INVESTMENTS®

Q4 2020 Economic outlook

# Further to go

The Q3 bounce has created much-needed optimism. But while consumer and business confidence has been resilient, our recovery has further to go, and the path ahead may get more challenging. Equity valuations are near multidecade highs, uncertainty is rising heading into Q4, and income is evaporating. Investors will need diversification to manage volatility and, above all, a fresh reservoir of resiliency to draw from to finish out the year.

**Lara Rhame**
**Chief U.S. Economist, Managing Director**

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economies and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

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Dear Reader,

While writing my Q4 outlook, I thought a lot about resilience. We've seen it in our economy, which rebounded more in Q3 than anyone could have expected. We've seen it in business, as companies have developed new strategies to reach customers. And we've seen it in our families and households—I know I have, anyway—as working and schooling from home has forced everyone to pitch in and support one another.

2020 has been a difficult journey (it's hard to believe it isn't over), but we still have further to go. This recession started in such an extraordinary way, but it is looking increasingly more ordinary. History remains an imperfect guide given an unprecedented pandemic and policy that pushes boundaries yet risks being too cautious. For investors, sky-high valuations are crashing headlong into a perfect storm of uncertainty. We may yet need to dig deep and discover a fresh reservoir of resilience.

Wishing you and yours good health,

Lara

**Lara Rhame**
Chief U.S. Economist
Managing Director

The Q3 bounce has been much stronger than expected, creating optimism that the recovery has traction which will carry through the end of 2020. While consumer and business confidence has been resilient, our recovery has further to go, and the path ahead may get more challenging. For investors, equity valuations are near multidecade highs, uncertainty is rising heading into Q4, and income is evaporating. This perfect storm points to the need for diversification to manage volatility.

**Key takeaways**

- The Q3 bounce has been stronger than we expected, and consumers remain resilient.
- Economic dislocations are shifting from temporary to permanent.
- Concerns about volatility are rising, and traditional fixed income is running out of room.

## After the Q3 bounce

The Q3 bounce has been much stronger than I expected, a rare example of when I have been pleased to be wrong. The physical reopening of large swaths of the country, along with a massive dose of fiscal stimulus in the spring, helped drive robust household consumption in the third quarter. Resilience in business and consumer confidence also reflected the hope that near-term challenges will be transitory despite their enormity and that we will be back on track soon. A widely observed consensus forecast for Q3 GDP now calls for a 19.1% gain following Q2's -31.4% plunge, but the risk is that this estimate for third quarter growth is in fact too pessimistic—the bounce could be as high as 30%.

**Real GDP**
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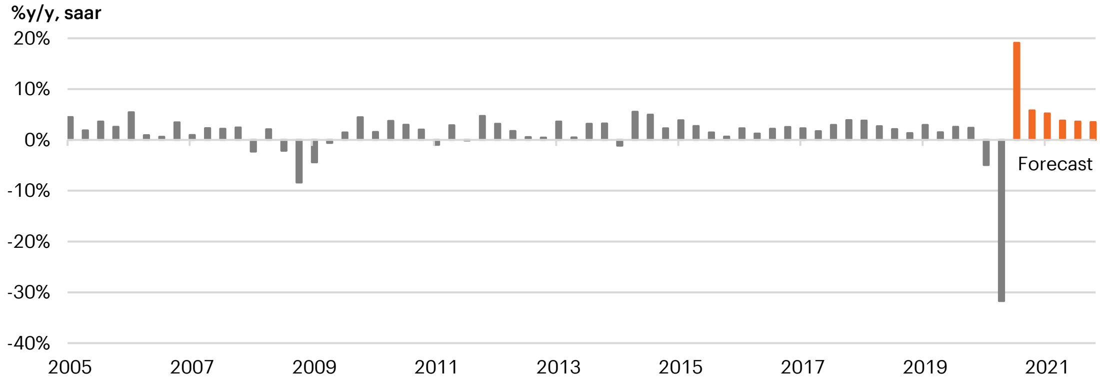



Source: Bureau of Economic Analysis, as of September 15, 2020. Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, Q3 2020, August 14, 2020.

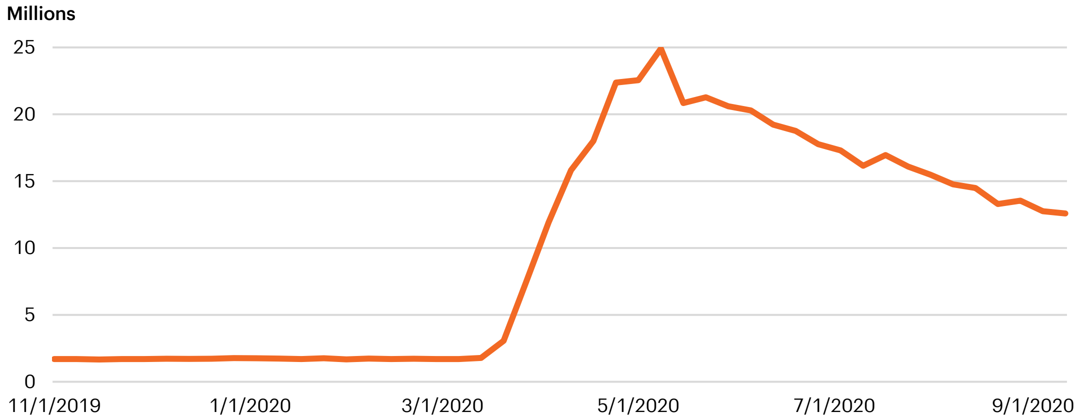
Does this mean the economy is experiencing a V-shaped recovery? Unfortunately not. Parts of the economy, however, have experienced a robust bounce in activity back to—or even better than—pre-COVID levels. One shining example of this is residential real estate. Low interest rates have encouraged home buyers to pull the trigger and caused refinancing activity to surge. Existing home sales hit 6 million in August, the highest level since the end of 2006. Housing starts have bounced close to pre-COVID levels and show that uncertainty hasn't stopped developers from breaking ground on new projects. While this is good news, housing is a relatively small part of the overall economy; for the last five years, it has made up only 3.3% of

GDP.[1] While too small to offset other areas of economic weakness, we expect residential investment to remain a bright spot for growth looking ahead.

