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Economic Review & Outlook

THIRD QUARTER | 2020

2020 Election Primer

Going into this year, investors were primarily focused on the election and its potential market impact. As the coronavirus (COVID-19) pandemic took hold of markets and the global economy, the election has taken somewhat of a backseat. Now, with November quickly approaching, we believe that politics will start coming back into the spotlight.

In this quarter's Economic Review & Outlook, we will outline the key 2020 races, potential market implications, and what impact the election could have on the economy. We will also discuss how we are positioning our portfolios given the uncertainty of the current environment.

First, we will summarize recent economic developments and provide a market update.

Economic Overview

ECONOMIC PAIN OF SHUTDOWNS FELT AS U.S. ENTERS RECESSION

While COVID-related shutdowns began for most Americans in March, it wasn't until the second quarter that the extent of the economic damage was revealed. On June 8, the National Bureau of Economic Research officially announced that the U.S. economy had entered a recession beginning in February. While official numbers have not been released, it is estimated that the economy contracted by 5% in the first quarter and even more in the second quarter. The initial jobless claims have dwarfed anything we've experienced in the past and the April unemployment rate of nearly 15% is the highest it's been since the Great Depression, shown in Exhibit A.

INCREASED OPTIMISM ABOUT THE FUTURE

Despite these bleak numbers, we did see encouraging signs of a rebound as the economy began to reopen. May marked the largest one-month increase in retail sales (17.7%) on record and the unemployment rate, while still very high, has come down from its peak. Encouraging research around coronavirus treatments and a growing awareness of the economic costs have prompted a desire by many citizens to return to normalcy.

We have seen evidence, however, that reopening businesses or destinations, even with social distancing, can lead to spikes in infections in certain areas. Also, some are expecting a second wave of the virus later this year as we enter flu season. A vaccine would go a long way to stem this risk; however, only the most optimistic projections foresee a vaccine to be ready for mass distribution in 2020.

SOCIAL UNREST IN THE U.S. AND ABROAD

During the quarter, China looked to further exercise sovereignty over Hong Kong by drafting a resolution that would allow mainland security forces to freely operate within the "semi-autonomous" region. Most view this as a tactic to suppress anti-Beijing protests, which have been going on for more than a year. This move led to even more protests, as well as condemnation from the G7 (or Group of Seven). The U.S. State Department went as far as declaring that it no longer recognizes Hong Kong as significantly autonomous from China. This could have a damaging impact on Hong Kong's trade status, as well as overall relations between China and the rest of the developed world.

On May 25, onlookers recorded an unarmed George Floyd being killed by a Minneapolis police officer. This tragic event led to mass protests around the country that were not only centered around Floyd's treatment or excessive police force, but also general race relations and systemic inequalities. While we see these discussions as positive and necessary, these are complicated issues and may lead to further tensions in the future.

Exhibit A

UNEMPLOYMENT RATE
1948-2020

Source: U.S. Department of Labor

Asset Class Performance

January	February	March	April	May	June	Q2	YTD
Gold 4.0%	Diversified Bonds 1.8%	Gold 1.8%	U.S. Stocks 12.8%	Commodities 18.7%	Emerging Market Stocks 7.4%	U.S. Stocks 20.5%	Gold 17.1%
Diversified Bonds 1.9%	Gold -1.2%	Diversified Bonds -0.6%	Emerging Market Stocks 9.2%	U.S. Stocks 4.8%	Commodities 5.5%	Emerging Market Stocks 18.2%	Diversified Bonds 6.1%
U.S. Stocks 0.0%	Emerging Market Stocks -5.3%	U.S. Stocks -12.4%	Int'l Developed 6.5%	Int'l Developed 4.4%	Int'l Developed 3.4%	Commodities 17.2%	U.S. Stocks -3.1%
Int'l Developed -2.1%	Commodities -7.6%	Int'l Developed -13.2%	Gold 6.1%	Gold 2.7%	Gold 2.8%	Int'l Developed 15.1%	Emerging Market Stocks -9.7%
Emerging Market Stocks -4.7%	U.S. Stocks -8.2%	Emerging Market Stocks -15.4%	Diversified Bonds 1.8%	Emerging Market Stocks 0.8%	U.S. Stocks 2.0%	Gold 12.1%	Int'l Developed -11.1%
Commodities -8.7%	Int'l Developed -9.0%	Commodities -24.3%	Commodities -6.4%	Diversified Bonds 0.5%	Diversified Bonds 0.6%	Diversified Bonds 2.9%	Commodities -25.1%

