SECOR | ASSET MANAGEMENT

SECOR Asset Management

Market Commentary

September 8, 2020

Federal Reserve's New Policy Framework

- **Evolving Macroeconomic Backdrop Since Prior Statement[1]**

	2012	2020	Rationale
Assumed Potential Growth	2.5%	1.8%	-Aging demographics -Slower productivity growth
r* (Neutral Policy Rate)[2]	4.25%	2.5%	-Higher saving rate -Less demand for capital
u* (Natural Unemployment Rate)[3]	5.5%	4.1%	-Phillips curve flatter
Long-term Inflation Expectations[4]	2.0%	1.7%	-Declining inflation expectations

- **Key Reasons for Modifying Monetary Policy Framework**
  - r* closer to Effective lower-bound (0) constrains ability of policy rate to stem downturns
  - Recent 50-year lows in unemployment did not prompt excessive price pressures
  - Persistently below-target inflation becoming imbedded in expectations concern

1. Sources: Speech: Fed Chair Powell (8/27/20), Vice Chair Clarida (8/31/20), and Fed's SEP 2012 and 2020.
2. Nominal 2.5% r* referenced by Powell equivalent to real 0.5% r* referenced in SECOR's May 2019 "Revisiting Neutral Real Rate Assumptions" Paper. Key rationale – aging demographics and slower productivity growth – also aligned.
3. The unemployment rate has hovered near 50-year lows for roughly 2 years, well below most estimates of its non-inflationary sustainable level.
4. Persistent undershoot of 2% objective cause for concern. Inflation that runs below long-term expectations can result in an adverse cycle of ever-lower inflation and inflation expectations. Well-anchored expectations are critical for giving the Fed the latitude to support employment when necessary without destabilizing inflation.

Federal Reserve's New Policy Framework

- **Principal Changes in Fed's 2020 Statement**
  - Clarifies 2% inflation target is not a ceiling but an average Fed seeks to achieve over time by:
    - Offsetting persistently low-inflation with "moderately" above target inflation
  - Potentially important changes in interpreting full employment mandate include:
    - Effectively eliminated possibility of preemptive rate increases[5]
    - Maximum employment redefined as broad-based inclusive goal[6]

- **Some Clarifications/Addendums[7]**
  - Inflation target goal, not a formulaic commitment but:
    - "An ex ante aspiration, not a mechanical reaction function - nor is it a commitment to conduct monetary policy tethered to any particular formula or rule"
  - Fed's toolkit considered ample even if policy rate at Effective lower-bound[8]
    - Forward guidance and large-scale asset purchases effective sources of support
  - Financial stability concerns should be addressed with macroprudential tools although:
    - Some recent Fed papers noted exceptions possible in extraordinary circumstances

5. Powell noted that policy decisions can be affected by "shortfalls" of employment from its maximum level but not by upside deviations. Change reflects view that robust job markets can be sustained without causing an outbreak in inflation and effectively eliminates possibility of preemptive rate increases
6. Powell noted that the change reflects Fed's appreciation for the benefits of a strong labor market, particularly for many in low and moderate-income communities.
7. Fed Vice Chair Richard Clarida: 8/31/20 speech.
8. Effective lower bound of zero for Fed. Jerome Powell: "We do not see negative policy rates as likely to be an appropriate policy response have in the United States."

Federal Reserve's New Policy Framework

- **Opinions Regarding Significance of New Policy Framework**
  - Not expected to have much, if any, effect in current economic environment
    - Unemployment rate ~8.5% and inflation below 2%
  - Changes imply more dovish reaction function for Fed over the long term[9]

9. Fed Governor Brainard recently suggested Fed might not have tightened policy as much from 2015-18 if new framework had been in place. Goldman Sachs simulations suggest new framework will generate: Moderately lower funds rate path, slightly higher inflation and lower unemployment.

Abe's 8-Year Tenure as Japan's Prime Minister Qualified Success

- **Abe's Significant Achievements Include:**
  - Brought the stability and continuity of leadership favored by markets
  - Leading role in negotiating several important trade pacts including:
    - Bilateral agreements with US and EU and CPTPP (11- country pact in lieu of TPP)
  - Effectively ended deflation
  - Implemented some significant structural reforms[1]
  - Seemingly able to work with Trump and Xi Jinping on important issues

- **His Three Arrows Not Transformative but Positive for Economy[2]**
  - Did not achieve 2% inflation rate but deflation ended
  - Created a lot of jobs but failed to increase productivity
  - Per capita income (pre-pandemic) grew on Abe's watch[3]

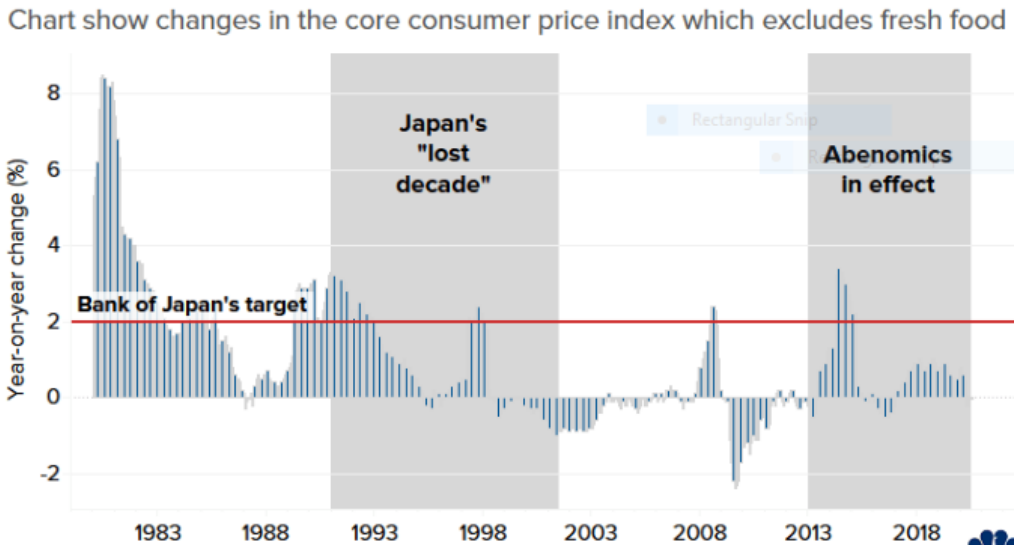
1. Structural reforms facilitated raising labor force participation and increased tourism (from ~10 million per year in 2012 to ~30 million pre-pandemic).
2. In 2013 Abe introduced his three arrow – bold monetary policy, flexible fiscal policy and structural change – aimed at transforming Japan's lackluster economy.
3. Per capita income increased from $45.7K in 2012 to $49.2K in 2019 (latest available year). As indicated in recent SECOR paper: Japan's per capita growth rate based on IMF data for the decade ending in 2021 will be above the rates forecast for the major European countries and nearly in line with the US's growth rate. Moreover, Japan's 3% unemployment for the decade is no doubt the envy of much of the world.

