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Economic and Market Environment

Third Quarter 2020

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The Economy

- After a 10-year cycle of recovery/expansion, the longest on record for the U.S. economy, a deep recession began in February.
- Because the recession was caused by a shutdown of the economy, not normal recessionary forces, it is expected to be a brief one.
- The economy is now open again, and recovery likely began in April/May. Massive amounts of fiscal and monetary stimulus are aiding the recovery.
- The spread of COVID-19, after moderating nationally, is gaining strength again, thereby threatening to slow the pace of economic recovery.
- Measures of mobility and engagement have improved but remain depressed relative to normal activity.
- Recovery to 2019 economic levels will likely take until 2022 at least, and closure of the output gap will take even longer.
- We expect the U.S. economy will fully recover and begin another long recovery/expansion cycle that should last for years. We believe the "2% World" of 2% GDP growth, inflation, and interest rates will return.

Stocks and Bonds

- The sequence of COVID-19 spread, national shutdown, and reopening led to extreme volatility in the stock market.
- A peak-to-trough decline of 35% in the S&P 500 was followed by a near-complete retracement. Since then, the popular averages have declined somewhat, leaving them in negative territory year-to-date.
- Many investors are confused by the sharp recovery of stock prices in the face of dire economic circumstances. We believe it is explainable.
- Bond yields remain very low, reflecting Federal funds at 0%, and very low inflation expectations.
- We believe over the longer term, high-quality stocks can return to trend line growth of high-single- to low-double-digit total investment return.
- While bond yields may rise marginally from depressed levels, we expect them to remain very low relative to history.
- Geo-political surprises, such as COVID-19, are always a potential threat to economic and market stability. U.S./China relations are deteriorating, another concern. High-quality, liquid investments are the best hedge against these threats.

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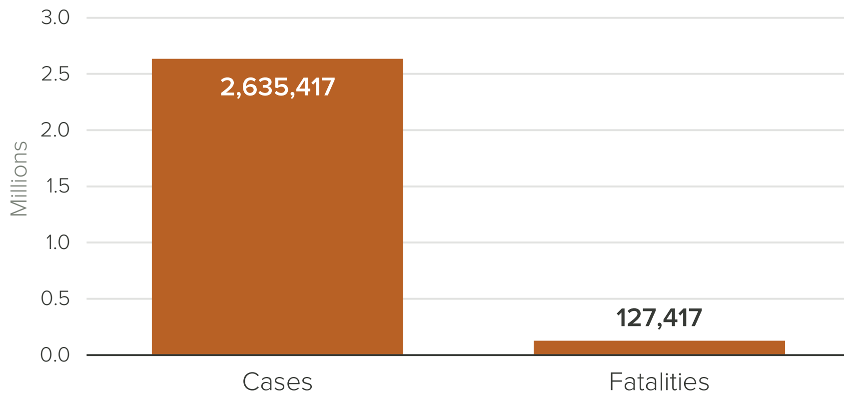
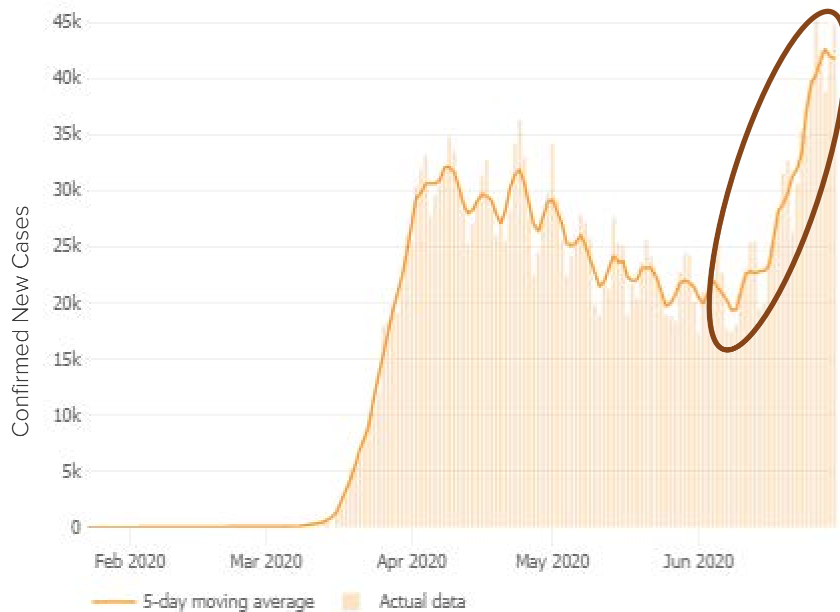


