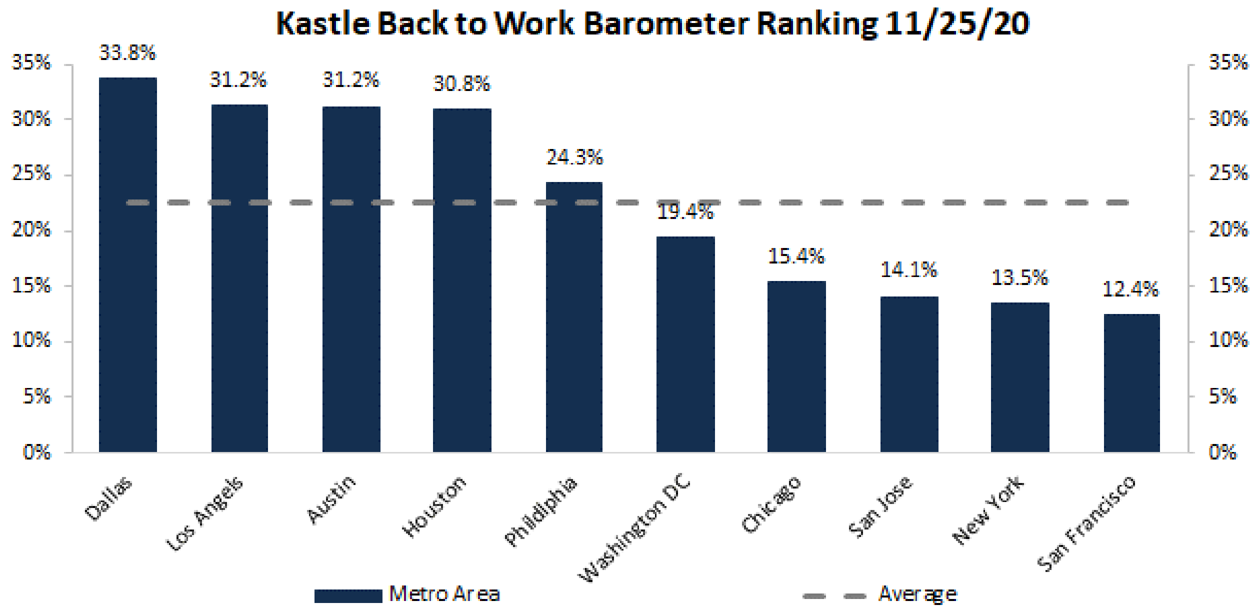


Assets	Neutral	Liabilities
Interest Rate Env	Govt Deficit	Nonres Constr
Housing	Trade Deficit	
Employment	Wage Inflation	
Business Conf	Price Inflation	
Manufacturing	Credit Environ	
Cons Spending	Capex Eqp	
	Cons Conf	

Economic:	Oct '19	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct '20
Assets	4	5	5	2	1	1	1	1	1	3	5	5	6
Liabilities	3	3	3	4	9	9	8	4	2	2	1	1	1
Net	1	2	2	-2	-8	-8	-7	-3	-1	1	4	4	5

Economic conditions were healthy heading into the recession and consumers in relatively good shape. Housing activity was strong and has strengthened since the initial restrictions earlier in the year, driven by low interest rates and increased demand as consumer preferences for single family living have increased. Business confidence has improved with the potential for a vaccine coming and clarity around the current election cycle. CEOs and small business owners do not like making capex expenditures and hiring decisions in an unknown economic or regulatory environment. As confidence improves, they can make adjustments based on conditions and move forward with investment. Consumer sentiment has been weaker and has represented a risk to consumer spending. The most recent release ticked up some and may represent increasing confidence as a vaccine draws nearer.

A large number of workers continue to work remotely. The chart on the following page shows across ten major metropolitan areas an average of less than 25% have returned to the office. This remains a headwind to commercial real estate and the many small businesses that serve central business districts. While many businesses have adapted well to remote working, getting workers back into offices is needed or the economies around these business districts will suffer.



Getting people back to work has been tailwind for the economy and can provide continued support if the remaining unemployed can be brought back into the labor market. Getting workers back into offices would also be a substantial boost to these local economies. With several promising vaccines moving toward approval and election politics soon to be resolved, some sort of stimulus deal looks more likely and would help prevent economic activity from fading after the initial rebound we have experienced. This would help bridge the gap until the economy can fully open back up. We remain optimistic that economic conditions can continue to improve, however we are mindful that conditions are fragile and are monitoring the employment situation. If the virus can be brought under control and the unemployed brought back to work quickly, there is broad underlying strength to support continued economic expansion.

RSA PORTFOLIO STRATEGY

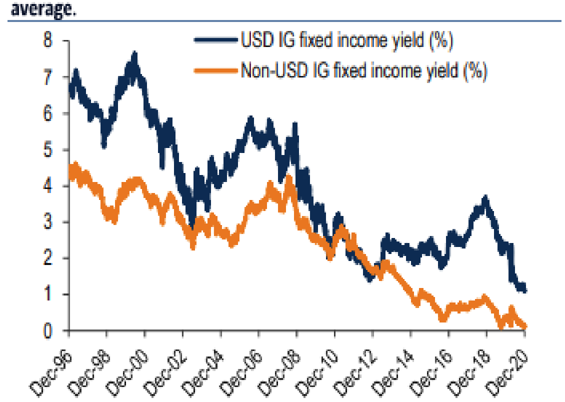
Interest Rates and Fixed Income Strategy

By Lance Lachney

At the time of our last quarterly meeting, the Retirement Systems was wrapping up its 2020 fiscal year. Within public fixed income markets, the fund was able to produce a shade under 8%, on the heels of a pandemic-induced treasury rally and the accompanying stabilization in corporate credit during the latter half of the year. As the fiscal year came to an end, the primary market for investment grade debt remained robust. The strong demand for corporate debt and yield allowed companies to issue more than $1.5 trillion in the calendar year. However, the objective has now shifted from one of cash accumulation for liquidity purposes to advantageous refinancing and liability management. Markets were further enhanced due to extended support from the Federal Reserve, as it is poised to keep short interest rates near zero until 2023.

During the following months, political headlines dictated much of the movement in yields. In October, interest rates were able to move higher despite President Trump's Covid-19 diagnosis. The market also started to factor in the increasing odds of a Democratic sweep, that could result in a much larger stimulus bill. Risk assets outperformed and the yield curve steepened. Investment grade debt eked out a positive return, while high yield fared a little better due to its lower duration profile. Corporate debt was also supported by a relatively solid start to the earnings season.

Figure 21: Non-USD global IG bonds are yielding close to zero an average.



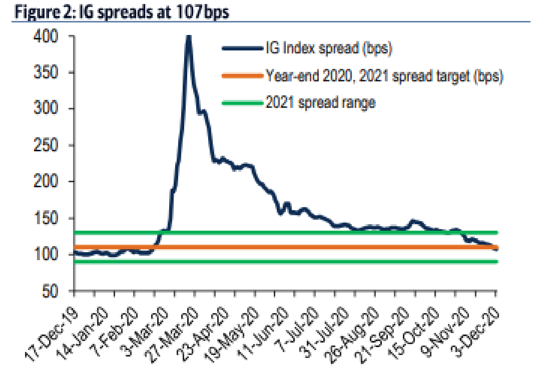
Source: ICE Data Indices, LLC, BofA Global Research

Equity volatility and election results dominated the early parts of November. The sell-off induced by climbing virus cases and newly enacted European lockdowns was quickly reversed as a likely Republican Senate would provide a more favorable corporate environment. Treasury yields moved slightly lower during this time. However, there was a substantial tightening of corporate spreads with lower-rated credits being the biggest beneficiary. The breaking news of a viable vaccine immediately moved rates higher, but yields did pull back and settle in. Corporate spreads managed to hang tight as the rising number of cases could potentially speed up a deal in Congress. Spread levels were also supported by the fact that the Fed has plenty of ammunition left at its disposal. Long-end treasury yields did fall towards the start of the Thanksgiving holiday as the market began to price in a potential move out the curve in the Fed's asset purchasing program. However, this was short-lived as the minutes from the previous meeting did not suggest any change in the near term.