Abe's Mixed Economic Record

- Essentially ended deflation
- But failed to reach 2% inflation target (ex period after 2014 consumption tax increase)

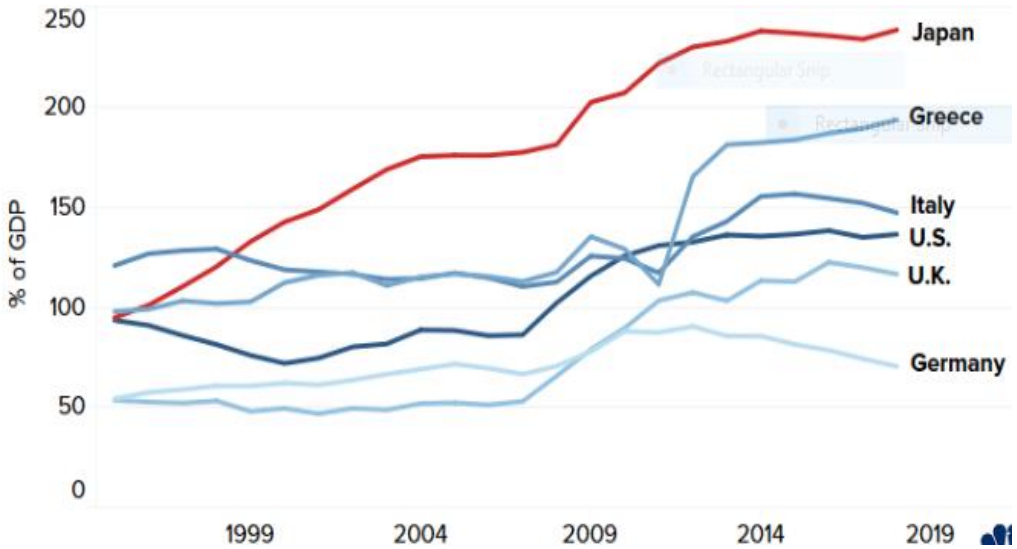
- Japan's debt level roughly stable since 2012 but still a global outlier
- Abe raised consumption tax in two increments from 5% to 10%[1]

Inflation



Source: Gov't Refinitiv

Government Debt



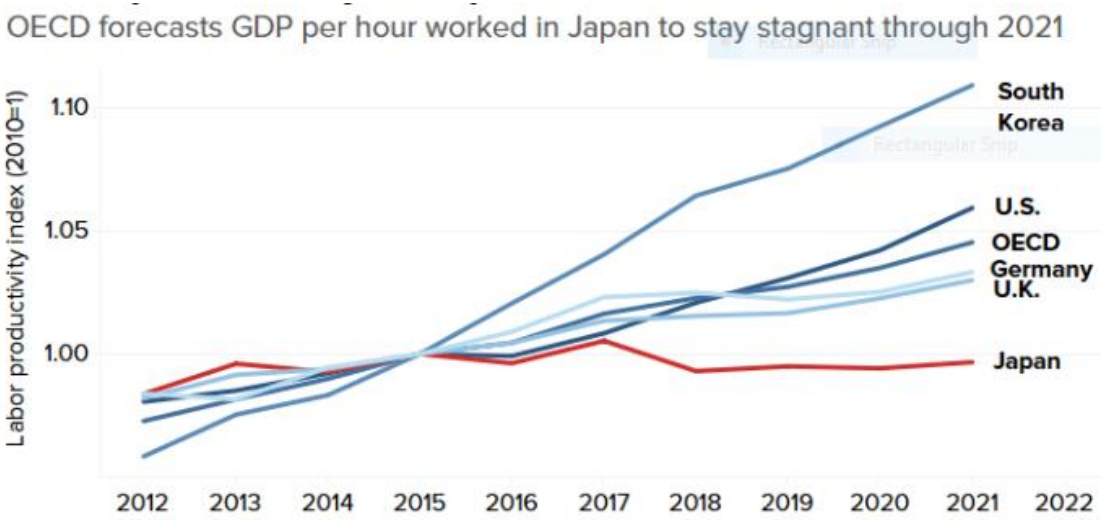
Source: OECD

1. 2015 recession attributed to 2014 increase in consumption tax from 5% to 8%. Economy better positioned to accommodate further consumption tax increase from 8% to 10% in 2019. Current 2020 recession largely attributed to pandemic.

