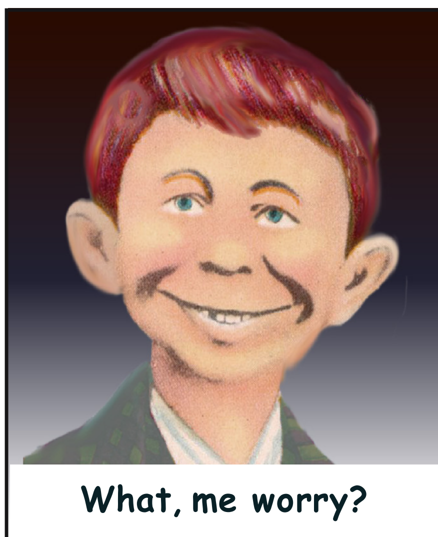
INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

THIRD QUARTER 2020: WHAT, ME WORRY?

Can any one of you by worrying add a single hour to your life? Therefore, do not worry about tomorrow, for tomorrow will worry about itself. Each day has enough troubles of its own.
-Luke 12:25, Matthew 6:34

In 1954, the cover page of the inaugural edition of *MAD* magazine introduced the world to Alfred E. Neuman. With his gap-tooth grin and protruding ears, Neuman presents an air of insouciance to match his slogan.



What, me worry?

Of course, we look back at the 1950's as an era of complacency—and why not? Conformity was the order of the day. American supremacy was undisputed. The Korean War was over. The economy enjoyed a long expansion, solid 3% GDP growth, a 30% rise in real household income, low inflation, and balanced federal budgets. McDonald's was born, Disneyland was opened, and the military-industrial complex flourished. And the nation rocked and rolled.

How much more raucous the present seems! The post-modern world appears in disarray. Globalism, free trade, and multilateralism are in retreat. A global pandemic is raging. Economies around the globe are struggling to recover from the economic fallout of this public health crisis. American society is profoundly polarized as it approaches an election that may end up being contested.

What, me worry?

MARKETS LEAD THE ECONOMY

Worry is most often a prideful way of thinking that you have more control over life and its circumstances than you actually do.
-June Hunt

Markets sure didn't seem to see much to worry about this quarter, defying the bears who thought they knew better. The narrative of the re-opening of the economy and the prospects for improving corporate profits next year powered strong returns in the third quarter. So, it was like a carnival barker pitching a game of chance, "Everyone's a winner."

Asset Class	Index	3rd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	8.9%	5.6%
US Small Cap Stocks	Russell 2000	4.9%	-8.7%
International Developed Markets Stocks	MSCI EAFE	4.8%	-7.1%
Emerging Markets Stocks	MSCI EM	9.6%	-1.2%
Real Estate Securities	MSCI US Real Estate	1.6%	-17.1%
Commodities	Bloomberg Commodity Futures	8.8%	-13.0%
Bonds	Bloomberg Barclays US Aggregate	0.6%	6.8%
Cash	FTSE 3-month US T-Bill	0.1%	0.2%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

Of course, the prize is inconsequential at a carnival—a stuffed animal no one could want. But the stock market—well, money matters!

Robust third quarter returns enabled US large cap stocks to generate positive year-to-date returns. However, smaller US stocks, international developed and emerging markets, and real estate securities have more ground to make up. Bond returns continue to be strong, although it is price appreciation rather than income generation that is driving fixed income results.

The strong quarterly returns, however, need an asterisk, as they were achieved in the first two months of the quarter. Across the board, equities produced negative mid-single digit returns in September.