The largest sector of the economy driving the arc of the recovery is **household consumption.** Personal consumption accounts for 70% of GDP, and in Q3 it was certainly the source of sharp rebound in growth. The consumer had several key supports in Q3, namely government stimulus and supplemental unemployment benefits, all of which helped drive the personal savings rate to 33.6%. With reopening in Q3 came a surge in goods spending which has fully recovered and in fact surpassed pre-pandemic levels. Spending on services, however, has remained challenged. We peel back the layers on this part of the economy which generates roughly $8 trillion per year in aggregate demand—an area that perhaps receives less attention than it deserves given that pandemic-related challenges remain and could be a headwind for a robust recovery.

The consumer is the driving force of growth and will continue to set the pace of the recovery in the fourth quarter and beyond. This puts consumer confidence and employment conditions at the center of our radar. Consumer confidence has stabilized in Q3. While well still below the jubilant levels of February 2020, consumer confidence remains resilient in the face of over 20 million jobs lost in the spring, about half of which have returned. In September, the unemployment rate was 7.9%, still high by historic standards.

**Continuing claims remain elevated**




Source: U.S. Department of Labor, as of September 27, 2020.

Despite the recovery of 11.4 million jobs since May,[2] the pace of improvement has started to slow as **temporary disruption is becoming permanent.** While headline job gains have continued and temporary unemployment has fallen, permanent job losses have increased. This is impacting businesses, too, as data shows that permanent business closures are rising. This recession started in an extraordinary way thanks to COVID-19, but the very real risk is that it turns into something more ordinary, with lingering high unemployment that becomes its own headwind, regardless of the arc of the pandemic.

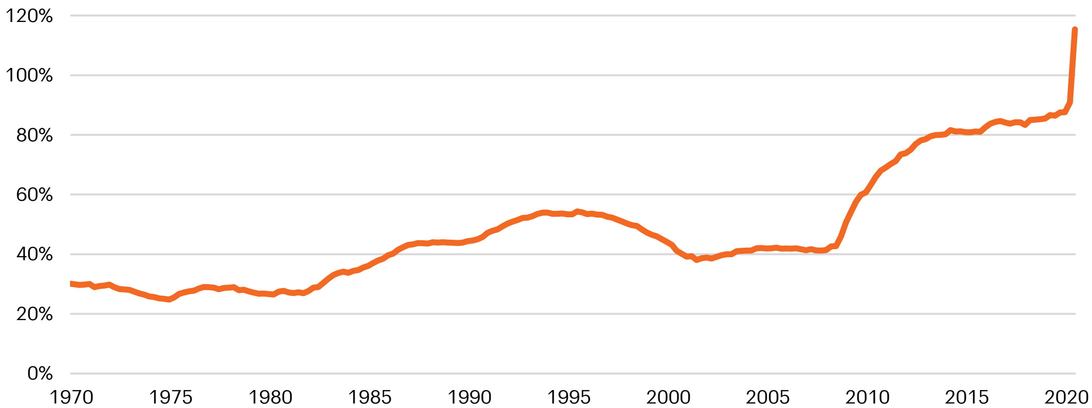
The fourth quarter will also give a clearer picture of the state of the economy without the benefit of broad fiscal support. Much of the **fiscal stimulus** will wear off, as unemployment benefits have been tapped and PPP funding is winding down. Looking to Q4 and beyond, the single largest swing factor in GDP forecasts is the underlying assumption about further fiscal stimulus. We remain pessimistic on the near-term prospect of another fiscal package being passed, despite overwhelming signs that it will be necessary. It is worth considering what scenarios the economy could face under a range of fiscal spending outcomes.

1 Average share of GDP from 2015–2019.
2 Total nonfarm payrolls, as of October 2, 2020.

## Deficits, elections and zero rates: Policy pushes the boundaries

Do **deficits** matter anymore? This is one of the most common questions I am asked these days. The answer may be surprising: Yes, but not in the way most of us might expect. Clearly at top of mind is the federal government deficit, which has gone from bad to worse in 2020. The federal deficit has exploded to 15% of GDP in Q3 as badly needed fiscal stimulus, combined with a plunge in GDP, hit epic proportions. However, going forward, state and local deficits may become a more important headwind to growth. The reality is the federal government is to a large degree acting rationally to take advantage of interest rates at historic lows to issue debt.

**U.S. federal debt outstanding, % of GDP**




Source: Bureau of Economic Analysis, Federal Reserve, FS Investments, as of September 25, 2020.

Fed policy has also tested the limits and pushed the boundaries of monetary policy for the past several decades. The **Fed's framework review** is only the latest example of how monetary policy has shifted radically over the past year and will impact investors over the next decade. While the change to the Fed's inflation target may seem irrelevant—the Fed has missed its inflation target for the past decade—it means that interest rates are likely to remain at or near zero even far after the COVID recession has passed.

The **2020 presidential election** looms as a Q4 event that could have significant impact on the economy. We mine the data in search of a pattern around equities. Given the unusual nature of 2020, it is perhaps unsurprising that usual metrics about the economies of swing states are not well correlated to polling. At time of writing, markets expect an incumbent loss, which implies markets may have already digested a higher tax profile but also have expectations for higher spending. Finally, we show that virus cases have a significant impact on polling.

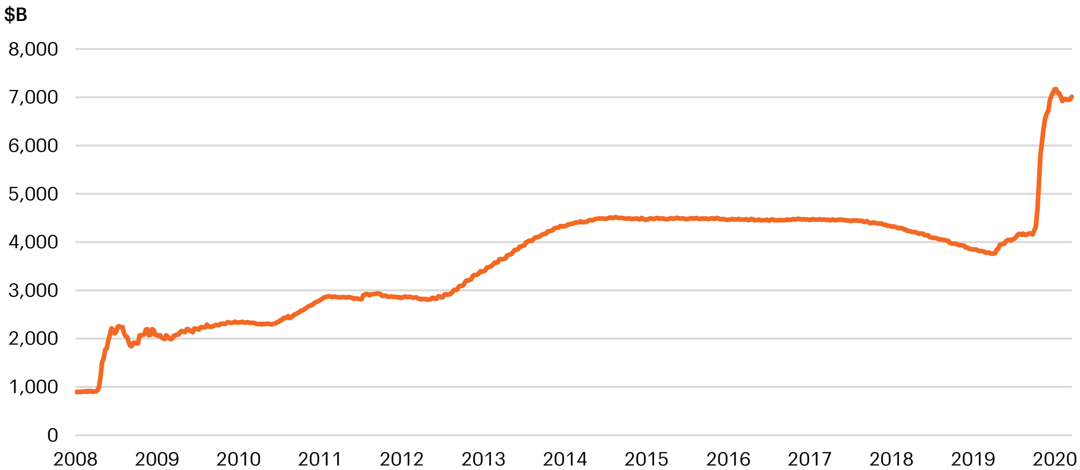
## Investors should recalibrate their expectations

This unprecedented policy uncertainty leaves investors in an unusual place. For investors, Q3 has arguably been easier than most had initially expected. The S&P 500 was up 8.3% on the quarter, and while benchmark interest rates went virtually nowhere, traditional fixed income total returns were—once again—supported by fresh price gains. Many investors could be easily forgiven for assuming the worst is in the rearview mirror.

