THE PRIVATE CLIENT GROUP
WEALTH MANAGEMENT

ECONOMIC & MARKET INSIGHTS

Second Quarter 2020

EXECUTIVE SUMMARY

The capital markets staged an unprecedented rally during the second quarter, fueled by optimism COVID–19 would soon be defeated, and massive government stimulus would sustain businesses and markets in the meantime. Sentiment turned on a dime as risk-taking returned to favor. Assets flowed into the equity and credit markets that had been shunned a few weeks earlier. All major asset classes gained ground for the quarter. Liquidity also rebounded in the corporate and municipal bond markets as trading stabilized and bond spreads returned to normal levels.

Economic news, while reflecting a sharp slowdown, was generally better than expected. Housing, retail sales and manufacturing all surprised on the upside. Even employment data, which had experienced its most dramatic downturn since the Great Depression, showed signs of recovery. Asia and Europe also saw a pickup in business activity and an increase in positive economic surprises. In late June, the International Monetary Fund (IMF) even raised its 2021 growth forecast for advanced economies, although its forecast for emerging and developing economies was lowered.

In the U.S., the outperformance of a small group of technology stocks and the extreme divergence between value and growth has created historically disconnected valuations. Although emerging markets have been hard hit by the pandemic, their long-term growth potential and demographic trends remain favorable relative to the more stagnant developed countries. European and Asian emerging countries have had more success at disease containment and were among the first to restart economic activity. These regions led emerging markets to outperform during the second quarter. In contrast, Latin America has suffered some of the most devastating numbers in terms of infections and casualties. Several countries also face political instability and poor economic policies. Many active managers have been able to add value through stock selection and outperform market benchmarks.

We are in an environment of extreme uncertainty in which economic forecasts and corporate earnings guidance may be unusually inaccurate. While government stimulus is keeping the U.S. afloat, a surge in debt and the potential for inflation down the road are dangers. Many strategists believe the worst is behind us, but the global economy faces many risks including the resilience of COVID-19. For the U.S., a hostile relationship with China, civil unrest and contentious elections with major policy implications creates an unpredictable environment. Opportunity will eventually come from the dislocations in the public and private markets.

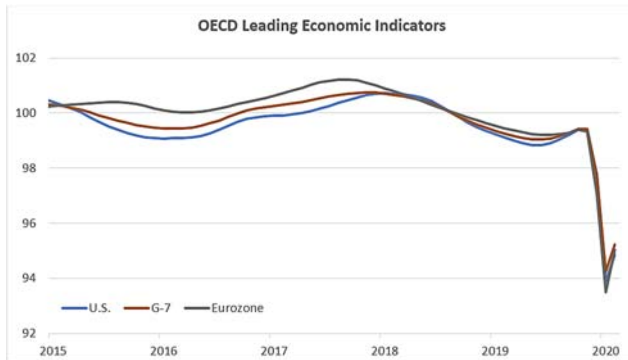
ECONOMIC INSIGHTS

Several months into the COVID-19 crisis and its effect on the economy remains far-reaching but varied. After several weeks of encouraging data and progress towards reopening the country, numerous setbacks emerged. On the public health front, there have been notable spikes in cases, particularly in states that fared better earlier in the crisis. Setbacks in reopening could bring progress towards a recovery into question. The nature of the crisis can also result in dramatically different ramifications for different segments of the economy. For instance, higher-paying desk jobs tend to translate more easily to remote work whereas lower-skilled jobs remain more challenged. This disparity could further increase an already wide wealth gap in the U.S.

Many economic indicators came off historic lows reached in March and April as people resumed elements of their normal lives. While any improvements are encouraging, there is a long road ahead before the global economy can recover much of the lost ground stemming from the COVID-fallout. Unemployment continues to be at record highs, creating an enduring headwind for consumer spending over the next several years. The pandemic triggered a quick and deep recession in terms of the decline in economic activity, although the forward-looking stock market appears to believe that it will be short in duration. Over the second half of the year, the long-term outlook should become less murky as we learn important details about how businesses and communities can function while keeping coronavirus at bay.

