Market and Economic Insights

Quarterly review and outlook

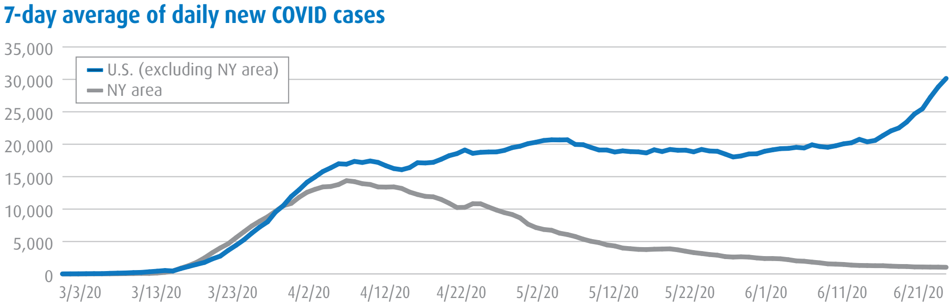
Colossal policy responses in the second quarter reassured investors that the U.S. economy can weather the COVID-19 downturn, with a relatively quick return to risk assets pushing the S&P 500® up 20.5% for the period, its best quarter since 1998. After bottoming in March, U.S. stocks rose as much as 44% before the rally stalled a bit over the last few weeks of the quarter. We saw a few signs of hesitation for more policy among lawmakers as indicators improved, but overall both Congress and the Federal Reserve (Fed) remain prepared to do more. While we believe unprecedented fiscal and monetary policy justify a constructive position on risk assets, at the moment markets seem to be looking past certain macro risks. With U.S. COVID-19 cases rising again and an election approaching, investors will have to reckon with these risks relatively soon. As a result, while we are optimistic regarding a U.S. recovery, we believe much of the good news is factored into current markets. Though the path forward will be choppy, the trend should be positive.

Table of contents

COVID-19 isn't going away

New COVID-19 cases began accelerating again in some U.S. states late in the second quarter. With many states reopening and the healthcare precautions themselves now politicized, perhaps this is not surprising. Some states, notably in the south and west, were forced to pause or even reverse reopening due to the virus spike. The U.S. does have the capacity to handle these cases in its healthcare system and the mortality rate has remained steady, though medical professionals have reminded us that this number will lag new cases. Even if the mortality rate starts to rise again, however, political forces seem aligned against a second economic "full stop" on the scale we saw in March and April. The clock is ticking on President Trump's re-election campaign and senior administration officials have assured that no second lockdown is coming. It would seem that only the most dire relapse could overcome these political exigencies. As a result, we think the most detrimental economic effects of the virus are unlikely to return, though the human cost may become more painful yet in the U.S.

7-day average of daily new COVID cases



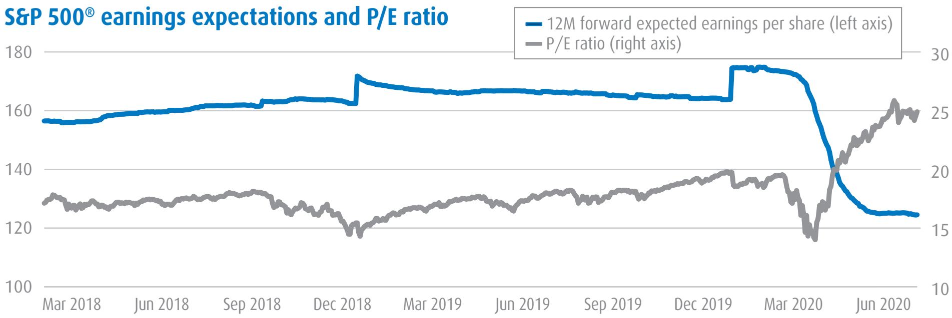
Source: Bloomberg LP, BMO Global Asset Management

Continued

A choppy recovery

While we do not expect a second lockdown, we do expect the economic recovery in the U.S. to be uneven. Job losses in May were less severe than expected and markedly improved versus April, which at 19.6 million jobs lost was the worst monthly decline in U.S. history. Retail spending, which plummeted during the lockdown, bounced significantly in May after states reopened but remained down 6.1% from a year earlier. For the moment, markets seem to be treating bad news that could have been worse as good news. Second-quarter corporate earnings were marked down 37% versus the end of March, but the market appears to have given companies a pre-emptive mulligan on the second half of 2020 and relaxed expectations until the first quarter of 2021.

