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American Portfolios Quarterly Market Commentary
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THE ECONOMIC SWINGS that have taken place in the U.S. and globally during the past six months have been nothing short of mind blowing, with a U.S. GDP decline of 31.7 percent in the second quarter and an expected bounce back of at least 20 percent in the third quarter, and perhaps even topping 30 percent, according to some forecasts. The lockdowns and reopening of the economy, coupled with massive government stimulus, have fueled these wide swings.

The recent surge in economic activity is a welcome occurrence, but coming off the bottom of the worst economic numbers ever experienced in the U.S., our focus is more on the aggregate levels where the economy will "settle" and not on the rate of change from temporarily-depressed levels. In addition, we also have to consider that this is not a typical boom-bust economic cycle, but a period of long-term shifts and adjustments with significant industry and way-of-life impacts. We have broken down this current cycle into three phases: the early bounce back, the balancing act and the new normal.

It is clear to us that the easy work of the early bounce back (Phase One) is behind us and we are now entering Phase Two of the economic recovery, which is the attempt to reach pre-pandemic economic levels while suppressing the spread of COVID-19. We expect this stage to last through 2021 and then move to Phase Three, the "new normal," which we anticipate will be driven by a vaccine and the lasting effects of the pandemic on employment and demand destruction, and the work-from-home trend, among other areas.

Phase Two is a balancing act. Perhaps that is why, no matter where you turn, some market pundits refer to the strength of the economy in one sentence and then discuss the need for fiscal stimulus in the next. We expect this phase to be challenging, fueling concerns about the fourth quarter of 2020 and into 2021, when the fantastic sequential monthly and quarterly improvements flatten out and the economy needs to move forward without massive bailouts and income support. Outside of the March – June economic downdraft, we believe this phase will be the most difficult of this cycle and the hardest of the recovery. Our expectation is that investors will shift focus from improving second-derivative changes as positive news to comparing economic data to pre-crisis levels, attempting to handicap what a sustainable long-term economic picture looks like rather than riding the euphoria of the bounce back.

We expect this phase to see a significant decline in fiscal support to both households and businesses, although there could still be sizable bailouts in select industries like the airlines or even a broader package early on. This is also the period where deferred mortgage payments and credit cards come due, potentially raising delinquency levels and debt write offs, strong potential headwinds.

Until COVID-19 vaccines are widely available, social distancing is necessary, which creates varying degrees of operating difficulty across industries. Many businesses have and will continue to experience a sizable reduction in operating capacity, which obviously leads to reduced revenue streams, less labor demand and, ultimately, impaired profitability. An economy with less disposable income and higher risk related to

uncertainty and the ability to pay back debt provides significant challenges for investors and appears to be a headwind for at least the next year, possibly more. Corporate defaults could well pick up through 2021. The risks that seemed to have dissipated during the first phase of the recovery could not only re-emerge, but become amplified during this phase with less government support and less corporate cushion. The longer operations are impaired, the more companies won't have enough financial strength to stay above water.

We will discuss Phase Three in depth in future reports. From a high-level perspective, we will move into this phase after a vaccine is widely accepted. It is seemingly the only catalyst that will propel the U.S. economy back to its former heights, in our view. While a handful of companies have received accelerated FDA approval for potential vaccines, testing has had its challenges, as will the production and rollout of any approved vaccines. As such, we do not see the economy returning to normal levels of activity until 2022.

IS THE FED'S JOB DONE?

In the first half of the year, the Federal Reserve (the Fed) took strong action to support the economy and financial markets, cutting the federal funds rate to a range of 0 – .25 percent, opening or expanding a very wide range of facilities designed to support different parts of the bond market and doubling the size of its balance sheet. This was welcomed by the financial markets, likely fueling a notable increase in asset prices.

The Fed has stated that it expects interest rates to remain at emergency levels through 2023 and will allow inflation to "run hot." At the current time, we do not see any reason to doubt this forecast. Although money supply growth (M2) increased more than 20 percent, year over year, at the same time the velocity of money declined 20 percent, meaning that we are currently in a period of overall price stability. While supply disruptions and capacity contraction may put upward pressure on prices in some industries or geographic areas, we point to demographics and secular forces at play to balance this: the graying of America, excessive debt loads and technological innovation, all deflationary in nature.

In fact, the Fed's preferred measure of inflation, the core personal consumption expenditure deflator, rose 1.5 percent in the 12-month period through July 31. This measure of inflation has averaged 1.7 percent over the past five years and 1.6 percent over the past decade. This gives them plenty of room to leave the Fed funds rate unchanged after inflation starts to pick up.