Source: Johns Hopkins University & Medicine – Coronavirus Resource Center
Data as of July 1, 2020



Source: Johns Hopkins University & Medicine – Coronavirus Resource Center
Data as of July 1, 2020

- COVID-19 is proving to be a formidable adversary. It has taken a heavy toll on our country with over 125,000 deaths reported.
- Strict measures of social distancing have proven effective but are difficult to maintain in a disciplined manner.
- Recent trends are disturbing. The Memorial Day to Fourth of July window proved to be challenging, as cases are accelerating again after the curve had been flattened.
- A new wave of cases extending Phase 1 is likely to limit mobility and engagement, essential elements of more robust economic activity.
- Scientists are of the opinion that Wave 2 is likely to arrive late fall/early winter.

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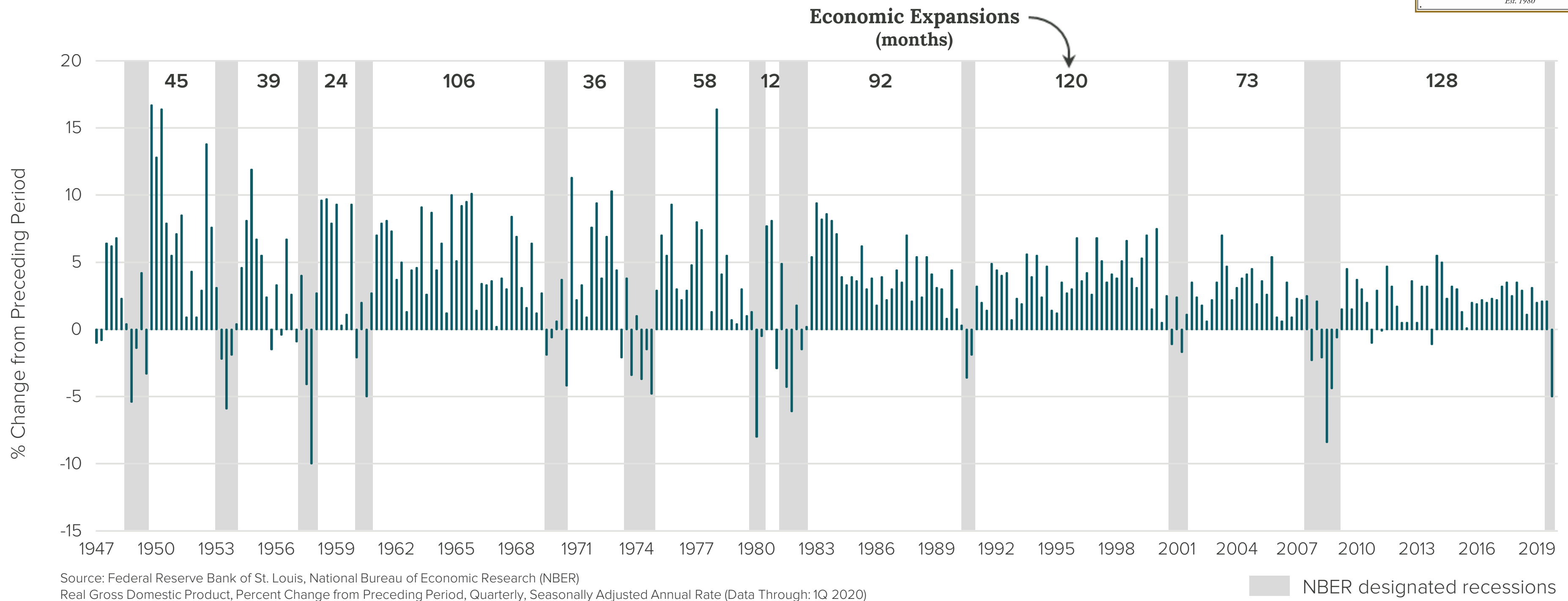

