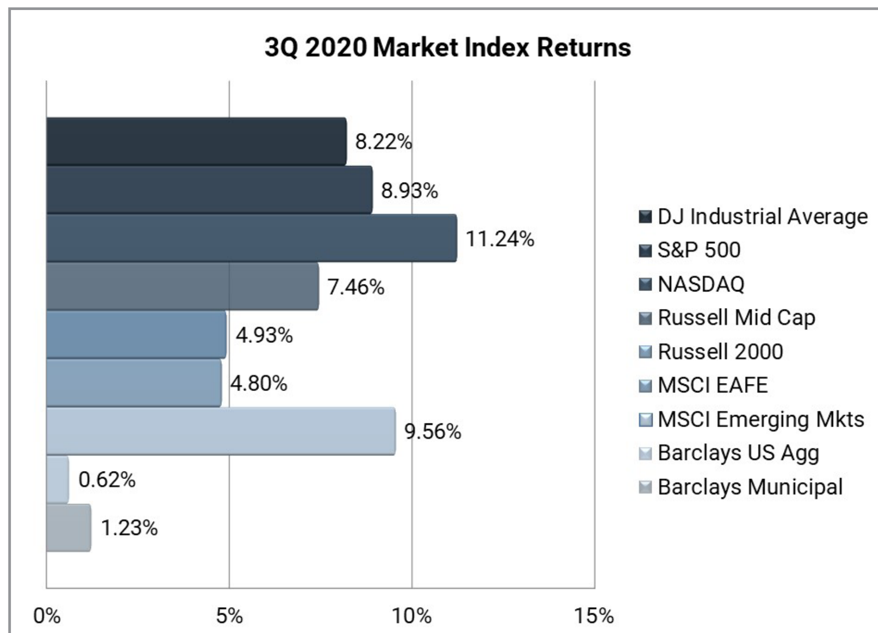
LINSCOMB WILLIAMS
WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Third Quarter 2020*

the ECONOMY

As it became clear that economic activity bottomed in early April, the analysis of the environment shifted from how long the recession might last to the characteristics of the impending recovery. Opinions on this, especially among media pundits, vary widely. We've heard that it could look like a "V", "U", "L", "W", or even a "K." If the alphabet isn't your game, perhaps the form of the iconic Nike Swoosh makes more sense. Some have suggested that the design of a square root expression is the most apt description. But whatever letter you like, shape you select, or pattern you prefer, let's not miss the forest for the trees. We don't need to get the precise trajectory of the recovery exactly correct for investing success. Rather the fact that the economy *is recovering*, and appears poised to continue to do so, has been very beneficial for financial markets.

While the 2nd quarter set records for all the wrong reasons where the economy is concerned, the 3rd looks like it is going to experience an equally historic rebound. The Federal Reserve Bank of Atlanta projects that 3rd quarter GDP grew at over a 35 percent annual rate! Not enough to make up for the prior decline, but a step in the right direction. Labor market data are already reflecting this good news. The current unemployment rate of 7.9 percent suggests ongoing challenges, but is a far cry better than the 14.7 percent peak in April. In fact, the U.S. economy has already gained back over half the jobs lost during the recession. The pace of net job creation began to moderate last month, and will



continue to do so going forward, but there has nonetheless been a much quicker return to work than was initially anticipated. We'd be remiss not to mention that, with the reopening of state economies and a return to something closer to a "normal" day-to-day working environment, that the risk of more rapid spread of coronavirus is higher. Yet, with enhanced safety protocols in place, the U.S. has thus far mostly avoided a repeat of the type of uncontrolled spread that hit the northeast in March and April, which prompted many of the early lockdowns.

