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Investment Perspective

August 2020

Market Recap

It was another noteworthy month for stocks with the S&P 500 posting its best August since 1984. Gains were again led by the largest technology-related constituents, with the technology sector gaining nearly 12% for the month. International markets were also solidly higher, although emerging markets lagged the gains in U.S. stocks by a significant margin. Meanwhile, in contrast to recent months, bonds lost some ground in August as longer-term yields rose in response to generally positive economic data. The decline was most acute in investment grade corporate bonds, which were down 1.7% for the month. However, high yield bonds benefitted from the general risk-on environment and gained nearly 1.0%.

Index Returns as of August 31, 2020			
		August	1-YR
Domestic Equity	S&P 500 TR	7.19%	21.92%
	Russell 2000	5.63%	6.00%
Intl Equity	MSCI EAFE NR	5.14%	6.13%
	MSCI Emerging NR	2.21%	14.49%
Fixed-Income	Barclays U.S. Aggregate	-0.81%	6.47%
	Barclays U.S. High Yield	0.95%	4.71%
	Barclays U.S. Corporate	-1.72%	8.54%

Recent economic data has continued to indicate a relative broad recovery has remained intact despite some regional pauses of reopening plans. The recovery has been led by an impressive rebound in manufacturing data and a remarkable surge in housing market activity. The ISM Manufacturing survey for August reached a very robust level of 56 percent, which was its best reading since November 2018. The new orders component of the survey was also encouraging, rising for a third straight month to 67.6 percent. New home sales have also continued to exceed even increasingly optimistic analyst projections and in July reached the highest level since 2006. Importantly, the inventory of new and existing homes remains low by historical standards and with the millennial generation entering their peak homebuying years the potential for housing to lead the economic recovery appears far stronger than exiting the 2008 crisis.

The employment data, while far from uniformly robust, continues to generally indicate a steady recovery. The nonfarm payrolls report for August, released on September 4th, showed the labor market adding a significant number of jobs for the fourth straight month. Nonfarm payrolls increased by 1.37 million during August and the employment rate fell to 8.4%, an almost 2 percentage point improvement that easily exceeded the consensus estimates of economists. Although the job gains have been encouraging, the pace of recovery has slowed somewhat the past two months and payrolls remain 11.5 million below their pre-pandemic level. One arguably concerning datapoint that warrants watching is a rising number of workers who classify themselves as permanently unemployed. While still well below the number of permanently unemployed reported in the aftermath of the financial crisis, the recent rise suggests a full recovery in the labor market may be a very prolonged process even under an optimistic virus scenario.

The Federal Reserve's annual symposium for leading global central bankers and economists that normally is held in Jackson Hole, Wyoming, was held virtually this year on August 27th and 28th. Fed Chairman Jerome Powell's remarks at the event outlined a potentially important shift in the central bank's overall monetary policy framework. Going forward, the Fed will consider its dual objectives of maximum employment and stable prices within the context of a more broad-based employment goal and an average inflation target. The shift to emphasizing the broadest measures of employment strength suggests that Fed policy will be less influenced by a historically low unemployment rate in future cycles if evidence of discouraged workers and some degree of labor market slack remains. At the same time, the move toward average inflation targeting allows the flexibility for policymakers to let inflation run well above the Fed's long-term target of 2% for a sustained period following prolonged readings of abnormally low inflation. This shift in the Fed's overall framework suggests future monetary policy adjustments will have an asymmetric emphasis on supporting labor market strength versus keeping inflation in check, which while very understandable given the current backdrop of secular stagnation and low inflation also potentially increases futures risks associated with asset bubbles and rising inflationary pressures.

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September and October have tended to bring increased market volatility, particularly during presidential election years. The early days of September have lived up to this volatile reputation as of this writing, with the S&P 500 suffering its biggest one-day decline since June on September 3rd. While much of this recent volatility has thus far been concentrated in large-cap technology stocks that had reached extremely overbought levels and exhibited some highly unusual option market activity, there are several reasons for at least a modest degree of near-term caution. The most obvious potential catalyst for some volatility is the election, which given an increased emphasis on mail-in voting could realistically lead to a period of weeks after the election when the outcome remains in doubt. A potential mitigating factor is that the futures curve of equity market volatility is very elevated around the election, suggesting investors are widely expecting volatility in November and have already positioned for it.

Arguably the most important reason for some caution is a continuing divergence seen in long-term measures of market breadth. Market breadth is a concept that measures the percentage of stocks that are participating in a move up or down. As shown in the chart below, the percentage of NYSE stocks trading above their 200-day moving averages remains below 50% despite the S&P 500 rallying to a record high. This measure of long-term breadth is abnormally weak relative to the early periods of the big bull markets of the past 30 years. To be certain, this divergence has been in place for months and thus far has not slowed the advance of the major U.S. equity indices. It is also true that other measures of market breadth are more encouraging, which mitigates some of our concerns. However, seeing the market strength expand to a broader group of stocks would give us some confidence that the market rally is likely to remain intact well into 2021.

Exhibit 1. Percentage of NYSE stocks above 200-day moving average

Source: Bloomberg

In addition to market breadth, we will be monitoring measures of market sentiment and corporate credit in determining potential portfolio adjustments heading into the fourth quarter. Continued resilience in corporate credit markets, during what is typically a seasonally volatile period, would be an encouraging sign that the risk of renewed economic weakness is diminishing. A continued general improvement in key virus metrics, particularly hospitalizations, as we move into flu season for the northern hemisphere would also support the case for the global economic recovery proving sustainable into 2021 and beyond even in the absence of a highly effective vaccine or treatment.

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Index Definitions

S&P 500 TR - An index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Russell 2000 - An index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

MSCI EAFE NR - An index that serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

MSCI Emerging Markets NR - An index that serves as a benchmark of the performance in global emerging markets as represented by 23 emerging economies. Net return (NR) indices subtract from dividend reinvestment calculations the withholding taxes retained at the source for foreigners who do not benefit from a double taxation treaty.

Barclays U.S. Aggregate - A broad base index, maintained by Barclays Capital, and is often used to represent investment grade bonds being traded in the U.S. Barclays Capital (BarCap) U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

Thomson/Reuters CRB - The index track baskets of 19 commodities and is intended to be a representative indicator of global commodity markets.

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