- This picture illustrates nominal GDP (real GDP plus inflation) over the last 70 years. Nominal GDP is the real world in which companies and consumers live and compete in.
- Note the length of expansions compared to recessions (shaded areas). Recessions are typically short, and this one, while likely to be very deep, should be even shorter than normal.
- The second quarter, ending June 30, should show the greatest decline, estimated to be at a rate of some -30% to -40% on an annualized basis.
- A review of this chart is encouraging. While vulnerable to contraction, our economy has consistently demonstrated resiliency and a return to growth. We expect the same in this cycle.

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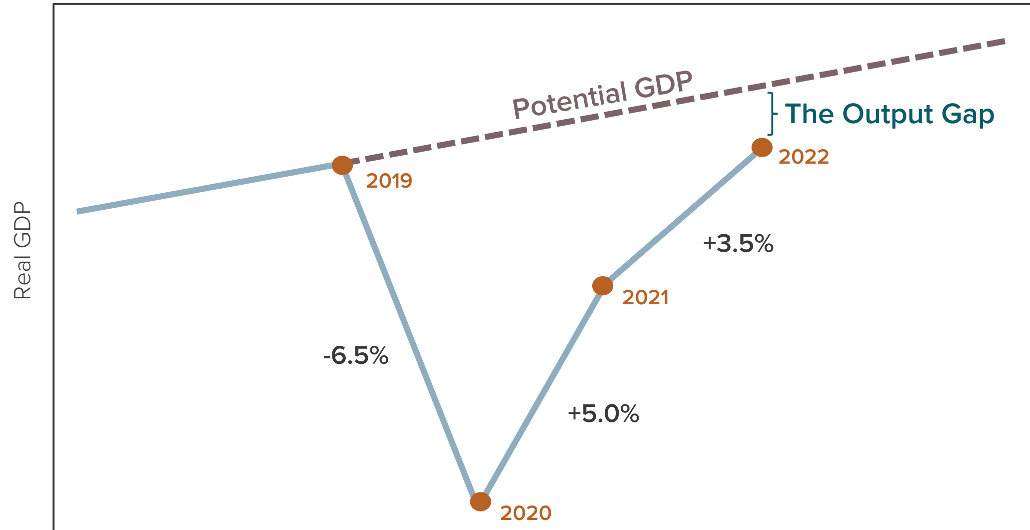

2019 GDP	2020 GDP (-6.5%)	2021 GDP (+5.0%)	2022 GDP (+3.5%)
$21,733 Trillion	$20,320 Trillion	$21,336 Trillion	$22,082 Trillion

Source: Federal Reserve projections; Crawford estimates

- In this example, we use most recent Federal Reserve (Fed) projections for real GDP growth. We do not attach high confidence to their accuracy, but they provide a framework for viewing the future and making assumptions about the economic recovery.
- The sequence of recovery conforms to a U-shaped scenario. In late 2022 it is possible that the level of output will be back to 2019 levels, but the output gap (the difference between actual and potential GDP) will not have been closed.
- A negative output gap is inherently disinflationary since it implies a shortage of demand relative to supply. We do not dismiss the possibility of higher levels of inflation at some point in the future, but we do not expect it in the next few years, at least.