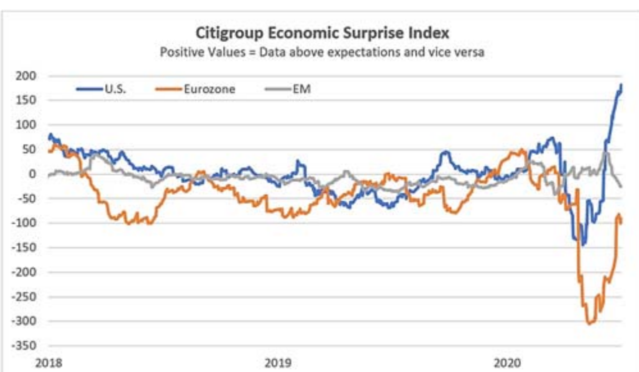
Federal Reserve Bank of New York

The Weekly Economic Index measures the expected change in GDP, incorporating several factors such as unemployment claims and gasoline sales. Recent readings recovered from prior record lows as people resumed portions of their regular lifestyles, although there remains a long way to go to return to positive readings.



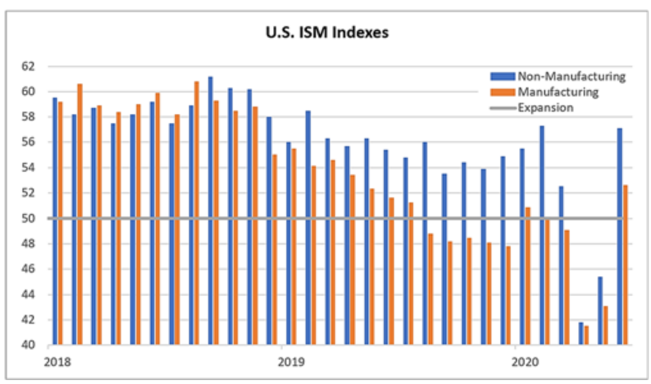
Organization for Economic Cooperation and Development

After showing signs of recovering in late 2019, leading economic indicators turned sharply lower in early 2020. These indicators are intended to determine inflection points in economic growth and have since turned positive indicating that the recovery has taken early form.



Citigroup

There has been a heightened level of volatility as economic indicators attempt to make sense of the current state of the economy. The U.S. and Europe have seen dramatic recoveries from lows reached earlier in 2020. Emerging markets held up better initially but have weakened recently.

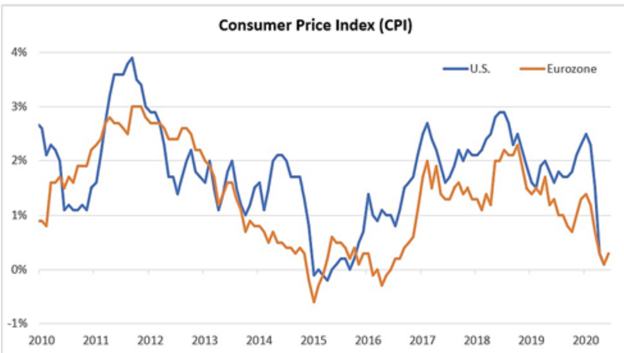


Institute for Supply Management

Both manufacturing and non-manufacturing ISM indexes recovered sharply back into expansion territory in June. The increases recorded from May to June also represent some of the largest single-month jumps in the indexes' history. While encouraging, some of the increase could be based on pent-up demand.

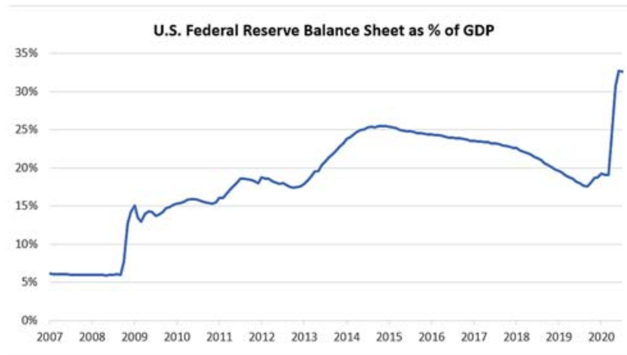
The Federal Reserve's balance sheet extended its march higher, reflecting the massive levels of easing to help stabilize the domestic economy. For context, the Fed's assets have grown by roughly $3 trillion since the start of the year and the Fed's balance sheet now exceeds 30% of GDP. The federal funds rate was cut to near-zero and there are few signs it will increase anytime soon. With the potential for more domestic stimulus on the table, the federal debt will see levels never reached before in history. Such deficits will require significant discipline and potentially higher taxes following the COVID crisis to get under control. A sharp recession paired with a collapse in oil prices contributed to a fall in already low inflation levels. While inflation should remain low in the near-term, stabilization in oil prices, massive levels of government intervention and increased costs for businesses having to comply with new health standards could contribute to higher levels in the future.

