2020 Mid-Year Economic and Markets Update: Cross Currents and a COVID Hangover

The beginning of an unbalanced journey toward economic recovery

July 2020

Key Observations

- The sequential improvement in global monthly economic data is a welcome signpost, but it is our view that year-over-year data trends more acutely reflect private sector financial conditions. Incrementally higher financial asset valuations may hinge on the breadth and speed of global economies re-opening.

- The Fed's bold policy response to the economic downturn effectively created a floor for risk assets and a ceiling for both credit spreads and the U.S. dollar. The degree to which foreign developed central banks follow suit may support multiple expansions among foreign-denominated equities relative to U.S. stocks. Low inflation expectations should allow central banks to support further accommodations, while the economic downturn may also pressure elected officials to pass fiscal stimulus.

- Halfway through 2020, multiple known unknowns appear priced into financial assets. As such, the short and intermediate-term outlook for risk assets will likely hinge on economic reality relative to expectations in the second half of 2020 and unknown unknowns that may emerge. Second and third-quarter corporate earnings results should indicate the pace of economic recovery in 2021.

We began the year bearing a cautious view regarding opportunities across the financial markets. Evidence of a maturing economic cycle and somewhat elevated valuations (on the heels of the strong returns generated by markets in 2019) caused us to pause, thoughtfully take stock of the investing landscape and conclude that a focus on risk management trumped striving for return in 2020.

While our forecast certainly did not contemplate the emergence of a global pandemic unleashing, in essence, a ready-made and debilitating economic slowdown, our decision to elevate considerations relating to portfolio risk reaffirms the necessity for investors to be adaptable to evolving economic and investing backdrops.

More recently, markets have taken their cue from nascent data hinting at the potential containment of the virus and society's ability to, perhaps, nimbly affect an economic re-awakening. Recent returns across risk assets appear indicative of a seemingly unrelenting and robust economic recovery in the second half of the year.

However, we caution investors to remain on guard. Although we are hard-pressed to imagine that the environment confronting investors the last several months will be replicated any time soon, we do expect market conditions will remain tenuous until a more comprehensive resolution to the health crisis is devised.

Financial Market Conditions

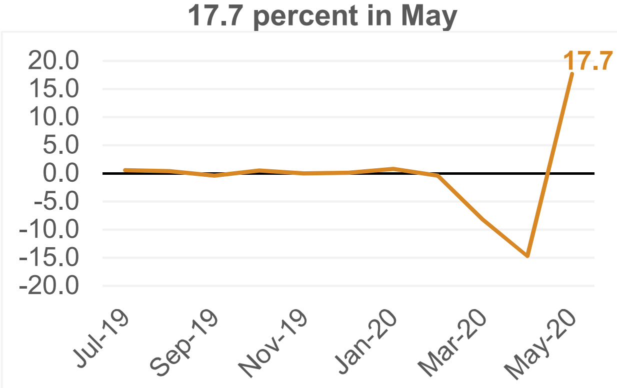
Economic Growth

The International Monetary Fund (IMF) expects global GDP to shrink 4.9 percent in 2020, which would mark the worst global economic slowdown in nearly 100 years. The IMF forecasts a gradual recovery in the second half of 2020, and 5.4 percent growth in 2021 (down 0.4 percent from its April forecast), anchored on the expectation that global economies will experience a smooth path toward normalcy.

While the sequential improvement in U.S. business activity[1] was a welcome signpost that the pace of economic contraction slowed considerably in June, year-over-year trends more acutely reflect the challenging conditions facing the private sector. This trend highlights an important consideration when measuring progress toward a recovery: sequential improvement in economic data is encouraging, but year-over-year comparisons more accurately illustrate the economic reality facing many businesses and households. Economic data tied to household consumption, which historically represents about two-thirds of U.S. GDP growth, underscores that point. Compared to last year, May retail sales fell 6.1 percent, inclusive of a 17.7 percent increase over April. A vital measure of the eventual economic recovery will be the speed by which year-over-year comparisons improve.