Abe's Mixed Economic Record

- Japan's labor productivity roughly flat since 2012 but, significantly underperformed other major nations

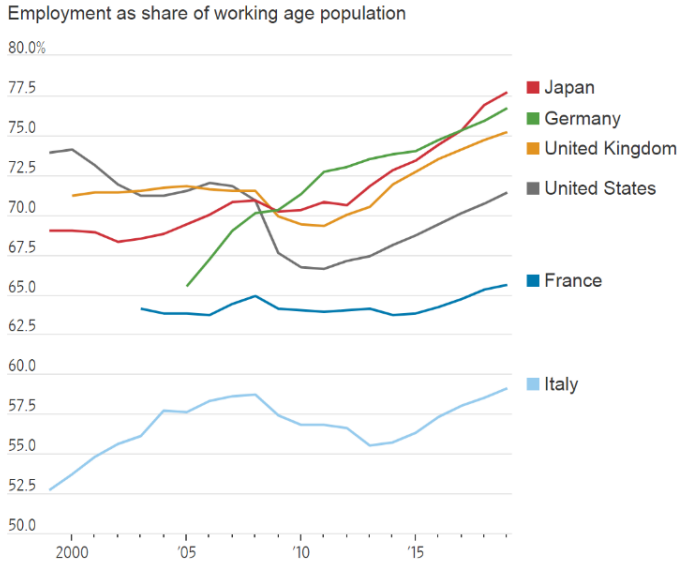
Labor Productivity



Source: OECD

- Japan's labor force participation rate jumped from 70% to 78% since 2012
- Abe's programs made it easier for women, older citizens and foreigners to work in Japan
- Sharp increase in labor force may have restrained productivity growth

Job Creation Strong



Note: Data for some years unavailable for France, Germany and U.K.
Source: OECD

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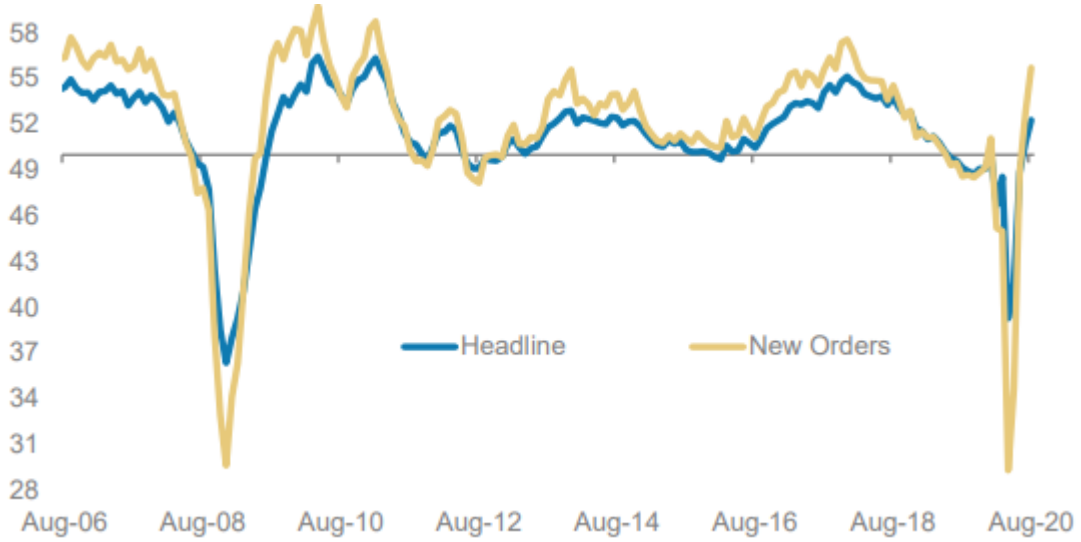
Macroeconomy: Brief Update

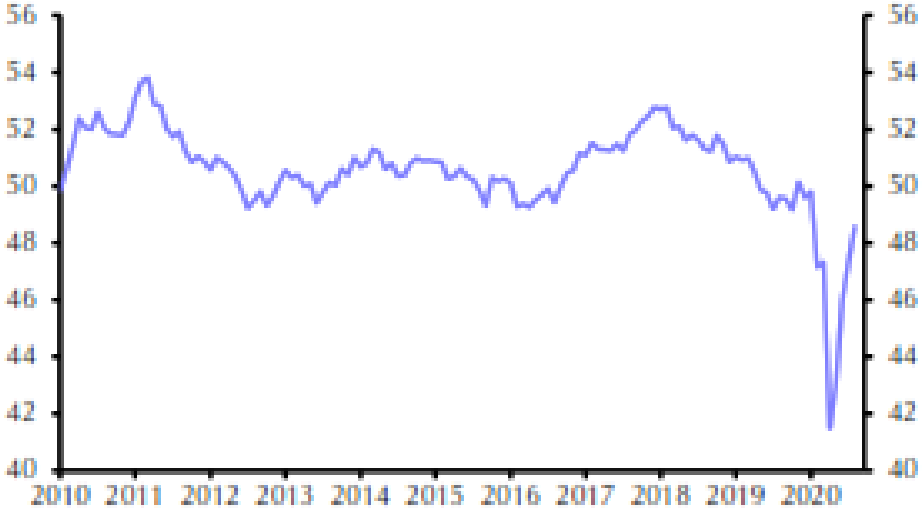
- **Most Recent Global Data Consistent With Quarterly Outlook[1]**
  - Continuing strength reflected in global manufacturing PMIs for August
  - Covid-19 concerns, high unemployment, weakness in sectors of service economy…
    - Such as hospitality and tourism still constraining pace of recovery

Global Manufacturing[2] PMIs



Source: Markit, MS

Global Manufacturing Employment Index[3]