**Volatility** looms as a concern, particularly around the election. The derivatives market shows a highly unusual demand for insurance to protect against a sell-off around the election. And even in the months after Election Day, implied volatility remains elevated. Economic policy uncertainty is also elevated, amplifying market risk around the election. For investors who have been lulled by the drop in volatility in Q3, signs are that acute volatility is now widely expected.

For **equities**, investors face two important questions heading into Q4. The first is how to make sense of current valuations, which by virtually every measure are in the highest 5% since 1990. The second is how to invest in a fundamentally changed market that has become hyper-concentrated into large, growth-oriented tech stocks. The need for diversification is rising as a host of uncertainties is gathering.

**Fed balance sheet balloons in response to economic crisis**




Source: Federal Reserve, as of September 25, 2020.

Finally, traditional **fixed income** has increasingly run out of room. The Fed's response to the COVID crisis caused an aggressive fresh round of quantitative easing. Adding $3 trillion to the balance sheet over five weeks caused yields to plunge across the yield curve. Outside of a hefty price return, income returns have decreased sharply. We consider where rates could go from here, and what it means for investors. Should rates fall meaningfully, it would likely correspond with a severe market disconnect in another area—hardly a favorable outcome. If rates rise, investors will be faced with the downside of high duration risk. Q4 may finally be the quarter when investors realize that traditional fixed income is in need of repair.

# Household consumption: Services spending stumbles

**Key takeaways**
- Household spending propelled the Q3 GDP surge.
- Spending on services has been challenged by the pandemic and could linger as a headwind to a full recovery.
- Consumer confidence has been resilient but needs to be monitored closely.

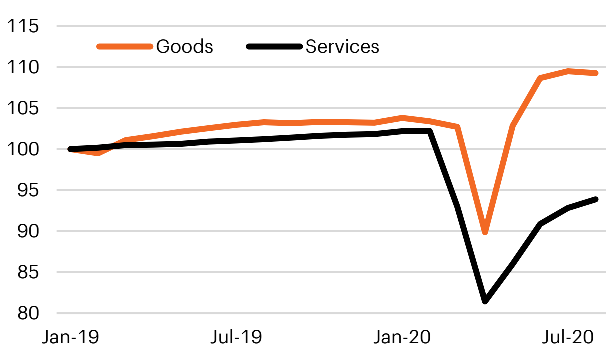
Household consumption is the single largest engine driving U.S. GDP growth, dwarfing other sectors of the economy. On average, spending by households makes up nearly 70% of GDP. How the pandemic will impact household spending—in both the short and long term—has become a deciding factor in the recovery.

The Q3 bounce is due in large part to the robust comeback in consumption. Given spending in July and August, consumption ended up surging more than 30% in the third quarter. This reinforces our expectation that Q3 GDP growth could beat the consensus estimate of 19.1%.[3]

Looking to Q4, it is important to understand what is driving consumer spending—and what is not. Spending on goods has delivered a classic V-shaped recovery. As lockdowns eased, pent-up demand was supercharged with checks from fiscal stimulus and supplemental unemployment insurance, and goods spending surged. Auto sales, a significant part of goods spending, have staged a significant rebound as used car sales have been strong.

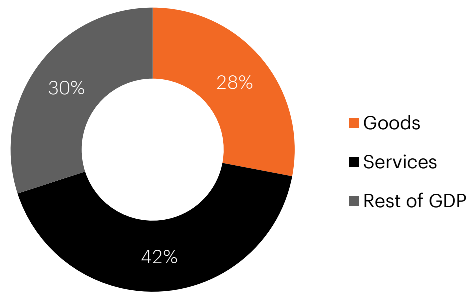
**Goods vs. services spending**

Indexed to Jan. 2019 = 100




Source: Bureau of Economic Analysis, FS Investments, as of October 1, 2020.

**Share of U.S. real GDP**




Source: Bureau of Economic Analysis, FS Investments, as of September 25, 2020. 2019 average shown.

Services spending, however, remains far weaker than before the pandemic. This is key because spending on services makes up about three-fifths of total household consumption—or 42% of the entire economy. Services spending on housing has remained flat through the pandemic, but other categories including health care, transportation (which includes public transportation and air travel) and recreation (vacations, casinos and movie theaters) have all fallen sharply and only modestly recovered.

Our expectation is that much of this spending will be limited due to the nature of the pandemic. The reality is that even if a vaccine is developed soon, distribution will take time, and many of the limits currently in place could linger. Even if spending on services recovers 90%, that still implies a shortfall of almost $1 trillion a year in aggregate demand.

Looking to 2021, it remains to be seen whether consumer spending will remain as strong as it has been heading into Q4. A headwind for future consumption is the fading support of the CARES Act. Supplemental unemployment ran out several months ago and the household savings rate, inflated by stimulus checks, has faded to 14.1% from a high of 33.6% in April. Consumer confidence has been resilient so far, rising off its post-COVID lows despite an unemployment rate that remains historically high. Whether the consumer can continue to power our economy is still highly uncertain and could come down to employment in 2021 and whether the government can enact further fiscal stimulus.

3 Median forecast for Q3 2020 Real GDP, Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, August 14, 2020.

# Q4 and beyond: Disruptions risk becoming permanent

**Key takeaways**

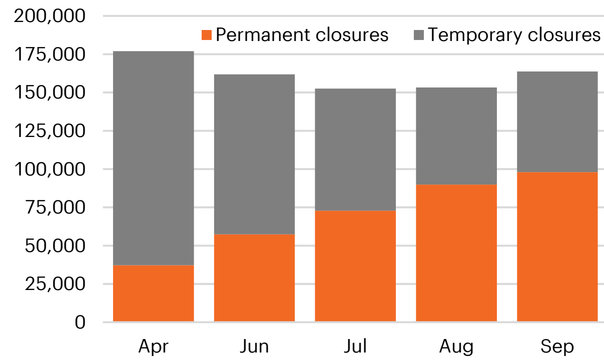
- Concerns are growing that economic dislocations will linger.
- Business closures are turning permanent, and jobs data shows permanent layoffs rising.
- While the recession started in an extraordinary way, it may end up looking more typical.