The unusual circumstances of this crisis result in a varied impact on corporate earnings for different areas of the economy. For instance, earnings growth forecasts for the technology and utility sectors are up compared to the end of last year, while earnings estimates for sectors such as energy and consumer discretionary have fallen sharply. This contributes to an overall fall in second-quarter S&P 500 earnings, although the story beneath the surface is more varied. Looking ahead, the future state of the economy is possibly the most uncertain it's been in many decades, which is only exacerbated by the impending election. Nonetheless, the economy and markets will persist and find ways to adapt to the heightened level of change.



U.S. Bureau of Labor Statistics

Inflation readings are well below where they finished last year due to the current recession and a fall in the price of oil. Looking forward, massive amounts of stimulus, paired with increased costs of consumer goods/services in a post-COVID world could spur higher inflation.

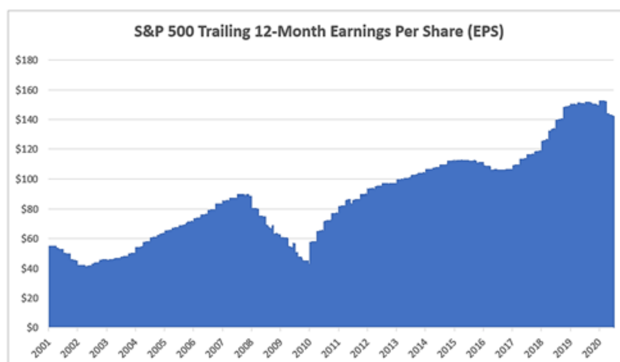


Bloomberg

Unprecedented government intervention has steadily grown the Fed's balance sheet as a percentage of GDP. Fed assets have increased by more than $3 trillion so far this year and show no signs of falling. Record levels of debt will likely present an economic burden going forward that needs to be met with fiscal discipline and/or higher taxes.

U.S. Federal Reserve and Bloomberg

After a quick spike during a flight-to-quality early in the COVID-crisis, the relative value of the dollar has fallen back to more normalized levels. Lower interest rates and near-endless loosening of monetary policy have diminished the relative attractiveness of the U.S. Dollar relative to international currencies.



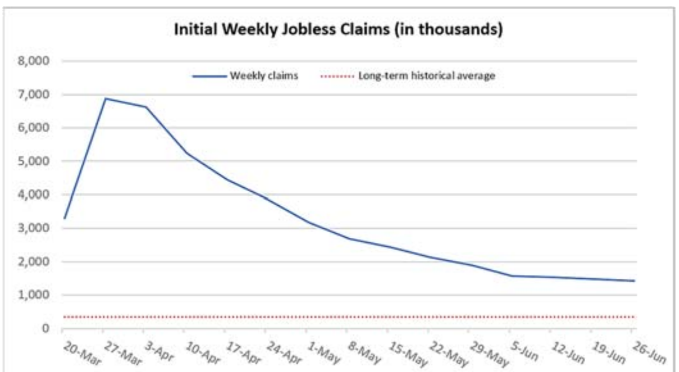
Bloomberg

Consensus estimates suggest that S&P 500 earnings are likely to fall throughout 2020 and then recover in 2021. While the extent and duration of the earnings impact are still uncertain, markets are forward-looking and there is a much higher degree of certainty that they will rebound in the medium- to longer-term.

