# INVESTMENT STRATEGY OUTLOOK

September 2020

## THE ECONOMY

### Labor Market Healing, But Far From Healthy

As is apparent in much of the top-tier economic data, the U.S. economy is clearly making progress on the road back from the brief but violent recession stemming from the COVID-19 virus and the efforts to stem its spread. But, it is also apparent that there is still a long way to go before the economy is fully healed. Moreover, there are reasons to worry that the road to recovery is getting bumpier and longer. This is perhaps best illustrated by the labor market.

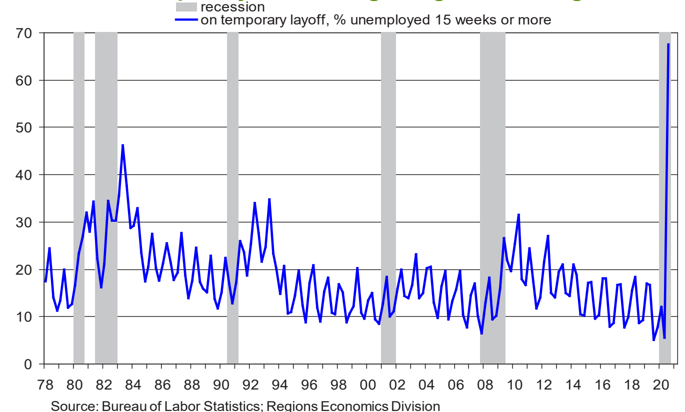
Total nonfarm employment rose by 1.371 million jobs in August, with private sector payrolls up by 1.027 million jobs and public sector payrolls up by 344,000 jobs, though 238,000 of these jobs are temporary Census jobs that will go away in a few months. The unemployment rate fell to 8.4 percent in August from 10.2 percent in July. Over the past four months, private sector payrolls have risen by 10.473 million jobs. To our point, however, as impressive as these job gains may seem, they nonetheless leave private sector payrolls 10.718 million jobs below the level as of February.

There are reasons to think that recouping the remaining 10.7 million jobs will be much harder, and take much longer, than recouping the first 10.5 million jobs proved to be. First, private sector job gains over the past four months have been heavily concentrated amongst leisure and hospitality services, education and health services, and retail trade. These three industry groups have combined to account for 69.1 percent of private sector job gains over the past four months. That these three industry groups have dominated private sector job gains is understandable, given that these were the industry groups hit the hardest by the pandemic, and recent job gains in these industry groups reflect the economy opening back up and starting down the road to normal. But, as these “reopening effects” fade, which we expect will be apparent in the September data, the pace of monthly job growth will slow considerably unless hiring across other industry groups ramps up sharply, which at present seems unlikely.

So, no, the next 10.7 million jobs won’t come as rapidly or as easily as did the first 10.5 million jobs. At the same time, initial claims for Unemployment Insurance benefits remain notably elevated, even if down significantly from their early-April peaks. The not seasonally adjusted data continue to show over 800,000 filings per week, roughly four times the pre-pandemic run rate. Moreover, a number of large corporations across an array of industry groups have announced plans for large-scale job cuts, most of which have yet to show up in the monthly labor market data.

Another reason for concern, and one which we feel should be getting much more attention than it is, is the increasing duration of employment, particularly amongst those job losers classified as being on temporary layoff. In August, the median duration of unemployment rose to 16.7 weeks, the longest since December 2013 and up from 9.1 weeks in February 2020. But, in August, 67.1 percent of those classified as being on temporary layoff had been out of work for 15 weeks or longer, easily the highest share on record.

Recall that in April, when nonfarm payrolls fell by 19.385 million jobs, 88 percent of those who lost their job reported being on temporary layoff, as opposed to having lost their job permanently. At the time, we noted that it would be important to monitor the rate at which those on temporary layoff returned to work, and our fear was that a significant number of what began as temporary layoffs would morph into permanent job losses. We also addressed this point in the May 2020 edition of this publication. While it is too soon to draw definitive conclusions, the data suggest our fear was not unwarranted.