The Q3 bounce has been strong, but our economy is still facing significant disruptions. Restaurants, hotels and gyms have been badly impaired by restrictions required to contain the pandemic. Small businesses, despite the lifeline offered by PPP funding, are still experiencing high uncertainty. The risk to the economic recovery is that dislocations which started out as temporary because of mandated closures will increasingly turn permanent.

There is clear evidence of this in the labor market, which has seen a significant recovery in Q3. Temporary unemployment has staged a big recovery, from a high of over 18 million in April to just over 6 million in August. This is still a high number by any standard, but the pace of recovery has been faster than we had expected. Yet permanent unemployment has risen significantly—up 2.2 million since February—and is expected to rise further.

These permanent job losses take longer to return. Employment is considered a lagging indicator of the economy as companies are slow to rehire once a recession has ended. After the last recession ended in 2009, temporary unemployment recovered by 2013, while permanent unemployment was not back to pre-recession levels until 2015.

**Business closures shift to permanent**

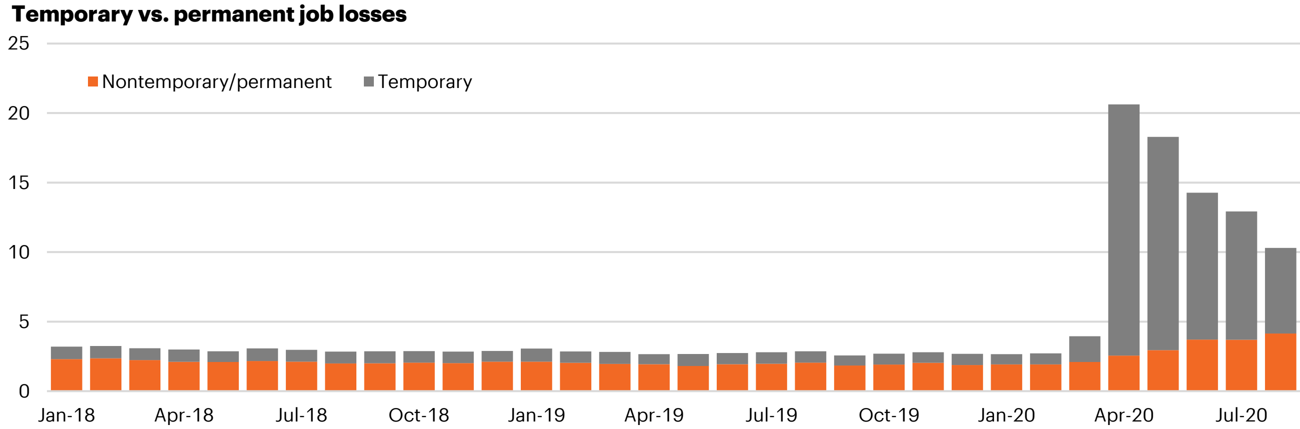



Source: Yelp, FS Investments, as of September 25, 2020.

Business closures are also increasingly becoming permanent. In September, 60% of business closures were permanent compared to 21% in April. This has hit the restaurant industry the hardest, as that sector has seen the largest share of both closures and permanent closures.

This recession started in an extraordinary way, with job losses and economic dislocation front-loaded to the beginning. Yet the very real risk is that this recession starts to look more ordinary: Business closures cause banks to tighten lending standards and permanent job losses and lingering unemployment lead households to curb spending, all of which causes businesses to be more cautious when rehiring. Over the next several quarters, this recession may end up looking more typical than it began.

**Temporary vs. permanent job losses**




Source: Bureau of Labor Statistics, as of September 25, 2020.

# Fiscal stimulus: A trillion here, a trillion there...

**Key takeaways**
- Fiscal stimulus is an enormous swing factor for GDP forecasts.
- Negotiations are coalescing around $1.5 trillion, but urgency has lapsed.
- Thoughtful legislation now will be cheaper than emergency legislation should the economy face more acute weakness.

One of the biggest swing factors to the economic outlook will be fiscal stimulus. Both the timing and magnitude of future fiscal stimulus remain highly uncertain, throwing a huge unknown into the outlook.

**CARES Act**

| | |
|---|---|
| $560B | Direct payments to households |
| $377B* | SBA loans |
| $208B | Loans to major industries |
| $154B | Payments to medical/ hospital industries |
| $500B | Corporations |
| $340B | State & local governments |
| $44B | Education/other |
| **$1.8 trillion** | **Total outlays** |

*An additional $300B was added to this program
Source: U.S. Department of the Treasury, Congressional Budget Office, FS Investments.

To contemplate the impact of future stimulus, it is useful to revisit what stimulus we have received so far. The CARES Act, the bulk of which was passed at the end of March, measured $1.8 trillion in outlays plus tax cuts and deferments bringing the total closer to $2.2 trillion, or 10% of GDP. This dwarfed the 2009 stimulus bill, which was less than $1 trillion.

The CARES Act was comprehensive, touching many pain points of the economy. Now, future fiscal stimulus has become mired in political bickering about how best to impact growth going forward.

Democrats' proposals for further fiscal stimulus have been aggressive. The most recent proposal was $2.2 trillion, down from a whopping $3.4 trillion previously. (It is hard not to revise Senator Everett Dirksen's famous quote to "a *trillion* here and a *trillion* there, and soon you're talking real money.") This latest proposal would retroactively reinstate supplemental unemployment benefits of $600/week and include another round of $1,200 stimulus checks to households. In addition, there would be aid for cities and states, schools, childcare and restaurants.

Republicans' proposal has been relatively smaller, most recently at $1.7 trillion, up from just under $1 trillion. This has similar stimulus checks, scaled-back supplemental unemployment checks of $400/week, money for state and local governments (a sticking point in prior negotiations) and more focus on pushing money to small businesses.

Where has the urgency gone? Back in March, the plunging equity market, along with an economic shutdown, was a huge incentive for the government to come together and pass the CARES Act. Now, as the equity market has staged a full recovery (and then some) and data shows a better Q3 bounce than expected, the urgency has evaporated. That does not mean more stimulus is not needed, however. We could envision a scenario where the economy contracts again, modestly, in Q1 2021. Not a double-digit drop like Q2 2020, but enough retrenchment in consumption and business investment to contract by 1%–2%. This may well create fresh urgency around more fiscal stimulus.

One of the most critical lessons we observe is that, when done under emergency circumstances, fiscal stimulus needs to be larger and tends to be sloppier. Put differently: Legislation takes time to be targeted. The risk—that fresh stimulus money misses the mark, is misused or goes unused—rises when legislation is passed in haste.

