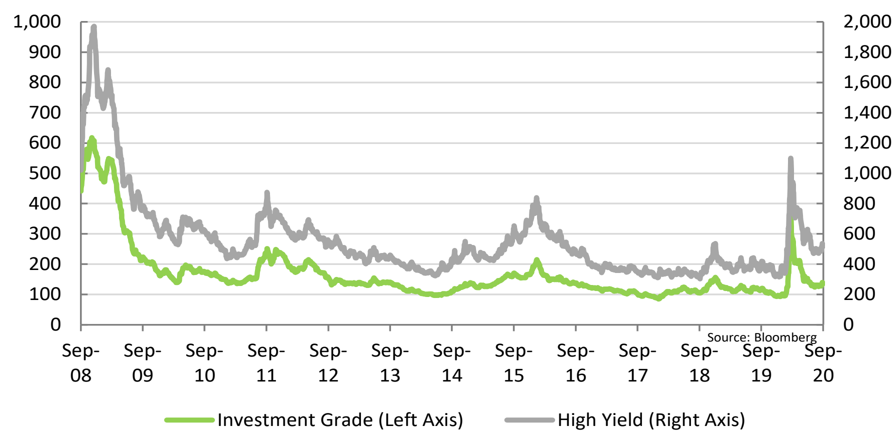
FIXED INCOME OUTLOOK

REGIONS
INVESTMENT MANAGEMENT

The Pandemic, Inflation, Taxes, and the Elections

October 2020

Corporate Average Option-Adjusted Spreads (Basis Points)

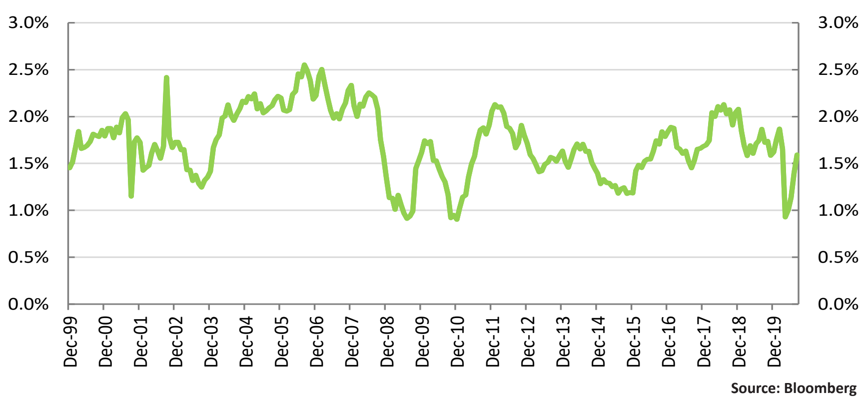


The last several weeks—let alone the last nine months—have provided surprises at almost every turn. Most, if not all, are tied either directly or indirectly to the Covid-19 pandemic. Stocks have been volatile after hitting new highs while bonds have mostly held their own and are beating stocks year-to-date. A second stimulus bill has been batted around Washington, politics rose to new levels of raucousness, and the pandemic has found its way into the White House—all with a month to go to the elections. As investors, these events are important to the extent they impact a still precarious economy. Though trending down, the unemployment rate remains high and a new round of corporate layoffs from some high-profile companies is a bit unsettling.

Notably, the Federal Open Market Committee led by Chairman Jay Powell has done about all that is possible with the monetary arrows in its quiver to win the economic battle against the pandemic. Still, the Fed hasn't given up. Last month, Team Powell opined that inflation would be allowed to push past its longstanding 2% target in the short-to-intermediate term to "average" 2% over the longer term. Nonetheless, the Fed's preferred measure of inflation—the Personal Consumption Expenditures Core Deflator—seemingly remains stuck at sub 2% levels. The latest reading was 1.6%. While other measures suggest inflation is a little higher, the ability to move the needle meaningfully is problematic as greater forces—demographics, technological advances, and globalization—are at work here.

Demographics are permanently altering spending/savings patterns. Household formations have been delayed and birth rates continue to slide lower. An older population tends to spend less and, when they do spend, they tend to spend differently. New technologies are enabling all of us to do vastly more than we ever dreamed with substantially fewer resources including the human kind. While one might argue globalization has seen its day, in the long run, the lowest cost producer will likely win wherever its location. As a result, we believe the fed funds rate will likely remain at zero-bound levels through at least the end of 2022.

