Third Quarter 2020 Outlook
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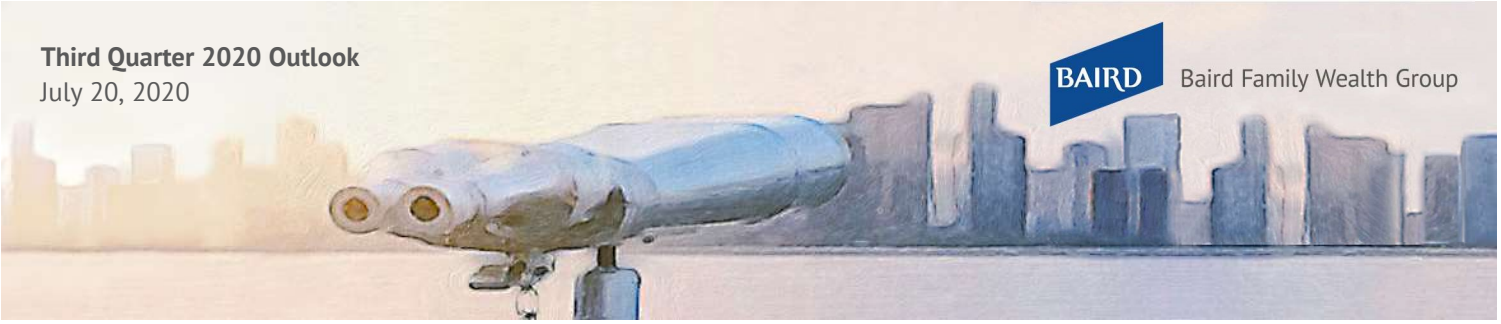
BAIRD Baird Family Wealth Group



Summary: The second quarter saw a sharp rebound in riskier asset classes due to extraordinary support from the Federal Reserve and optimism around the reopening of the economy. Even though the stock market did not see the type of capitulation typically associated with market bottoms, valuations became attractive in March as many investors reduced exposure. The Federal Reserve kickstarted the up move in the market cycle by dramatically increasing the money supply while Congress passed the largest emergency aid package in U.S. history. Investors quickly changed course and drove valuations back to high levels in record time. Thus far, the stock market recovery has outpaced that of the economy. Indicators of economic activity bounced from the extremely low levels of March and April, but for the most part, have a long way to go to return to pre-lockdown levels. Driven by government stimulus, online purchases and pent up demand released as the economy reopened, retail sales are a striking exception having almost completely recovered. Further stimulus may be required to maintain retail sales and drive consumer confidence higher unless the broader economy can fully re-open and recover quickly. At this point, a quick recovery seems unlikely as cities and states look to re-implement restrictive measures to curb the recent resurgence in Coronavirus cases. That means businesses, already over-burdened with debt, will have to borrow even more just to stay afloat. The fall election adds to the uncertainty as the result holds the possibility of significantly higher taxes. Ultimately, positive demographics should drive the economic cycle higher – it may just take time. Given high market valuations, huge amounts of debt, and election uncertainty, we suggest clients cautiously rebalance to their strategic allocation, looking to add opportunistically to more risky assets only on major pullbacks.

- Most asset classes were positive during the quarter. Consumer Discretionary, Technology and Energy stocks led the way for more risky asset classes. Smaller company stocks outperformed larger while growth stocks, up 6.6% YTD, have significantly outperformed value stocks, down 16.1% YTD. Investment grade corporate bonds, up 9%, led all less risky assets. Municipal bonds were up 2.7% during the quarter.
- The Association of Individual Investors survey showed investors reduced exposure to the stock market in March but not as significantly as during past cycle downturns. Also, the type of capitulation typically associated with market bottoms did not materialize as April survey data from the New York Fed indicated investors increasingly believed the stock market would be higher next year.
- The Federal Reserve flooded the markets with cash and helped many floundering companies stay in business. The money supply, as measured MZM, increased $5 trillion year over year, an amount equivalent to almost 25% of the entire annual output of the United State economy. The CAPE ratio suggested stock market valuations were attractive at the end of March but are now back to a high level.
- Driven by over $2 trillion in government aid, online shopping and pent up demand, retail sales have almost completely recovered to pre-lockdown levels. Unless Congress acts again soon, that may change with the Paycheck Protection Program and extra unemployment benefits set to run out by the end of summer.
- The recent surge in COVID-19 cases will be a critical factor in people's willingness to fully engage in the types of activities the U.S. economy is depending on for a complete economy recovery. Clearly, there would be little activity if cities and states are forced to return to lock-down.
- Economic measures such Consumer Confidence and Industrial Production bounced but it will take time for them to reach pre-lockdown levels. Mobility data gathered from cell phones shows that people are avoiding mass transportation. Hotel occupancy is down 30% and passenger air travel, as measured at TSA checkpoints, is still down more than 70% compared to 2019. Post 9/11, air travel declined 30% and took 3 years to recover, suggesting complete economic recovery may take longer than expected.
- According to Federal Reserve data, corporate debt and loans increased at the highest rate since 2007, just before the credit crisis, and now represent almost 50% of GDP. Bankruptcies have been rising and are up 26% for the first six month of 2020 over the first six month of 2019. The federal government's budget deficit increased four-fold in the last nine month and total U.S. debt has doubled in the just the last ten years.
- The presidential candidate currently leading in the polls, Joe Biden, has proposed a $4 trillion tax increase, which includes an increase in the top individual rate, a new payroll tax for high income earners and an increase in the corporate tax rate. Given the U.S. deficit and debt levels, higher taxes may be in our future regardless of who is elected in the fall.
- Given high market valuations, huge amounts of debt, and election uncertainty, we suggest clients cautiously rebalance to their strategic allocation, looking to add opportunistically to more risky assets only on major pullbacks.

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