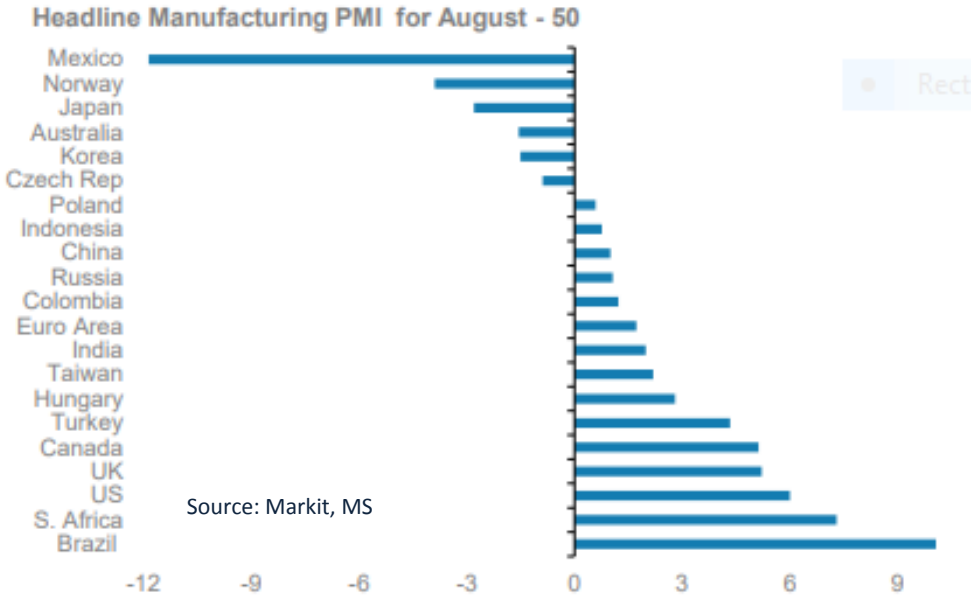


Source: Markit, CE. As of August 2020

1. Quarterly Macroeconomic Outlook Update 8/17/20
2. Global manufacturing PMI: 52.3 in August vs. 50.8 in July. New orders: 55.7 in August vs. 52.8 in July.
3. The global manufacturing employment index rose in August but is still below the critical "no change" level of 50, implying further job losses are to come.

Macroeconomy: Brief Update

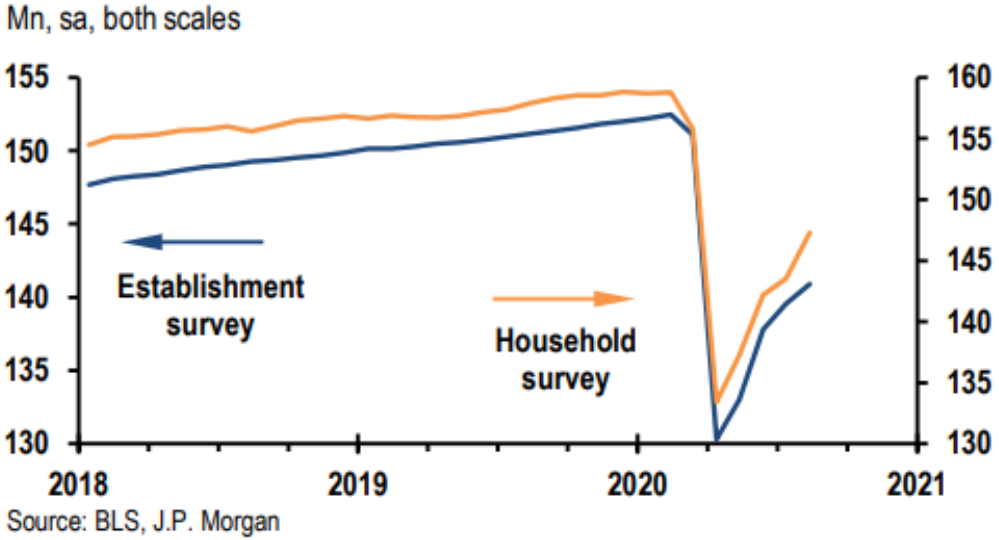
Breadth of Manufacturing Expansion



- 71% of major economies now have headline PMIs in expansion

- US employment registered robust increase in August
  - Payroll employment +1.4 million
  - Outsized +3.8 million household gain
    - Still ~11.5 million below February peak

US Employment[1]

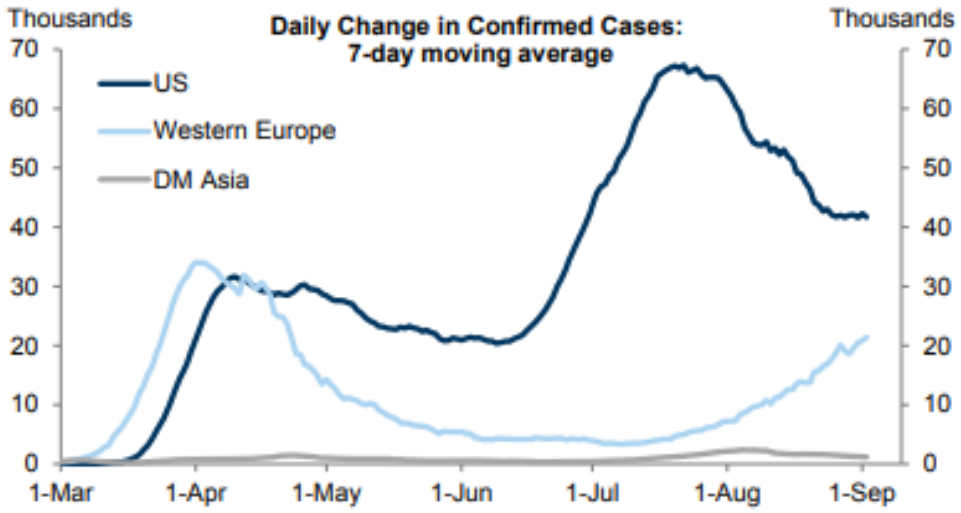


1. US payroll employment increased 1.4 million in August (including 250K federal workers, largely census temps) a robust increase but less than in prior three months and still 11.5 million below the February peak. The household survey registered a more robust 3.8 million gain in August. Household data, however, underperformed in early months of pandemic.

Covid-19 New Case Update

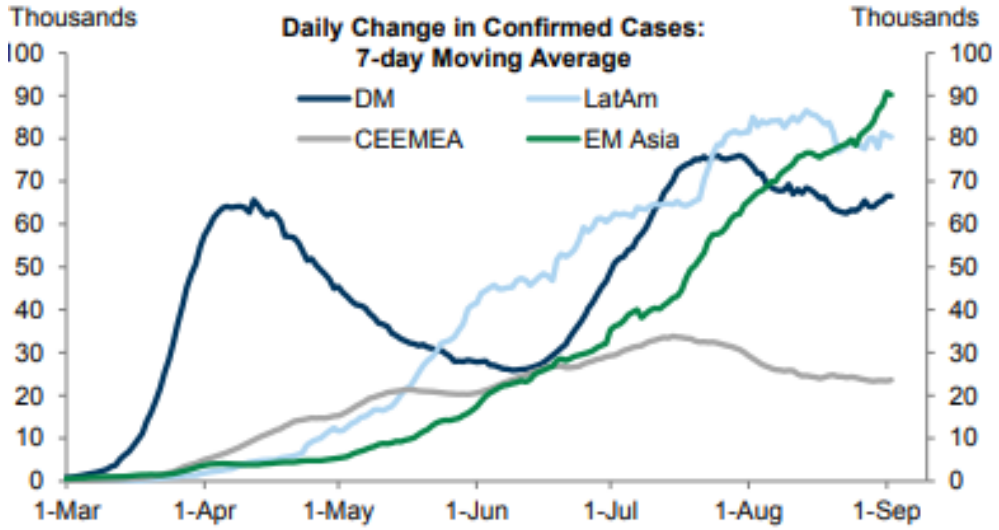
- US: New infections declining but still relatively high
- Europe: 2nd wave, particularly in France and Spain
  - Outbreak appears manageable, however[1]
- Cases still rising sharply in EM Asia (ex China)[2]
- High in Latin America but levelling off