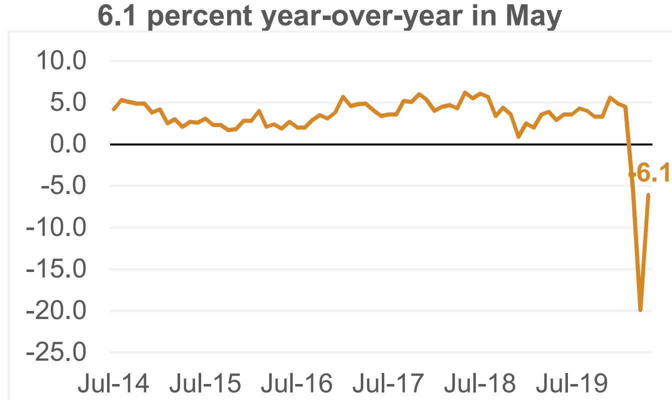
We will continue to monitor macroeconomic data but acknowledge the prospect for incrementally higher financial asset valuations in the back half of 2020 may well hinge on the breadth and speed of re-opening. Therefore, we currently prioritize careful and thoughtful risk analysis focused on aligning investors' portfolio allocations and investment horizons over a reach for potentially higher return.

Month-over-month retail sales increased by 17.7 percent in May



Source: Bloomberg

Inclusive of the bounce, retail sales fell 6.1 percent year-over-year in May



Source: Bloomberg

[1] Business activity is measured using Global Markit IHS PMI Composite data through June 2020

Evidence validating the efficacy of these curtailments to forge broader economic stability is promising, but very preliminary. We anticipate several speed bumps on the path to a sustained pick-up in the economy.

Monetary Policy

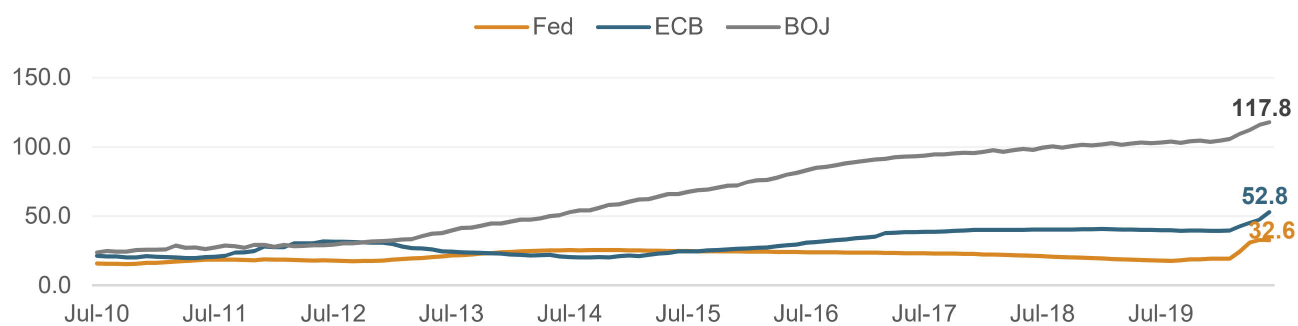
Global central banks responded to the economic downturn predictably by slashing interest rates and expanding their balance sheets. In a noteworthy move, the Federal Reserve created more than 10 facilities to broaden the range of assets it was willing to buy, including high yield debt. It further indicated that it stood ready to deploy more monetary stimulus if necessary. The bold policy stance paid off. Volatility across financial assets fell, credit spreads narrowed and the U.S. dollar weakened against developed economies and large trading partners.

In the second half of 2020, we expect the Fed to incrementally grow its balance sheet, albeit at a slower pace. Foreign developed and emerging market central banks may also step up policy accommodations to support their economies, which may buoy international equity multiples. Furthermore, synchronized monetary easing may cause investment-grade corporate bond spreads to tighten from current levels.

Accordingly, and in light of wider credit spreads today than at the beginning of 2020, we removed a theme in our *2020 Outlook: Corporate Credit Watch*. The premise for our theme at the beginning of 2020 was that slowing economic growth, tight credit spreads and prevalence of BBB-rated corporate debt warranted more tempered allocations to credit and thoughtful utilization of active managers. Although we still favor actively-managed strategies in the asset class, corporate credit spreads potentially offer a more favorable return profile as the economy begins to recover.

Central bank balance sheets as a percent of GDP

Despite unprecedented levels of monetary easing, the Fed has a lot more policy room to support economic activity.



Source: Bloomberg. Data as of June 30, 2020.