Last week, the long end the treasury curve rose dramatically. It also steepened by a similar amount with the front end anchored due to Fed policy and rising inflation expectations. The curve, measured by the differential in 2yr and 10yr treasury yields, is at its widest level in three years. Spread product, especially high yield debt, has managed to outperform fiscal year-to-date. In typical fashion, mortgage-backed securities have underperformed corporate credit in risk-on moves and likewise underperformed treasuries in rate rallies. The fund has been woefully inactive in the new fiscal year. This is as tough of an investing environment in fixed income that I can recall. I would like to provide further insight into the current climate within the fixed income landscape.

Although it has been stated numerous times, there is approximately $17.5 trillion of negative-yielding global debt. Currently, Germany's entire sovereign curve is in negative territory. Southern European countries, that were on the verge of bankruptcy several years ago, have yields now approaching 0%. The European Central Bank, with its recent extension of asset purchases could potentially own close to 40% of all German and Italian sovereign debt within a year. The Federal Open Market Committee is poised to highlight its intentions about additional asset purchases as early as next week. It has over a $1trn of additional firepower to position its purchases further out the curve if needed. In Asia, it has been four years since the Bank of Japan enacted yield curve control by targeting its 10yr JGB. In total, global central banks have placed an additional $8.2trn onto their respective balance sheets in this most recent crisis.

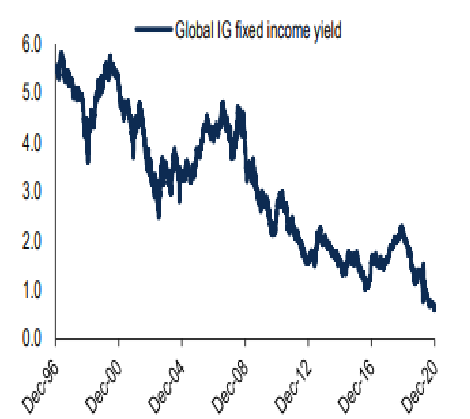
Figure 2: IG spreads at 107bps



Source: ICE Data Indices, LLC, BofA Global Research

Within the corporate market, the current yield for the investment grade index now stands at a record low of approximately 1.80%. Investment grade spreads have rallied 300bps from their widest levels in March. At the same time, duration for the index is at record highs, meaning investors are only receiving approximately 20bps of yield for each additional unit of interest rate risk. The average yield for global high yield debt has also fallen to record lows under 5%. Corporate debt balances have surged during this time, but so have cash levels. Companies have taken this opportunity to eliminate approximately 25% of next year's maturities through refinancing or redemption.

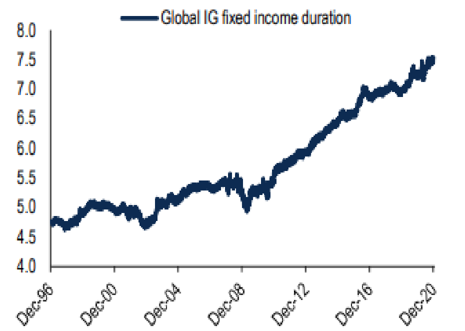
Figure 18: Yields are near historic lows.



Source: ICE Data Indices, LLC, BofA Global Research

The argument that I am making is there are very few investable options at this point. While yields are reaching historic lows, investors have never been more exposed to interest rate risk. As companies tender for or redeem short term obligations, investors are given the option of reinvesting proceeds at paltry levels in the front end of the market or have their duration exposure extended as short-term notes exit the portfolio. This is also taking place amid a recovery in inflation expectations, buoyed by vaccine announcements, manufacturing data, and hopes for fiscal stimulus relatively soon. Not to mention, the favorable inflation year over year comparisons on the horizon. However, one can certainly argue about the sustainability of higher inflation given that a lasting economic recovery might take quite a bit longer than expected, especially with the considerable amount of slack in the labor market. Global central banks will also be accommodative as necessary and as the last decade has shown, low rates are vital for a global economy that has become dependent upon them. Going forward, the fund will continue to take advantage of the periodic moves higher in rates to add a little protection to the portfolio. However, with yields at these low levels, the margin for error has all but evaporated.

Figure 16: Global IG market duration has extended steadily since 2008.



Source: ICE Data Indices, LLC, BofA Global Research

Domestic Equity Strategy

By Allan Carr

This time last year, we ended this piece stating that barring something unforeseen, we didn't see a recession in the forecast and therefore remained constructive on stocks. We pointed out that despite being noisy, election years were usually good ones for the market with an average return exceeding 10% over the past 21 elections.

We got half of it right. It's hard to imagine that we sit today with the S&P 500 up 15% on the year after witnessing a -32% GDP print in the second quarter, unemployment going from 4.4% to 14% in a month, and the fastest 30% drop in history with the S&P falling over 30% in just 22 trading days.

We will spare everyone the superlatives and won't rehash what has happened this year beyond the paragraph above and a brief discussion of what's transpired in the markets in recent weeks.

November was an incredible month. The S&P500 was up 11%, Dow up 13%, Midcap up 14%, and Smallcap up over 18%. We saw energy, industrials, Spain, and Italy all have their best months ever. Now into early December, we sit at all-time highs on the S&P500, Dow, and the Nasdaq. The rally over the last 6 weeks is attributable to numerous things:

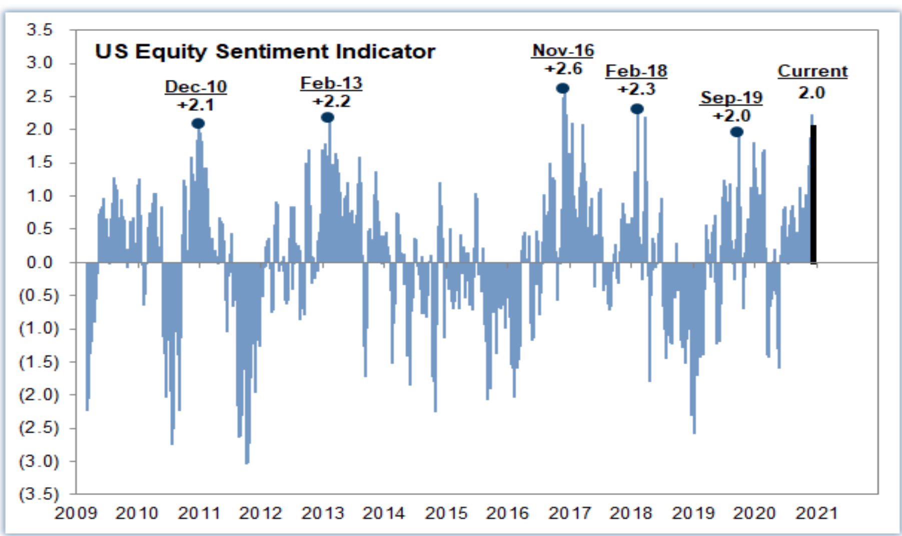
- The biggest positive recently has been the wave of good vaccine news giving hope of a return to normalcy in the second half of next year.
- Presidential election appears to be done when there were fears over a messy and drawn out contested election in courts.
- We are still awaiting the January 5th Senate runoff in Georgia, but the belief is there will be divided government with republicans keeping the Senate. This is viewed positively for risk assets as the new administration won't be able to push through more progressive nominations, agendas, regulations, etc.
- So far, Biden's appointments have been welcomed by the markets: Janet Yellen as treasury secretary is much more appealing to markets than the rumors of Elizabeth Warren.
- Weeks ago it appeared there was little chance of another stimulus package getting done before year end. In recent days there has been renewed optimism that a trimmed down package will be passed any day now.
- The yield curve has steepened.
- M&A and IPO activity has been robust.
- Earnings and guidance have been better than expected