S&P 500® earnings expectations and P/E ratio



Source: Bloomberg LP

“Job losses in May were less severe than expected and markedly improved versus April, which at 19.6 million jobs lost was the worst monthly decline in U.S. history.”

Fiscal policy: A bit of the old partisanship but no roadblocks

Fiscal policy has helped keep a floor under markets throughout the COVID-19 crisis. We've seen noteworthy bipartisan support for stimulus to this point and we expect Congress to reach a deal on another round in the range of $1 trillion. However, we have seen some signs of "policy fatigue" and improving indicators such as May's retail sales bounce may begin to erode the political will for additional stimulus at the current scale. The enhanced unemployment benefits Congress approved at the height of the crisis expire on July 31 and the extension of these benefits has become more politically contentious. Detractors believe the more generous benefits create a greater incentive to stay out of the workforce (thus keeping unemployment higher) while those in favor believe that extending them will help the most vulnerable and support consumer spending. A scaling back in unemployment benefits would erode the buying power of many unemployed people, which would have negative near-term implications for the U.S. recovery.

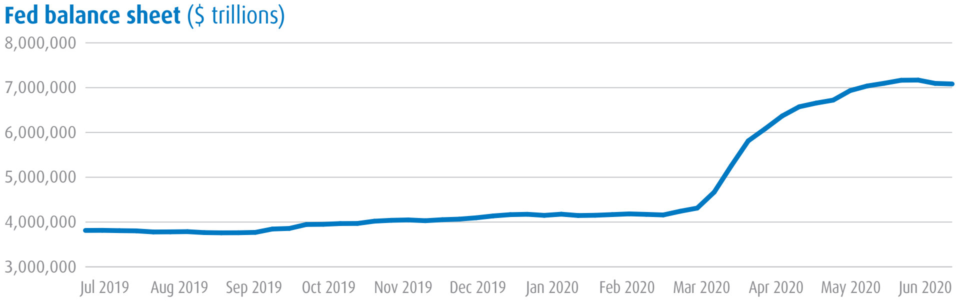
We believe continued support for small businesses will be less controversial and should appear in the next stimulus bill. The Paycheck Protection Program (PPP) has been instrumental in greatly reducing the number of bankruptcies among small businesses, which employ nearly half of all private-sector workers.

“A scaling back in unemployment benefits would erode the buying power of many unemployed people, which would have negative near-term implications for the U.S. recovery.”

The future's uncertain but the Fed is ready for it

Despite some indicators suggesting the worst of the COVID-19 economic damage is over, the Federal Reserve remained dovish overall at its June meeting. The Fed will maintain its current pace of monthly balance-sheet expansion, which equates to a $1.5 trillion annual pace and is larger than any previous program of quantitative easing.

Fed balance sheet ($ trillions)



Source: Bloomberg LP, Federal Reserve, BMO Global Asset Management

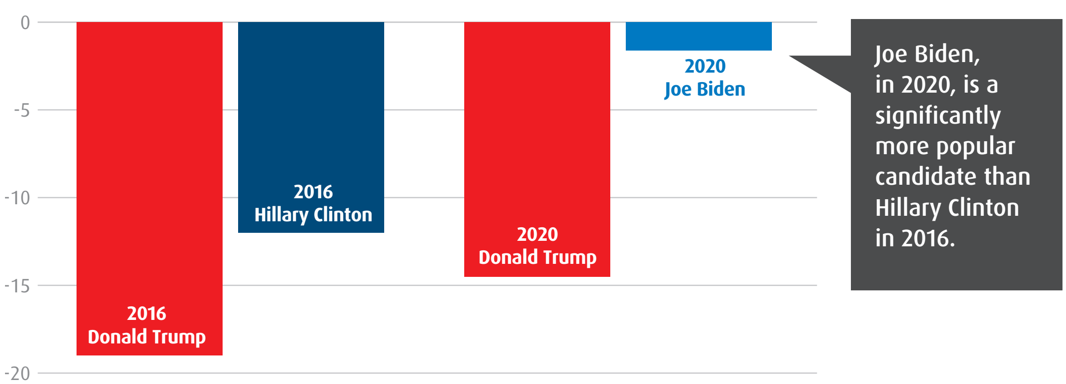
Even with the size of the Fed's commitment, Chairman Powell still reminded Congress that additional "direct fiscal support may be needed." Powell continued to emphasize that the path forward for the economy depends on the route taken by the virus, which is still fraught with uncertainty. Market participants looking for quantitative criteria for raising interest rates were disappointed, with Powell quipping, "We're not even *thinking about* thinking about raising rates." The Fed also resumed its Summary of Economic Projections, known as the "dot plot." No members submitted a negative interest rate dot, but the median expectation was for zero rates through the end of 2022 with the unemployment rate declining to 5.5% and core inflation of 1.7%. However, in these uncertain times, we concur with Chairman Powell that the path forward is very uncertain and no economic model will accurately capture the dynamics in play.