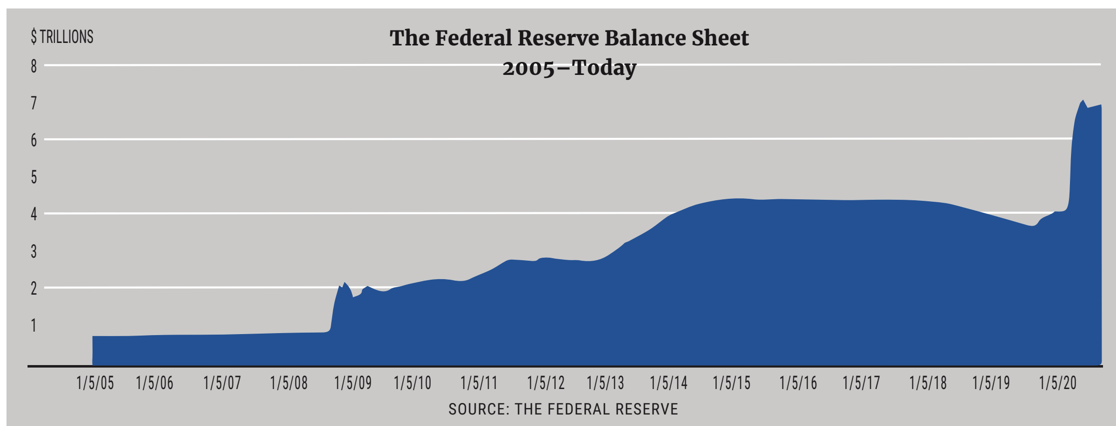
The surprising, even head-scratching, revival of global equity markets is, we believe, attributable to three phenomena: extraordinary government responses, perceived progress in the healthcare crisis, and a bounce in global economies following the end of widespread lockdowns. Will these factors continue to support markets, or will they break down? We'll look at each one, in turn.

ALL OF GOVERNMENT: CHAIRMAN POWELL WORRIES

It's not time to worry yet.
--Harper Lee, To Kill a Mockingbird

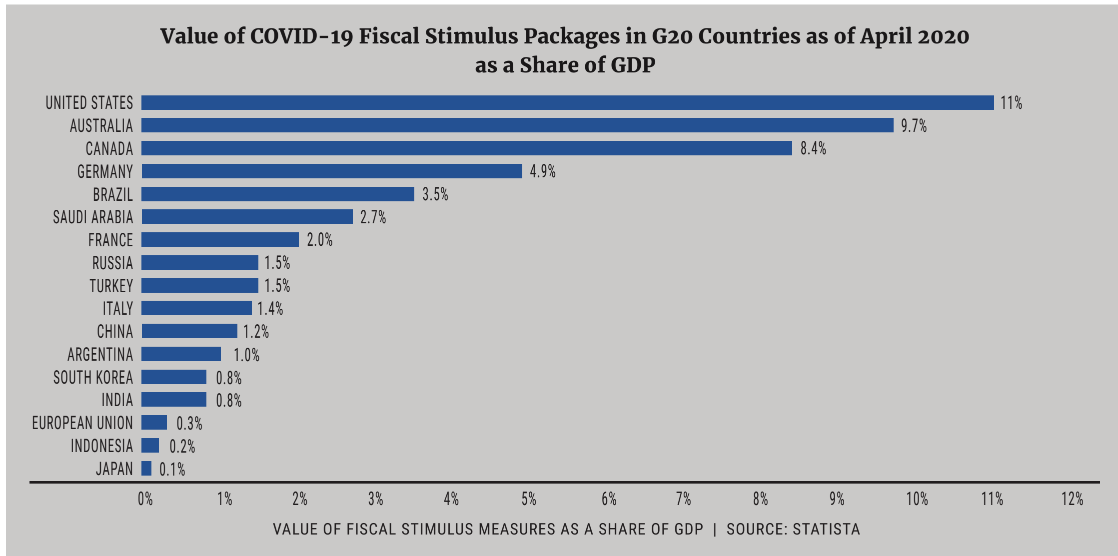
For most of us, when we encounter a stressful situation, we resort to coping strategies we've learned over time that have worked for us: deep breathing or meditating, working out, getting a massage, going shopping. But when you lead the world's most powerful central bank, and you determine that it is time to worry, you deploy your awesome power to deliver financial shock and awe.

That's just what Fed Chair Jay Powell did earlier this year, as the US economy plunged into recession following pandemic-driven lockdowns. Acting preemptively, the Fed cut interest rates to zero, reinstituted open market bond purchase programs (otherwise known as quantitative easing) and established nine lending programs designed to backstop and provide liquidity for the credit markets. This included state and municipal governments, money markets, corporate loans, junk bonds, and so on.