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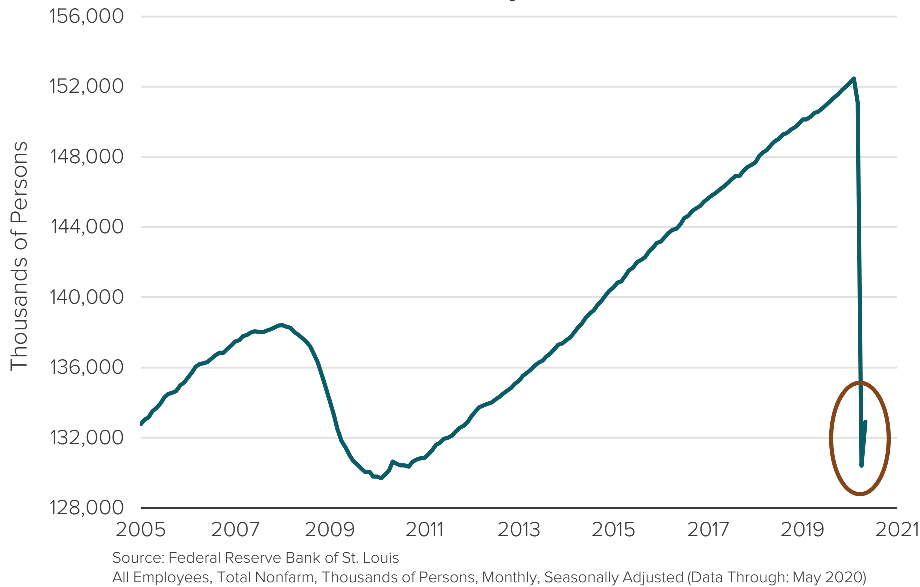
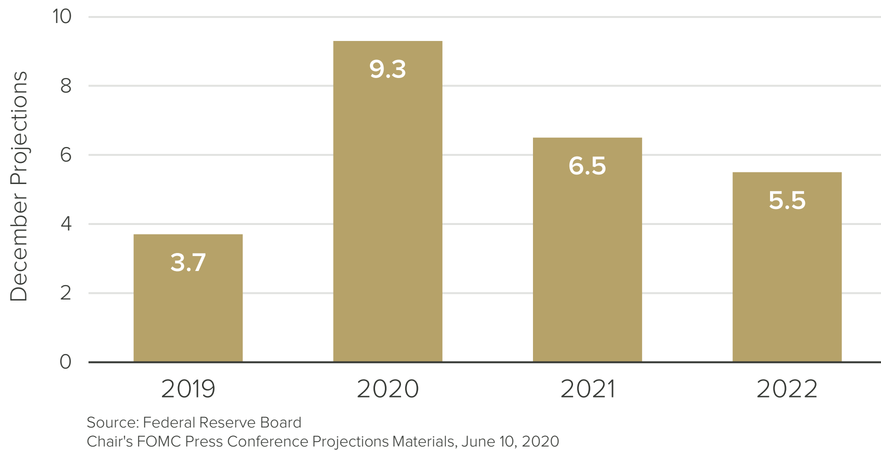


Source: Federal Reserve Bank of St. Louis
All Employees, Total Nonfarm, Thousands of Persons, Monthly, Seasonally Adjusted (Data Through: May 2020)



Source: Federal Reserve Board
Chair's FOMC Press Conference Projections Materials, June 10, 2020

- We have noted the shortage of demand relative to supply. Overall demand is a function of many factors, not the least of which is employment.
- Employed people have more money to spend. Unemployed people have less money to spend.
- Recent improvement in employment is encouraging.
- Fed projections for unemployment over the next few years suggest declining unemployment after this year, but far from reaching 2019 levels.
- If 3.5% unemployment, the lowest in 50 years or so, could not generate more than 2% GDP growth, an unemployment rate of 5.5% is not likely to produce high growth or inflationary tendencies in the economy.