Indeed, there's been quite a run of encouraging data and news. The consensus seems to have landed on stimulus passing this month, the GA runoff resulting in divided government in January, and a successful vaccine rollout leading to a reopening in late summer. This is seen as the Goldilocks scenario for risk assets, but we'd caution that the hay is not yet in the barn:

- Polling numbers and predicting elections have never been lousier than the last 4 years. The republicans must win one of the two runoff elections or the democrats will have unified government.
- Fiscal stimulus talks could fall through or be skinnied even further; talks started at $2.5T and now are sub-$1T. While they've come to an agreement on the size, they are still wrangling over language and details.
- Vaccine news is undoubtedly positive but at the same time cases and deaths are headed rapidly in the wrong direction.
- Does widespread vaccination being in sight increase the likelihood of officials ordering more shutdowns if cases/deaths keep trending the wrong way?
- What if there are vaccine side affects or disruptions in the delivery/administering that push the timeline out?

Given how well the market has reacted to recent good news, we are a bit cautious near term. Adding to our near term angst, several of the sentiment readings we follow are signalling caution. We often reference the Citigroup Panic/Euphoria model as one of our favorite indicators and it's in "euphoria" territory. We see similar cautious signals in the BofA Merrill Fund Manager Survey, as well as the Goldman Sachs Sentiment Indicator (Exhibit 1).

Exhibit 1



Source: Goldman Sachs Global Investment Research

We are also seeing possible signs of bubble-type speculative behavior in markets. Tesla is up over 650% this year and has a market cap of $600B (10x the size of GM). Bitcoin is up nearly 300% from March. Just this week we've seen big name IPO's being priced well above the marketed range, then exploding in their debuts. Doordash (DASH) targeted an IPO range of $75-85, priced at $102, and then traded up 85% on the opening day to close just shy of $190. AirBnB (ABNB) targeted a range of $44-50, ultimately priced at $68, and then traded as high as $165 on its first day of public trading. And these aren't small deals. On day one as a public company ABNB was valued at $100B, the same market cap as Lockheed Martin(LMT).

In total, IPO's have raised over $75B this year, the best year since 2014. The deal calendar has been resilient in a tough year and should be viewed positively overall. It's another capital raising vehicle that has become wildly popular in recent years that has many people warning of a bubble. SPAC's (special purpose acquistion company) have raised over $77B this year per SPACinsider.com, the same amount as the traditional IPO market. Also known as "blank check companies", SPAC's raise money with no specific use but to merge and/or acquire something in the future.

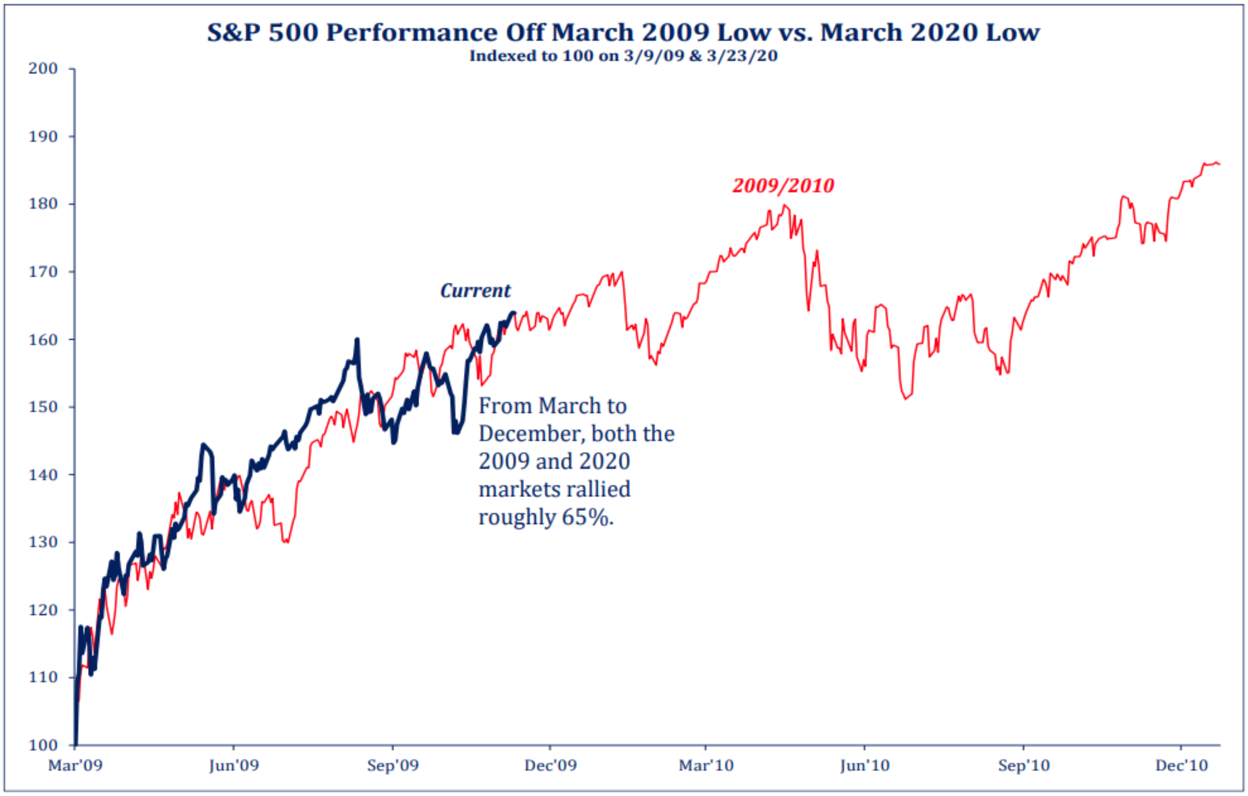
Famed investor Jeremy Grantham was recently the unintended beneficiary of this year's SPAC craze when a car battery company he'd invested $12.5MM in 7 years ago was merged into a SPAC. The SPAC shares were trading at $10 when the deal was announced on September 2nd. The deal closed in late November and as of December 10th, the shares were trading at over $76 making Grantham's investment worth $365MM; a $300MM windfall in just 3 months. Most people would be ecstatic, but Grantham was bluntly critical saying "this is unlike anything else in my career. This was by accident the single biggest investment I have ever made" and that he thought SPAC's were "a reprehensible instrument, and very very speculative by definition."

While seeing speculative action is something to keep an eye on, it's not overly worrisome for now as it appears to be contained in small pockets and in fewer hands. Seeing bubble-like action in Bitcoin, TSLA, and SPAC's is much less concerning than seeing it widespread across technology names in 2000, and especially versus seeing it in housing and housing backed debt instruments in 2007.

Similarly, the sentiment readings aforementioned do not lead us to think we are due for a sustained bear market or anything draconian. We just think the next 6 months could be choppy and we would not be surprised to see a correction or two as we navigate the vaccination period.

An interesting parallel is to look at this year next to 2009 when we were coming out of the financial crisis (Exhibit 2, Strategas).

Exhibit 2



In both 2009 and this year, the market bottomed roughly in March and then rallied 65% into December. Similarly, back in December 2009 sentiment readings were also stretched. The market had a very solid year in 2010, up 15%. However, there were some painful bumps in the road with an 8% selloff in January and a 16% correction from April to July. It would not surprise us to see something similar in 2021, with fits and starts in the first half during the vaccination rollout, followed by a solid second half to end the year.