The impact on GDP is material, if hard to pin down exactly. Estimates of the consumption multiplier of direct payments to households are 30–60% (the rest being allocated toward savings or paying down debt). This could push GDP growth up almost 1% for the next several quarters, a nontrivial amount when trend growth is still around 2%. Most forecasters—including Fed presidents—have been assuming some fiscal stimulus; $1 trillion–$1.5 trillion is often cited. Should nothing materialize, growth estimates may be trimmed down for Q4 2020 and 2021 overall.

# Deficits: Do they matter anymore?

**Key takeaways**

- Federal deficits are soaring, but low interest rates and Fed QE limit near- and medium-term risks.
- City and state budgets, however, could have a more immediate and meaningful negative impact to the economic recovery.

The U.S. government deficit has soared as COVID-related fiscal stimulus was required in the first half of 2020. Concern about rising deficits was top of mind before the pandemic. Now many are toggling between concern and resignation, asking, "With interest rates so low, do deficits even matter anymore?"

Fed policies including QE and historically low interest rates have enabled the government to undertake significant stimulus with little downside risk (for now). Given the challenges facing the economy, it makes sense for the government to be opportunistic and issue debt with interest rates so low—much like homeowners locking in low interest rates by refinancing their homes. Looking ahead, we expect large government deficits to be a part of the financial landscape for years to come.

Much depends on the long-run trajectory of interest rates. For decades, interest rates have been on a downtrend due to lower inflation and demographics. In the U.S. and around the world, the baby boomer cohort has sought safer assets to build savings ahead of retirement. We expect this to continue for the next decade. Combined with global monetary policy keeping interest rates low, servicing a higher deficit seems to cost relatively little.

Of more immediate concern for the economy are state and local government deficits, which have exploded during the crisis. The plunge in tax revenue and the need to pay out unemployment insurance have gutted local balance sheets. Unlike the federal government, these entities need to balance their budgets and do not have the luxury of issuing unlimited amounts of debt to fill the gap.

This has immediate implications for the economic recovery. City and state government spending accounted for 10.6% of GDP in 2019—more than federal spending. City and state governments employ significantly more workers than the federal government.

City and state government spending fell sharply after the 2007–2009 recession. Local government spending didn't become a support for the economy until 2014, five years after that recession ended. In Q2, state and local spending shaved four-tenths off GDP, a paltry sum compared to the 31.4% overall decline. Yet looking to Q4 and beyond, with GDP expected to post single-digit growth rates, weak state and local spending could be a noticeable drag.

Tax policy in the next four years is also a looming uncertainty given the election year, with the focus squarely on federal taxes. Yet few may be prepared for the fact that whoever sits in the White House in January 2021, state and local taxes are sure to rise in the coming years to fill the significant budget shortfalls created this year.

While the deferral budget deficit tends to get most of the attention, state and local budget shortfalls may hinder economic recovery in the near term.

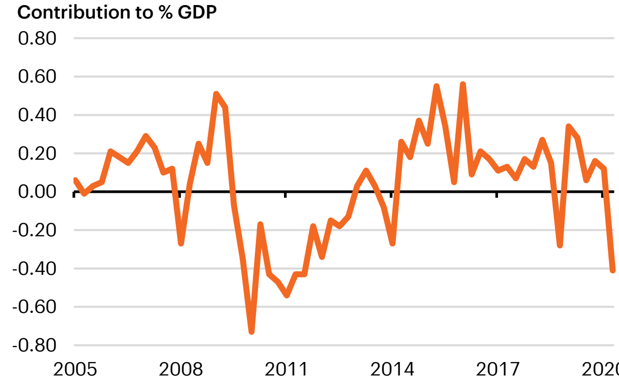
**Deficits have skyrocketed**

Annual federal deficit, % GDP


Source: Macrobond, BEA, CBO. Projections are based upon CBO estimates for 2020 and 2021 and CBO projections for real GDP.

**State and local government spending**

Contribution to % GDP




Source: Bureau of Economic Analysis, as of September 25, 2020.

# Fed policy: Low interest rates for years to come

**Key takeaways**
- The Fed's framework review has important implications for monetary policy in the coming decade, long after the economy has renormalized.
- Markets had already largely digested the new framework's implication of low interest rates far into the future.

In August, the Fed announced a new framework. The big reveal—18 months in the making—was that instead of targeting inflation at 2%, policymakers would now target "inflation that averages 2% over time." Managing inflation is one of two mandated functions of the Fed. (Keeping unemployment low is the other.) At the root of the Fed's problem is that it has missed its 2% inflation target for the past 10 years, when the PCE deflator averaged only 1.54%.

An example of how the new framework could impact monetary policy can be found in the 2015–2018 rate hikes. Under the new guidelines, this "preemptive" rate hike cycle would not have occurred. While the unemployment rate was close to full employment and falling when the Fed started raising rates, inflation was not consistently at 2%.

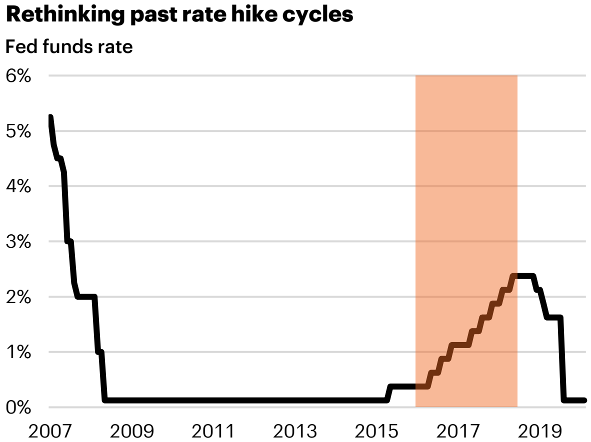
Markets had already internalized the implications of the Fed's new framework. Typically, long-run inflation expectations trade alongside long-run expectations for the Fed funds rate. Yet in Q3, while inflation expectations largely recovered to pre-pandemic levels as the economy bounced, long-run interest rate expectations did not. A 5-year proxy for the Fed funds rate is still virtually zero.

One could argue this conversation is irrelevant. We are in the earliest stages of a highly unusual recovery from the worst recession in living memory. Why should we be considering when to raise rates?

This is critical for investors to understand amid optimism around a vaccine and hope that the economy will "return to normal" at some point in the next several years: The new Fed framework means that even if the jobless rate fell significantly and the economy returned to sustained potential growth (currently around 2%), policymakers would still likely hold interest rates where they are: at zero. This commitment to long-term lower rates will mean the income challenge is here to stay, even if optimistic growth scenarios come to fruition.