EMPLOYMENT AND THE CONSUMER

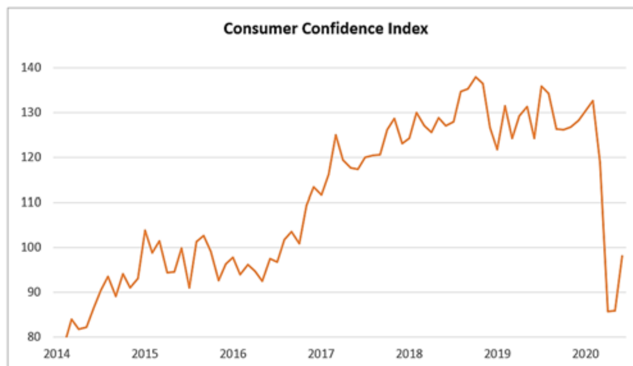
After the first quarter's record-breaking count of initial jobless claims, the second quarter indicated a gradual recovery is underway. The U.S. unemployment rate rose slightly in March to reflect some initial effects of the economic shutdown, and then more than tripled in April to 14.7% since retreating to roughly 11% through June. Being released monthly, this figure is somewhat lagged but also considered to be a more accurate snapshot of the labor market since it accounts for job losses netted out by job gains. A timelier statistic that's released, the initial weekly jobless claims report, also depicts a gloomier story after skyrocketing to nearly 7 million Americans that filed for unemployment benefits in late March. This weekly report has similarly trended downward through the last week of the quarter which reported almost 1.5 million initial claims. However, it is critiqued as somewhat misleading since it does not account for people who have started new jobs, rather only those who have recently lost their jobs. Regardless of what you read, the labor market is on the slow rebound but may take longer than we'd like to return to its pre-pandemic levels as many people's long-term job status remains unknown.

Investor sentiment often plays a large part in the progression of the economy and the markets. Typically, rising prices imply positive sentiment while falling prices imply negativity. As a barometer for investor sentiment, the consumer confidence index remained elevated for years until a slight dip in March. After it took a nosedive in April, it's made a quick upwards trend again and can be helpful to anyone looking to assess the current environment. Roughly positively correlated to the stock market, it accurately reflected the fear and unknown that investors felt as the pandemic took hold. Over the quarter, some businesses swiftly adapted to the "new normal" and figured out the necessary steps to keep their doors open. Likewise, there have been some businesses that couldn't adapt, or simply chose not to given the circumstances, and closed for good. Each scenario had profound impacts, positive or negative based on the outcome, on consumer-related statistics as well as the employment market.



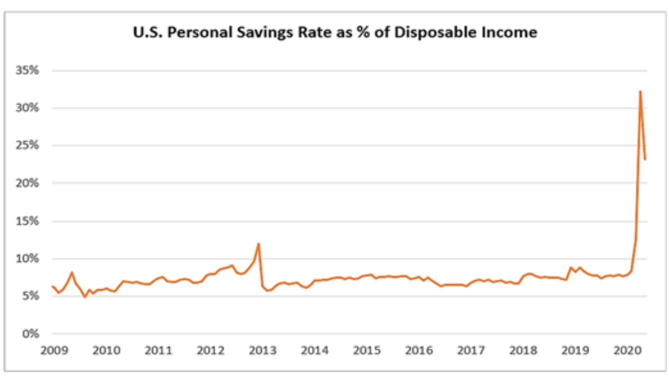
Labor Department

Initial jobless claims slowly trickled down to more manageable levels but are still well above the long-term 50-year historical weekly average.



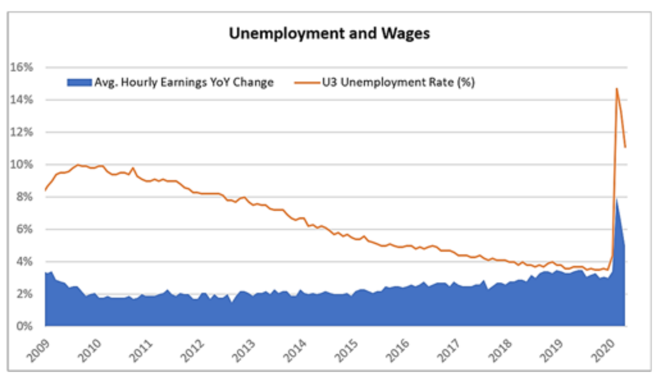
Conference Board

Consumer confidence levels fell to its lowest reading since 2014 but appear to be making a recovery and hint of improved overall investor sentiment since March.



Bureau of Economic Analysis

The U.S. personal savings rate quickly spiked to above 30% in the middle of the pandemic but has since fallen as more people seek out new investment opportunities.



