First Midwest | WEALTH MANAGEMENT

Market Outlook

Third Quarter 2020

Jason R. Bulinski, CFA®
Donald A. Powell, CFA®
Joseph W. Styrna, CFA®

Economic Outlook

Third Quarter Bounce. After a record recessionary decline (-31.7%) in the second quarter, the U.S. economy is expected to show a record improvement (+25%) in the third quarter, with continued recovery (+5%) estimated in the fourth quarter. The Federal Reserve has pledged to hold interest rates near zero through 2023, including announcing a new policy for long-term inflation targeting. Under this plan, called "Flexible Average Inflation Targeting," the Fed will allow inflation to remain above its 2% target level for a while before raising rates. This is an effort to help the economic recovery.

During the third quarter of 2020, U.S. economic data improved from the pandemic lows. Job gains were reported during the re-openings. Housing data is near multi-year highs, with lower interest rates boosting demand for mortgages. Consumer confidence, business surveys, and industrial production have trended higher after the March-April collapse, though they remain far from pre-pandemic levels. Similar trends were seen in Europe and Asia – although there were fears of a second lockdown in the U.K due to rising infection rates.

Key Third Quarter Economic Indicators

	2020	2019	2018
GDP[1] U.S. Growth Rate	Q2/20:-31.7%; Q2/20:25%E 2020 Estimate: -4.4%	2.30%	2.90%
Unemployment Rate	Sept: 7.9%	3.90%	4.10%
Payroll Additions[2]	Sep: +661k YTD: -10.3M	2,133,000	2,269,000
Consumer Price Index	Aug YOY: 1.3%	1.8%	1.9%
Employment Cost Index	Q2-20 YOY: 2.7%	2.7%	2.9%

Source:
[1] Bureau of Economic Analysis, Next GDP Release: October 29, 2020. GDP Estimates from Bloomberg.
[2] Bureau of Labor Statistics, Next Jobs Release: November 6, 2020

Why the Third Quarter Bounce May Lead to Continued Recovery:

- **Aggressive Global Monetary Stimulus and Fiscal Stimulus.** Policymakers all over the globe have made unprecedented efforts to assist the recovery. Countries have announced ultra-low interest rates (including negative rates), quantitative easing programs to drive down long-term rates and additional fiscal relief packages. As of early October, Congress and the White House were negotiating an additional fiscal relief package totaling approximately one trillion dollars.
- **Lower For Longer.** Global inflation is expected to remain low for years, allowing global monetary policymakers to continue to boost stimulus efforts. Low interest rates allow for lower mortgage and credit cards rates, providing substantial impact for common consumers. Low rates also benefit larger companies by helping them refinance and boosting their buybacks and dividends.
- **Treatments/Vaccines.** Announcements of various phase three vaccine trials are expected in the fourth quarter, from multiple vendors. While the CDC has signaled that a vaccine may not be readily available until mid-2021, it could be available sooner to medical workers, at-risk individuals, and first responders. This would provide a boost of confidence.
- **Re-Openings Lead Toward Recovery.** As the economy is reopening, the public is adapting its personal consumption and spending on services to accommodate for the virus. While data has gradually improved, there are speedbumps – some areas had to slow (or reverse) the re-opening process.
- **Improvements in Survey Data.** Although far from pre-pandemic highs, consumer confidence has trended higher for the past few months, as the recovery has taken shape. This is further seen in retail sales, which have returned to near-record levels, thanks to a boost in online spending. Business survey data has trended higher recently. It remains at expansionary levels.

Concerns for the Fourth Quarter and Beyond:

- **Fear of a Second Wave that Coincides with Flu Season.** A steep rise in infections could hurt confidence and slow the recovery. Due to improved testing capabilities, we don't expect a return to the earlier 2020 lockdowns, but it could weigh on potential growth.
- **Lack of Capex.** Business spending remains cautious given the uncertainty of the global economic environment. As the recovery unfolds, this could be a boost to growth at some point in 2021.
- **Labor Market Pain.** Progress has been made. Roughly half of the employees who lost their jobs earlier in 2020 have been brought back to work. Unfortunately, the levels of weekly claims remain elevated. As of early October, there had been 28 straight weeks of new jobless claims over 800,000; during the financial crisis, that level never reached 700,000.
- **Small Business Struggles.** Some measures of small business confidence have improved, but overall they remain at low levels. Small businesses have been forced to open with limited capacity due to social distancing constraints. Furthermore, smaller companies have limited access to funding relative to major corporations. There are also concerns of small business bankruptcies, now that the Paycheck Protection Program has ended.
- **Geo-Politics and Elections.** Despite the U.S.-China "phase one" deal, the U.S. reported a record trade deficit. And, trade tensions across the Atlantic continue as Brexit negotiations approach a year-end deadline. After the first debate in the U.S. election, betting sites showed a 50/50 chance of a Democratic blue wave. A contested election would drag down business confidence and expansion.