Due to the ongoing presence of the coronavirus, certain segments of the economy have recovered more quickly than others. With both mandated and voluntary social distancing requirements, service industries like travel, leisure, and general entertainment and hospitality are still struggling. Fortunately, non-Covid-related healthcare seems to be back operating close to normal. Housing and manufacturing, though, have really stood out over the past few months. Home sales recently jumped to levels last seen over a decade ago, and new construction is already back to where it was at the start of 2020. All-time low mortgage rates have certainly helped spur the rebound. On the manufacturing side, whether its railroad intermodal traffic, high-tech chip design, or auto production, a variety of sub-sectors are back to operating at, or close to, pre-pandemic capacity levels.

Europe experienced a similar pick-up in activity, though in the process a number of countries, once hailed as clear successes in their virus containment efforts, have seen infection rates rise noticeably over the past few months. The unemployment rate for the 27-member European Union (EU) has been relatively steady this year, currently at 7.4 percent. This measure never did rise near as high as it did in the U.S., likely due to the different approaches respective governments took. The U.S. generally took a more laissez-faire approach to the labor market, choosing to replace foregone income as a result of job loss through direct payments. The EU, on the other hand, was more likely to subsidize companies directly, compensating firms for keeping workers employed even at much lower production levels. Last quarter, the EU made history with the size and scope of its mutual economic aid package, which is likely a major reason for the increase in business confidence throughout the continent.

The big news out of Japan was that Shinzo Abe, the country's longest serving Prime Minister, will be stepping down for health reasons. His replacement, Yoshihide Suga, is poised to continue the policies favored by his predecessor. It's likely to be as smooth a transition of power as we'll see in any developed nation for the foreseeable future. Japan also seems to have the coronavirus relatively under control, and has been able to quickly restart production in most of its biggest industries. And one note on Australia, which, compared to other high-income nations, has been the picture of prudence as far as government spending goes. Its debt-to-GDP ratio checks in at less than 50 percent. Yet, even Australia is now loosening the purse strings. Its government is committed to running fiscal deficits of 11 percent, 5 percent, and 4 percent over the next three years to cushion the pandemic's blow.

Emerging markets can be separated into two categories – South and East Asian nations, and everyone else. The former is actually leading the global recovery, while the latter is trailing behind. In spite of China's dubious reporting and data collection on the coronavirus within its borders, many of the economic statistics we track suggest that it was the first country to escape recession and farthest along the path to normalization. China likely will have flat, if not modestly positive, year-over-year GDP growth through the 3rd quarter. South Korea, Taiwan, and even Vietnam have followed similar trajectories. Confirmation of the global rebound in manufacturing can be seen in South Korean exports, which have surged in recent months. This data set has often been a good leading indicator for corporate earnings, so bodes well for near-term profits of multinational firms.

CENTRAL BANKS

As active as global central banks were in the first half of 2020, there was very little new to report in the 3rd quarter, which may be just how central bankers want it. The short story is that the accommodative policy implemented in the first half of this year looks set to continue for years to come. While longer-term interest rates are more sensitive to market forces and are likely to fluctuate some, central banks are committed to keeping shorter-term rates near at or near zero for the foreseeable future. For those institutions with the capacity, various quantitative easing and asset purchase programs will remain in place as long as deemed necessary. In a sense, these programs have "worked", in that financial markets are operating much more smoothly today compared to six months ago.

One novel policy out of the Federal Reserve (Fed), that, while still in its infancy, we're keeping an eye on is what has been referred to as "flexible average inflation targeting." There isn't yet a precise definition attached to it, but former Fed Chair Ben Bernanke recently shed some light on what it could mean going forward. In essence, the idea is that if inflation runs below a 2 percent target for some period of time, then the Fed would be prepared to let inflation exceed that target in the future, so that, on average, the 2 percent target is hit. Now, what that period of time may be is yet unspecified, and whether the Fed's current tools are fine-tuned enough to hit those targets remains to be seen. But, nonetheless, there are some implications for policy going forward. Mr. Bernanke believes that of the Fed's dual mandate, a higher priority may be placed on employment goals versus lower inflation going forward. Historically, the Fed has often raised interest rates preemptively in order to head off potential higher inflation. Now though, it seems likely it will try to keep rates at low levels until the economy is actually experiencing that inflation, rather than relying on a forecast of it.