In other words, with each passing month, the line between “temporary” and “permanent” is becoming more and more blurred. It is somewhat telling that the number of permanent job losses has risen over the past three months; of those unemployed in August, 3.411 million reported they had lost their job permanently, a number that will almost surely continue to climb in the months ahead given the recent spate of job cut announcements. The rising duration of unemployment suggests the economy is healing at a slow and uneven rate, but there are longer term implications as well. Numerous studies show that, as the duration of unemployment increases, the probability of one finding a new job diminishes, and those who do find a job after a long stretch of unemployment often see a significant cut in earnings. In other words, the longer the duration of unemployment becomes, the greater the likelihood of lasting damage, both to the individuals who have lost jobs and to the broader economy.

It would be a mistake to point to the better than 10 million jobs added over the past four months or to an 8.4 percent unemployment rate and assume that the labor market is on autopilot, making it simply a matter of time before the job losses seen in March and April are recouped. This plays into the ongoing debate over whether there is a need for Congress to pass legislation providing further assistance for the unemployed. Some are pointing to the recent monthly job growth and declining unemployment rate as evidence that no further aid is warranted, but the data on the duration of unemployment suggest otherwise. Keep in mind that those who were amongst the first to lose jobs and file for Unemployment Insurance benefits are now beginning to exhaust their regular benefits, and while special pandemic-related programs will provide benefits for an additional time, those too will ultimately be exhausted. In short, the data on the duration of unemployment suggest there is more work for Congress to do.▲

*Source: BLS; U.S. Department of Labor*

## STOCKS

### Exceptions to Every ‘Rule’

August proved to be a stellar month for domestic stocks as the S&P 500 index produced a 7% return – the index’s best August in 34 years. From 1991 through 2019, August had generated an average return of -0.62%, the worst average return of any calendar month over that time period. The S&P 500 hasn’t historically fared much better in September, generating an average return of -0.12% since 1991, and the month has ended in a negative return more often than any other over that time frame. The S&P 500’s batting average in September, or how often it has closed higher versus lower, is 58.6% since 1991, the lowest ‘hit ratio’ of any calendar month, underscoring how challenging it has been for equity investors to turn a profit during September.

The S&P 500’s September struggles are well known, but the same could have been said for August, and if investors had moved to the sidelines at the end of July they would have missed the best August in over three decades. Last month was a reminder that basing one’s allocation to stocks off historical trading trends or patterns can be filled with potential pitfalls. Historical patterns and proverbs we read and

hear about surrounding markets and investing often only hold true 'more times than not,' or are akin to coin-flips, but continue to garner interest due to how catchy they often seem. "Sell in May and go away" is one adage we've likely all heard that comes to mind as a trading 'strategy' that is easily implemented as it advocates for selling stocks at the start of May and buying them back at the start of October each calendar year. Over the past three decades, investors following the "Sell in May" proverb have fared well, outperforming buy and hold by a sizable margin, but through last month investors that sold the S&P 500 on May 1 of this year and walked away would have left a 20%-plus gain on the table. With one month left, the May through September time frame this year is setting up to be the S&P 500's best since 2009. There are exceptions to every investing 'rule,' with August providing another case study on how expecting history to rhyme can lead our allocations and portfolios astray if relied upon too heavily.

We remain in a weak spot in the calendar for stocks, historically speaking, through September, and with elections in November rapidly approaching, elevated volatility should be expected as market participants position for a period of heightened uncertainty leading up to and in the aftermath of the election as the volume of mail-in ballots could keep results a mystery for some time post-election. However, outflows from stock ETFs and mutual funds have been exceeded by inflows into bond funds over recent months, despite the ongoing global equity rally. Equity outflows may leave investors under-allocated to stocks, specifically economically sensitive or pro-cyclical sectors should the economic recovery accelerate into year-end. In short, 'frothy' or overly optimistic investor sentiment is less of a concern outside of mega-cap and high-flying technology and communication services names.