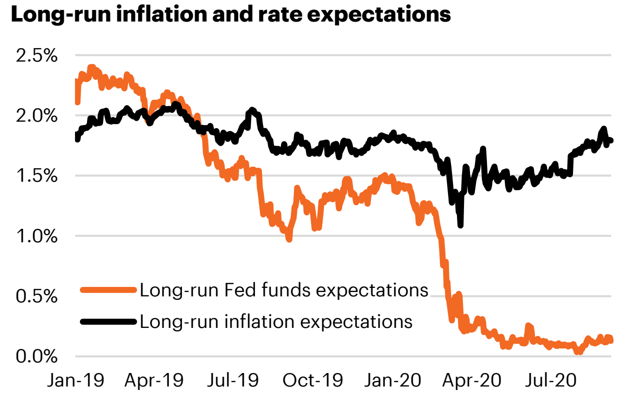
At the end of the day, the framework review did not address the Fed's other problem—that with the Fed funds rate at zero, the Fed's toolkit is increasingly limited. The Fed has tools to effectively stabilize financial markets, which it deployed in March and April, including facilities to purchase a wide range of assets. Yet direct efforts to stimulate the economy outside of cutting interest rates—like the Main Street Lending Program—have not gained significant traction. Further creativity may be required to truly fix low inflation, which has seemingly become entrenched.

**Rethinking past rate hike cycles**




Source: Federal Reserve, as of September 25, 2020.

**Long-run inflation and rate expectations**




Source: Bloomberg Finance, L.P., as of September 8, 2020.
Long-run Fed rate expectations are the 5Y OIS yield, and long-run inflation expectations are the 5Y-5Y forward breakeven.

# 2020 election: The election, the economy and the virus

**Key takeaways**

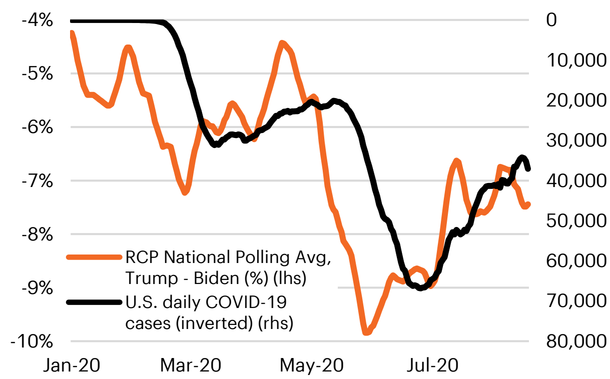
- Usual metrics connecting the economy to polling do not seem to apply in 2020.
- Equities historically underperform when the incumbent loses.
- The arc of the pandemic seems to be a key determinant of the presidential race.

The presidential election looms as a key event of Q4. 2020 has been unprecedented, and the election seems to be following that trend. Usual metrics like employment conditions in battleground states seem to have little connection to polling. For example, Arizona and Florida—critical swing states—have both lagged the national recovery in employment hours.[4] Yet in Arizona, poll results are unchanged, while in Florida, Trump is up almost 3 points since June.

Finding an equity market pattern around presidential elections is a quadrennial exercise that often bears little fruit. On average, regardless of the outcome, the equity market reaction is relatively muted for the first three months. Looking beyond, of course—a timeframe where policy changes are implemented and thereby reflected in the economy—one conclusion that stands out is the underperformance of equities when the incumbent party loses.

For now, markets appear to be pricing a Biden victory.[5] Biden's stated economic plan calls for significantly more spending, and higher taxes—in particular taking back half of the Tax Cuts and Jobs Act tax cuts by raising corporate taxes to 28%. On balance, this would likely be a net positive for GDP over the next several years but would also lead to higher deficits.

**Election polling has tracked the virus**

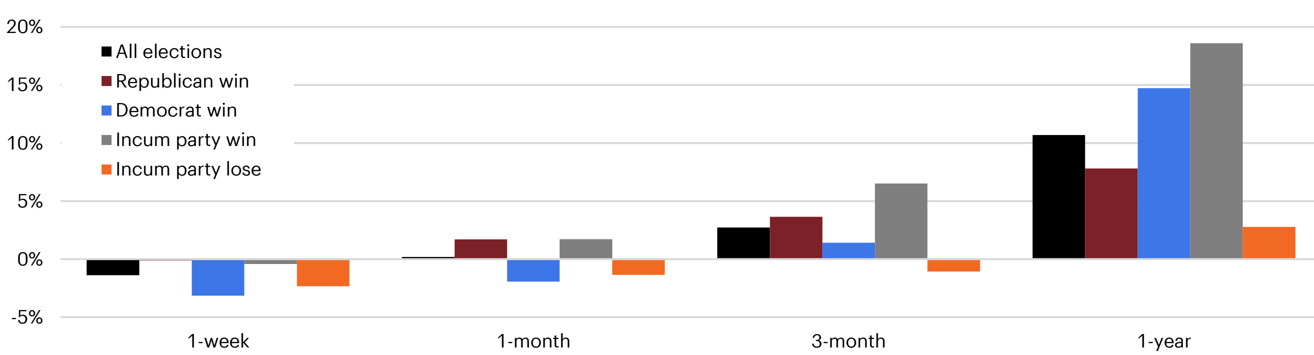



Source: Real Clear Politics, The COVID Tracking Project, as of September 25, 2020.

Other legislation will impact the economy as well. Being "tough on China" is something upon which both parties now seem to agree. Potential impacts thereof include higher regulation, particularly for energy, and greater focus on competition, which could impact technology companies. Immigration is a sphere where the president has significant latitude to act unilaterally. However, the pandemic and global travel restrictions could be a near-term hurdle to allowing significantly more seasonal or even skilled workers to return.

At the end of the day, the outcome of the election may hinge on the arc of the pandemic, as this factor seems to be more directly tied to polling results than traditional economic outcomes.

**Average S&P 500 total return post-election**




Source: Macrobond, FS Investments, as of September 11, 2020. Data reflects presidential elections from 1970 to 2016.

4 Bureau of Labor Statistics hourly workers index, as of August 29, 2020.

5 PredictIt has a Biden victory priced at 62 vs. a Trump victory priced at 42, as of September 30, 2020. Biden has consistently led over the past 90 days.

# Equities: Volatility straight ahead!

**Key takeaways**

- Volatility has remained elevated despite market gains in the past five months.
- Options pricing shows implied volatility has risen sharply the day of the election and is elevated thereafter.
- Economic policy uncertainty has also remained exceptionally high.