US/Western Europe/DM Asia



Source: JHU, GS

Major EMs (ex China) /DMs



Source: JHU, GS

1. Although infections in France and Spain are close to or above Spring peaks, fatalities have barely increased – due to increased testing, older individual's self shielding and improved therapeutics
2. India particular concern: New cases have more than tripled in the last two months and are new at 1.5 times the EM average.

Major Country/Regional Briefs

- **US: Fiscal Cliff Not Evident in August Data**
  - Job market continued to recover from April trough
  - Chase credit card data flattened in past two months
    - But pullback not yet apparent
  - Auto sales and private residential construction edged up in latest month[1]
  - Questions arising regarding size and likelihood of added fiscal stimulus[2]

- **Euro Area: Latest Data Mixed**
  - Retail sales still in line with pre-pandemic levels, despite some July weakness
  - Employment report positive on balance[3]
  - Composite PMI remained in expansionary territory, despite sharp fall in services

- **Japan: Abe's Likely Replacement Promising Policy Continuity[4]**
  - Industrial production rebounding: +8% in July

1. US unit auto sales 15.2 million saar in August +3.9% vs. July. Private residential construction up 2% in July
2. New questions about added fiscal stimulus for the US coming to the fare. Before August employment report: Democrats were arguing for $2 trillion plus package and Republicans were proposing stimulus of ~$1 trillion. However, over weekend Larry Kudlow (top-Trump economic advisor) said: "economy on self-sustaining recovery path "and" could live with no deal on new stimulus." Mitch McConnell said the cooperative we experienced in March and April seems to be eroding as we get closer to the election.
3. The Euro Area unemployment rate rose 0.2%-pt. to 7.9% in July but workers seem to be moving out of short-term work schemes and raising their hours.
4. Chief Cabinet Secretary Suga, overwhelming favorite to replace Abe, has announced that he is committed to following Abe's economic policies and that he supports the BoJ's monetary stance

Major Country/Regional Briefs

- **UK: Currently Experiencing Short-Term Post-Lockdown Jump**
  - Support building for extending/reforming emergency measures to:
    - Avoid fiscal consolidation in the autumn
  - Post Brexit trade negotiations resumed today (Sept. 8)
    - Important issues remain to be resolved[5]
    - Reaching agreement will not be easy but:
      - December agreement still most likely scenario
      - May have to include provisions for follow-up discussions on thorny issues

- **China: Recovery Continuing and Broadening**
  - Latest PMIs point to manufacturing expanding/growing strength in services[6]

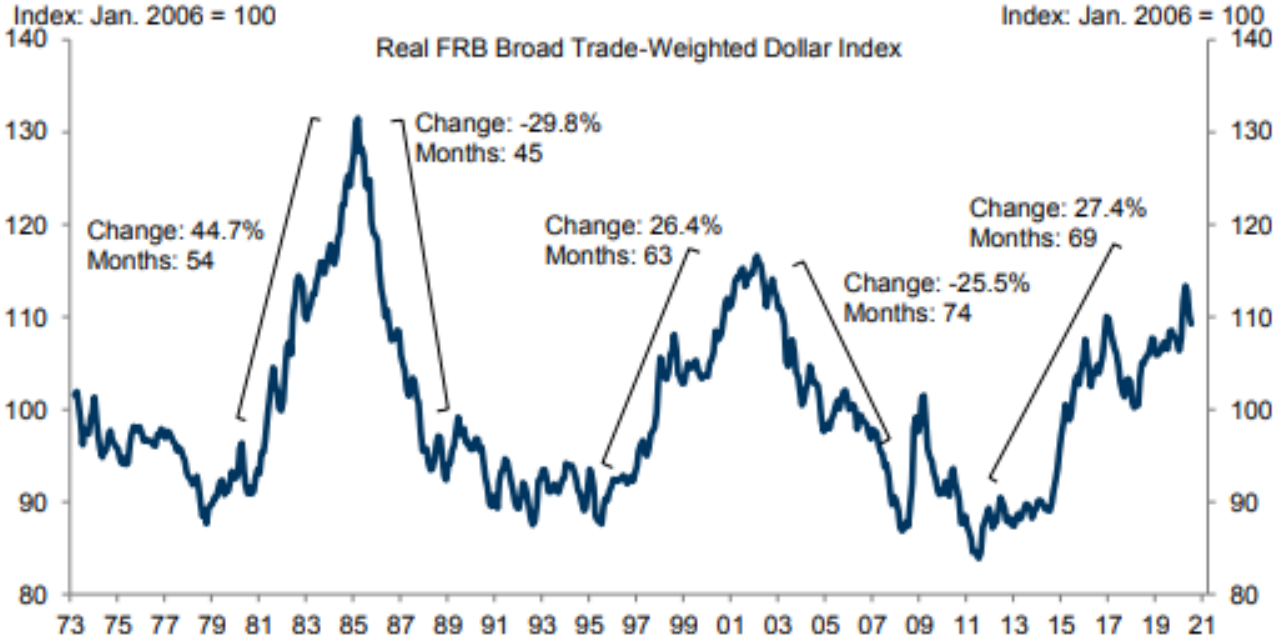
5. Important outstanding issues include: new UK law that could override key parts of withdrawal agreement, fishery and workers rights and environmental standards
6. China's official manufacturing PMI was broadly stable at 51 in August, while the headline Caixin/Markit index rose to 53.1, highest level since January 2011. The service index, however, rebounded to 54.3 in August suggesting that some of the businesses hardest hit by lockdowns – catering, to recreation and tourism are starting to recover.

