First Midwest | WEALTH MANAGEMENT

Market Outlook

Second Quarter 2020

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Economic Outlook

A Dismal Second Quarter U.S. economic growth is expected to bounce back into positive territory in the third quarter (Bloomberg consensus estimate is +20%) after a horrific drop in the second quarter (an estimated -34.5%). Given double-digit unemployment resulting from the stay-at-home orders, the Federal Reserve funds rate is forecast to remain near 0% through 2022. In addition, the Fed continues to purchase government bonds and signaled purchases of hundreds of billions in corporate bonds as well. This aggressive monetary policy is aimed at allowing consumers and businesses to borrow at ultra-low rates. In July, Congress extended the Paycheck Protection Program through August. The program offers loans to small businesses. Furthermore, Congress is expected to ultimately pass another round of fiscal relief, possibly to help state governments fund the health costs of fighting the pandemic and potentially to provide further assistance to households. This is intended to further stabilize the economy, which showed improvements after most data bottomed out in April. Overseas economic data also improved later in the second quarter.

	2020	2019	2018
GDP[1] U.S. Growth Rate	Q1/20:-5.0%; Q2/20: -35%E 2020 Estimate: -5.6%	2.30%	2.90%
Unemployment Rate	June 11.1%	3.90%	4.10%
Payroll Additions[2]	June: +4.8M YTD: -14.2M	2,133,000	2,269,000
Consumer Price Index	May YOY: 0.1%	1.8%	1.9%
Employment Cost Index	Q1-20 YOY: 2.8%	2.7%	2.9%

Source:
[1] Bureau of Economic Analysis, Next GDP Release: July 30, 2020. GDP Estimates from Bloomberg.
[2] Bureau of Labor Statistics, Next Jobs Release: August 7, 2020

The sharp recession may turn into a big third-quarter bounce, albeit with concerns about the labor market. This may lead to further stabilization in the fourth quarter, based on:

- **Advancements in Treatments.** Four vaccines were expected to enter Phase 3 trials in July. Globally, well over 100 vaccines are in trials. Beyond medial companies, global governments are also assisting with funding for treatments. Any advancements in treatments should result in major improvements in consumer and business confidence.
- **Global Fiscal Stimulus and Monetary Stimulus.** In addition to the U.S., policymakers all over the globe have expanded fiscal relief packages and announced plans to fund infrastructure. Central banks announced lower interest rates and quantitative easing, or bond purchasing, programs.
- **Low Inflation.** With global inflation low, central banks can maintain low interest rates for an extended period to help consumers and businesses with borrowing expenses. Inflation in food has ticked up, partially due to the global supply chain challenges presented by the pandemic.
- **Re-Openings Point Toward Recovery.** Different regions of the global economy began to re-open at differing speeds, with differing success. We expect mixed results, leading to “fits and starts,” which will gradually improve over time. In early July, some states paused planned re-openings as coronavirus infections spiked in their jurisdiction.
- **Continued Improvements in Data.** Although most economic reports remain at recessionary levels overall, improvements were seen later in the second quarter. For example, weekly jobless claims have trended down from the record high levels in March. Business and consumer confidence bounced up from the April lows. The May and June jobs reports and the May retail sales report showed upside surprise, with retail sales potentially revealing pent-up demand.

After a third quarter bounce, areas of concern heading towards the fourth quarter include:

- **Rising Virus Case Counts.** In early July, cases in the United States hit daily records, indicating that a return to normal remains elusive and the probability of a V-shaped economic recovery is unlikely. Improvements have been made in health care equipment, so a return to full lockdowns seems unlikely. However, without a vaccine, some consumers may not have confidence in retail shops, restaurants, events, travel, and other communal activities.
- **Lack of Capex.** Business spending was weak prior to the pandemic and remains so. There are a handful of industries (like information technology) that have gained from the work from home environment. Even with interest rates at low levels, we are not expecting a major pick up in business investment until the recovery shows sustainability.
- **Labor Market Lag.** Similar to capex, businesses may be hesitant to add to payrolls relative to pre-pandemic levels. Many businesses that re-open are doing so at reduced capacity. Furthermore, labor markets tend to be a lagging indicator. The Federal Reserve estimate for the unemployment rate for the end of 2020 is 9.3%.
- **Geo-Politics, Elections and the Unknowns.** Trade tensions remained in the headlines as the White House threatened tariffs on the EU. Social justice protests continue globally. Equities rose in June despite a dip in the President’s poll numbers (GOP is expected to hold at least the Senate). The markets may begin to focus more on the U.S. election in late summer, when attention turns to the nominating conventions.

Stocks

Trough of Downturn Leading to a Record-Breaking Stock Rally. The fear of the global pandemic began to wane, leading to a sharp reversal in markets. Investors gained confidence that earnings growth will eventually be restored. When this will happen is an open question. Wall Street analysts are still highly uncertain with near-term earnings, since many companies have pulled guidance or received a free pass for missing expectations. The last time we have seen this level of uncertainty with earnings estimates was in 2007 and 2008. The overall market and most economists agree that the recently completed Q2 will likely be the trough of the downturn. The stock market has remained resilient, despite the hazy outlook, boosted by unprecedented levels of government stimulus. FactSet data shows corporate earnings among S&P 500 companies are projected to have fallen nearly 44% year over year in Q2. All 11 sectors of the index are expected to post declines, with energy, consumer-discretionary, and industrial companies seeing the biggest drops.