Grouped in the discussion with sentiment readings and record highs has been recent fund flows. Headlines of "record equity inflows" over the last 6 weeks and "record money market withdrawals" are textbook bull market top warnings signs. However, digging below the surface paints a less disturbing picture than the headlines suggest. In aggregate since the beginning of 2019, equities have been the loser versus cash, despite 225 bps of Fed rate cuts (Exhibit 3). Additionally, even with sizable money market redemptions lately, there's still roughly $1 Trillion more in money markets than there was to start the year (Exhibit 4).

Exhibit 3

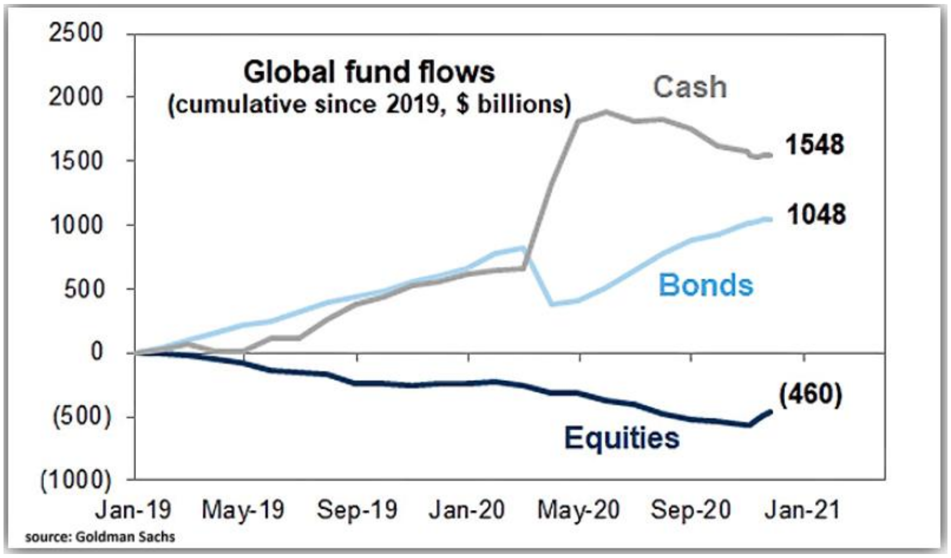
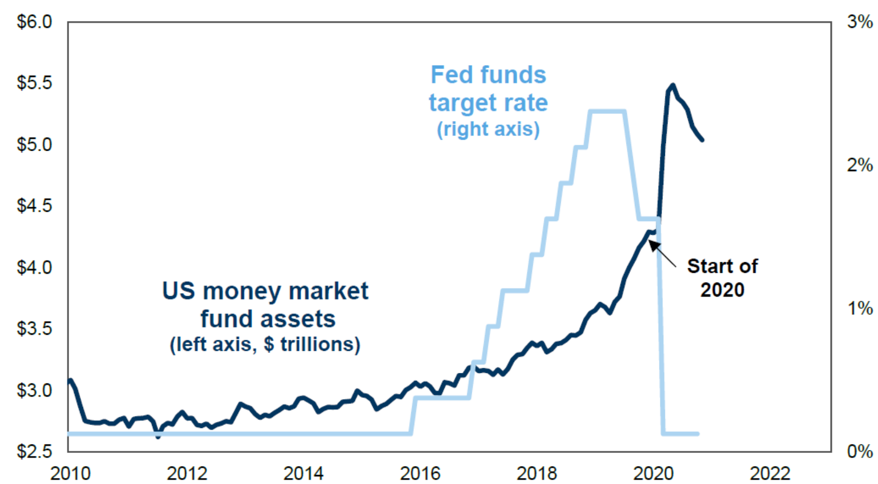


Exhibit 4

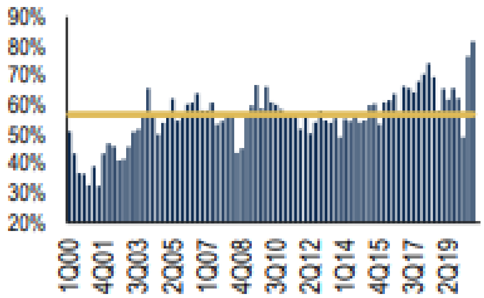


Source: EPFR, FRB, Goldman Sachs Global Investment Research

Looking beyond the near term cautiousness, there are underpinnings that suggest a more constructive outlook in the second half 2021 and beyond. First is the earnings picture. Earnings and sales have have been beating their dramatically lowered expectations (Exhibit 5), and forward guidance by companies has seen a historic surge (Exhibit 6).

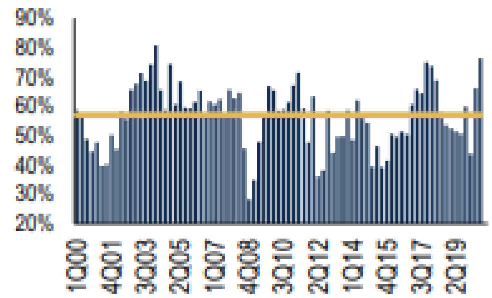
EXHIBIT 5

Chart 27: % beating on EPS (3Q as of 11/6/20)



Source: FactSet, BofA US Equity & Quant Strategy

Chart 28: % beating on sales (3Q as of 11/6/20)

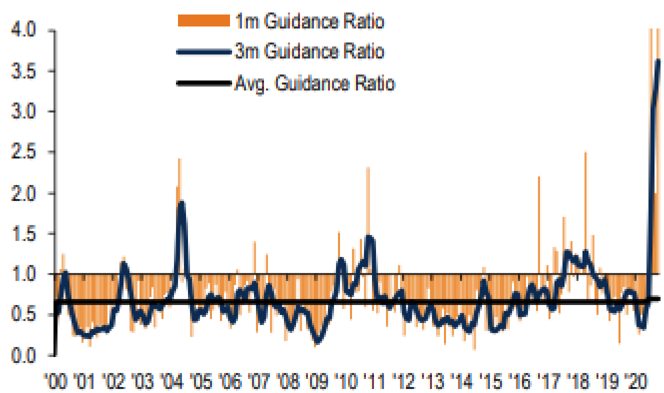


Source: FactSet, BofA US Equity & Quant Strategy

EXHIBIT 6

Chart 30: Strongest guidance trends in history ...

S&P 500 Management Guidance Ratio (# Above vs. Below Consensus) – 10/20



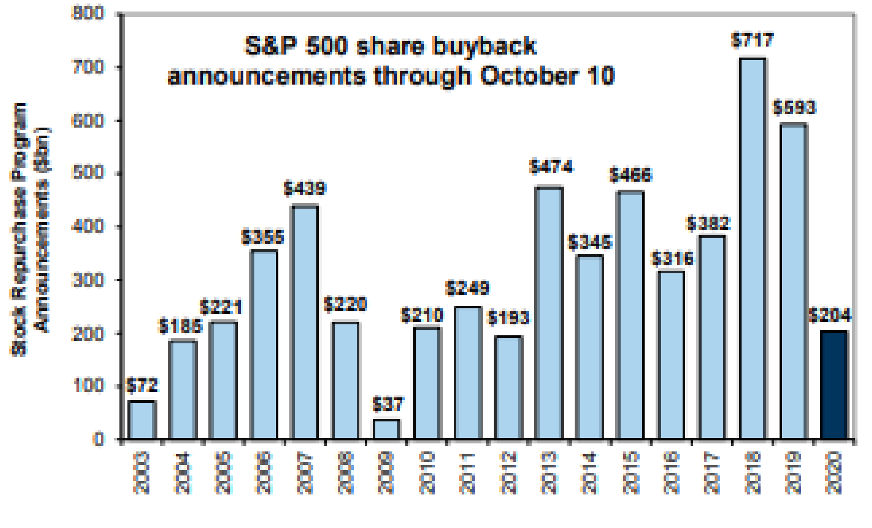
Source: Bloomberg BofA US Equity & Quant Strategy

S&P earnings were $163 in 2019 and this year is looking to be roughly $140. Earnings for 2021 are forecasted to be in the $165 to $170 range, based on a pent-up demand rebound in the second half. It's pretty impressive to think 2021 could take out pre-pandemic earnings with only half the year being "normal." Looking out to 2022, earnings are forecasted around $200, up 15-20%.