Fiscal

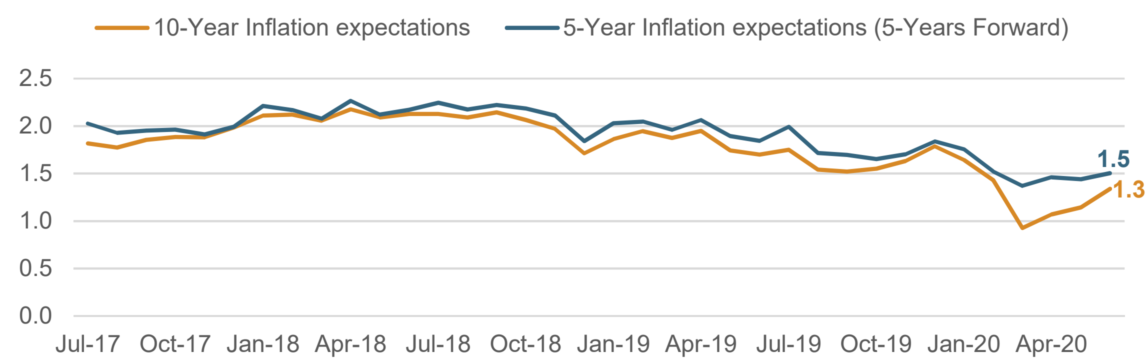
The U.S. fiscal policy response was swift and provided households with much-needed support during the economic slowdown. Some of those benefits, most notably in the form of emergency pandemic compensation, are scheduled to expire in July. With approximately 30 million individuals collecting some form of unemployment benefits and active case counts on the rise in some parts of the country just five months before elections, bipartisan support for another round of fiscal stimulus appears highly probable.

Inflation

Plummeting energy prices and a sharp decline in economic activity in May pulled the annualized inflation rate down to just 0.2 percent. Amid the backdrop of lower year-over-year commodity prices and consumption trends, headline inflation will likely remain well below the Fed's intended 2.0 percent target for some time. According to the Fed's projections, the earliest inflation may return to target levels is 2023. Looking ahead, the trajectory for inflation will likely parallel the pace that economic activity normalizes over the next few quarters.

In our view, the short to intermediate-term inflation climate should provide favorable conditions for fixed-income allocations. Long-term inflation expectations are well anchored today, but a sustained upside surprise would likely be positive for global equities, all else equal.

Long-term inflation expectations bounced but remain well below the Fed's 2.0 percent target

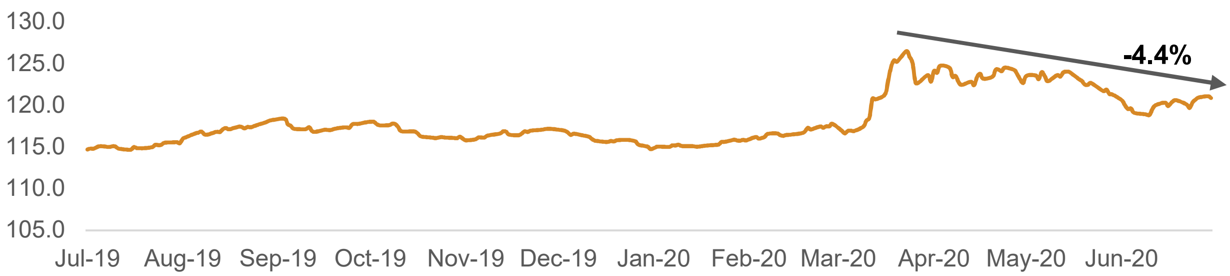


Source: Bloomberg. Data as of June 30, 2020.

Currency

A sharp rise in demand for U.S. denominated assets earlier this year, a corollary to extreme market volatility, propelled the U.S. trade-weighted dollar higher by as much as ten percent before it fell 4.4 percent in response to the Fed's aggressive policy reaction. The dollar appeared to stabilize at the end of June, but currency valuations react in a relative manner. Therefore, should volatility continue its path toward more normal levels and developed foreign central banks around the globe take steps to accelerate monetary stimulus, the dollar could weaken in the second half of 2020.

U.S. dollar responds to the Fed's "whatever it takes" policy response



Source: Bloomberg. Data as of June 30, 2020.

Investment Themes

1. **2020 Outlook: Managing Risk > Targeting Return**
   Mid-Year 2020 Update: A COVID Hangover

   Key Observation Beginning 2020 – Incrementally weak manufacturing and household data suggested the U.S. economy may be approaching the late stages of its business cycle. Meanwhile, the manufacturing sector in Europe remains weak and emerging markets are grappling with a secular slowdown in China and slower global growth.