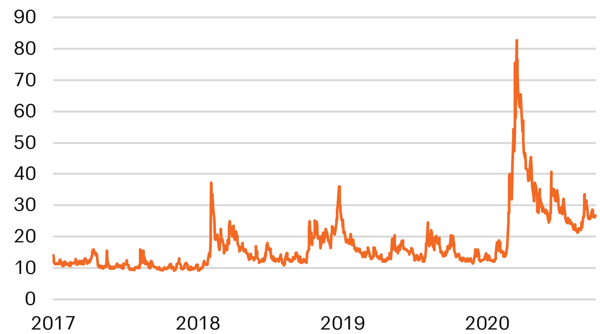
The November 3 presidential election is the big event on the radar for markets, and investors are bracing for volatility to kick up significantly. A look at options pricing shows a very steep volatility curve compared with prior cycles, and implied volatility for Election Day is extremely high.

This is reflected in pricing for S&P 500 puts with a strike price of 3,350, not far from where the index is trading now. In other words, this is protection against a market decline from current levels that would allow investors to sell at close to current price levels.

The fact that investors are purchasing insurance (or the financial market equivalent) around the actual election highly suggests concern that the election outcome will be contested. But a notable feature of the curve is that volatility is expected to remain elevated well beyond the election, with a projected peak in December.

This could either reflect concerns that any dispute around election results would be protracted, or it could mean that, should Biden win, investors are concerned markets will sell off.

**CBOE Volatility Index (VIX)**

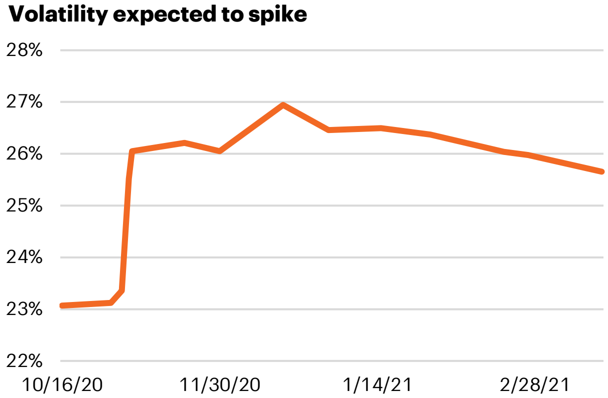



Source: Macrobond, as of October 1, 2020.

Either way, the fact that volatility is expected to remain so much higher than the long-run average for months after the election is a historic anomaly. It is also noteworthy that this is unique to U.S. equity markets.

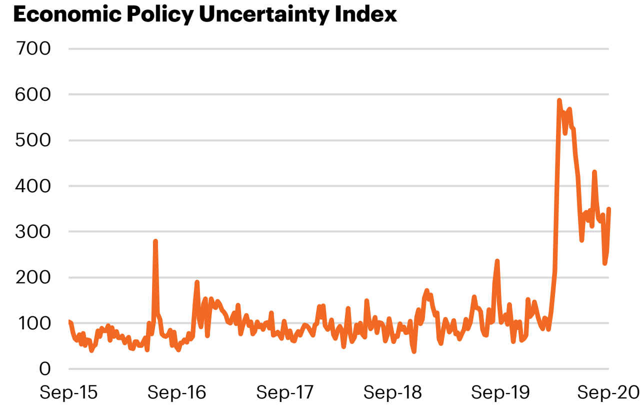
More broadly, economic policy uncertainty remains elevated due to a variety of factors. The pandemic, the lack of clarity on further fiscal stimulus, and the upcoming election have all coalesced into a perfect storm. So far, consumer confidence has remained resilient in the face of these many headwinds. But elevated economic policy uncertainty is a known headwind to business investment, an important sector of our economy.[6] Currently, economic policy uncertainty has sustained levels higher than the last recession and dwarfs the jump in uncertainty around the 2016 election.

**Volatility expected to spike**




Source: Bloomberg Finance, L.P., as of September 28, 2020. Reflects S&P 500 puts with a strike price of 3,350.

**Economic Policy Uncertainty Index**




Source: St. Louis Federal Reserve FRED, as of September 11, 2020.

6 See "Measuring Economic Policy Uncertainty" (2012) by Scott Baker, Nicholas Bloom and Steven Davis.

# Equities: Concentration on diversification

**Key takeaways**
- U.S. equity markets continued to rise for most of Q3 but took a breather in September.
- Valuations are at their highest level since at least the early 2000s.
- Outperformance by large-cap tech stocks has created a market that is highly concentrated.
- Diversification continues to be the most important aspect of investing in 2020.

U.S. equity markets continued to climb during most of the third quarter, and the S&P 500 reached an all-time high in early September. Markets then took a pause for the remainder of September as the election neared and hopes for further fiscal stimulus began to fade. Even with these declines, valuations remain high, especially given pervasive economic uncertainty. For investors, the two important questions become 1) how to make sense of current valuations and 2) how to invest in a fundamentally changed equity market.

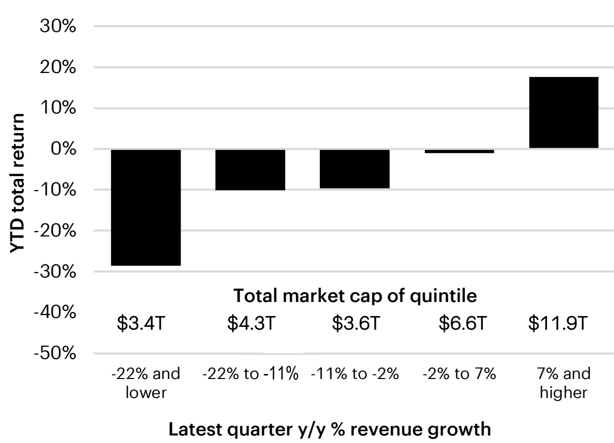
First, let's take a look at valuations. The S&P 500 currently sits at a 12-month forward P/E ratio of 24.8x, which is in the highest 5% of observations since 1990. Other measures like EV/EBITDA and price-to-book are also near the top of their historical ranges. While valuations at these levels are concerning, at least in the case of P/E and EV/EBITDA, they do have limitations in that they price stocks based solely upon the next 12 months of expected results. The COVID-19 crisis is unique in that it has caused a massive decline in near-term earnings expectations, but analysts expect earnings to recover more quickly than during the last recession.