Source: FactSet. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Despite all the continued uncertainty and poor economic results, markets bounced back strongly in the second quarter. Equities led the way, with U.S. stocks gaining 20.5%. Emerging market (+18.2%) and international developed (+15.1%) stocks also did well. Gold had another positive quarter, as investors pondered the long-term implications of the recent stimulus. Commodities continued their slide early in the quarter but rebounded in May, finishing the second quarter up 17.2%. Bonds (+2.9%) had moderate gains.

While the second quarter showed positive results, stocks remain negative year-to-date, which is to be expected given the economic damage we've seen. Commodities are down even more but could benefit should things continue to reopen. Gold and bonds have done their job as defensive portfolio components, though both had points of volatility this year. Some investors fear this rally is unjustified since the pandemic is still ongoing. That remains to be seen; however, we believe markets will ultimately adjust to the appropriate price relative to whatever economic landscape lies ahead. We will continue to monitor the data as it comes in, as well as market prices, and adjust our allocations accordingly.

Our Perspective

WHAT'S AT STAKE IN NOVEMBER

Elections are inherently difficult to predict; however, it seems that uncertainty has increased in recent years. Looking back four years, no one thought an outsider like Donald Trump could win the presidency. Now, as we prepare for the 2020 election, it seems like the outlook is constantly changing, and there is much at stake.

Below, we will examine the major races and potential economic and market implications. Our goal is not to predict outcomes, but to prepare you for multiple scenarios and offer some perspective.

TRUMP'S BID FOR A SECOND TERM

While President Trump's first term has been filled with controversy, many expected him to be a favorite for reelection going into the year because the economy was perceived as strong, with steady growth, a booming stock market, and unemployment near record lows. Historically, a healthy economy bodes well for incumbents. This narrative took a sharp turn as coronavirus sent the economy to a grinding halt. Another major challenge has been the recent unrest sparked by George Floyd's death. We are not here to speculate on where to place blame, but we know that these factors have left Trump with an uphill battle to win a second term.

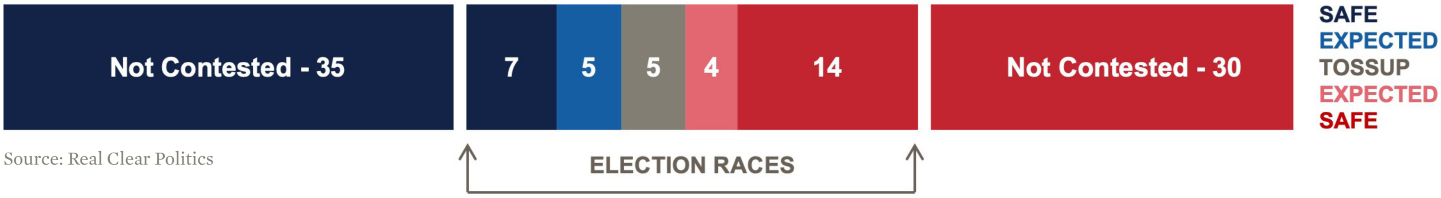
We cannot fully evaluate Trump's chances without examining his opponent. The race for the Democratic nomination took many twists early in the year before Joe Biden emerged as the presumptive nominee. This is important, as Biden has been viewed by some as the candidate most capable of defeating Trump, due to his perceived moderate approach and appeal in key swing states. That being said, he has some controversy in his past, has made verbal gaffes, and his age and health have been called into question.

So, who has the advantage? As of now it appears to be Biden, though we would not say that conclusively. Trump's biggest challenge is the electoral map. Trump's path to victory is narrower than Biden's, giving him little margin for error. Several states which Trump narrowly won in 2016, such as Arizona, Florida, North Carolina, Pennsylvania, and Wisconsin, are expected to be up for grabs. He will need to win most of them, if not all, to be reelected.

