Quarterly Market Review & Outlook

July 2020

Quarter in Review

It is likely that most investors exited the first half of 2020 breathing a sigh of relief. While the year's first quarter saw historic chaos in equity and fixed income markets, the second quarter brought not only a significant reduction in volatility but also a remarkable rebound in asset prices. For instance, the S&P 500, which lost over 19% in the first three months of the year, posted an impressive 20% return in the second quarter, its best quarterly return since 1998. International markets also shared in the bounce back, with the MSCI All Country World ex-U.S. Index gaining 16% last quarter after losing 23.5% in the first quarter.

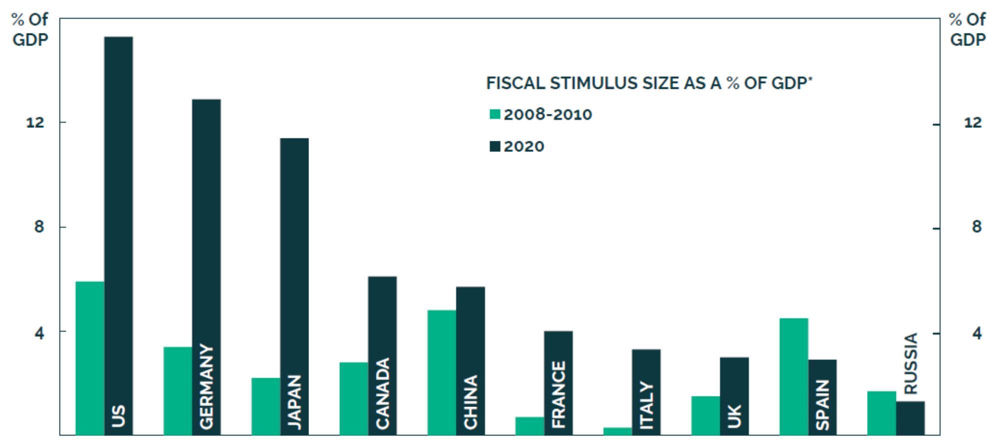
These results may seem contradictory and confusing given that the U.S. economy is still in contraction, states and other countries have not fully re-opened, and there is not yet a COVID-19 vaccine. The following are some factors to consider in understanding what helped lead markets higher despite the uncertain economic outlook:

Central Banks to the Rescue

In anticipation of the dire economic effects from COVID-19-related shutdowns, the Federal Reserve Board (Fed) acted quickly to cut short-term interest rates to 0% and unleash a range of policy tools unprecedented in scale and scope, including instituting large scale asset purchase programs and establishing swap lines to ensure that international partners would have access to U.S. dollars. The speedy policy response not only restored trading functionality to bond markets, but also helped keep borrowing costs low for companies who needed access to capital in the wake of the COVID shutdown. As a result, what was a very troubled market in March became a much healthier market during the second quarter as investors grew increasingly confident in the ability of businesses to survive the pandemic-induced shock with improved access to capital. The monetary policy support also helped buoy stock markets; low interest rates theoretically increase the premium investors are willing to pay for stocks, helping to boost stock prices. The Fed's policies were mirrored by most major central banks around the world resulting in an historic and coordinated wave of liquidity to support global capital markets.

Massive Government Response

The economic shock from COVID-19 led to catastrophic job losses and unprecedented strain on businesses, many of which have been forced to close for months due to lockdown measures. The U.S. government acted quickly to ameliorate the strain and in March passed the CARES Act, providing households and businesses much-needed financial assistance to help weather the initial shock from the shutdown. Without this support, there would likely have been catastrophic consequences that would have reverberated throughout the economy via drastically reduced spending and



Source: BCA Research

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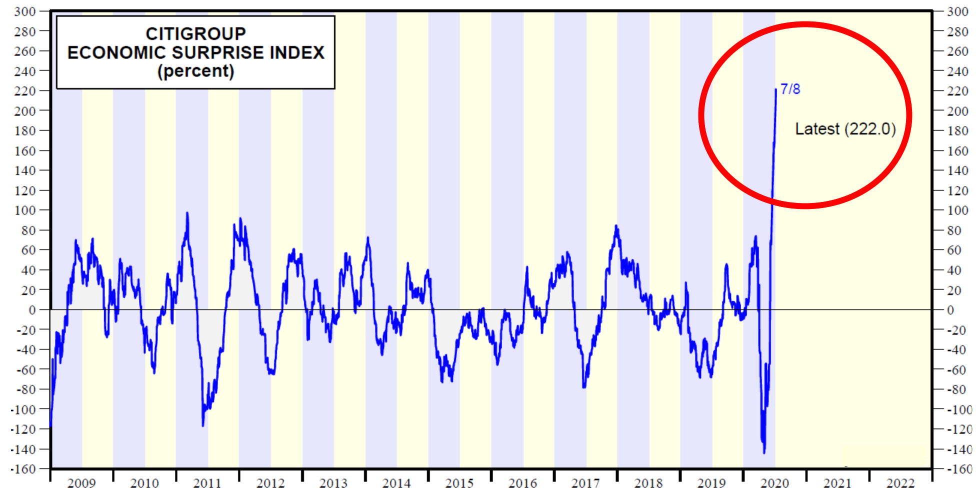
widespread bankruptcies. The speed and magnitude of the CARES Act helped inspire investor confidence that the worst-case fears of a long-lasting economic depression caused by the shutdown were increasingly unlikely. Similar fiscal policies were enacted by countries worldwide, resulting in one of the largest and broadest fiscal policy responses of the past century.