Without debating the possible long term repercussions of the trillions of monetary and fiscal stimulus injected into the system, a weaker dollar in the near term should add a couple percentage points of growth to S&P500 earnings in 2021. It also should attract foreign buyers, with Goldman Sachs estimating the weaker dollar could result in $350B of incremental equity purchases from abroad next year.

Another catalyst for stocks is the return of corporate buybacks. Repurchases aren't likely to get back to pre-pandemic levels, but they should be up meaningfully after being down nearly 70% this year (Exhibit 7).

EXHIBIT 7



Source: Goldman Sachs Global Investment Research

Lastly, excess cash/savings is noticeable with both the consumer and corporations. On the corporate side, Goldman estimates cash on balance sheets at 11% for S&P500 companies, which is near a top decile ranking since 1975. The call for a pent up demand rebound in the second half is not based solely on people wanting to get out and spend and travel after being cooped up. It's estimated that Americans have saved nearly $1.5T more than trend due to increased government stimulus and decreased spending. Wolfe Research estimates that even after accounting for paying down debt, there is north of $800B stuffed underneath the mattress.

In closing, recent strength and sentiment warrant caution over the coming months. Looking further out, we see upside to equities over the next 12-18 months if vaccination goes well and we have the much anticipated "reopening" in the second half of next year. When viewing in isolation, valuations look stretched versus history. However, when assessing the entire landscape and the growth possibilities post pandemic, valuation is more palatable in the yield starved world we are currently in.

International Equity Strategy

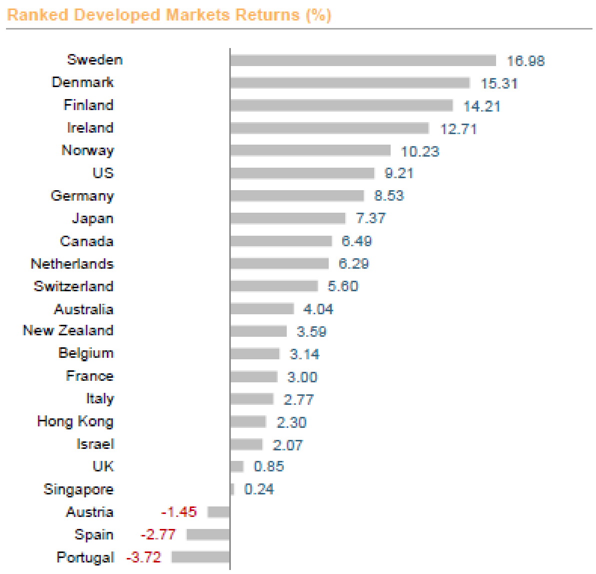
By Steve Lambdin

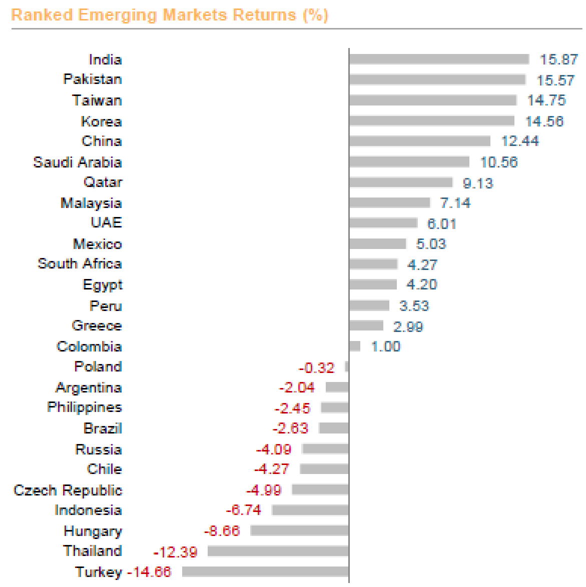
Global equities posted a second consecutive quarter of good returns as a global economic recovery began to take shape and a COVID-19 vaccine inched closer to reality. This gave investors a giant sigh of relief and pushed them to put more risk on through equities. Investors are looking forward to what the global economy will look like post this pandemic. Fiscal and monetary policy responses to this pandemic continued at unprecedented levels as most governments and central banks have taken actions to cushion the economic blow from this. Many economies remained in some type of mandated partial lockdown in order to control the spread of this virus. Beyond the virus and probably on almost every investor's mind in the period was the rhetoric around the outcome of the U.S. Presential election. The race was a daily dose of theatrics, concerns, and uncertainties indicating a close election could be at hand. It seemed like most investors accepted this with a forward eye looking to clarity on policy and direction once the election is over. This could be another catalyst for the global equity markets. Also, European politics continue as Brexit negotiations in the period led to no agreements in place as of the end of the quarter. Both sides are holding tight with their respective demands, but dialogue continued and many are hopeful for some type of resolution later in 2020 or early 2021. In addition, many are watching economic data points in China and the rest of Asia, as these economies could be the first regions to post economic growth since the pandemic started as investors are looking for these economies to take the lead.

		Annualized		
	Quarter	1 Year	5 Year	10 Year
US Treasury Bills (one month)	0.03%	0.83%	1.07%	0.55%
Barclays Capital US Gov't/Credit Inter Bond	0.61%	6.32%	3.39%	2.91%
Standard & Poor's 500	8.93%	15.15%	14.15%	13.74%
Russell 1000 Value (large cap value)	5.59%	-5.03%	7.66%	9.95%
Russell 2000 (small cap)	4.93%	0.39%	8.00%	9.85%
MSCI Europe, Australasia and Far East (EAFE)	4.80%	0.49%	5.26%	4.62%
MSCI Europe, Australasia and Far East (EAFE) Small Cap	10.25%	6.84%	7.37%	7.33%
MSCI Emerging Markets	9.56%	10.54%	8.97%	2.50%
Wilshire REIT	1.25%	-17.69%	3.65%	8.00%

Source for returns: Morningstar ™ as of 9/30/2020.