U.S. Bureau of Labor Statistics

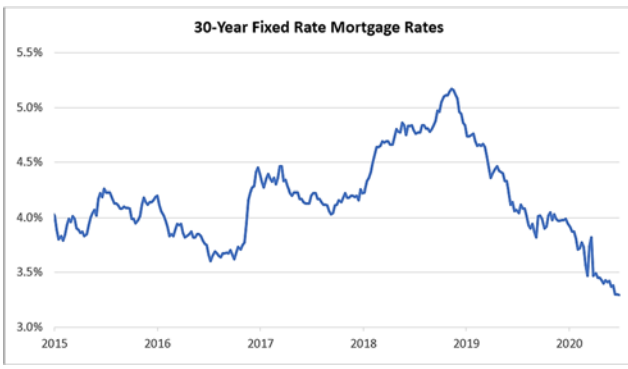
The widely talked about unemployment rate accelerated to more than 14% in April but has fallen back since. Separately, hourly earnings have increased that reflect the widespread job loss among lower-paid workers.

RESIDENTIAL AND COMMERCIAL REAL ESTATE

2020 continues to be an unusual year for the housing market. It kicked off with strong tailwinds from a robust economy and low mortgage rates. Activity then came to a complete standstill in March and April but has recently picked up steam. The residential sector's peak spring season has migrated to summer and is now in full swing. Still, the deterioration of the labor market could have longer-lasting implications for housing accessibility and push more people to rent for longer.

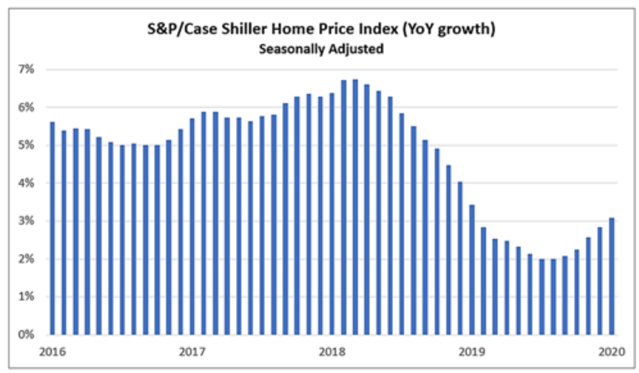
Housing market data has generally trended higher since the lows reached in March and April. June purchase applications reached the second-highest weekly level for the year and represented a 12% increase from a year prior. This is a stark contrast from the 2008 Great Recession when it took more than a decade for purchase demand to return to prior levels — although that was a housing centric crisis. While the bounce back is encouraging, Freddie Mac still expects that home sales will not recover to 2019 levels until 2022. Home pricing growth is also expected to flatten out. It's also uncertain how the market will fare once the heightened level of government assistance subsides and the full effects of current unemployment levels are felt.

Commercial real estate tends to be in a tougher spot when compared to the residential market. Further, select sectors within the commercial space face strong headwinds. Hotels are forecast to suffer the most with average occupancies representing a fraction of years' prior. Retail locations are grappling with store closures and bankruptcies of several notable national chains. Office landlords are anxiously awaiting the return of their tenants and are eager to better understand what the future of work looks like. On the more positive end, the industrial sector has proved more resilient and better equipped for this environment.



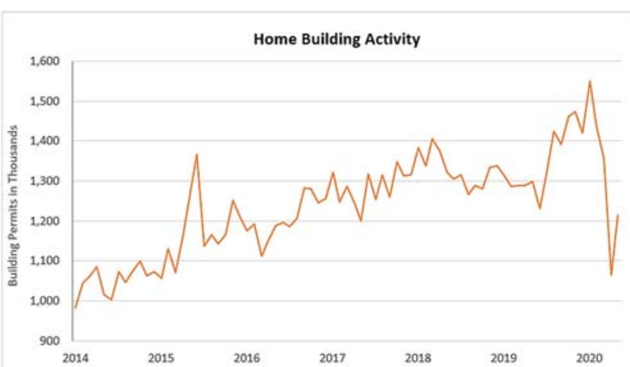
Mortgage Bankers Association

Mortgage rates have fallen extensively since the start of the year and stand at record lows. Forecasts expect that rates will remain low for the next few years, offering some support for the real estate market.



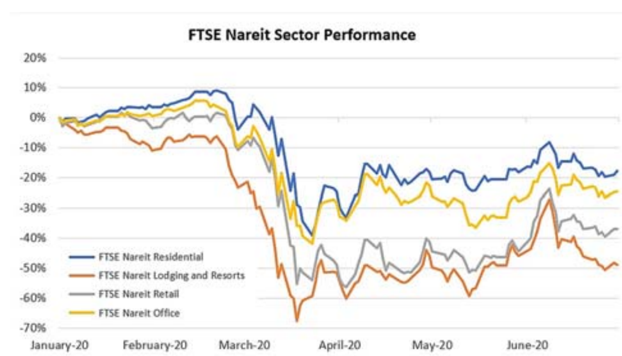
S&P/Case Shiller

The rate of increase in home prices has remained positive throughout the current crisis. The pace of growth has increased from lows reached in March/April but is still well below levels from the past several years.