   Mid-Year 2020 Update – Although we expected the pace of economic activity to slow in 2020 compared to 2019, we were sorely disheartened by the human and economic consequences brought forth by the global pandemic. Economic growth measures fell to historically low levels as mitigation efforts took their toll on household consumption and business activity. A global Markit IHS PMI Composite data reading of 49.7 in June offered evidence that the pace of economic contraction slowed in June, compared to May, as economies emerge from shelter-in-place. Recall that an observation below 50 indicates a contraction in economic activity while an observation above 50 indicates expansion. The recent rise in confirmed case counts may slow the path to more normal levels of economic activity.

Economic activity contracted in June, but trended in the right direction
Markit PMI data > 50 indicates business expansion – a critical level for profit expectations

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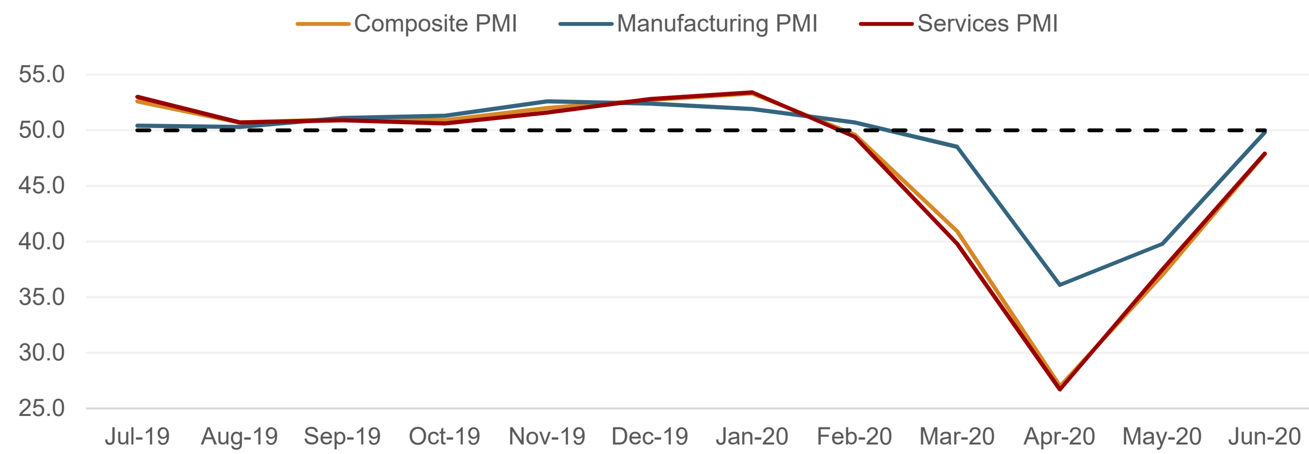


Source: Bloomberg. Data as of June 30, 2020.

Portfolio Impact – Amid an abundance of economic data, none may be more important to discern the economic outlook than (1) changes to the number confirmed COVID-19 cases and (2) the fatality rate. The trajectory of these statistics will likely influence consumption behavior irrespective of government-initiated mitigation efforts. We acknowledge the inherent uncertainty associated with the pandemic and expect heightened levels of market volatility until a clear treatment is developed. For this reason, we believe a prudent investment risk management strategy, inclusive of short and intermediate-term cash needs, will be critical to navigate market volatility.

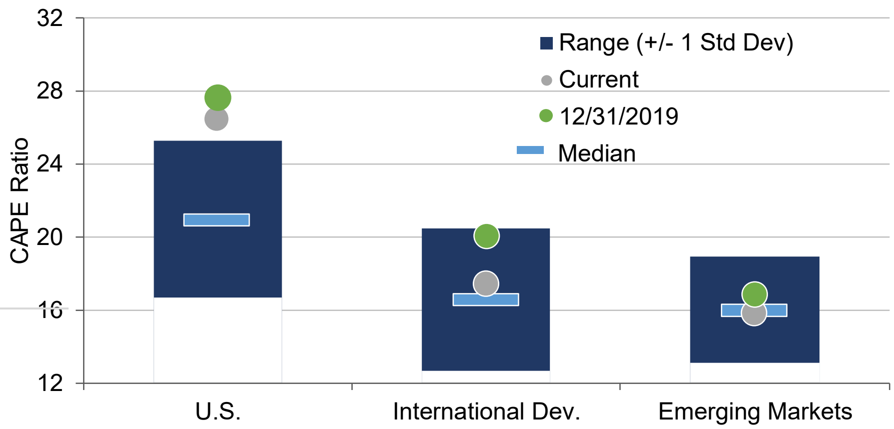
2. 2020 Outlook: A Case for Global Equities (No Change)