Major Country/Regional Briefs

New Questions Coming to Fore regarding Emerging Markets (EM)

- Are lockdowns affordable, particularly for poorer countries? No easy answer[7]
- Will weaker USD[8] be a plus for EMs?
  - Proponents argue weaker dollar; should stimulate trade and cross-border borrowings[9]
  - Skeptics: Covid-19 could mute traditional positive responses
    - Tourism traditionally an important source of revenue for EMs suffering currently
    - Weaker USD may remove some funding pressures but not enough to offset effects of pandemic and loss of fiscal power

US Dollar



Source: Federal Reserve Board, Goldman Sachs. As of August 25, 2020

7. India, the world's fifth largest economy, contracted ~25% yoy in Q2. Chief economist at Renaissance Capital: "They will have to give up on lockdowns" – they don't work and are not worth the economic pain.
8. Representative USD forecasts: GS: USD expected to depreciate 15% from March peak over next few years. State Street: USD could weaken as much as 15-20% against peers over next 5 years.
9. GS economists argue with close to 100% of international trade for some EMs invoiced in USD and 2/3s of cross-border credit denominated in USD, the weak dollar will be an EM tail wind.

Market Performance*

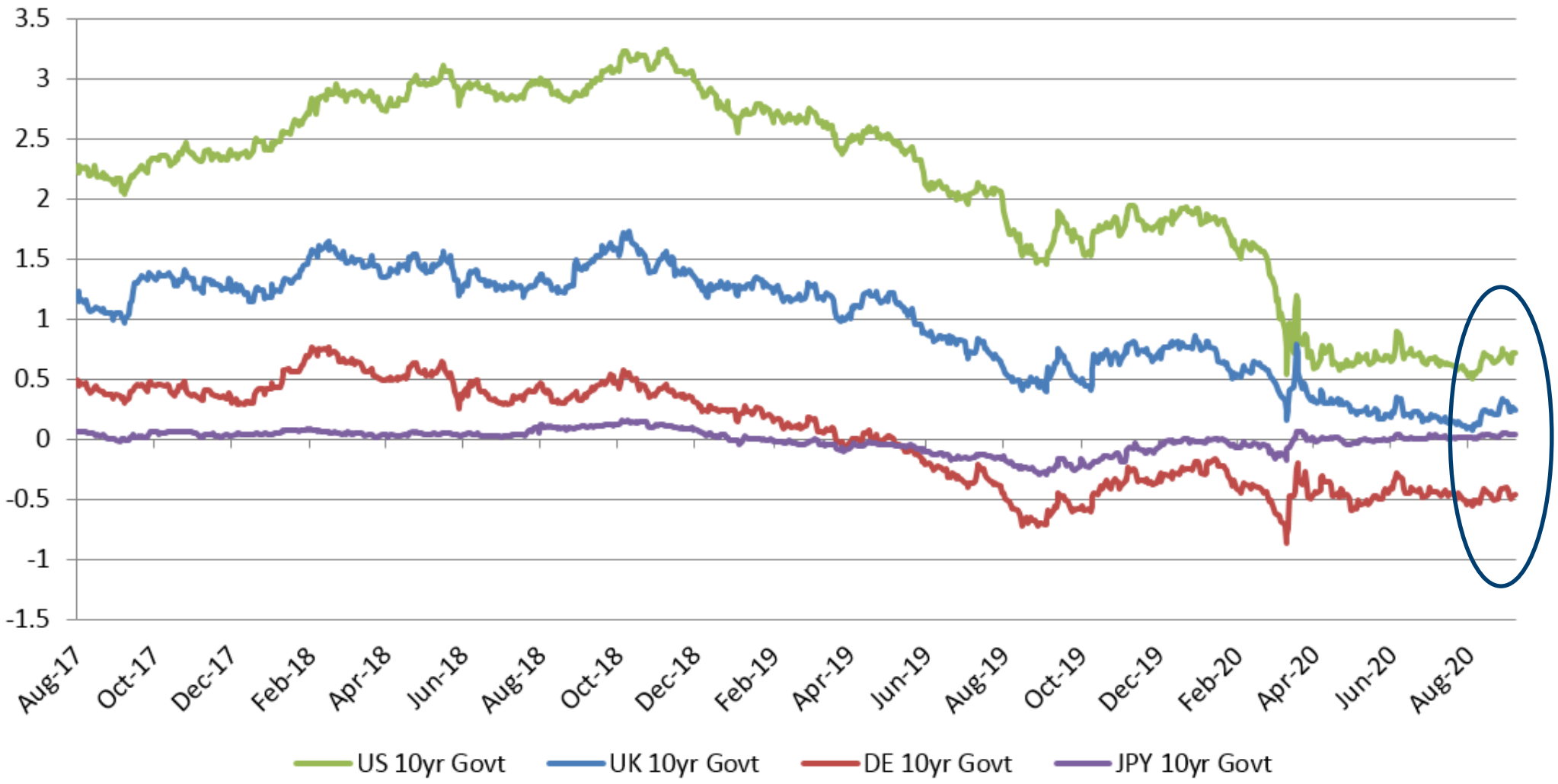
(USD)	Since 8/17	YTD	Since 3/31	2019	2018
Equities					
MSCI ACWI	0.55%	2.92%	30.88%	26.60%	-9.42%
MSCI EAFE	-0.57%	-5.49%	22.47%	22.01%	-13.79%
MSCI EM	-0.42%	-0.16%	30.69%	18.42%	-14.57%
MSCI US	2.28%	9.36%	36.31%	30.88%	-5.04%
Fixed Income					
BarCap Global Agg Total Return (Hedged)	-0.15%	4.38%	2.89%	8.22%	1.76%
Citi US 10+ Govt Bond Index	-0.76%	20.52%	-0.08%	14.89%	-1.89%
BarCap US High Yield Total Return (Unhedged)	1.04%	1.78%	16.57%	14.32%	-2.08%
Oil					
WTI Crude	-4.17%	-27.79%	28.96%	15.64%	-6.86%
Brent Crude	-8.51%	-31.82%	15.41%	9.66%	-3.87%
Currency					
USD/EUR	0.34%	-5.08%	-7.22%	1.86%	-7.73%
USD/GBP	-0.62%	0.50%	-5.87%	-3.76%	6.16%
USD/JPY	0.19%	-2.19%	-1.55%	-1.00%	-2.54%
USD/CNH	-1.44%	-1.92%	-3.60%	1.38%	5.53%
USD/TRY	0.90%	25.44%	13.31%	11.93%	40.19%
USD/ARS	2.03%	24.68%	15.93%	58.95%	100.07%