FIXED INCOME

As we mentioned earlier, financial markets have been much more navigable lately thanks to massive central bank interventions. This is especially true in fixed income markets, which were blessedly uneventful in the 3rd quarter. Government bond yields barely budged, with the 10-year U.S. Treasury ending the quarter in the exact same place that it started, 0.69 percent. Shorter-term rates did fall somewhat, leading to a steeper yield curve.

Bond returns were muted but positive in the 3rd quarter. The Bloomberg Barclays U.S. Aggregate Bond Index, a basket of U.S. investment grade corporate and government bonds, rose 0.62 percent. Lower-rated high-yield securities benefited from a generally risk-on environment, gaining 4.71 percent.

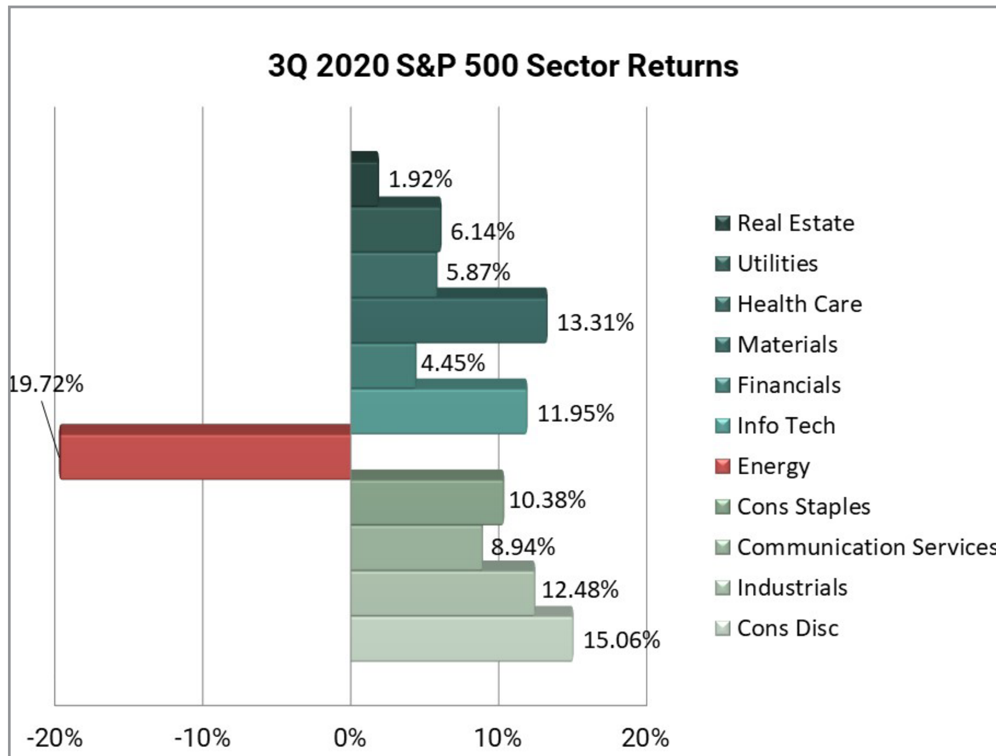
Municipal issues were solid as well, rising 1.23 percent. Many states and localities are in a much better financial shape today than was feared 6 months ago, giving a lift to the market. There are, of course, idiosyncratic trouble spots we'll be watching, but the broader municipal market is functioning well.

EQUITY

And the beat goes in equity markets, as the S&P 500 followed up a great 2nd quarter with a very good 3rd. Overall, U.S. large cap stocks were up 8.93 percent, despite a mild September swoon. Technology shares continued to perform well, but it was actually consumer discretionary and materials sectors that led the way, up 15.06 percent and 13.31 percent. To be sure, Amazon is a large part of the consumer discretionary space, but the sub-index's outperformance speaks to the resilience of household income in the U.S., surely helped by a large dose of government stimulus. Materials benefitted from the aforementioned pick- up in manufacturing activity and rising commodity prices, excluding oil. Small cap companies trailed their large cap peers, but the Russell 2000 still delivered 4.93 percent for the quarter.

