MARKET INSIGHTS

QUARTERLY

Q3 2020 REVIEW

A division of Zions Bancorporation, N.A.

WEALTH & FIDUCIARY SERVICES

ECONOMY

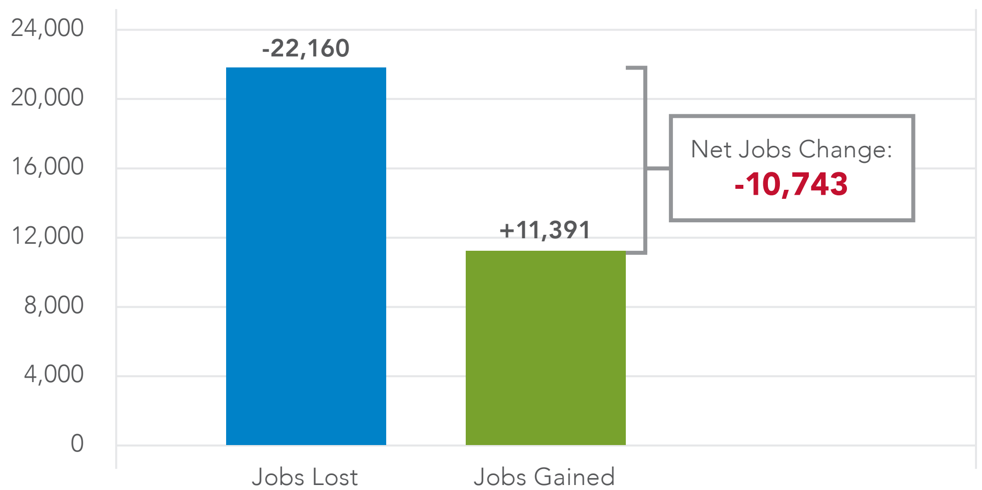
After experiencing unprecedented disruptions due to the COVID-19 pandemic, the U.S. economy remains on track to recovery even as the threat of the virus lingers. Economic data frequently beat expectations and growth, as measured by Gross domestic product (GDP), and may reach 30 percent annualized for the third quarter according to the Atlanta Fed GDP Now forecast. Consensus GDP forecasts, as measured by Bloomberg, steadily increased from 20 percent to 25 percent in September.

U.S. retail sales, which do not include travel and leisure, have already passed their pre-pandemic peak, and the manufacturing sector has also exhibited gradual improvement. Residential housing is perhaps the strongest segment of the economy, benefiting from record-low mortgage rates and limited supply, which can be traced to a timid rebuild in the aftermath of the Great Financial Crisis. Existing home sales for August reached their highest annualized pace since 2006. The robust fiscal stimulus passed back in April has played a key role in the economic recovery providing income replacement to workers and assistance to businesses. The economic rebound caused the Fed to update their economic growth forecasts for 2020 but reduced 2021 and 2022 growth expectations due to the more front-end loaded nature of the recovery.

The labor market continues to heal as evidenced by the September employment report, where non-farm payrolls increased by 661,000, after rising an adjusted 1.5 million in August and 1.7 million in July (U.S. Bureau of Labor Statistics data). Over the past five months, the economy has added back more than half of the jobs lost in March and April. The progress is encouraging, but there is still further to go.

With an election looming and Coronavirus cases remaining elevated, uncertainty remains high in the U.S. economy. The need for continued Federal stimulus is important. Economic fundamentals were strong heading into the pandemic, and once there is an effective treatment for the virus, the economy should return to strong growth. However, as we're approaching the seven-month point of the pandemic, longer term economic impacts appear to be setting in, which could hinder the potential for future growth. Still, the trajectory remains positive but continued improvement is likely to come more slowly.

JOBS LOST STILL OUTNUMBER JOBS GAINED BY 10.7 MILLION



Source: Bureau of Labor Statistics

GLOBAL EQUITIES

Over the third quarter, stock prices benefited from steady progress on reopening economies, better-than-expected economic data, optimism around vaccine prospects, and hopes for another fiscal stimulus package. The second-quarter earnings season, which began in July, revealed that corporate profits bounced back stronger than expected and helped fuel the stock market gains.