U.S. Bureau of the Census, U.S. Department of Housing and Urban Development

Home-building activity had a stark decline following restrictions on construction activity at the height of the crisis. Activity has since picked up to meet pent-up demand but has a long way to go before a full recovery.



Nareit

There's a high level of disparity across different areas of the real estate market. The residential sector has generally held up the best due to continued demand while lodging/resorts and retail remain challenged.

MARKET INSIGHTS

EQUITY MARKETS

Following a decimating first quarter of the year for equity markets, the second quarter was quite the opposite after record-high levels of some indices were briefly reached. Amazingly, the S&P 500 Index recorded its single best quarter return since 1998, after it rose 20.5%. With such a profound reversal, the index is now sitting at a -3.1% year-to-date return – simply unbelievable considering the extreme levels of volatility it's experienced and events that have unfolded. It's also an arguable point that the stock market's valuation levels, sustained by future optimism, are diverging away from the status of the economy. The U.S. is still leading its international counterparts for both the recent quarter and the year. Also, emerging markets beat the broader developed international markets for the recent quarter and the year, reversing past years' trends.

In the U.S., all sectors produced positive returns. Leading everything was consumer discretionary, which soared as more people adjusted to being home more often and sought to take advantage of home improvement projects or even companies' online accessibility features. Following close behind was the information technology sector, which stocks have capitalized on the situation the pandemic has created as people and companies everywhere are being modernized. Energy, after having a strong second quarter, is still by far the worst-performing sector for the year but was also able to enjoy the recent benefits of increased demand levels of air and land travel levels as certain parts of the country continue their slow reopening process. Growth outpaced value, much like what's occurred for the past decade, while the return disparity was meaningful at more than 16%.

Bloomberg

Valuation multiples plummeted in the midst of the market's turmoil, but quickly rebounded to their pre-pandemic levels. Time will tell if this rebound was too swift and aggressive.

FIXED INCOME AND ALTERNATIVE MARKETS

Fixed income markets stabilized during the second quarter following the massive sell-off and liquidity crunch experienced at the height of the coronavirus crisis. Demand for yield in the face of near-zero cash rates and improving sentiment drove investors back to credit-sensitive bonds including high yield and emerging market debt. In the U.S., credit spreads fell sharply following the Fed's announcement that it would purchase corporate bonds directly in addition to through ETFs. Investment grade spreads are now below long-term averages. Lower rates have caused new issuance to surge as issuers return to the capital markets. New issuance of investment grade bonds was the highest in 30 years and high yield issuance also materially picked up.

There are signs of credit quality retrenchment. Credit rating downgrades and the percent of bonds trading at distressed levels have both spiked. The municipal segment faces strong headwinds as revenues from income and sales taxes contract. However, most municipal issuers came into the current health care crisis with surplus funds and have a range of tools at their disposal to cut costs. Government programs to provide funding and lending facilities to municipalities and essential sectors such as health care and transportation are widely expected to provide a backstop.

The Fed continued to purchase Treasuries and mortgages, dampening yields and supporting bond prices in those sectors. The yield curve was fairly stable over the quarter with a small uptick at the short end. The Fed's balance sheet grew to over $7 trillion during the quarter, an increase of $3 trillion. U.S. Treasury yields remained near historic lows, with the 10-year skirting 1%. The Fed has recently communicated its plan to keep the policy rate at 0%–0.25% until at least 2022. Although the risk of negative rates in the U.S. seems to have abated for now, the portion of global bonds with negative yields is again on the rise.

Barclays Capital

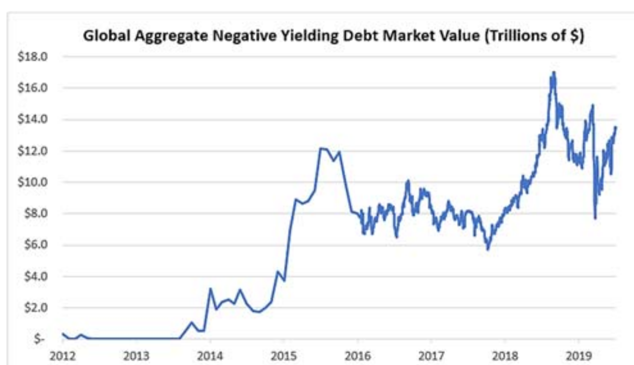
After sharply spiking at the start of the coronavirus crisis, high yield spreads retrenched to more normal levels. Above average yields reflect concerns over rising corporate leverage and the mounting threat of defaults.