Key Observation Beginning 2020 – U.S. stocks once again led the rebound in global equities despite relatively more attractive valuations for international equities at the beginning of 2020. In fact, despite carrying a relatively elevated valuation each year, the S&P 500 Index outperformed the MSCI EAFE Index in seven of the last 10 calendar years! Since 1978, however, the S&P 500 Index outperformed the MSCI EAFE Index in just 14 of the last 42 (33 percent) calendar years. Furthermore, our research shows relative performance between domestic and international equities is cyclical and influenced by U.S. dollar strength (or weakness) relative to major currencies. While valuations are observable and measurable, currency fluctuations are difficult to predict. Therefore, given international equities have relatively more favorable valuations and the prospect that U.S. dollar strength may abate, we continue to recommend global equity diversification.

Mid-Year 2020 Update – The first half of 2020 was a tale of two quarters for equity valuations. Investors who stuck with a disciplined rebalancing strategy at the end of March had an opportunity to add to equity allocations at valuations that were in-line with (U.S.) or below (International Developed and Emerging Markets) median levels over the last 15 years. While U.S. valuations look somewhat full by historical comparisons, upside could come from additional fiscal stimulus should reopening risks materialize. Conversely, international equity valuations are relatively more attractive and may benefit from U.S. dollar weakness triggered by U.S. monetary and fiscal policies.

Equity Valuations (Trailing 15 Years)

The second quarter equity rally pushed up valuations globally, bringing them close to pre-COVID 2019 year-end levels.



Source: MSCI Indices as of June 30, 2020.

Portfolio Impact – We continue to recommend strategic allocations to international developed and emerging market equities to take advantage of opportunities outside of the U.S.

3. Cross Currents (New Theme)

Key Observation Mid-Year 2020 – Investor confidence that government stimulus would counteract the economic fallout of COVID-19 was noticeable in the second quarter even as economic data was mired by containment measures. At the halfway point of 2020, implied volatility (VIX) stood at just 30.4, significantly lower than its peak (82.7) in the first quarter, but still elevated by historical standards. The decline in implied volatility corresponded to a partial recovery in global risk assets and left some investors wondering if economic data will be a governor to further upside in the second half.

Multiple known unknowns (uneven recovery around the globe, pace of U.S. economic recovery and time to develop a COVID treatment to name a few) appear priced into financial assets already. As such, the short and intermediate-term outlook for risk assets will likely hinge on economic reality relative to expectations in the second half of 2020 and unknown unknowns that may emerge. Therefore, we favor adhering to a disciplined asset allocation strategy, rooted in fundamentals, that otherwise aligns with an investor's time horizon and risk tolerances.

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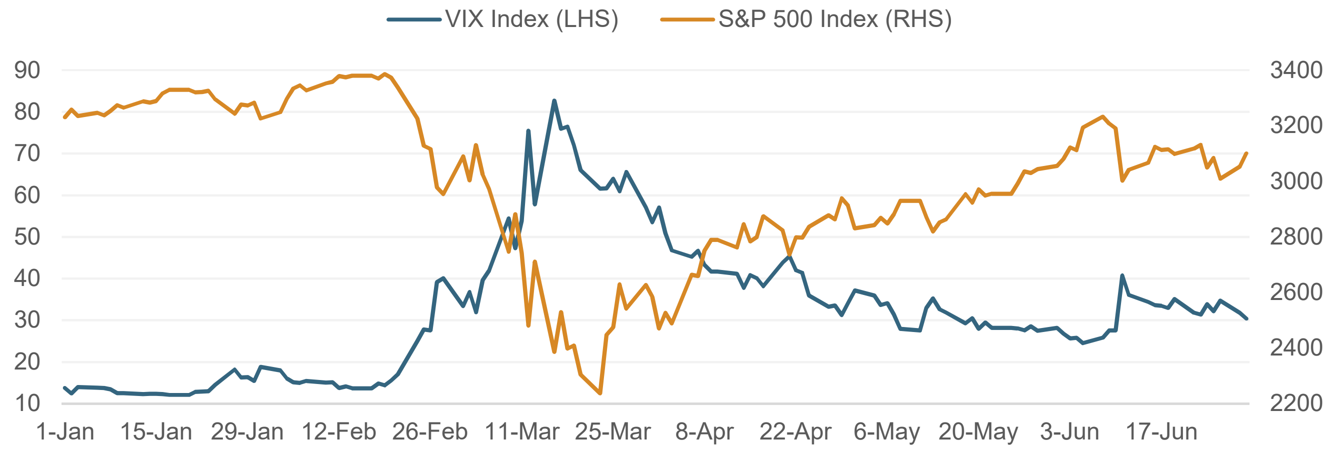
S&P 500 Index & Volatility