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GREEN SHOOTS: LOOKING FOR EARLY SIGNS OF RECOVERY

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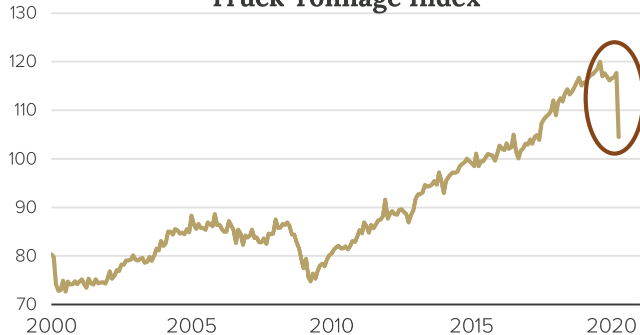
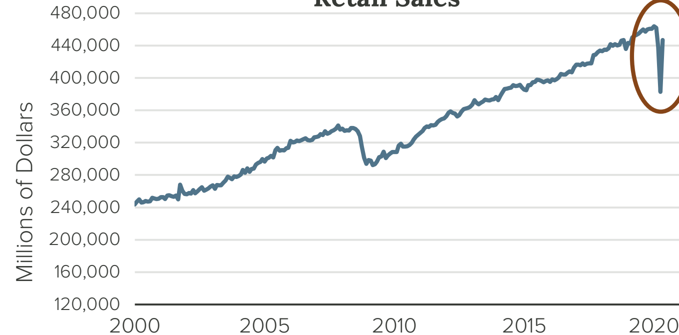


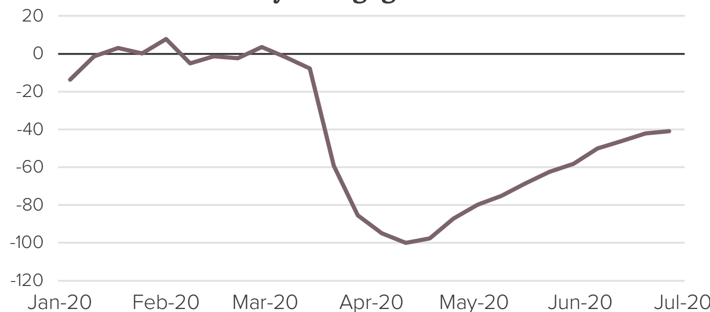
Source: Federal Reserve Bank of St. Louis; Truck Tonnage, Truck Tonnage Index, Monthly, Seasonally Adjusted (Data Through: April 2020)



Source: Federal Reserve Bank of St. Louis; Advance Retail Sales: Retail (Excluding Food Services), Millions of Dollars, Monthly, Seasonally Adjusted (Data Through: May 2020)

Source: Federal Reserve Bank of St. Louis; University of Michigan: Consumer Sentiment, Index 1966:Q1=100, Monthly, Not Seasonally Adjusted (Data Through: May 2020)

Source: FactSet; ISM Manufacturing Index (Data Through: May 2020)



Source: Federal Reserve Bank of Dallas; Mobility and Engagement Index, scaled weekly (Data Through: June 27, 2020)

- We noted that economic recovery began in April/May of this year.
- A number of economic series confirm the beginning of recovery and illustrate how deep the contraction in activity has been.
- We remain optimistic that these and other series will show continuing improvement over time.

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The Mobility and Engagement Index (formerly the "Social Distancing Index") measures the deviation from normal mobility behaviors induced by COVID-19. The updated name recognizes that social distancing, or the limiting of close contact with others outside your household, can be practiced while mobility and engagement improve.

FISCAL

Amount ($Bn)	Measure
$293	One-time recovery rebate checks amounting to $1,200 per adult and $500 per child up to certain income limits
$268	Boost to unemployment benefits, adding $600 per week to every check until July 31, expanding program to cover contractors and self-employed and extending program from 26 weeks to 39 weeks
$27	Grants to airlines and businesses deemed important for national security. Non-forgivable loans through Fed are excluded as they are assumed to be repaid
$760	Small business relief, mostly "forgivable loans" for spending on payroll, rent, utilities
$150	Direct aid to state and local governments
$425	Health-related spending
$517	Other spending and tax breaks
$2.441 trillion	**~11.8% of GDP**