Emerging markets were actually the top performer over the past three months, rising 9.56 percent. We noted that a number of South and East Asian economies were leading the recovery, and that's been reflected in stock prices. Taiwan, China, India, and South Korea all experienced double-digit returns in the 3rd quarter. Returns for foreign developed markets were more subdued, up 4.80 percent. Japan, in particular, has shown impressive momentum, with its Nikkei stock index breaking out to a new all-time high.

The combination of higher stock prices in the midst of a profits downturn leaves investors facing valuations that are on the high side historically. The forward price-to-earnings multiple on the S&P 500 is around 22x currently. Lower interest rates, an ongoing economic recovery, and the expectation of further government stimulus has investors looking past the valley towards an earnings' rebound into 2021.



OUTLOOK

Last quarter we discussed the apparent disconnect between stocks and the economy, with equity markets and other risk assets rising substantially despite record drops in global GDP. But it's crucial to remember that stocks are generally a leading indicator, in that they start to move higher in advance of the broader economy. With the 3rd quarter now in the books, it looks like investors have gotten it right so far. Though still below prior peaks, the global economy has surged back, and we believe the recovery is poised to continue, albeit at a slower rate going forward.

Much of the high frequency data we follow – mobility, gasoline demand, restaurant reservations, and credit card spending, for example – has been tracking higher throughout the 3rd quarter, and likely continues to improve as economies gradually reopen. As activity has returned, we've seen a notable increase in business confidence from both small and large firms. Of course, it will take some time to return to the old ways of doing things, if, in fact, it ever fully does for some firms, but overall, we get the sense that many are learning to live with the added precautions a pandemic dictates and are adjusting well. PMI data, which are timely gauges of business activity around the world, are almost uniformly in expansion territory, which tends to be good news for profits and business investment.

The biggest near-term risk is undoubtedly the coronavirus, and ongoing efforts to contain and mitigate its impact. Infection rates have ticked back up in some places, which could mean a resumption of various restrictions on activity. But the type of blunt, wide-scale lockdowns implemented earlier this year seem like only a remote possibility. Fortunately, the medical community knows much more about effectively treating Covid patients now, which ought to ease the burden on patients and healthcare systems. Also, nine vaccines are in late stage trials, by our count, with some likely to be available for distribution in 2021.

Another swing factor, in our opinion, is further fiscal stimulus. There are on-again, off-again discussions of a Phase 4 package in Washington, which at last check could add up to another $1.8 trillion in government spending. That's a lot of money dumped into the economy, much of which could find its way to corporate income statements. Speaking of Washington, there's a Presidential election coming up. And while it is certainly important for the economy and financial markets, historically stocks have done about equally well regardless of which party holds the Presidency. It's not that the President, makeup of Congress, and their policies don't matter. Rather, there are many other factors that affect stock market performance, all of which need to be taken into account when assessing the market environment.

One trend we're keeping a close eye on is how the next administration handles the U.S. relationship with China, which has been a bit testy, to say the least. Regardless of who wins the election this fall, the ongoing rise of China's economy has the potential to disrupt the current geopolitical order. Also, the continued digitization of society and the emergence of new technology-fueled business models, in everything from retail and transportation to power generation and payment processing, promises to bring with it new challenges and opportunities for investors.

Though economic recovery has clearly taken hold around the world, the outlook is still more uncertain than usual, thanks to an upcoming Presidential election and persistent impact of the coronavirus pandemic. Financial markets have rewarded investors who stayed the course this year and are reflecting a guarded optimism about the future. Valuations are on the high side, to be sure, but not offsides, in our opinion, given lower interest rates and the potential for further large-scale stimulus. As always, the Linscomb & Williams team is monitoring markets and portfolios on a daily basis, and we are available to visit regarding questions or concerns you may have.

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