Source: Bloomberg

Indexes are unmanaged, do not reflect the deduction of fees and expenses, and are not available for direct investment.

*Thru September 07, 2020

Sovereign Bond Yields

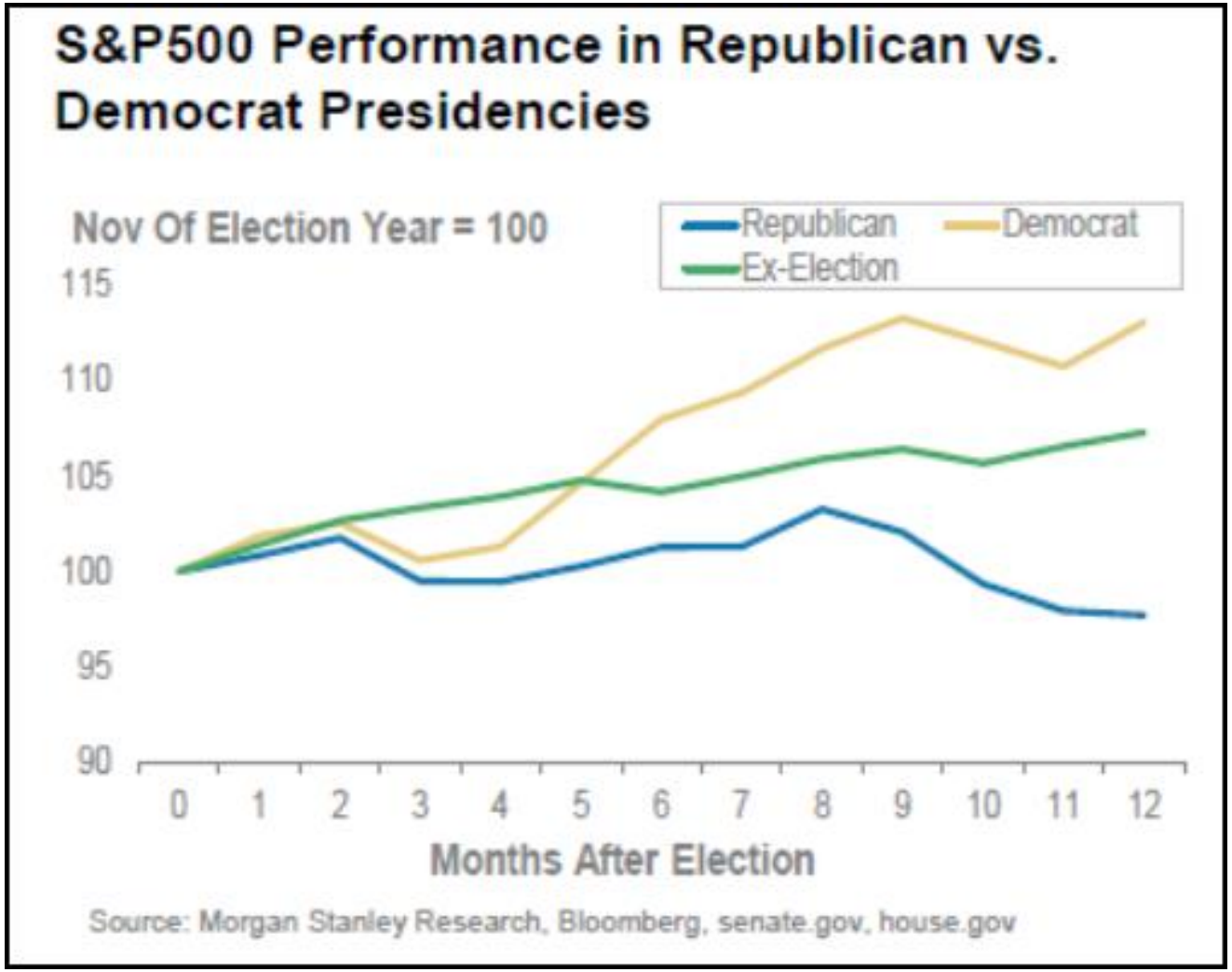


Source: Bloomberg

Public Equity Update

US Equity Markets & Presidential Elections

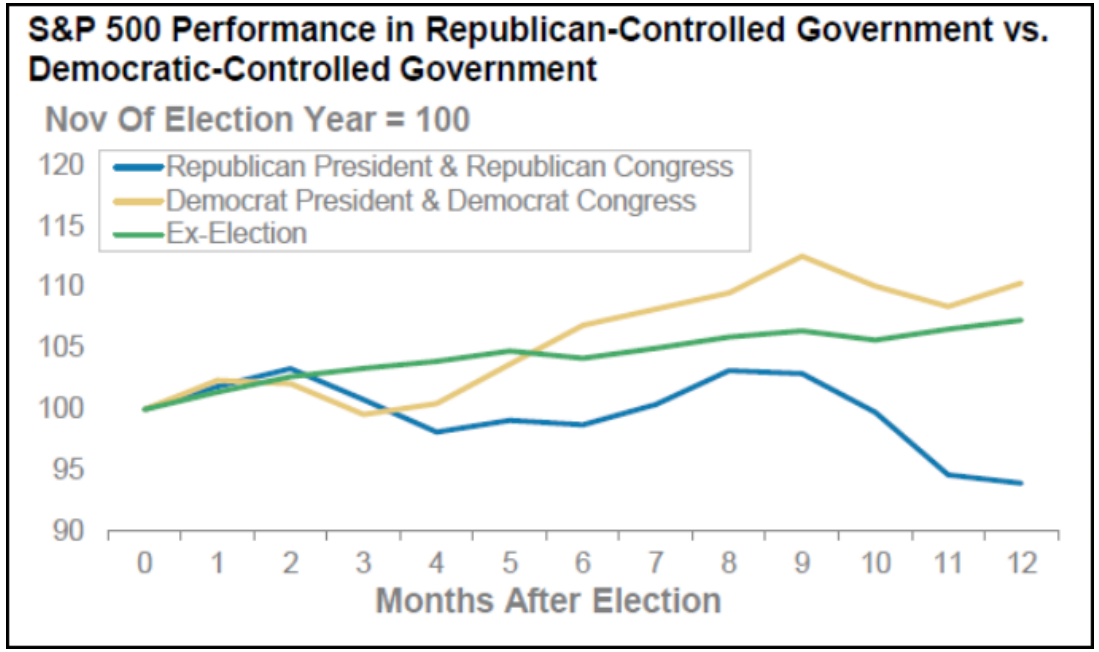
Equity markets have fared better in the first 12 months after electing a Democrat.

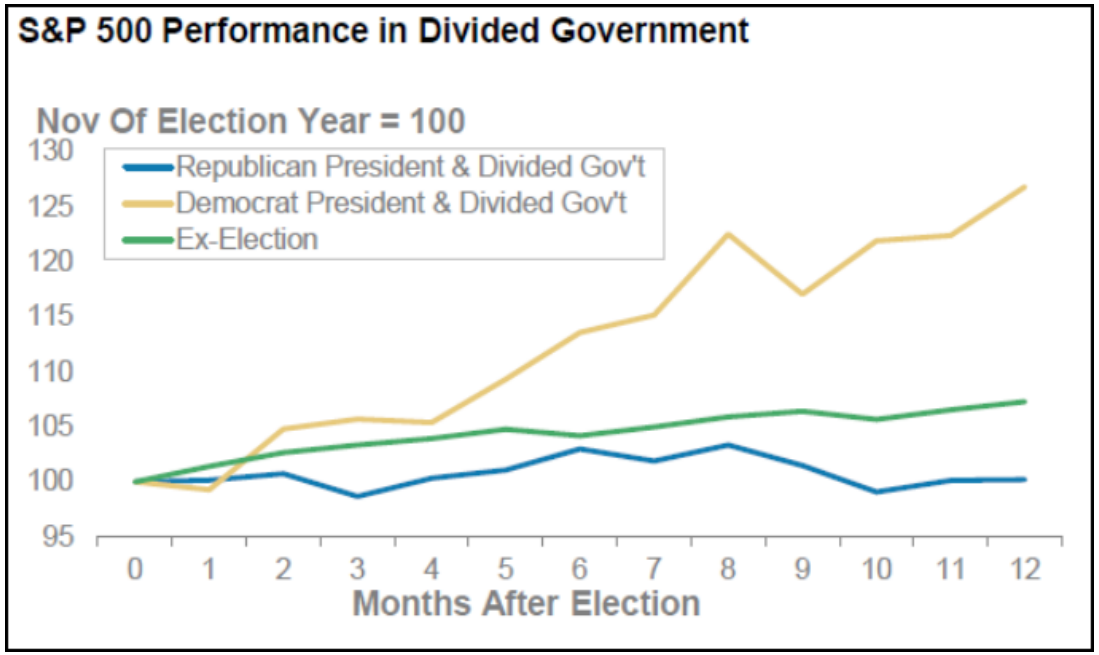


Source: Morgan Stanley Research, Bloomberg, senate.gov, house.gov. Elections 1928 – 2012.

US Equity Markets & Presidential Elections

- Equity markets have been weakest in the year after election in Republican-controlled governments.
- Democratic presidents and divided government have been the sweet spot for equity markets in the year following an election.





Source: Morgan Stanley Research, Bloomberg, senate.gov, house.gov. Elections 1928 – 2012.

US Equity Markets & Presidential Elections

And over the four years of the Presidential term, market returns have also been better with a Democrat in the White House; Senate and House control has made little difference with a Democrat President.

	Average Annual Return	Standard Deviation	Number of Years
Democratic President	15.08%	17.32%	48
Democratic President (with a one-year lag)	12.36%	16.95%	47
Democratic House	11.54%	20.17%	64
Democratic Senate	12.71%	19.26%	60