That being said, the fuel that got us to this point has been spent. And while monetary policy will likely remain accommodative in the short to medium term, we expect its ability to support growth and stimulate the financial markets to wane into 2021. This current phase is likely to be a challenging period for central banks with few remaining tools to provide additional stimulus or manage unexpected challenges, which is why we believe Fed Chairman Jerome Powell has increasingly discussed the need for fiscal stimulus, seemingly hoping to pass the baton to the government.

IT'S ALL ABOUT THE JOBS…

The labor market deserves significant attention, given the massive changes it has experienced over the last seven months and its importance to disposable income. Our biggest concern about the next phase is the ongoing unemployment uncertainty. There are many jobs that are just not coming back and others that could take years to do so. The impact from this has yet to be felt because of the massive government stimulus that

has taken place. Many low-wage workers took home more money with the government unemployment kicker than they typically made in their jobs. The consensus estimate for U.S. unemployment by the fourth quarter of 2021 sits at 9.5 percent, almost six percentage points higher than pre-COVID-19 levels. If this forecast is accurate, it highlights the challenges still to be faced.

The labor market has recouped a little more than half of the 22 million jobs lost. September's employment gain was the most tepid since April, and unemployment claims of 840,000 during the week of Oct. 3 were four times worse than normal, and well above the levels seen in any of the past recessions dating back 70 years.

Furthermore, 13.6 million new unemployment claims have been registered in just the past three months and new hires have slowed after a post-lockdown jump, both concerning to the long-term health of the economy at this stage of the recovery. Also concerning are that temporary layoffs are increasingly morphing into permanent layoffs, or at least that appears to be the case. More than 2.4 million people have been out of work for longer than 27 weeks and almost 5 million people have been out of work for 15 – 26 weeks.

We think the employment data paints a very different picture about the economy than the stock market does. We do not think the severity and long-term implications of this labor market downturn are fully understood at this point because most market participants have been too enthralled with the early recovery bounce of Phase One.

If we are wrong about this, it will be because we are underestimating future government stimulus, most likely a result of a "Blue Wave" sweep of the White House and Congress. Still, we doubt even massive spending will bring back 10 million jobs; but based on the government's fiscal response in the early part of the crisis, we suppose anything is possible. Case in point, in the first half of the year, wages and salaries declined by $400 billion, year over year, yet personal income skyrocketed $1.1 trillion driven by $1.7 trillion of government handouts. This has already been a recession like no other. It is quite possible that personal income drops in 2021, perhaps stalling the recovery and providing more of the W-shaped trajectory than V-shaped recovery that the market has seemingly priced in. And even if the government backstops the consumer once again, it will be on borrowed money, exacerbating an already-significant debt concern. Consumer spending is 70 percent of the economy during normal times, so this is a significant issue that we will continue to stay focused on. As far as government stimulus goes, we think it is very unlikely anything gets done before the presidential election, no matter the political rhetoric. 2021 is a more likely timeframe, and even more likely should the Democrats gain control of the Senate.

IS A BLUE WAVE COMING?

We recently released a Research Report that analyzed the key issues of the upcoming election and laid out possible outcomes and their effects on the financial markets. Please see that report for a more in-depth discussion. Herein, we will discuss the high points.

While Democratic candidate former Vice President Joe Biden appears to be leading quite handily in the polls, we suggest the race for the White House is much tighter than it appears; although, now seemingly leaning toward a Biden win. That being said, we think the key issue in the upcoming election is not who wins the presidency, but whether or not there is a "Blue Wave," with Democrats flipping both the White House and the

Senate—or even just the Senate. A big Democratic win this election is the scenario we believe would bring the most change to the economy and financial markets. Further complicating matters are absentee ballots and the possibility of a contested election, discussed below.

While Biden is certainly not a lock for the presidency, a lot can happen in the next few weeks; but with control of the House of Representatives and a chance to flip the Senate, Democrats have a significant shot at winning control of all three. Current polls suggest that the House of Representatives will remain under Democratic control, but many of the Senate races are reflecting very close contests for the 35 seats that are up for re-election.

Republicans currently hold the Senate majority with 53 seats. In order for the Democrats to win the majority, they must win a net three seats if they also win the Presidency (because the Vice President casts the tie-breaking vote in legislation), or net four seats if they do not. This year, 35 seats are up for election, 23 currently held by Republicans and 12 by Democrats. There are several competitive races that could result in seats moving to the other side of the aisle. A lot has to go right for either party to sweep government control, but we think it is likely that the Democrats either win all three or only maintain the House, given party voting lines down the ticket.