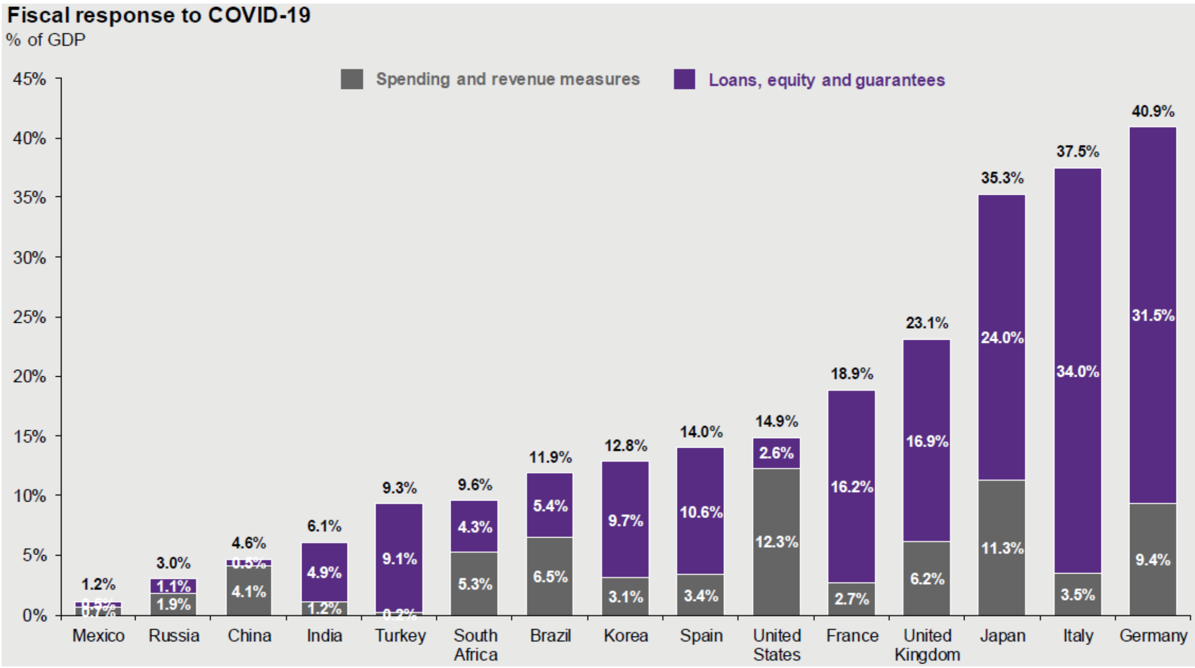
The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned +4.80% and +9.56% respectively during the third quarter of 2020 vs. +8.93% for the S&P 500 Index. Investors warmed up to emerging market equities as a way to put more risk on and play the expected economic rebound from the pandemic. Continuing from the trends of the previous quarter, the U.S. dollar weakened as investors continued to put risk back on in the markets outside of the U.S. and this helped returns as currency movements provided about +3.6% for unhedged U.S. investors. The Pacific region was slightly stronger than the European region as the Japanese equity market rose +7.3% in the period as investors seemed to embrace the new prime minister's pledge for continued policy continuity. As expected, the more cyclically oriented sectors were stronger vs. the more defensive sectors of the markets as Consumer Discretionary, Technology, Materials, and Industrials performed well vs. the Energy and Financial sectors. Even though WTI Crude oil was virtually flat in the period, many other commodities rose quite substantially in the quarter such as Copper, Nickel, Zinc, and Natural Gas. This is indicative of a reflating economic outlook.





Sources: Resource Consulting Group, MSCI

So far into the fourth quarter of 2020 thru early December, global equities have picked up steam and have risen significantly as vaccine announcements from Pfizer and Moderna coupled with even more stimulus packages as well as results from the U.S. Presidential election have pushed global equity markets to new highs. Investors are rotating to more “risk on” positioning, such as emerging market equities vs large cap stocks, value over-growth stocks, and cyclical shares over defensive ones. A result of this massive rotation and re-positioning has been the falling U.S. dollar. As this transpires, we would expect global stocks to perform well. Only time will tell if these actions result in better performance from outside the U.S. equity markets over the next year. The MSCI EAFE Index and the MSCI Emerging Markets Index are up approximately +13% and +15% respectively through early December, vs. +10% for the S&P 500 Index.

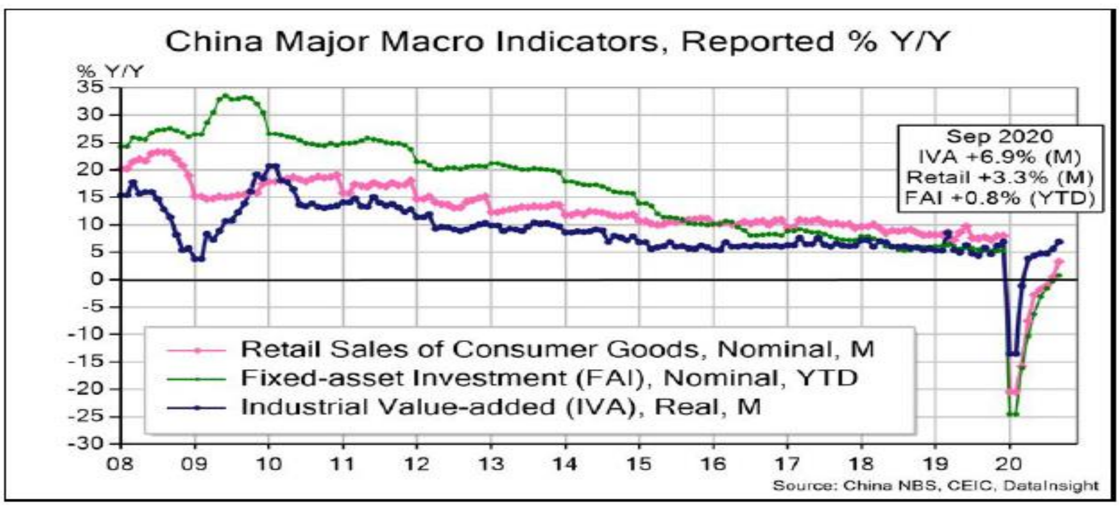


Source: IMF, JP Morgan Asset Management

Asia Update

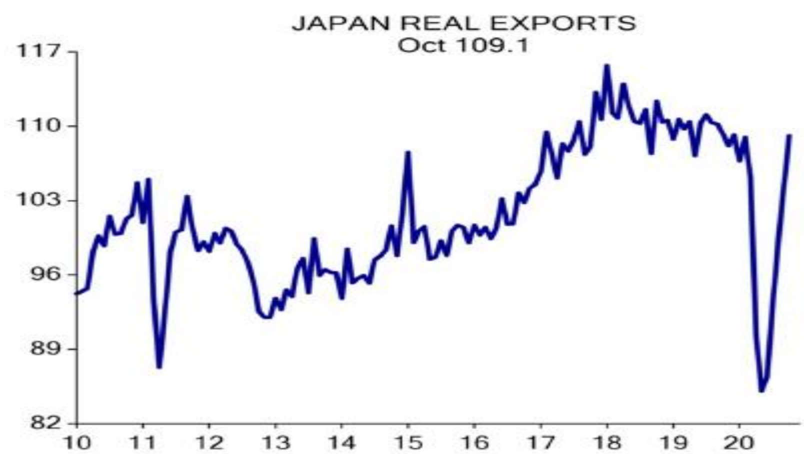
Asian equities continued to shine in the third quarter even in the face of weak economic readings and some surprising political news. As mentioned in the previous quarterly update, Japan has a new Prime Minister, Yoshihide Suga. Thus far, markets have responded quite enthusiastically as he promised policy continuity to a large degree with its very loose monetary policy. This news coupled with the global re-opening trade that continued in the quarter was enough to overcome rather weak economic data points and push equities up +7.3% in the period. Australian equities lagged as new lockdowns in certain areas were put in place from a second wave of COVID-19 infections. Hong Kong equities also fell behind as well as geopolitical tensions remain high from U.S. trade sanctions imposed on Chinese and Hong Kong officials in the period. Overall, the MSCI Pacific region rose +5.4% in the period, which was ahead of other regions in the MSCI EAFE Index.