Unified Democrat (Pres., House, & Senate)	15.07%	18.21%	35
Democratic President and Senate, Republican House	15.94%	14.36%	4
Democratic President, Republican House and Senate	14.76%	16.61%	9

	Average Annual Return	Standard Deviation	Number of Years
Republican President	7.88%	22.38%	42
Republican President (with a one-year lag)	11.02%	23.17%	43
Republican House	12.17%	20.17%	26
Republican Senate	10.48%	21.79%	29
Unified Republican (Pres., House, & Senate)	9.22%	24.34%	13
Republican President and Senate, Democratic House	5.01%	23.97%	8
Republican President, Democratic House and Senate	8.15%	21.58%	21

Source: McLean Asset Management, How Do Presidential Elections Affect Stock Market Returns? Data 1926 – 2015.

US Equity Markets & Presidential Elections

- US equity markets not only survived, but thrived, during some of the most anti-business administrations of the last century.

- **Franklin D. Roosevelt** - Elected Nov. 1932, died in office in Apr. 1945 during 4th term.
  - S&P 500 Total Return Nov. 1932 – Mar. 1945: +11.5%/yr.

- **Lyndon B. Johnson** – Took office in Nov. 1963 (JFK assassination), re-elected in 1964.
  - S&P 500 Total Return Dec 1963 – Oct 1968: +10.7%/yr.

- **Barack Obama** – Elected 2008, re-elected 2012.
  - S&P 500 Total Return Nov. 2008 – Oct. 2016: +12.7%/yr.

Source: Standard & Poor's, SECOR.

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