A lot can change between now and November. We do not know how either candidate will perform on the debate stage, whether the economy will rebound, or if any new controversies will arise. Despite Trump's falling poll numbers, 2016 proved that polls can be unreliable. Let's not forget that even the most pessimistic forecast for Trump today would put him miles ahead of his perceived chances at this point in 2016, so it would be unwise to write him off.

Exhibit B

2020 SENATE ELECTION RACES



Source: Real Clear Politics

Tossup States: Arizona, Montana, Iowa, North Carolina, and Maine

THE HOUSE AND SENATE

The congressional elections should not be overlooked as they will be key in either empowering or neutralizing whoever wins the presidency. We will start with the House of Representatives. Even when Trump's prospects looked brighter, many predicted the Democrats would have the inside track to maintain their majority in the House. That outlook has solidified in recent months, yet sentiment can change quickly. Even if the Democrats do maintain control of the House, the margin of victory will be important as it will determine how aggressive they can be legislatively, particularly if Biden is president.

While current Senate membership leans to the right (53-47), 23 of the 35 seats up for grabs in 2020 are held by Republicans. This gives Democrats ample opportunity to gain the three seats (four if Trump wins) needed to take control. Combining seats not up for election and races not expected to be competitive gives Republicans a starting advantage of 44-42, illustrated by Exhibit B. Of the 14 races remaining, Republicans currently lead in four, while five lean Democrat and five are considered tossups. This gives Republicans little margin for error, as a strong showing from the left could put the Senate in Democrats' hands as well.

With the advantage shifting toward the Democrats over the past six months, the potential for a Democratic sweep has become a distinct possibility. At the same time, a Republican sweep should not be taken off the table given the current environment and recent election history. We will now review what these results could mean for the economy and markets.

POSSIBLE ECONOMIC AND MARKET IMPLICATIONS

One investing truism is that markets dislike uncertainty and election years give the markets one more thing to worry about. With increasing election coverage as November approaches, we will likely see more volatility as the races play out. Also, while most of us despise seeing gridlock in Congress, surprisingly, markets tend to prefer it, as it decreases the potential for uncertainty and change. Therefore, while markets might favor the more business-friendly Trump, even a Biden victory paired with Republicans controlling at least one chamber of Congress may appease investors.

While the importance of solid leadership and governance is one of our core investment principles, it's imperative to not overreact to one election cycle. In fact, many studies have shown a weak relationship between economic growth and which party occupies the White House because leadership is not concentrated in the hands of the president. Governance at the congressional, judicial, local, and corporate levels also matters. On top of that, the political environment is just one of many factors that drive the ultimate success of an economy. Although you can't ignore the potential impact of politics altogether, it should not be the only thing driving your portfolio decisions.

Our Investment Strategy

One advantage of our process is that we always expect—and are prepared for—volatility in risky assets like stocks, including in election seasons. We never attempt to predict their short-term movements, and we try to shield short-term portfolio assets from market risk as much as possible. Our objective is to protect assets that are needed soon even if markets respond poorly. We tend to not recommend significant equity exposure for assets unless they can be held for at least 10 years, which minimizes our exposure to any one market event.

For our longer-term strategies that hold significant amounts of equities, we do not seek to avoid uncertainty. In fact, the greater short-term uncertainty surrounding stocks is the very thing that allows them to outperform less volatile assets like bonds, over time and on average. This is known as the equity risk premium.

Even though we can afford to take on more volatility in longer-term portfolios, we employ diversification to avoid taking unnecessary risks that could jeopardize our investment goals. Having too much exposure to any one part of the market is always a risk, but that risk can be elevated during periods like this, as political change can produce winners and losers in certain industries or even countries. While some may attempt to project these outcomes ahead of time, we do not want to leave our portfolios exposed if things do not work out as planned.

Conclusion

It's easy to get caught up in the hype of election season and lose focus on the big picture. While elections do matter, there are many other factors that drive the success of the markets and economy. You should always be prepared for volatility, and if your goals are short-term in nature, it would be wise to insulate yourself from the impact of equities in any environment, political or not. We encourage those with long-term goals not to fear the uncertainty surrounding this election, but to remain patient and diversify to protect against various outcomes. Regardless of what happens in this election cycle or how markets respond, we do not believe that our ultimate success as investors, or as a country, will be determined on November 3.

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For more information please contact your financial advisor, call us at **800.841.0362**, or visit our website at **www.ronblue.com**.

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