S&P 500 concentration has garnered attention as the top-5 largest companies in the index by market cap – Apple, Microsoft, Amazon, Facebook, and Alphabet (Google) - now account for a 24% weight. A rotation out of secular growth stocks, specifically the information technology and communication services sectors which account for over 35% of the S&P 500, and into economically sensitive sectors could be a hurdle for the broader market to clear as September rolls along and political uncertainty ramps up. While acknowledging that a rotation out of growth and into value could drive choppiness, we maintain an overweight to domestic large-cap stocks (S&P 500) at the expense of international-developed markets, and believe that active managers are positioned to perform well on a relative basis versus benchmark(s) due to the concentration concerns outlined above. We maintain a neutral allocation to small and mid-cap U.S. stocks as well as emerging markets relative to our long-term strategic targets as these are more volatile areas and could experience outsized moves lower should the U.S. dollar reverse course and strengthen on safe-haven flows as we get closer to the election.

It remains to be seen if the S&P 500 can break with 'tradition' and post a positive return in September, but revisiting your goals and asset allocation now likely makes sense to ensure alignment after a strong rally off of the March lows and as we enter into a potentially tenuous political season. ▲

*Source: Bloomberg, Factset*

## BONDS

### Less for More

On August 27, Federal Open Market Committee (FOMC) Chair Jerome Powell made a speech to the Kansas City Fed's annual Jackson Hole symposium in which he announced a shift in the FOMC's inflation strategy, with the FOMC now targeting an average inflation rate of 2.0 percent "over time." This shift was well-telegraphed and shouldn't have come as a much of a surprise to market participants, but what was news was how, going forward, the Committee will assess monetary policy in the context of "shortfalls from" as opposed to "deviations from" full employment This has led to speculation that the federal funds rate could potentially remain at the zero-bound far longer than most, including us, might have anticipated. Treasury yields in the 10- to 30-year portion of the curve initially moved higher on the news to levels last seen in June as the FOMC's announcement proved to be more dovish than even the most dovish of expectations. Still, the initial backup in rates proved short-lived as long-dated Treasury yields were again back to pre-symposium levels as of the first week of September.

Despite current low yields, Treasuries can continue to play a valuable role within the core fixed income portion of multi-asset portfolios to help mitigate portfolio drawdown and provide a buffer against selloffs in risk assets such as equities and corporate credit. That said, yields across the Treasury curve are at or near all-time lows, providing little cushion against even a modest rise in interest rates driven by a more constructive economic growth outlook and/or rising inflation expectations into 4Q and year-end. Notably, the Bloomberg Barclays U.S. Aggregate Bond Index, a commonly used benchmark for core fixed income managers, carries a duration of over 6.5 years, a level last eclipsed in the 1970's, while carrying a yield-to-worst (YTW) of just 1.1%, implying that investors in many index-linked fixed income products are being forced to take on sizable interest rate risk for a lower expected return. This is the source of the "less for more" tagline in the title as investors are receiving less compensation, i.e. yield, for taking on more interest rate risk in their portfolios.

Treasuries could experience outflows over coming months as economic momentum builds and demand from abroad, specifically China, wanes, potentially leading yields to trend grind higher into year-end, a move that could be intensified should economic growth and/or inflation expectations surprise to the upside. After an impressive four-plus month rally from late-March lows, investors in investment-grade (IG) corporate bonds booked some profits and rotated into riskier, higher yielding issues in August. While the Bloomberg Barclays U.S. Corporates index fell 1.3% the Bloomberg Barclays High Yield (HY) index fared much better, rising 0.9% during the prior month. Entering September, the IG corporates index was higher by 6.9% year-to-date, while HY lagged meaningfully, generating a total return of just 1.6%. There are limits to investor generosity, however, and even in a liquidity-fueled environment at some point they begin to balk at low yields. 1.8% on IG corporates and 5.2% on HY corporates appears to be the 'line in the sand' at present.

As boring as it may sound, diversification remains of paramount importance in the current environment as yields on 'safe' and 'risky' instruments alike appear paltry. Our preferred positioning remains a mix of Treasuries, high quality corporate bonds, and asset-backed securities which form a solid 'core,' while riskier, higher yielding corporate bonds and U.S. dollar denominated emerging market debt provide some additional yield pickup, but also inject volatility into a portfolio and must be appropriately sized. ▲

*Source: Bloomberg, Factset*

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