Bloomberg

Sovereign bond yields stabilized during the quarter. With most developed debt having negative or close to zero yield, higher yielding emerging market debt has become more attractive to investors despite elevated risks.

Bloomberg

A resurgence in investor demand and the promise of Fed support helped to stabilize municipal bond yields. However, even high-quality municipal bonds were still yielding more than similar duration Treasuries.

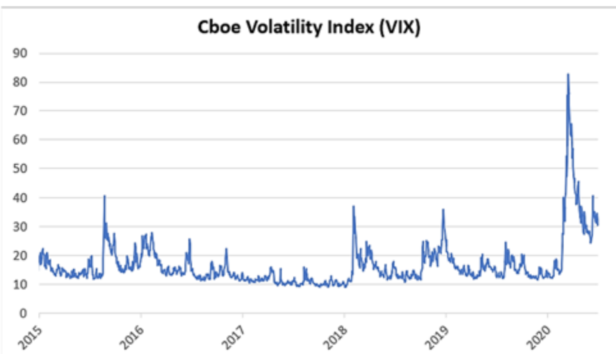


Bloomberg Barclays

The share of global bonds with negative yields is again on the upswing as central banks reduce rates to support hard hit local economies. Negative rates create a challenging environment for banks and insurance companies.

Hedging and tactical trading strategies overall did well during the quarter, led by equity-oriented styles, particularly those with an emphasis on technology companies. Stock price volatility and the divergent impact of the current health crisis on different industry sectors should create a robust opportunity set for fund managers focused on stock picking. Reduced dispersion across risk-oriented assets as well as sudden, sentiment-driven shifts in market prices have created a challenging backdrop for managers with active trading strategies. As a result, global macro and CTA strategies have struggled in recent months. Despite a slowdown in deal activity, merger arbitrage had a good quarter. Wider deal spreads and an expected wave of corporate reorganizations bode well for event-driven strategies in general.

Gold and other "flight to quality" precious metals have been the highest performing investments during the pandemic-led market correction. Most other commodity sectors succumbed to the steep drop in global demand as trade and manufacturing suddenly shutdown. The price of oil has recently bounced back but remains too low for many producers to be profitable. The supply dispute between Russia and Saudi Arabia which weakened oil prices earlier in the year has dissipated for now, but OPEC as a power base may have been undermined.



Cboe, Bloomberg

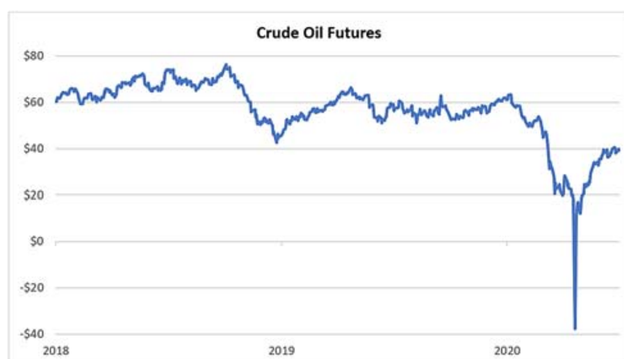
After briefly surpassing 80, VIX sharply declined, spanning 30 to 40 for much of the quarter. VIX remains elevated relative to its historical level in normal markets. A recent upswing suggests investor sentiment may be deteriorating.

Cboe, Bloomberg

The correlation between stocks tends to rise during market corrections and periods of heightened volatility. High stock correlations should dissipate as investors recognize the disparate fortunes faced by sectors and companies during the pandemic.

Bloomberg

Gold has recently proven its worth as a safe haven, rising almost 17% year to date. Although many forecasters predict further gains, the price of gold is influenced by the U.S. dollar and central bank actions and can be unpredictable.



U.S. Energy Information Administration

After a precipitous decline, the price of oil has rebounded to about $40. The price of oil is a bell-weather for the economy and inflation. Low energy prices have an outsized influence on oil-producing regions, particularly in emerging countries.

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