As the chart shows, the Fed has expanded its balance sheet by over $3 trillion, in its—largely successful, thus far—efforts to restore and support market liquidity.

Congress, too, stared into the abyss, and panicked. In short order, it exhibited an uncharacteristic bipartisan spirit as it passed three bills pouring almost $4 trillion into the economy—funds for airlines, healthcare systems, state governments, small businesses, households, and so on.



As this graphic makes clear, the rapid and enormous US fiscal response was substantially greater than that of other sovereign governments, both in absolute terms (as the world's largest economy) and as a proportion of GDP.

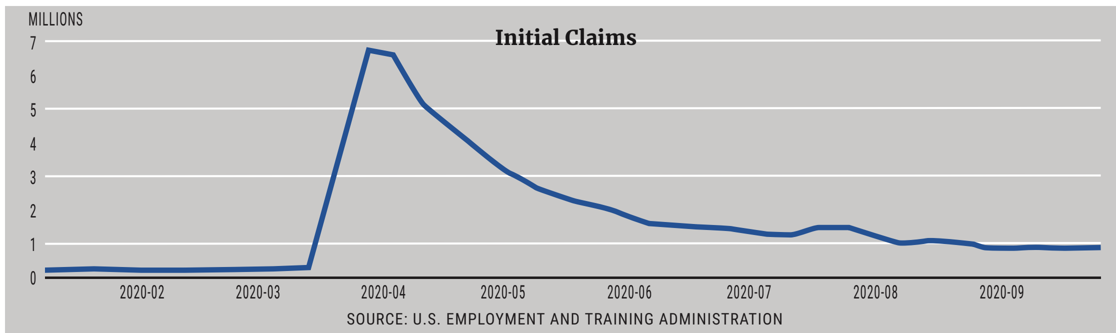
The all-in commitment of both the Fed and Congress to provide economic relief in the form of massive monetary and fiscal support has buoyed financial markets. Recent Fed minutes and Fed governors' remarks have reassured investors that interest rates will stay low for a very long time to come—Chair Powell emphasized that point when he said, "We're not even thinking about thinking about raising interest rates." Translation: we've got your back, for years to come.

While the Fed's support for the economy is unwavering, the same cannot be said of Congress. When enhanced unemployment benefits expired at the end of July, the legislative branch returned to its fractious, partisan business-as-usual stance, thereby ending the extraordinary fiscal response that the CARES act represented. Recent equity market weakness may be attributed at least in part to a de-acceleration in the economic recovery as legislators differ and dither, unable to reach agreement on a new stimulus bill.

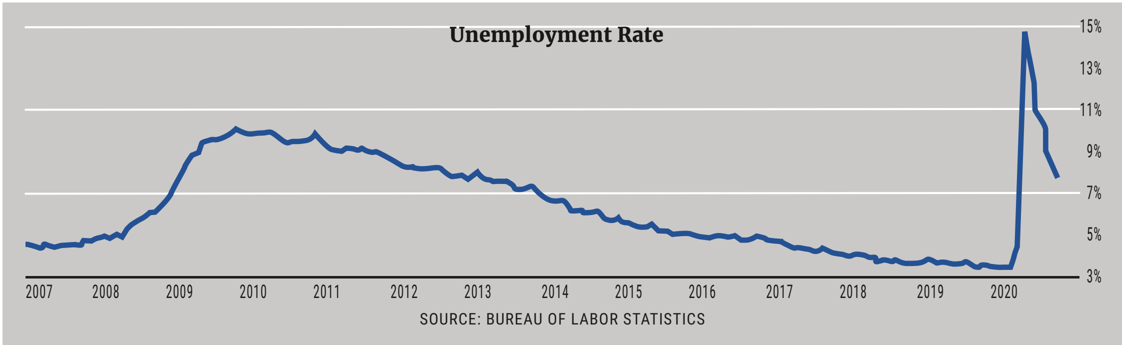
How now? Will the economic expansion—the third quarter will notch record growth, following the second quarter economic meltdown—continue? Even with this monumental government support, the question must be asked: Is it enough?

The Fed's present policies are designed to meet one of its two principal mandates, that of full employment.