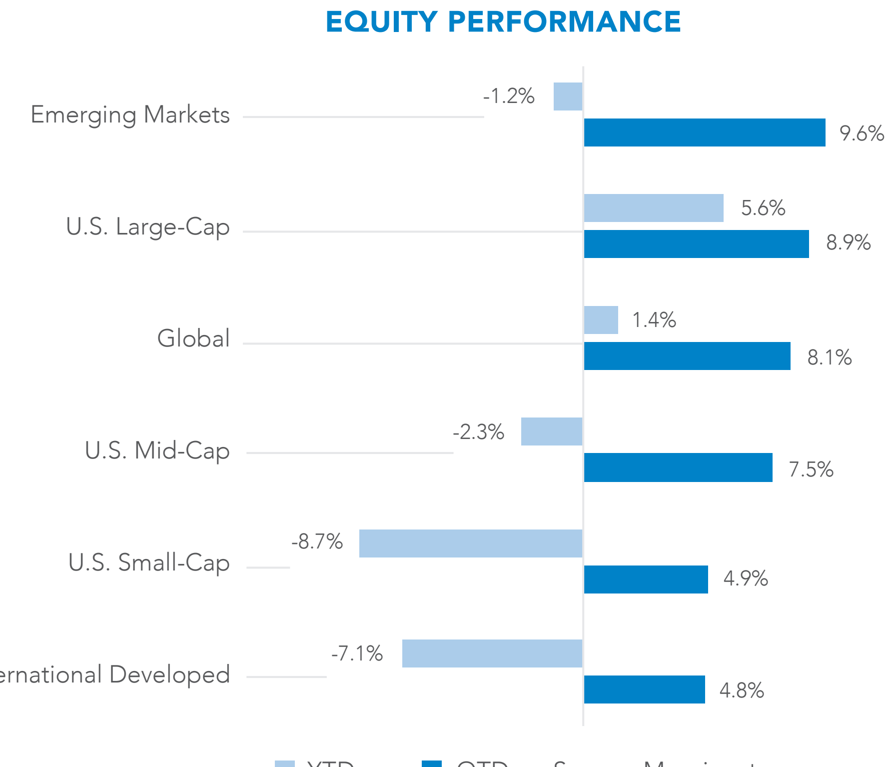
U.S. stocks, as measured by the S&P 500 Index, increased with an 8.9 percent total return, adding to the 20 percent rebound generated during the second quarter of 2020. Within the U.S., small-cap stocks also increased but lagged their large-cap counterparts due to a smaller weighting of technology stocks. Despite the pandemic-induced volatility early in the year, the S&P 500 Index is now positive on the year. However, this performance is dominated by some of the largest U.S. companies and masks the fact that many stocks are still down for the year. The equal-weighted S&P 500 Index is down 4.7 percent year-to-date through the end of September 2020.

Emerging markets led global equity market returns for the third quarter, paced by a strong rebound in China, whose economy may expand by the end of 2020. Developed international stocks, as measured by the MSCI EAFE Index, lagged the U.S. and emerging market equities but also finished the quarter higher. Like segments of the U.S. market, international equity markets are still negative year-to-date as the pandemic remains a risk to both global economies and equity markets.

September brought investors a reminder of market volatility. September and October have historically been the two most difficult calendar months for stocks and that is particularly true in an election year according to S&P data. In early September, the Nasdaq composite index suffered a 10 percent correction in just three days—one of the fastest corrections ever, and the fastest ever from a record high. Historically, the Nasdaq has tended to rise after quick corrections from new highs. Stocks were higher 6 and 12 months after those corrections more than 90 percent of the time going back 40 years, with the end of the 1990s bull market being the exception.

Election uncertainty is likely to keep volatility elevated over the near-term. A virus resurgence remains a risk, but governments appear focused on regional restrictions rather than a return to widespread lockdowns that are particularly damaging to economies. Despite risks, equities may help continued economic improvement and more attractive valuations relative to bonds.

