Outlook for August 2020

Key Market Drivers

Global Rebound Tapers Off

Just as quickly as they rebounded, many global economies are showing signs of leveling off. Here in the U.S., a resurgence of COVID-19 cases in several southern and western states is the primary driver behind the renewed slow down. Overseas, Japanese consumers are feeling the pressure of increased unemployment brought about by the virus, little wage growth, and higher sales taxes that took effect late last year. China, the first country impacted by the virus and the first to reopen, has regained almost all its lost production capacity. However, complete consumer re-engagement hasn't occurred, which could pressure manufacturing employment.

Fiscal Policy Aids Recovery

Fiscal policy working in tandem with monetary policy has buoyed the global recovery. Congress is currently negotiating another fiscal relief package that would potentially continue many of the measures previously enacted, provide aid to state and local governments, and offer employers liability protection. The European Union forged its first-ever unified fiscal policy when members agreed to a 750-billion-euro recovery fund that will lead to a pan-European bond issuance. Arguably, the ultimate economic success of the European Union may depend on a unified policy such as this one.

Our Perspective

Equity Markets

- The S&P 500 index entered July only 5% below its February highs. A handful of companies that benefited from the stay-at-home directives and the search for COVID-19 treatments and vaccines dominated the rebound. Broader participation is needed to provide confidence that the bear market/correction is indeed over.
- European equities have largely performed in line with U.S. equities over the last three months. However, they haven't recaptured their earlier underperformance. Greater exposure to cyclical sectors makes these markets more vulnerable to renewed business closures.
- Japanese equities received a boost from the reopening of economies around the world. The markets are depending on the strength of the global recovery to drive the country's export industries. Higher taxes and a burgeoning spike in the virus have impeded domestic consumption.
- Emerging markets stocks closed the gap with U.S. stocks thanks to strong Chinese equity markets and the recovery in the commodity-driven Latin American markets.

Bond Markets

- Investment-grade bonds have the best total returns of any asset class so far in 2020 due to the shift down in the intermediate to longer-term portion of the Treasury yield curve. As the Fed will likely prevent negative rates in intermediate-term bonds, total returns should be muted.
- While still up for the year, municipal bonds have underperformed their taxable counterparts because of the financial strain many state and local municipalities are facing. The outcome of the current fiscal relief negotiations could potentially alleviate some of this pressure and lead to relative outperformance.
- The high-yield market has recovered a significant portion of the credit-spread widening that occurred in March due to the Fed's willingness to backstop certain below-investment-grade bond issuers. Given the increased default risk, spreads could widen from current levels.
- The prices of many emerging market debt issues are higher due to a weaker dollar and a recovery in commodity prices. Like developed markets, sustaining this strong performance will depend on the progress in fighting the virus and global economies reopening.

Outlook for August 2020

Our Perspective (Continued)

Monetary Policies/ Currencies

- Over the past two months, the dollar has declined 5%. An ultra-easy monetary policy and the potential economic impact of the recent spike in Covid-19 rates are making international investments relatively more attractive to U.S. investors.
- The Fed is expected to maintain the current level of interest rates and asset purchases through 2021. As of now, a negative federal funds rate policy isn't likely. The Fed will use its publications and press conferences to communicate its forward guidance. Still, it may have to implement a yield curve control policy to prevent a curve inversion.
- The European Central Bank, Bank of England, and Bank of Japan are all expected to maintain their current short-term rates. They have also promised to provide more quantitative easing through longer-term asset purchases should their economies falter, or markets seize.
- The Peoples Bank of China is resisting the move to zero percent interest rates as the Chinese economy recovers. While it has the flexibility to use traditional monetary policy, the bank will likely strive to control any sharp appreciation of the renminbi to the dollar, given the recent escalation of tensions between the two countries.

What This Means for Investors

With the somewhat inevitable resurgence of the virus due to increased testing and the relaxation of mobility restrictions, investors should monitor the sustainability of the economic recovery and be more cautious in their bullishness over the summer. The bar is probably much higher for a resumption of economic closures. Complete consumer re-engagement is unlikely until a vaccine is produced.

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