Should the Democrats succeed, we would expect higher taxes and more government spending. That shouldn't surprise anyone. The question that needs to be answered is, will spending increase enough to offset higher taxes and a greater debt load? It remains to be seen. Not to mention, we would expect to see increased regulations on many industries, including conventional energy and technology, should Democrats sweep on Election Day, likely putting pressure on the financial markets or, at least, the aforementioned industries. Winners would likely be in clean energy, health care and construction. If Republicans retain control of either the Senate or the White House (and assuming the Democrats retain control of the House), we would expect the major aspects of current fiscal policy to be unchanged until at least the 2022 Congressional elections. Regardless of election results, trade conflict with China will likely persist, though the rules of engagement could change and perhaps soften with Democratic leadership.

ARE WE IN FOR AN ELECTION WEEK?

As we game plan possible outcomes for November's U.S. presidential election, the 2016 election could be a guide to what can happen in a contested election. As you may recall, U.S. stock futures plummeted overnight with safe-haven assets like gold rising, only to recover dramatically at the market open. At the time, many believed the stock market feared a Donald Trump presidency. However, we doubt that was the whole story or even the majority of it. Are we really to think that billion- and trillion-dollar asset managers sold heavily on the election night's results, only to dramatically change course after sleeping on it?

We suspect the more likely explanation is that the drop occurred because Hillary Clinton did not concede the race until the next morning and the stock market feared a contested election. It is certainly possible that this could happen again. While Biden did state he would accept the results, President Trump did not, plus Biden could certainly change his mind or be advised to do so.

We caution that market participants should also be prepared for an election week or weeks rather than an Election Day outcome. The vote count could take weeks to process given the high level of absentee ballots that are expected amid the COVID-19 pandemic, which could create sizable market unrest.

NAVIGATING THE MARKETS…

We believe that investors should continue to monitor economic fundamentals, tilt toward quality in both equity and fixed income, and maintain a well-diversified allocation. We expect volatility around the election and perhaps a notable sell-off. Depending on how one is positioned, this could offer an opportunity to add risk for the long-term. Investment time horizons extend far beyond election cycles and presidential terms, so sticking to a long-term investment plan is crucial during times like these.

As we stated in our aforementioned Research Report, we also caution that it is just as important to avoid certain actions. Politics has become emotional for many, shaping our identities. As investors, we must avoid allowing how we feel about politics to overrule our investment philosophies. Imagine having been upset that Trump won the presidency in 2016 and missing out on massive equity run of 2017, and longer-term throughout his first term. Focus on policies that impact the economy and financial markets, and leave everything else out of your investments. Certainly, social issues are important, but they rarely factor into financial asset valuations and investment returns across the broader market despite the importance and growing interest in Impact and ESG investing, which we view as more of a bottom-up philosophy.

That being said, we do have concerns over the valuations of some equity sectors, the extreme market concentration and the speculative retail trading in the equity and options markets that has recently accounted for a record share of total trading activity. Not to mention, we expect unemployment and underemployment to begin to increasingly weigh on U.S. consumer activity, the dominant engine behind U.S. growth, creating a significant concern for us given current market levels.

As far as valuations are concerned, we do know ultra-low interest rates have boosted the valuations of companies that are expected to earn the bulk of their profits in the future. When discounted back to the present, far-off cash flows are worth more today than in a higher-rate world. This has helped lift growth stocks to records even as earnings expectations have come down significantly. The investment community is paying more for duration today than they ever have in history, but since we can anticipate rates to stay low for years to come, this valuation driver becomes the dominant issue that will determine the market and prospective returns. This is why growth stocks outperformed value for much of the past decade, even before the pandemic. Ultimately, the growth-versus-value decision depends on what the economy will look like in Phase Three of the recovery. We think the divergence has become so great between the two that as we progress toward Phase Three, value could take the lead. Even though we don't expect interest rates to be a headwind for growth stocks any time soon, there is nowhere to go but up, so rates will no longer be multiple expansion fuel, either.

Growth and value stocks aside, it has become apparent to us that investment focus should become increasingly thematic and more selective than in the past because the equity markets, and financial assets in general, have become extended, in our view, with the risk toward the downside. Broader asset prices don't reflect the mid- to long-term economic outlook because the financial markets have been boosted by

unprecedented fiscal and monetary policy stimulus, requiring more nimble and focused asset allocation down to the industry and stock levels.

As a follow-up to this report and our election piece, we will be hosting a post-election call on Nov. 16. Hopefully, there will be a clear winner and we can discuss our expectations through the mid-term elections and any anticipated policy shifts.

QUESTIONS AND COMMENTS

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