Some signs of trouble for the Trump campaign

Markets have also not yet taken much account of the 2020 election, though this may soon change given Joe Biden's leadership in recent polls. Biden has built a lead over President Trump in national polling as well as in some key states such as Wisconsin and Pennsylvania. Recent protests in the U.S. following the death of George Floyd in police custody, and President Trump's hard line against the protests, may contribute to mobilizing voters this fall. Biden has capitalized on President Trump's falling popularity by positioning himself as a center-left candidate, appealing to centrist voters looking for modest change on policy and more meaningful change on tone. Markets are wary that Biden may shift his agenda if social unrest escalates and he tries to keep the more progressive wing of the party enthused. These events have already affected the campaign's choices for a vice-presidential candidate, with Amy Klobuchar bowing out as a result of her ties to the police officers charged with murdering Floyd. While 2016 exposed the dangers of relying on polls, a summer marked by social unrest, rising COVID-19 cases and slower-than-expected economic recovery will present challenges for the Trump campaign along with the Republican effort to maintain a majority in the Senate. We will have more about the election and its implications next quarter.

In these uncertain times, we concur with Chairman Powell that the path forward is very uncertain and no economic model will accurately capture the dynamics in play.

Net favorability of presidential candidates



Source: RealClear Politics. 2016 data as of November 8, 2016 / 2020 data as of June 24, 2020

The U.S. and China practice social distancing

U.S.-China relations continued to simmer, though actions on both sides remain muted and the "Phase One" trade deal remains intact. While we expect tough words from both sides, we believe the Trump administration will hold off on escalating tensions or breaking out of the deal, at least through the election. As a guest speaker at one of our recent investment forums noted, COVID-19 has widened the "trust deficit" between the two countries and made constructive engagements less viable. From China's perspective, the outcome of the U.S. election is unlikely to change the strategic competition at the heart of the relationship. Please see our recent report on China for further detail on these relations.

Europe tries to pull together

We have seen some positive developments towards tentative fiscal integration from the European Union. In May, French President Emmanuel Macron and German Chancellor Angela Merkel announced their joint support for the European Commission's Next Generation EU, a €750 billion recovery fund backed by the EU common budget. While the plan still needs to gain full approval by member states, the support from the largest EU members may signal greater cooperation on fiscal matters — both now and in the future. The underlying structural problems faced by EU states have been laid bare over the past decade as poorer southern countries have stagnated while their more prosperous northern neighbors have outperformed. A common fiscal framework may help to partially close this gap. While the developments are encouraging, we remain hesitant to view this initiative as a definitive turning point in the EU. Opposition to further integration remains, particularly in the north, and there are plenty of barriers along the way. However, these political developments will be an important factor in determining whether or not European markets can reverse their severe underperformance versus U.S. markets (an outcome we do not expect at the moment).

Positioning

During the quarter, we increased our allocation to investment-grade bonds. We believe investment-grade corporate bonds offer a good opportunity over the medium term with spreads still marginally cheap relative to history and the Fed's pledge to support this sector. Though equity markets seemed to set aside some of the macro risks noted above during the second quarter, we maintained our overweight to equities in part due to the large-scale and proactive monetary and fiscal policy response in the U.S. We believe these measures will prevent long-term damage to the economy and improve the likelihood of improvement in the second half of the year.

Though equity markets seemed to set aside some of the macro risks noted above during the second quarter, we maintained our overweight to equities in part due to the large-scale and proactive monetary and fiscal policy response in the U.S.

Let's connect

bmogamviewpoints.com

bmo-global-asset-management

BMO Global Asset Management