EQUITY PERFORMANCE



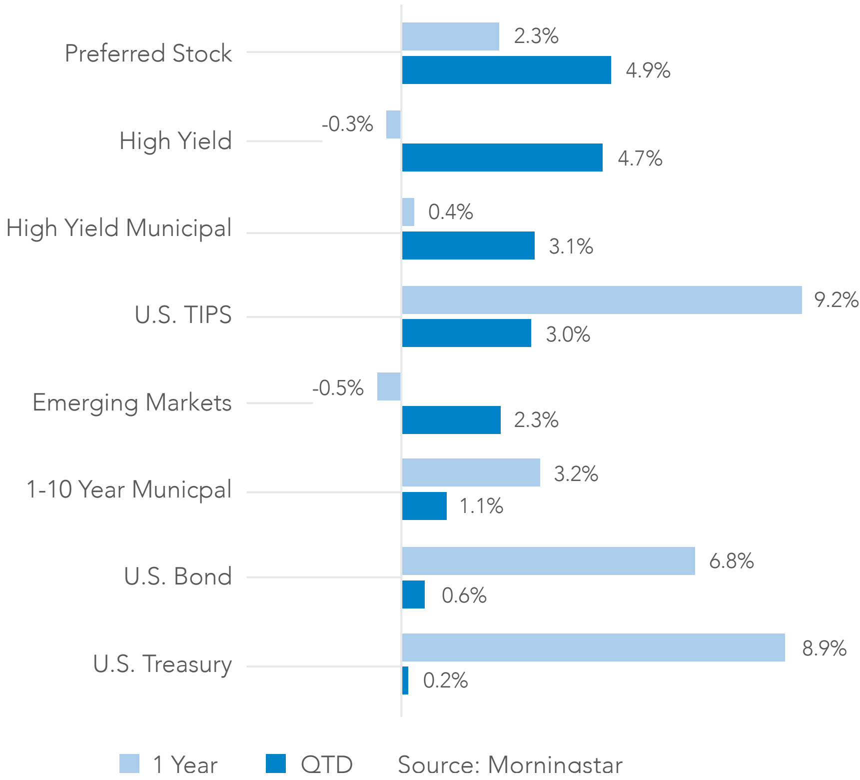
FIXED INCOME

U.S. Treasury yields remained range-bound during the third quarter as evidence of economic recovery was counterbalanced by the Federal Reserve (Fed) signaling rates would remain lower for a longer time. The quarter ended with the 10-year U.S. Treasury yield at 0.68 percent. After September's meeting, the Fed announced interest rates would stay near zero through the end of 2023, extended from the previous target end date of 2022. The Fed issued its new policy framework, initially discussed at the Jackson Hole Fed symposium in late August. In short, the Fed committed to keeping rates on hold until labor market conditions have reached their assessment of maximum employment and inflation stays above 2 percent for an unspecified period.

The Fed's "lower-for-even longer" message, and the economic improvement during the third quarter, helped drive stronger performance for lower-rated, more economically-sensitive bond sectors. While the Bloomberg Barclays U.S. Aggregate Bond Index, a broad measure of high-quality bond performance, rose just 0.6 percent, high yield bonds, emerging market debt and preferred securities generated strong results, as shown in the table below.

Higher-quality municipal bonds outperformed comparable taxable bonds during the period but still lag high-quality taxable counterparts on a year-to-date basis. High-yield municipals outpaced high-quality municipals as the sector continued to recover from March disruptions. High-quality municipal bond strength relative to Treasuries peaked in mid-August with valuations cheapening modestly through the end of the quarter. Municipal defaults are likely to increase in coming months, but we expect them to be isolated, as is historically the case, in the municipal market. No matter who wins the election, more federal aid is likely coming, and an increase in tax rates could be a positive catalyst for tax-exempt municipals bonds.