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U.S. and Global Stocks

Markets Buoyed by Optimism. Investors gained confidence that earnings growth is returning. More companies have had positive surprises against analysts' expectations, with fewer having disappointing results. Considering the widespread business disruptions, closures, and bankruptcies, the year's earnings decline has been relatively moderate. Amazingly, expected earnings for 2021 exceed record-setting results from before the pandemic. That is the benefit of record government and monetary stimulus combined with certain sectors of the market continuing to thrive off secular trends and adaptations to this new environment. Given the early stages of this fragile economic recovery, the stock market has shown limited preference in the upcoming election – provided the result is clear and unambiguous. In the 2000 election, the markets were in limbo from November 7 until December 12, when President Bush won the Supreme Court ruling. Stocks sold off 5% during that period of uncertainty.

S&P 500 Operating Earnings Growth Source: FactSet

	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%	-31.6%	-21.0%E	-12.7%E	-18.0%E
2021					25.7%E

Textbooks Got This Downturn Wrong. Historically, economic downturns are a time when both businesses and consumers reduce their debt and saving relative to income. During this downturn, corporate debt surged to record highs – it is now close to 60% of GDP. The nation and world are highly indebted, so expect to hear more and more from gold aficionados. No one knows for certain how it plays out, but there are few options. The most obvious is to spend more money in the hope that earnings and income levels return stronger than ever. Cyclical sectors and stocks may go up in anticipation of a further opening of the economy. We expect technology, industrials, consumer discretionary, and healthcare sectors to do relatively better next year.

Global Outlook. Our expectation is for a sustained economic recovery. There is an old Wall Street saying: "Bull markets climb a wall of worry." Stock valuations are relatively expensive -- the best stock gains always come within the first 6 months of a stock market bottom. The S&P 500 index gained 45% from its March 2020 low, in line with the 6-month gains from the lows of 1932, 1938, 1982, and 2009, which ranged from 44%-53%. The outcome of the election will determine what stock sectors have future tailwinds and headwinds in terms of future earnings growth, based on the ideology of the elected administration. Stay tuned.

Returns on Selected Major Indices

	3rd Quarter Returns	YTD Returns	2019 Returns	2018 Returns	2017 Returns
S&P 500	8.93%	5.58%	31.5%	-4.5%	21.8%
Russell 2000 Index	4.93%	-8.69%	25.5%	-11.0%	14.6%
NASDAQ Composite	11.02%	24.46%	35.2%	-3.9%	29.7%
International Developed Index	4.79%	-7.11%	22.0%	-13.8%	25.0%
Emerging Markets Index	9.57%	-1.14%	18.4%	-14.6%	37.3%

Source: Bloomberg

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Bonds and Interest Rates

Lower Interest Rates for the Foreseeable Future. For the last 10-plus years, the U.S. has had persistently sub-2% inflation, despite periods of positive job outlook and employment numbers. As a counter to this, the Federal Reserve updated its "Statement of Longer-Run Goals and Monetary Strategy" in August. The new strategy allows the Fed to let inflation run higher than 2% for a period, so that it averages 2% over time. And, the Fed will no longer raise rates as the economy approaches full employment. This will allow inflation – and inflation expectations – to take hold before any changes are made. With full employment in the U.S. not expected for about five more years, interest rates should stay low for a long time. And, even if the economy does produce inflation above 2%, the Fed could let it "run hot" until longer-term inflation averages 2%. After the last financial crisis, it took 7 years for a rate-raise. Expect something similar – if not a longer wait – this time around.

Yields Held Steady During the Third Quarter. The 10-year stayed flat at 0.68%, while 3-month to 7-year yields fell between 0.03%-0.05%. The 30-year yield rose 0.04%.

The Fed warned that the ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term. It also reiterated its commitment to use a full range of tools to support the economy. Policy measures and credit flow to U.S. households have helped financial conditions, but weaker demand and low oil prices have held down inflation. The Fed stated it will increase holdings of treasury securities and agency residential and commercial mortgage-backed securities at its current pace. This will support the flow of credit to households and businesses, keeping interest rates lower.

Bond portfolios continue to focus on credit quality and duration management. Interest rates will be in a holding pattern until a vaccine becomes available for wide use among the population. Longer-dated maturities should be held for higher coupon cash flows for the foreseeable future. Active bond portfolio durations should be 100%-110% of their benchmarks. Reinvestments should focus on the 7- to 10-year maturities. We also consider preferred stocks and high yield allocations for those who allow additional risk. We recommend an overweight to corporate debt stance when possible. The Fed has proven they are willing to step into the corporate sector to provide liquidity

Recent Yields on Common Securities

	9/30/20 Yields	3rd Quarter Yields	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

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Diversification does not ensure a profit or protect against a loss.

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