Portfolio Manager Commentary

October 9, 2020

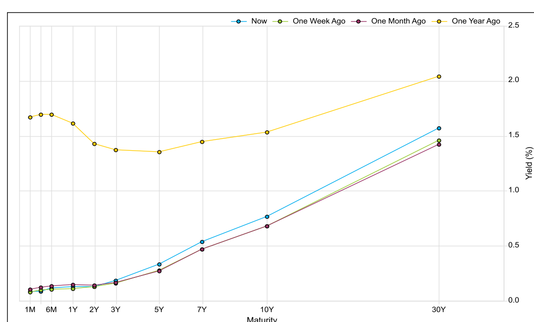
Economic Outlook

The U.S. Services Purchasing Managers' Index came in at 54.6 for September, the same level as August. The September ISM Services Index came in at 57.8 versus 56.9 for August. Both readings continue to be expansionary in nature. Otherwise a slow week for economic releases.

Fixed Income

The Federal Reserve is determined to push inflation higher from levels it considers dangerously low. For that to happen, it must first convince everyone that prices will accelerate in coming years. One big problem is that the measures that bond traders and others rely on for longer-term inflation expectations can often give conflicting and confusing signals. No one can agree on how best to use or interpret them, with even the Fed seemingly reluctant to fully explain its plan going forward on how to measure inflation properly in the context of what their definition is of letting prices run "hot". Yet depending on which measure you are looking to for a reading on inflation, it is still well short of the Fed's average two percent goal. With the Fed planning to keep rates near zero until price pressures re-emerge, it's a far from academic question. The prospect of an abrupt economic reflation lifted yields on U.S. debt to the highest in months last week, skewing the yield curve to near its steepest in four years and bringing forward bets that interest rates will continue to climb. While those bets dipped amid stop and start talks over a stimulus package, their resilience was a timely reminder for traders of what's at stake in nailing the outlook for inflation. For better or worse, the imperfect soup of frameworks, surveys and metrics is now at the heart of the Federal Reserve's monetary policy. Central bankers believe the public's expectations for inflation ultimately govern how high officials are able to lift rates. Yet gauges of the outlook have been too low for the Fed's liking for years. That concern played into its decision in 2018 to review policy making, and the central bank now plans to keep rates low until price gains average 2% over time, contingent on longer-term inflation expectations also remaining well anchored at that level. "Inflation expectations have always been important to the Fed's approach, but this new framework puts them front and center, in that the changes are aimed at keeping inflation expectations at 2%," said Brian Sack, director of global economics at D.E. Shaw & Co. and former head of the New York Fed's markets group. "That makes measuring those inflation expectations -- as best can be done -- even more important." The main question for the Fed and bond traders going forward is how that going to play out over the next few years and where does the possible inflation come from.

Change in Treasury Yield



Current Generic Bonds Yields

Treasuries		Agencies		Corporates		Municipals	
3 mo.	0.09%	3 mo	0.09%	3 mo	0.19%	3 mo	0.28%
6 mo	0.11%	6 mo	0.10%	6 mo	0.23%	6 mo	0.28%
1 yr	0.13%	1 yr	0.12%	1 yr	0.25%	1 yr	0.30%
2 yr	0.15%	2 yr	0.16%	2 yr	0.31%	2 yr	0.32%
5 yr	0.34%	5 yr	0.49%	5 yr	0.68%	5 yr	0.53%
10 yr	0.77%	10 yr	0.86%	10 yr	1.51%	10 yr	1.19%
30 yr	1.57%	30 yr		30 yr	2.65%	30 yr	2.03%

Equity

U.S. Equity finished the week positive as the S&P 500 (+3.86%) notched its strongest weekly gain since August. All sectors finished positive as Energy (+5.05%) and Materials (+5.07%) led the sectors; Communication Services (+2.15%) lagged the most. Value beat growth for the second week in a row as the Value index SVXK finishes the week with a +3.39% gain, a little less than a percent higher than growth's +2.65% return. Growth still holds a large lead over value with returns of +21.72% and -10.26%, respectively.

Big tech has been in the headlines for their strong performance and leadership in the market. For instance, big tech got all the credit when stocks soared in early September and were also blamed when equity was hit last month. However, according to SentimenTrader, tech has had an impressive rebound since then. While more than 75% of the stocks in the S&P 500 have closed above their 200-day average, for one of the few times in the past twenty years, more than 90% of the stocks in the NASDAQ 100 have closed above their moving averages.

Index Returns	Last Week	YTD
Dow Jones Industrials	3.26%	1.79%
S&P 500 (LCap)	3.84%	7.63%
S&P 400 (MCap)	4.92%	-3.23%
Russell 2000 (SCap)	6.38%	-1.85%
NASDAQ Composite	4.56%	29.06%
MSCI EAFE (Int'l)	2.80%	-4.18%
iShares Real Estate	1.17%	-8.40%

Source: FactSet Research Systems

Asset Allocation

Current Sentiment

Asset Class	Sentiment
Cash	Favorable
Short FI	Neutral
Intermediate FI	Neutral
Inflation-Adjusted FI	Neutral
High Yield FI	Unfavorable
International FI	Unfavorable
Equity Income	Neutral
Large Cap Equity	Favorable
Mid Cap Equity	Neutral
Small Cap Equity	Unfavorable
International Equity	Unfavorable
Emerging Markets Equity	Unfavorable
Real Estate	Neutral
Commodities	Unfavorable

Summary below - Current stance on most asset classes:

Cash - Overweighting due to market volatility and uncertainty from Covid-19.

Short Term Bonds - Relative to Intermediate Bonds, the reduced duration is preferable given the oversold long-end of the curve.

Intermediate Term Bonds - The current trading range of intermediate bonds warrants a neutral position with limited upside potential. Some opportunities still remain in certain sectors.

Inflation-Adjusted Bonds - Low inflation expected in near-term providing zero real return.

High Yield Bonds - Spreads are rising given the market turbulence and exposure to unnecessary credit risk when compared to Treasuries would not be advised.

International Bonds - Foreign bonds offer good diversification qualities and higher yield opportunities, however, risks have been elevated recently and investment should be made cautiously.

Equity Income - High quality and higher-dividend-paying companies remain attractive for long-term investors given their favorable risk-adjusted profile and current yield curves.

Large Cap Stocks - A favorable weighting is recommended. Growth continues to be a more favorable style and should continue to be overweighed versus Value.

Mid Cap Stocks - Mid cap exposure remains neutral - more attractive than small caps but not as attractive as large caps.

Small Cap Stocks - In broad market corrections, small cap stocks will suffer most with increased volatility. Underweight until a clearer picture of recovery ensues.

International Stocks - Given most foreign investment is in developed markets and European countries, until sovereign debt concerns are alleviated, an underweight is recommended.

Emerging Market Stocks - Stronger balance sheets, less debt, and better growth potential make emerging markets more fundamentally attractive than developed countries longer-term. However, trade uncertainty and dollar strength provide a headwind for EM in the near term.

Real Estate - Pricing has begun to stabilize and long-term valuations appear attractive. Real Estate should continue to be a strong alternative to other asset classes.

Commodities - Global demand should support higher prices if the global recovery remains on track. Volatility will be higher, and commodities will be susceptible to short-term price shocks, however, if used in conjunction with other asset classes, risk can be reduced substantially within a diversified portfolio. Used alone though is not recommended as the short-term outlook is not favorable.

Sources of statistical information are Bloomberg and Ned Davis Research.

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