FIXED INCOME PERFORMANCE



ALTERNATIVE INVESTMENTS

All four HFRX sub-indices generated positive returns during the quarter, with the HFRX Global Hedge Fund Index up 2.7 percent for the period and +1.6 percent year to date. Equity Long/Short managers performed best against the backdrop of a continued recovery in risk assets, followed by Relative Value and Event Driven managers, and Macro managers gaining.

MASTER LIMITED PARTNERSHIPS (MLPS)

After experiencing historic price swings during the second quarter, crude oil prices were range-bound for most of the third quarter and ended the period within 1 percent of its starting point. Despite oil price stability, the energy sector was once again a laggard as investors continue to question future profitability. In September, OPEC and non-OPEC oil-producing countries decided to maintain oil supply cuts agreed to in July 2020. Demand remains weak, however, and the supply news, as expected, failed to move oil prices.

REAL ESTATE (REITs)

REITs lagged broader equities in the third quarter as continued concerns about delayed return-to-work and inconsistent direction of new COVID cases weighed on the sector. The sector did, however, outperform in September as equities declined for the month, and posted better-than-expected 2Q earnings with improving rent collection. The average REIT yield declined slightly to 4.0 percent over the quarter, but the gap to the average S&P equity yield increased marginally over the quarter, helping valuations relative to stocks.

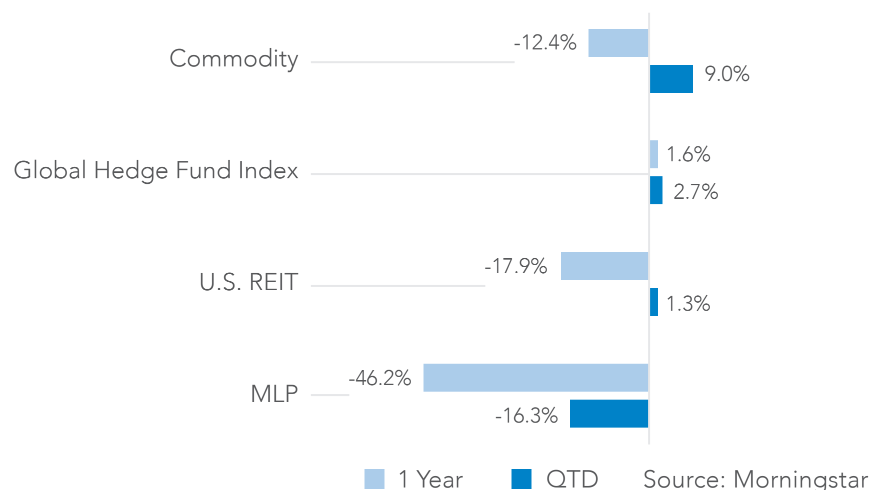
Self-Storage was the strongest performer in the quarter, up roughly 17 percent. The nascent de-urbanization trend has started to fuel greater demand, leading to attractive pricing power. Shopping Centers ended the quarter as the weakest performer. Retail, already contending with structural changes in the way consumers shop before the virus struck, continued to bear the brunt of the global recession. Shopping centers and regional malls are under pressure as more store closures are expected.

COMMODITIES

The price of gold increased sharply at the start of the third quarter, adding to already robust gains in 2020. The remarkable rally continued into early August as global central banks remained aggressive with additional stimulus and continuing to affirm lower-for-even-longer interest-rate policies. Additionally, in the U.S., expectations of potential yield caps on short-term Treasuries by the Fed added to gold momentum. As it became clear, however, that the Fed would not pursue “yield curve control,” gold prices drifted lower through the remainder of the quarter but still managed to finish higher.

For base metals, demand is expected to increase in parallel with the rising Chinese industrial activity. Macroeconomic conditions appear supportive as China remains committed to stimulating the economy through metals-intensive infrastructure projects, and as the world outside of China continues to reopen. While rapid restocking of industrial metals in China may pause, demand is expected to be great as the Chinese economy continues to rebound robustly from the pandemic. In the medium term, the performance of different metals should vary more as the impact of broad macro stimulus gives way to supply-and-demand differences.

REAL ASSETS AND ALTERNATIVE INVESTMENTS PERFORMANCE



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