Personal Consumption Expenditure Core Price Index (Year over Year Percentage Change)



It is worth noting that while consumer inflation remains subdued, asset prices have skyrocketed. The Fed's actions since March are pushing up asset prices while doing very little for consumption and thereby prices of goods and services. Just consider where the stock market is today relative to economic conditions. Not only are stocks up year-to-date, a litany of black box Special Purpose Acquisition Companies (SPACs) are being created to pursue the next "big idea." Bond prices have been driven higher too on global demand in a shrinking yield environment. And oh yeah, have you tried to buy a house lately? Super low interest rates coupled with lackluster single-family construction over the last dozen years have inventories low and prices moving up. Anecdotal evidence argues that demand for specific housing features may have shifted as well, so many prospective buyers can forget about negotiating the price. Certainly, one could argue that the Fed's extraordinary actions this spring succeeded in bringing stability to the markets thereby averting another deep financial crisis. Higher financial assets largely benefit investors while not doing much for those who have few resources and can't work from home.

Looking forward, the pandemic will likely accelerate these trends. As we stated in April, we are only beginning to understand the short-term and long-term health, societal, political, and financial/economic consequences of COVID-19. Technologically enabled trends that were already in place will accelerate, such as remote working, learning, healthcare delivery, and socialization. The consequences of these trends for location-based businesses such as offices, schools and universities, and sports/entertainment venues will likely be significant. Finally, the fiscal and monetary actions our political leaders are taking now will mold how we view the financial and economic landscape and the government's role in it.

Regardless of the elections this fall—and the surprising twists and turns in the battle for the presidency—taxes will likely go up starting with corporate America. Trillions of dollars in fiscal stimulus have been spent and more are being discussed as the pandemic drags on. Eventually, someone will have to pay for all this. While this will be a drag on corporate earnings and debt service, the post-pandemic recovery will be mitigating. The trick will be to survive the downturn. By taking advantage of the flood of liquidity provided by the Fed, we believe most corporate treasurers have loaded the cash coffers enough to make it through. Unfortunately, a few may live on as zombie companies, overloaded with debt and facing limited options to grow out of the burden.

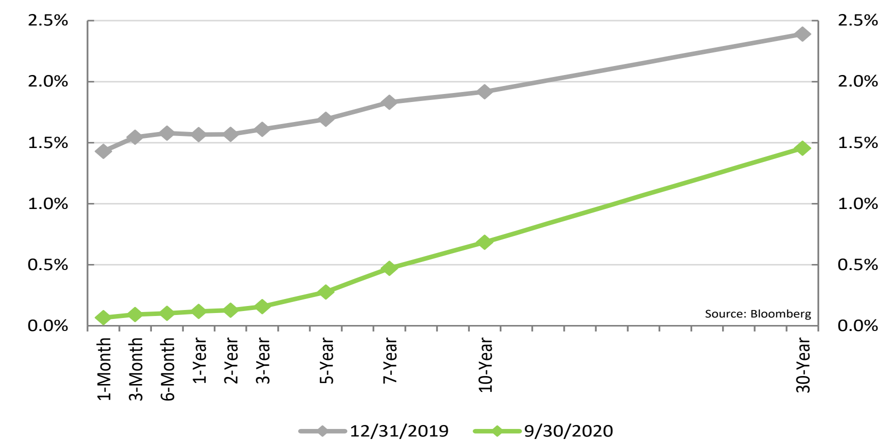
For these reasons, we believe inflation will remain subdued regardless of the Fed's decision to look the other way, a temporary spike related to a post pandemic economic recovery notwithstanding. The long-term weight of demographics, technology, and globalization is simply too great. In the long run, the real risk to the economy and to investors is more likely to be deflation. As for negative rates, the Fed has pledged to not go there, but eventually the markets may force their hand. On a lighter note, football found a way to happen and maybe Coach Powell will find a way too.

Sector Performance as of 9/30/2020

	QTD	YTD
Bloomberg Barclays US Aggregate Index	0.62%	6.79%
Bloomberg Barclays US Treasury Index	0.17%	8.90%
Bloomberg Barclays US MBS Index	0.11%	3.62%
Bloomberg Barclays US Corporate Index	1.54%	6.64%
Bloomberg Barclays US High Yield Index	4.60%	0.62%

Source: Bloomberg

Treasury Yield Curves



ABOUT REGIONS INVESTMENT MANAGEMENT

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*RIM invests primarily in securities that are rated in the top four rating categories by at least one NRSRO for all strategies. Bonds with these ratings are commonly referred to as "high quality."