China's economy continued to surprise many as second quarter GDP rose by +4.9%, the second straight quarter of growth in the toughest economic times seen in years. It would have been even better had it not been for some short comings in the services sector. We would also characterize the economy here as gaining momentum throughout the quarter, which probably sets up for even better growth in the fourth quarter. At this point, we do not really see a need for further immediate stimulus measures. Perhaps leaders here will take a wait and see approach on this issue. Industrial production picked up quite a bit in September, rising +6.9% after rising +5.6% in August. This is a clear signal of the rebound happening in China. Also, fixed asset growth rose in the third quarter as projects have finally started that have been put on hold since the pandemic started. Exports are rising as well, as September exports rose +9.9%, which is near the best levels of 2020. Exports to the U.S. have been particularly strong over the last few months as the U.S. continues to benefit from the re-opening. Retail sales are trending stronger as October sales are up +4.3% from a year earlier, which is the best level since the pandemic started. Discretionary goods such as automobiles and jewelry have been gaining momentum. CPI has been slowing sharply recently as October rose only +.5% from a year earlier, which was the first time in over three years this has been under +1%. Meat prices have fallen substantially over the last couple of months. The People's Bank of China (PBOC) remains watchful here and could lower interest rates if necessary, to keep the CPI from falling into negative territory. However, we put little likelihood of this happening. Looking out the next few months, we see the recovery gaining further momentum here as we believe this economy could be one of the first to get back to pre-COVID output levels. If this is the case, then we would expect this to be good for the equity markets here. Also, one issue to keep an eye on is how the new U.S. administration will approach trade relations with China. This could be a market moving event in either direction.



Source: Evercore ISI

The Japanese economy finally emerged from a three-quarter recession as third quarter GDP rose +5.5% from the previous quarter, or +23.9% from the previous year. This was the fastest pace expansion in more than 50 years and wound up beating most investor expectations. This is good evidence the region is beginning to move on from the effects of an economic lockdown in this economy. However, this economy is still well below pre-pandemic levels, which could take some time to get back to those levels. To help on this front, Prime Minister Suga announced a $708 billion USD economic stimulus package with full details still yet to be released. We believe Suga is off to a good start with this stimulus package in an effort to fight a COVID-19 second wave. Exports have been exceptionally strong and rose +31.3% in the third quarter. Key automobile and electrical equipment industries have restarted and seem to have good momentum. Industrial production continued to rise, as October was up +3.8% from a month earlier. This is the fifth month in a row of rising production. This is certainly moving in the right direction. Japan's leading economic index continued to move forward as October's reading of 93.8 is another high reached since February. This is a good sign that optimism is returning to the business climate. Consumer confidence continued to track higher as well, as November's reading of 33.7 is the highest levels since early 2020. Conditions in the labor market remain rather tough at the moment, as October's jobless rate rose to 3.1%, the highest level since the pandemic, while the jobs-to-applicant ratio fell to 1.04. For the recovery to deepen, we need to see a reversal of these trends and encourage companies to hire more workers. Going forward over the next few months, we are worried the recovery we have seen so far in this economy could run out of steam. However, as long as the prospects of more stimulus measures are being debated, this usually is good news for the equity markets, and we would not be surprised to see the equity market here rise to new multi-year highs.

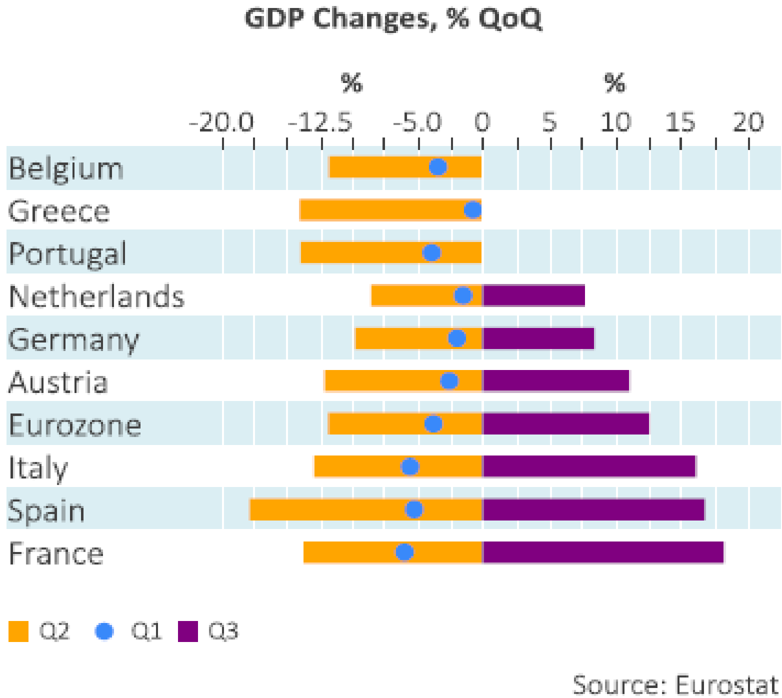


Sources: Evercore ISI

Europe Update

The third quarter brought a mixed bag of economic and COVID-19 news to the region. On the economic front, we saw some indications of an improving economic outlook as some key data points moved in the right direction, especially in the German economy. Large German exporters saw their respective share prices rise rather quickly in the quarter as the economy re-opened and shipments picked up to parts of Asia. On the virus front, we saw loosened restrictions for large swaths of the region returning to some level of normalcy. However, we did see a rebound in infection rates late in the quarter, perhaps indicating some type of second wave was upon the region. Government officials responded with just more localized lockdowns and restrictions this time in an effort to control any further outbreaks. This could be the blueprint to handle any type of further rise in infections. The European Central Bank (ECB) continued to be active in the period, with a 750 billion Euro Recovery Plan that is a package of loans and grants financed by bonds guaranteed by the members of the European Union (EU). Investors responded enthusiastically to these actions and pushed equity markets higher in the quarter. The MSCI European Index (ex. U.K.) rose +6% in the quarter as the German equity market led the way with a healthy +8.3% return.

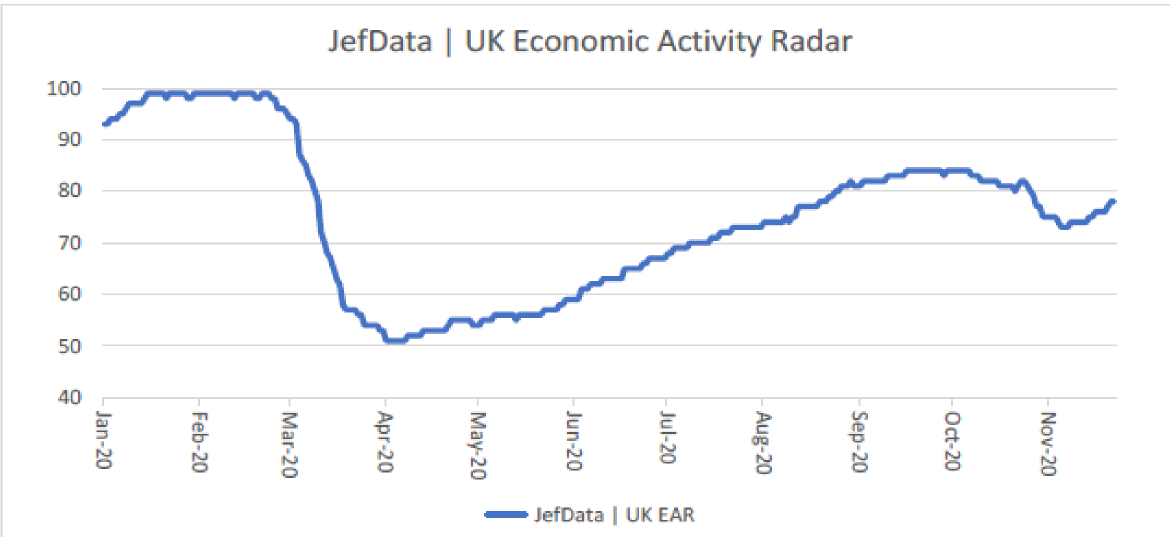
The European economy managed to climb out of the short recession as third quarter GDP rose +12.5% from the previous quarter. This came as no surprise as every other major region posted strong economic growth in the quarter and exited recessionary territory. Countries that suffered the most economic carnage over the first half of 2020 also saw the best growth in the third quarter, as the economies in Germany, France, Spain, and Italy provided the bulk of economic growth in the Eurozone. Large industrial companies that rely on a strong export market such as Siemens and Daimler posted strong gains during the period. Industrial production showed a declining trend throughout the third quarter as July was up +5.3% from the previous month, while September fell -.4% from the previous month. The industrial recovery has been uneven as lockdowns and restrictions are still hitting some areas more than others. The economic confidence index has been a little mixed over the last few months as November fell back to 87.6 from a recent high of 91.1 in October. While this can be a little erratic from month to month, we do believe the overall trend is still up from a more longer-term look. Retail sales have been up and down as well, but October sales were up +1.5% from September. This data point seems to be trending in the right direction as well as this economy continues to move away from quarantines and social restrictions. Core CPI continued its downward trend over the last few months and was reported to be up only +.2% year over year in November. This is a new record low for the region and remains very worrisome for the ECB. However, we do see this heading upward as the economy begins to reflate and growth starts to trend higher. Employment readings seem steady as the October unemployment rate fell just slightly to 8.4% from 8.5% in September. We believe we are on the cusp of better readings on this data point as the region sees further progress on the recovery, especially as government aid aimed at workers remains healthy. At the present time, we see Europe's economic recovery gaining a bit of momentum and will be a direct beneficiary of stronger U.S. and China economies as the Eurozone is a big exporter to these regions. However, this will remain fragile as risk from second wave COVID-19 infections are real and need to be contained in order to not disrupt a recovery. Vaccine distribution should alleviate a lot of these concerns.