Signs of Recovery



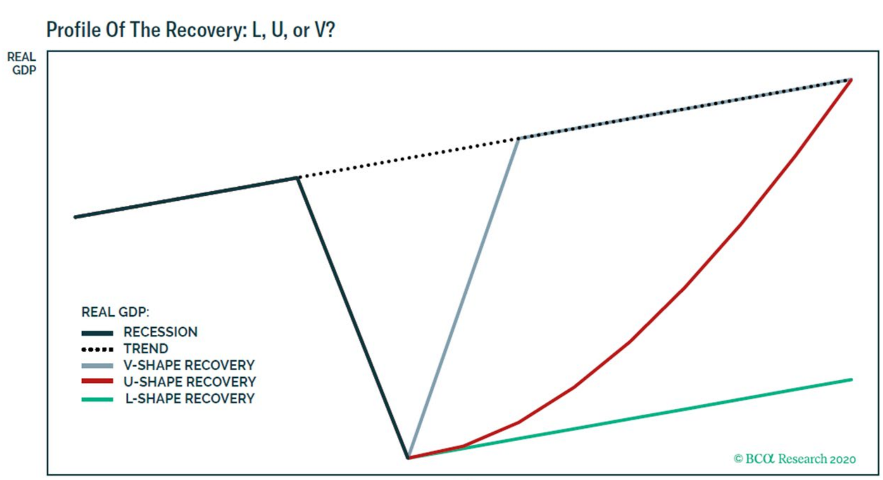
Source: Citigroup

The COVID-19-induced shutdown delivered a massive shock to the global economy, a shock that began to show in economic data as early as March. However, as the second quarter progressed, there were signs of a nascent recovery in economic activity, first abroad, where some economies reopened earlier than the U.S., and then at home. Globally, key leading economic indicators, such as jobs, retail sales, consumer sentiment, manufacturing, and even services, have begun to recover and even to surprise on the upside, evidenced by the Citi Economic Surprise index posting its highest reading ever in June. As a result, investors have started to gain confidence that the recovery may be faster, and deliver less long-term damage, than initially feared.

Investment Outlook

After the historic fall in global equity markets during the first quarter, we wrote to you about the extreme uncertainty facing markets and the need for caution moving forward. While the second quarter saw a remarkable rebound in capital markets as discussed above, the global economic backdrop remains highly uncertain as we enter the second half of 2020. As such, we continue to believe that caution and prudence remain warranted for investors given the significant challenges ahead for the global economy, and we will be watching the following closely:

Will the Economic Recovery Continue or Stall?



Source: BCA Research

As discussed earlier, investors responded positively to the initial signs of improvement in economic activity last quarter. However, while it is true that economic data seems to be bouncing back more quickly than expected, it is still broadly depressed compared to beginning of the year levels. Markets are so far responding more to the direction than to the magnitude of the recovery, a dynamic that may be challenged going forward. For instance, if demand does not recover quickly due to fears of a "second wave" of COVID-19 infections, temporary job losses may increasingly turn permanent as businesses close or are forced to lay off workers to survive, potentially reigniting fears of another leg down in economic activity. While any degree of improvement seemed like enough to encourage markets in the second quarter, going forward there is likely to be a greater focus on the magnitude and pace of the recovery.

Will Central Banks and Governments Continue to Provide Enough Support?

Quick decisions around monetary and fiscal policy initiatives were critical in restoring investor confidence during the second quarter, and it is likely that investors will need to see further policy support to maintain that confidence going forward. Recent commentary from the Fed makes it clear that monetary policy support in the form of low interest rates and increased liquidity will continue for as long as necessary, which should help underpin capital markets. However, there is a greater level of uncertainty around fiscal policy. While Congress is still mulling over the terms of any additional stimulus package, markets seem to have already priced in an implicit assumption that extended unemployment benefits and other fiscal supports will continue for as long as necessary. That assumption may be threatened by the current environment of heightened political discord. If unemployment remains high but Congress fails to pass another stimulus package, it could have a deleterious effect on asset prices that monetary policy initiatives cannot mitigate.

Will Geopolitical Strain Re-emerge?

While geopolitics took a relative backseat in the first half of the year, tensions are likely to re-emerge as the year continues. The presidential election year in the U.S. is set against a distressing backdrop of global pandemic, recession, social upheaval, and worsening economic inequality. As the election approaches, it is possible that there will be a flare up in U.S.-China tensions, which has been a popular issue with voters in the U.S. but a difficult one for businesses and markets. There is also an increasing possibility of a “blue wave” in November. In the event of a sweep, concerns that Democrats will roll back the Trump administration’s corporate tax reforms, thereby damaging corporate earnings at a time when they are already vulnerable, could roil markets.

Closing Thoughts

The ultimate impact of COVID-19 on the global economy and capital markets is still unknowable and likely will cause continued volatility. It seems prudent for investors to position for what may lie ahead by maintaining discipline around a long-term financial plan, staying diversified in their investment portfolios, and avoiding short-term, emotionally-driven investment decisions.

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