	Qtr 1	Qtr 2	Qtr 3	Qtr 4	Year
2017	14.0%	10.5%	6.6%	15.0%	11.0%
2018	24.8%	25.0%	19.3%	10.6%	20.1%
2019	-0.3%	-0.4%	-2.1%	0.9%	0.1%
2020	-15.0%	-43.8%E			-21.5%E
2021					28.2%E

Record-High Cuts to S&P 500 Make Valuation the Easy Target. The forward 12-month price/earnings ratio for the S&P 500 is 22.0. This P/E ratio is above the 5-year average (16.9) and above the 10-year average (15.2), according to FactSet. On the other hand, when we look two years forward, the P/E ratio drops to 19 as analysts have greater confidence earnings growth will eventually be restored, aided by a vaccine, a declining mortality rate, and continued monetary and fiscal stimulus. While there is great uncertainty about the pace of an economic recovery, along with changes across every sector of the U.S. economy, we continue to recommend investors have both COVID-19 new-economy stock groups and value-based old-economy stock groups. This protects against the extreme valuation gaps.

Global Outlook. Our expectations are for a long recovery time to the pre-COVID global growth levels, but the worst is behind us. Record liquidity from central banks and record low interest rates for both consumers and businesses give us confidence. We expect a more diversified stock portfolio that includes both value growth groups and international stocks. We are preparing for the upcoming U.S. elections and companies that benefited from substantive consumer behavior changes.

	2nd Quarter Returns	YTD Returns	2019 Returns	2018 Returns	2017 Returns
S&P 500	20.5%	-3.1%	31.5%	-4.5%	21.8%
Russell 2000 Index	25.4%	-13.0%	25.5%	-11.0%	14.6%
NASDAQ Composite	30.9%	12.7%	35.2%	-3.9%	29.7%
International Developed Index	14.9%	-11.3%	22.0%	-13.8%	25.0%
Emerging Markets Index	7.4%	-9.8%	18.4%	-14.6%	37.3%

Source: Bloomberg

Bonds and Interest Rates

Interest Rates Lower for Longer – Again. On June 10th, The Federal Reserve signaled it would not raise near-zero interest rates through at least 2022, slashed its estimate for U.S. gross domestic product this year to -6.5%, and raised its median forecast for 2020 unemployment to 9.3%. The central bank released updated economic projections for the first time since the coronavirus pandemic began in March and temporarily shuttered most of the United States. Inflation is likely to remain below 2% until 2023. The bank also projected its benchmark Fed Funds rate would stay unchanged for the next several years, sending a clear message to financial markets that the Fed will do whatever it takes to support the economy.

If we compare this situation to the financial crisis in 2008, Chairman Bernanke cut the Fed Funds rate to the same "zero bound" situation that exists today. At that time, the Fed's balance sheet started at $1 trillion and grew to $4 trillion. In 2013, a full 5 years later, the Fed hinted at a 0.25% increase in the Fed Funds rate and contemplated halting asset purchases. The market did not like this and volatility increased as selling began. This was later known as the "Taper Tantrum." Fast forward to March 2020, when Fed Chair Powell cut to the same level. This time, the Fed's balance sheet started at $4 trillion and today stands at $7 trillion. It is projected to go to $9 trillion before the pandemic is over. Bottom line: if past market behavior is indicative of future behavior, we do not see how interest rates change for at least the next 5 years, given the enormous growth in the Fed's balance sheet and the outlook for inflation.

U.S. Treasury Yields Fell in the Middle of the Curve. 1-month bills rose 0.07%, while the 3-month bills remained flat. The biggest changes in Q2 were 2-year, 3-year and 5-year and 30-year bonds, where yields fell between 0.07% and 0.1%. Yields remained relatively flat in the 7-year and 10-year parts of the curve.

Given the Fed actions in the market, US Treasuries have settled into a range: 5-year 0.24% to 0.34%, 7-year 0.44% to 0.56%, 10-year 0.62% to 0.74%, and 30-year 1.32% to 1.55%. Investors continue to value safety over returns. Demand and Fed purchases are likely to keep yields suppressed for at least the next 5 years. We would expect this until the virus is contained and the market resets expectations once the economy starts to return to normal.

Bond portfolios continue to focus on credit quality and maturity management. Interest rates will be range bound. Total return could be achieved with older, legacy bonds that pay higher coupons. Active bond portfolio durations should be 100%-110% of their benchmarks. Reinvestments should focus on the 7- to 10-year maturities and longer, if opportunities present themselves at maturity given the ranges previously discussed. Longer-dated maturities should be held for higher coupon cash flows for the foreseeable future. We recommend an overweight to corporate debt for accounts that allow those mandates. The Fed has proven they are willing to step into the corporate sector to provide liquidity.

	6/30/20 Yields	2nd Quarter Returns	12/31/19 Yields	12/31/18 Yields
3 Month T-Bill	0.13%	0.02%	1.54%	2.36%
2 Year Treasury	0.16%	0.10%	1.57%	2.49%
10 Year Treasury	0.68%	0.67%	1.92%	2.68%
2-10 Year Spread	+0.52		+0.35	+19
BB Int Gov/Credit		2.81%		

Source: Bloomberg

Past performance is no guarantee of future results. This commentary has been prepared for informational purposes and may include some forward-looking views which reflect current expectations and opinions which reflect our judgment and are subject to change. Market conditions may change due to further uncertainty, market volatility and/or economic disruptions caused by the COVID-19 global pandemic