Source: Adrian Lee & Partners; Eurostat

The U.K. economy continued to suffer from the effects of the pandemic as well as one of the slowest recoveries amongst the major regions around the globe. COVID-19 infections and death rates have hit this economy worse than others. This has forced lockdowns and quarantines to last longer than expected and delaying the economic progress witnessed in other regions. In addition, little true progress was made in the quarter on Brexit negotiations and this put investors in a very nervous position and unwilling to put on much risk. This led to the MSCI U.K. Index posting just an +.8% return in the third quarter, the worst among the major global regions for the second quarter in a row. This region needs some type of clarity regarding Brexit as well as measurable progress on the virus front to turn investors' attention back to the U.K. GDP rose +15.5% in the third quarter from the previous quarter, which was the largest growth on record. However, this economy is still further behind the pre-COVID-19 level than any of the other major economies around the globe. This is forcing the Bank of England (BOE) to institute additional stimulus measures. Industrial production has been rather flat lately following a snapback in June, as September's reading showed only +.5% growth from the previous month. Manufacturing was the weakest of the major categories of industrial production as restrictions and lockdowns took its toll in September. We would expect this to get marginally better in the months to come. Retail sales growth has been steady lately as October sales rose +1.3% from a month earlier. Christmas season shopping is underway and seems to be providing a small lift to the outlook as consumers want to get ahead of any more potential lockdowns in the economy. Core CPI rose +1.5% in October, which has cooled down a bit from the previous few months as food, clothing, and household items have been relatively stable.

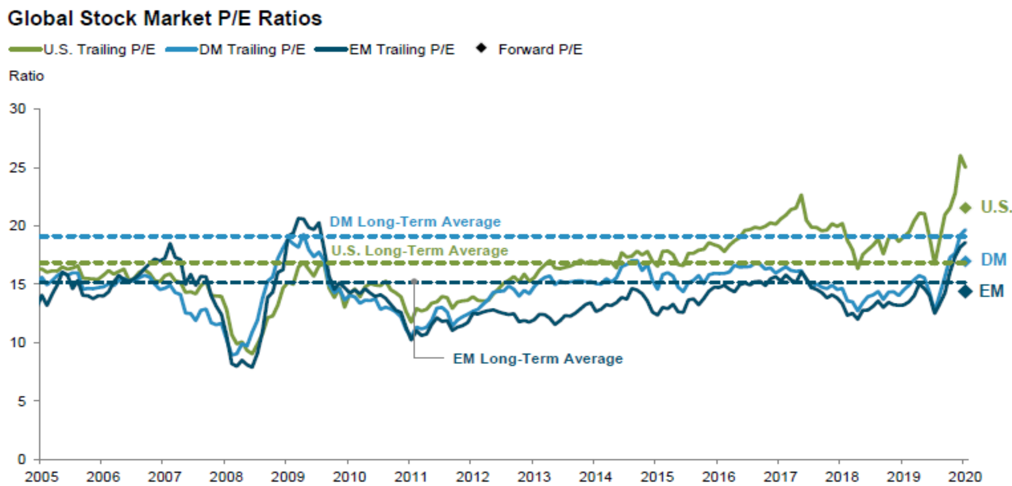
At its early November meeting, the Monetary Policy Committee (MPC) voted to maintain its main benchmark interest rate at .10%, but increase its bond purchase target by another 150 billion pounds to 795 billion pounds. These additional stimulus measures are an attempt to prevent a double-dip recession caused by the pandemic. Third quarter unemployment rose to 4.8%, which is the highest levels since late 2016. Many of the previously furloughed workers have turned into permanent job cuts. We look for more stimulus actions directed toward keeping workers on payrolls in the months ahead. Over the near term, we should see some progress on Brexit and perhaps this can bring some investors back to this equity market and provide a cyclical lift like what have seen in the other major markets around the globe.



Sources: Jefferies

Emerging Markets

Continuing the trend from the previous quarter, emerging market equities continued to lead the global equity markets in the third quarter as a strong rebound in commodity prices, a weak U.S. dollar, a rebound in some of the Asian economies, and progress on the vaccine front all came together to push these equities much higher. The cyclical sectors of Technology and Consumer Discretionary were leading gainers as we began to see a rotation by investors to a more “risk on” environment. Equity markets in China, India, Taiwan, and Korea were very strong and provided the leadership as consensus thinking among investors seemed to indicate these economies will see an economic rebound before the markets in Europe and Latin America. In addition, valuations in the emerging markets seem good to us as well vs. many other areas of the global equity markets that don’t look particularly appealing in terms of valuation. The MSCI Emerging Markets Index rose +9.56% in the period, which led returns in the developed markets. For our entire fiscal year, The MSCI Emerging Markets Index rose +10.5%, much better than large cap global equities outside of the U.S. Going forward, we are optimistic in further gains in this asset class as it looks setup quite nicely from an expected economic acceleration in many of these economies from a re-opening, a weak U.S. dollar outlook, contained inflation, substantial stimulus measures, and a vaccine that is just starting to be distributed globally.



Sources: Bloomberg; MSCI; Fidelity Investments 4Q Chartbook

<u>International Equity Activity/Strategy</u>

The continuing rally in the global equity markets since late March has been nothing short of spectacular. Many investors have never seen such a rebound over such a short period of time. Unprecedented policy responses surprised nearly everyone and provided a safety layer just at the right time to give investors the needed confidence to survive this pandemic and pushed most equity markets to fresh all-time highs. The path to a rebound seems much clearer at the moment as a vaccine is now in distribution mode, the U.S. elections are mostly behind us, the expectations of even further stimulus if needed, and well contained inflation should provide a good background for economic strengthening. Things that concern us a bit are extended valuations in some equity markets, Brexit, a fresh look at U.S./China relations, and a second wave of deadly COVID infections prior to a full distribution of a vaccine. Some of these issues could make for choppy markets as many markets are right at all-time highs. When we look at everything, we still see an upside case in global equities over the next few months.

We continue to be active with our put/call writing strategy on EEM, as premiums remain very attractive in the current equity market and interest rate climate. Emerging market equities still remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.75% of total assets and approximately 10.6% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Bloomberg, Jefferies, MSCI, Fidelity Investments, Adrian Lee and Partners, Eurostat, Evercore ISI, IMF, JP Morgan Asset Management, Resource Consulting Group, Morningstar)*