Source: CBO, JP Morgan Asset Management

MONETARY

- Fed Funds at 0%
- Quantitative Easing: Purchases of:
  - Treasury bonds
  - Corporate bonds
  - Junk bonds
- Main Street Lending Facility
- Forward Guidance
- Possible: Yield Curve Control

- The unprecedented nature of this recession has called for unprecedented fiscal and monetary support. Congress and the Fed have responded aggressively and appropriately.
- Many of the measures are intended to "bridge the gap," that is, provide immediate support for small businesses and the unemployed until the economy is strong enough to support them. Other measures are more long lasting.
- Further fiscal action may be required, depending on the speed of recovery. Some worry about the impact of fiscal measures on budget deficits. These concerns are real but are partially mitigated by very low interest rates, which ease servicing requirements of debt.

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- It is difficult to imagine a more dramatic chart than this one on the savings rate. A total lockdown prevents consumption. The money has to go somewhere and is captured by the savings rate.
- The table below indicates a 67% decline in expenditures for three months. This is obviously not sustainable. The dramatic increase in savings represents suspended but not canceled spending, and will be used as a forceful boost to consumption in coming quarters. The savings rate should decline rapidly.
- The high savings rate and its potential for spending augurs well for economic recovery.

Source: Federal Reserve Bank of St. Louis
Personal Saving Rate, Percent, Monthly, Seasonally Adjusted Annual Rate (Data Through: May 2020)

	February 2020	April 2020	Change	% of April Disposable Income
Comp & Other Income	$41,283	$37,339	-$3,943	66%
Govt. Transfer Payments	$9,946	$19,248	$9,301	34%
Disposable	**$51,229**	**$56,587**	**$5,358**	**100%**
Expenditures	-$47,008	-$37,940	$9,068	-67%
Savings	**$4,221**	**$18,647**	**$14,426**	**33%**

Source: Credit Suisse – Equity Research
Retail Sales: It's Only Just Begun (June 18, 2020)

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- Another amazing picture. Dramatic decline and dramatic recovery.
- We expect stocks to remain volatile until some of the uncertainty of the outlook for the economy and corporate earnings is resolved.
- We also believe that stocks are not likely to return to their low point in March.
- The action of the stock market reflects optimism that the economy and corporate earnings have already started to recover.
- Many question the strength in stocks in the face of dire economic circumstances. It should be remembered that the stock market is always looking forward.

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	2020 High	2020 Low	% Decline from High to Low	% Return Year to Date[1]
S&P 500 Index	3,394	2,192	-35.42%	-3.08%
S&P 500 Growth Index	2,120	1,454	-31.42%	+7.93%
S&P 500 Value Index	1,301	815	-37.36%	-15.52%
Russell 1000 Value Index	1,367	826	-39.58%	-16.26%
Russell 2000 Index	1,715	966	-43.68%	-12.98%

Source: FactSet, eVestment (Data Through: June 30, 2020) [1]Total Return

- The table illustrates that, from a style standpoint, there are two vastly different markets right now.
- While all styles tended to decline by roughly equal amounts, the recovery has been far different.
- Growth has outperformed value by record amounts this year, and over recent years as well. Time for a change?
- Large capitalization stocks have greatly outperformed smaller capitalization stocks even though over very long periods, smaller stocks have been superior performers. Time for a change?

Please see the last page for important disclosures. The S&P 500 Index is the Standard & Poor's Composite Index and is widely regarded as a single gauge of large-cap U.S. equities. It is market-cap weighted and includes 500 leading companies, capturing approximately 80% coverage of available market capitalization. The S&P 500 Growth index consists of large-capitalization U.S. equities that exhibit value characteristics (constituents are drawn from the S&P 500 Index). The S&P 500 Value index consists of large-capitalization U.S. equities that exhibit growth characteristics (constituents are drawn from the S&P 500 Index). The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

THE BOND MARKET: ARE NEGATIVE YIELDS POSSIBLE?