Regardless, equities appear to be expensively priced. Using Bloomberg consensus estimates, the S&P 500 is currently trading at nearly 7x the next three years of expected earnings, a level last seen during the early 2000s. In our view, low interest rates have been a key factor in driving these valuations up to current levels, and ultra-easy central bank policies have dampened volatility and compressed risk premia to create a "perfect storm" for stocks.

These dynamics have been accelerated during the current COVID-19 crisis; however, with nominal interest rates near zero and real rates deeply negative, it is uncertain how much more of a tailwind low rates can offer. This secular trend has rewarded large, growth-oriented tech stocks; the "Big 6" tech firms[7] now comprise about 25% of the S&P 500 market cap, up from 11% just four years ago. Clearly, these stocks have outperformed for a reason. The question continues to be not whether the appropriate stocks have been favored, but whether the magnitude of their outperformance is warranted.

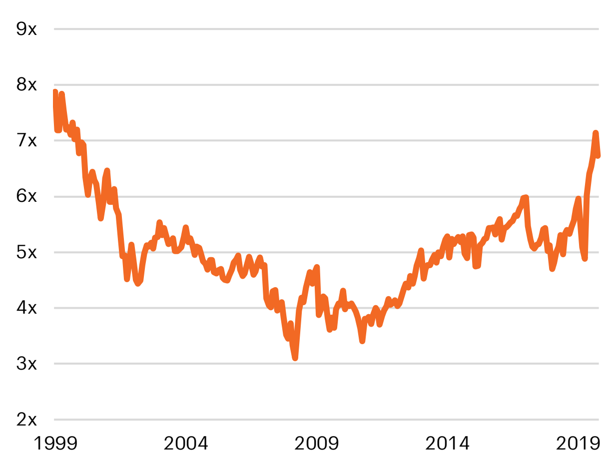
Investors must navigate a host of factors in today's equity market—uncertain future earnings, high valuations, central bank policy and elevated market concentration, to name a few. In our view, diversification continues to be the most crucial aspect of investing in this environment.

**Average returns based on revenue growth**
S&P 500 members, broken out by quintile of revenue growth




Source: Bloomberg Finance, L.P., FS Investments, as of September 25, 2020.

**S&P 500 price to next 3 years' earnings**




Source: Bloomberg Finance, L.P., FS Investments, as of September 25, 2020.

7 The "Big 6" are Apple, Facebook, Alphabet, Microsoft, Netflix and Amazon.

# Fixed income: Running out of room

**Key takeaways**
- Traditional fixed income returns have been supported by price gains, not income.
- We analyze scenarios of rates going up and down; unfortunately, neither offers an easy solution to finding income.
- Fed QE policies should offset rising federal deficits to keep interest rates low.

The Fed's response to the COVID crisis has exacerbated the challenges for investors seeking income. The market rout in early 2020 called for drastic action, and the Fed slashed interest rates to 0.00%–0.25% and started a fresh round of quantitative easing that included trillions of dollars of Treasury bond purchases. The result? A plunge in yields across the curve.

The knock-on effect to income investments has been immediate. Outside of a hefty price return, income returns have decreased sharply. The Barclays Agg now yields only 1.18%,[8] and further intervention to support corporate bond markets from the Fed has pushed yields down across the credit curve. Where do we go from here?

Yields have been on a multidecade decline as inflation has fallen and potential growth has decelerated. In the 1990s and 2000s, investors were still clipping a decent coupon. Yet for the past several years, with yields already near historic lows, the majority of returns from traditional fixed income have come from price appreciation, not income.

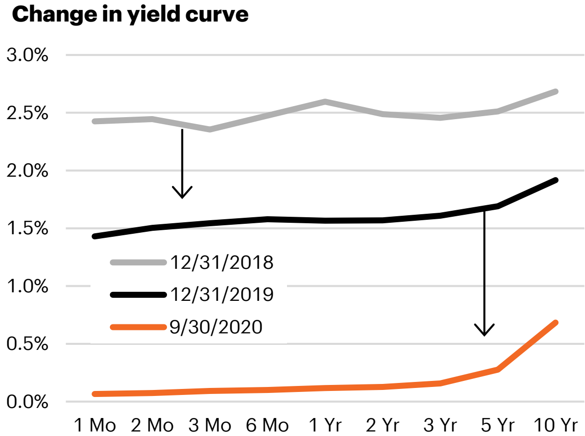
At this juncture, it is critical to consider where rates could go, and what that means for investors.

Could rates fall further, providing another round of solid returns for total fixed income based almost entirely on price gains? Certainly. In Q3, the 10-year Treasury held to a remarkably narrow range of 0.50%–0.75%, the lowest rates since WWII. But Europe and Japan have experienced negative long-term yields for years. It is not hard to envision a scenario where a flight to quality occurs that pushes U.S. long-term yields down, possibly even into negative territory. However, this would likely occur because equity markets (or another market) were experiencing acute dislocation. In other words, this would likely not be a desired outcome.

Could yields go up from here? This is also a possibility. The U.S. deficit has skyrocketed and the Treasury will need to issue trillions of dollars of debt. Supply-demand dynamics could potentially coincide with further improvement in the economic outlook, which could cause yields to rise 50 or even 100 bps (to 1.60%, as an example). Yet given the long duration of the Barclays Agg—now at 6.4 years—a 1% gain in interest rates would cause prices to fall 6.40%; total returns would decline notably. It is unlikely that Treasury yields would surge higher than 200 bps or more in the coming year given that the Fed is still actively engaged in QE.

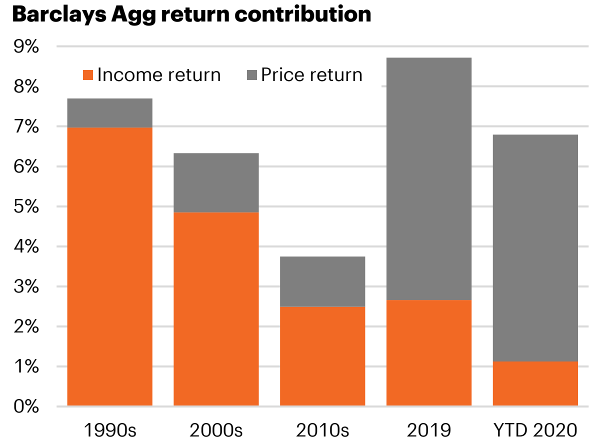
Q4 may be when investors finally realize that traditional fixed income has run out of room.

**Change in yield curve**




Source: Bloomberg Finance, L.P., as of September 30, 2020.

**Barclays Agg return contribution**




Source: Bloomberg Finance, L.P., FS Investments, as of September 30, 2020.

8 As of September 30, 2020.