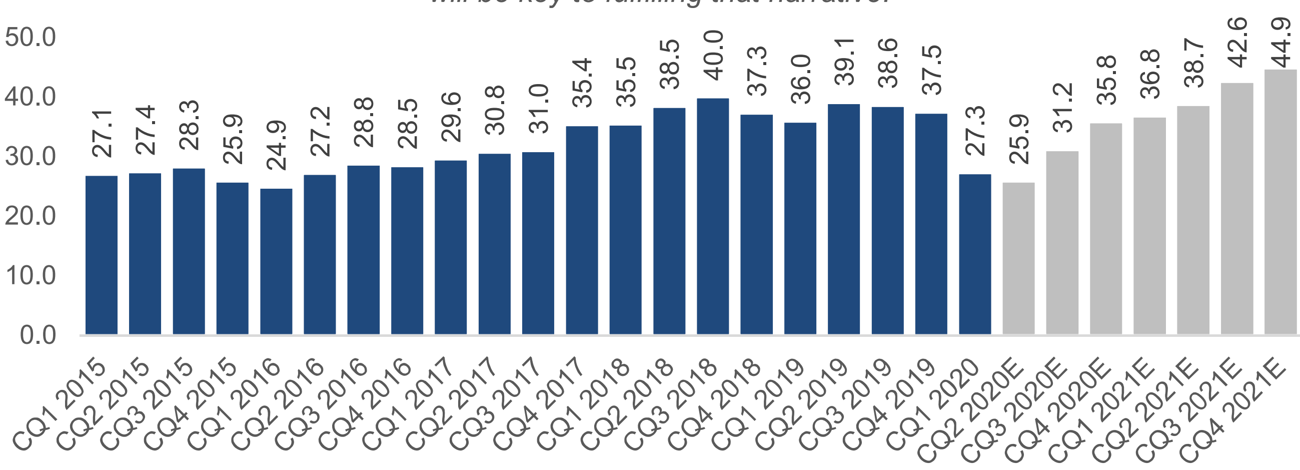
Low (and falling) implied volatility is generally associated with higher levels on the S&P 500 Index. The converse is also typically true. Therefore, falling volatility may be a key ingredient for higher stock prices.



Source: Bloomberg. Data as of June 30, 2020.

S&P 500 Index Earnings Growth Estimates

After peaking in second quarter of 2019, consensus estimates imply that corporate earnings will fully recover by the second quarter of 2021, which suggests that revenue and earnings results in the second half of 2020 will be key to fulfilling that narrative.



Source: Bloomberg. Data as of June 30, 2020.

Portfolio impact – The economic landscape is filled with uncertainty as policymakers around the globe react to the disruption caused by COVID and attempt to alleviate its impact on households. Despite the strong rally in risk assets since late March, forward-looking volatility measures broadly remain stubbornly high. The juxtaposition of financial asset volatility and reopening risks may challenge investor's resolve near term and accentuate the discipline of sticking to a predetermined strategy.

Investor Vigilance and Navigating Uncertainty

In summary, transitioning economic cycles are often accompanied by changes in leadership in asset class returns. The recent predominance of domestic growth equity is irrefutable while also serving as a potential source of frustration for many investors who (rightfully, we believe) adhere to more globally diversified portfolio constructs.

Nonetheless, investors should remain vigilant to changing return patterns as the world begins to stabilize and recover with greater consistency and vigor.

From an asset allocation perspective, we continue to update and evaluate our capital market assumptions and assess the implications on our client's portfolios. In the absence of any changes in objectives or cash needs, we advocate for maintaining an established strategic asset allocation rooted in fundamentals.

We encourage investors to keep their investment horizon in focus and not allow emotions to influence portfolio positioning.

For more information and assistance, contact your advisor at Hightower Texas.

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