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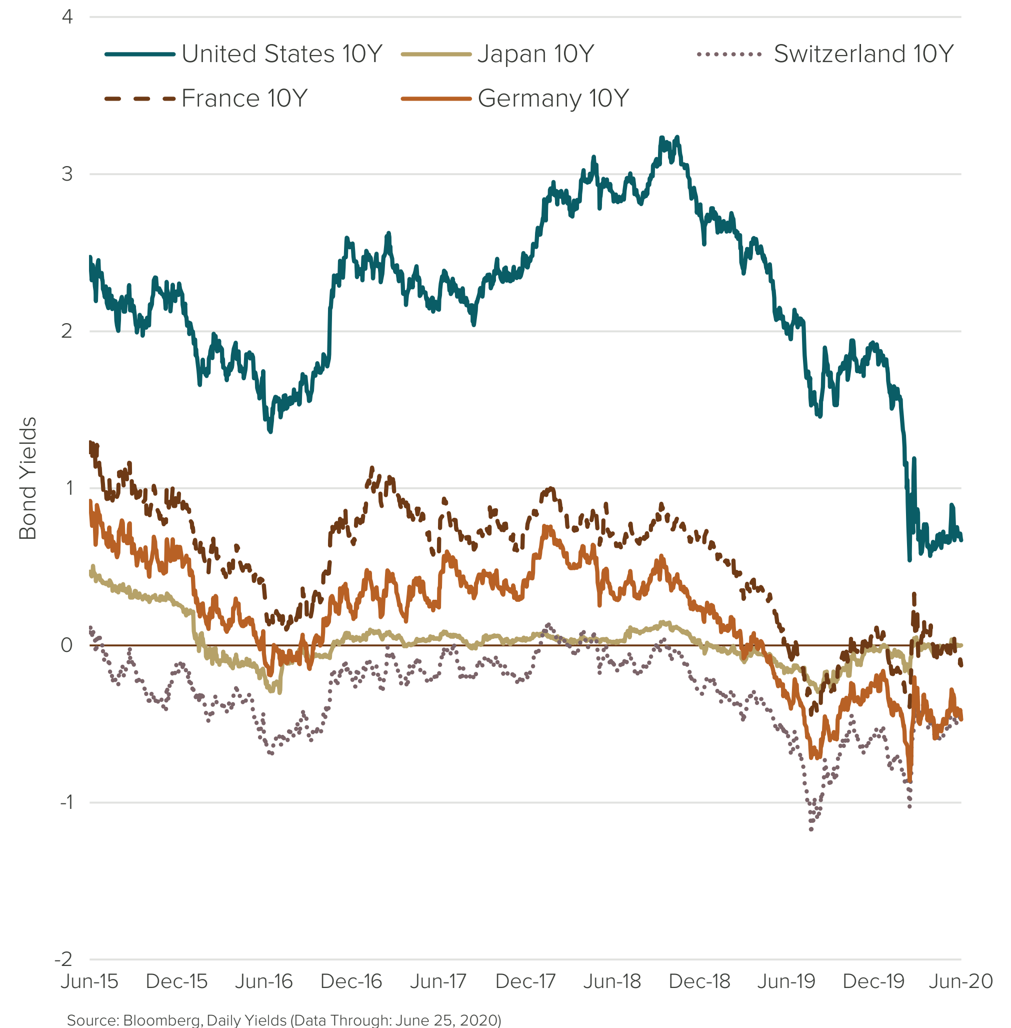
- Global interest rates as measured by 10-year government bonds have declined precipitously since mid-year 2018, and especially so since the outbreak of COVID-19.
- While the yield on the U.S. 10-year bond is still in positive territory, most developed country bonds trade with negative yields.
- Will U.S. yields eventually turn negative? We think not.
  - The Fed does not favor negative yields as stimulus.
  - Negative yields are a result of central bank policy intended to encourage lending by banks. Loan demand in the U.S. is adequate without the push from negative rates.
- We expect U.S. bond yields to remain very low for the next few years, but not negative.



Source: Bloomberg, Daily Yields (Data Through: June 25, 2020)

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