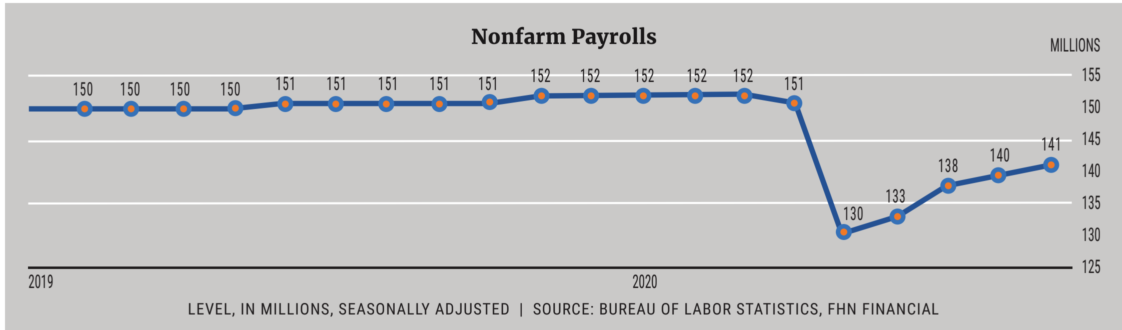
Early days for judging, but for now the picture on the labor front is one of mixed success. New weekly unemployment claims, having dropped dramatically as lockdowns ended, are now only slowly falling—so the bleeding has been stanched, but further improvements are needed.



Similarly, unemployment spiked to almost 15% in the spring; the September reading clocked in at 7.9%. That's a lot of improvement in a scant four months. But 7.9% is still historically elevated, a recessionary level.



One more look at the labor market is the number of people who are currently employed. As the chart below shows, about 20 million jobs were lost in the spring. We've recovered 10 million of them….and that means we've still got 10 million to go.

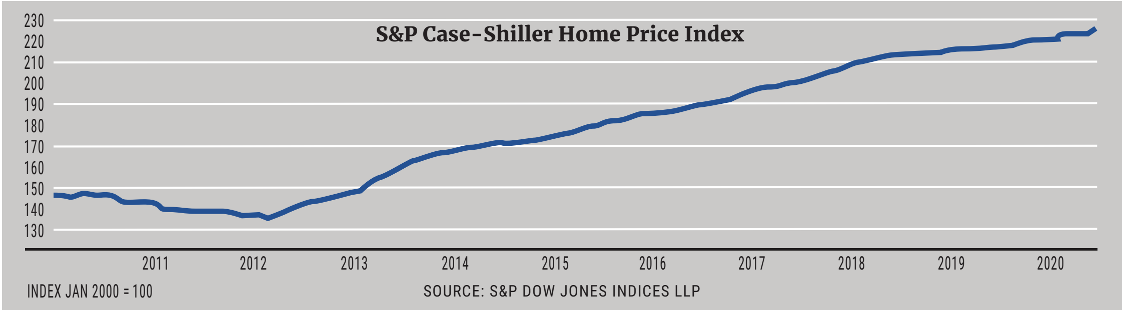


As these charts reflect, the labor market has both shown dramatic improvement and at the same time has a lot of distance to travel to return to pre-pandemic levels.

At the same time, corporate layoff announcements are snowballing, across a wide swath of industries—energy (Royal Dutch Shell), theme parks and entertainment (Disney), insurance (Allstate), investment banking (Goldman Sachs), travel (American Airlines), and so on.

So, the Fed's grade on the labor front is 'incomplete.'

Of course, the Fed doesn't have the tools to influence hiring directly. But its most powerful tool, setting interest rates, directly affects the cost of money. And lowering interest rates to near-zero has helped borrowers of all stripes. With the lowest rates in generations, the housing market has taken off, benefiting not just from low mortgage costs but also robust demand, with millennials forming households and city residents seeking suburban and rural shelter from COVID.



According to the S&P Case-Shiller Home Price Index, home prices are up 4.8% in July versus the prior year. Existing home sales have surged 10% in August, according to the National Association of Realtors. And the Census Bureau data indicate that new home sales have risen 43.2% above August 2019 levels.

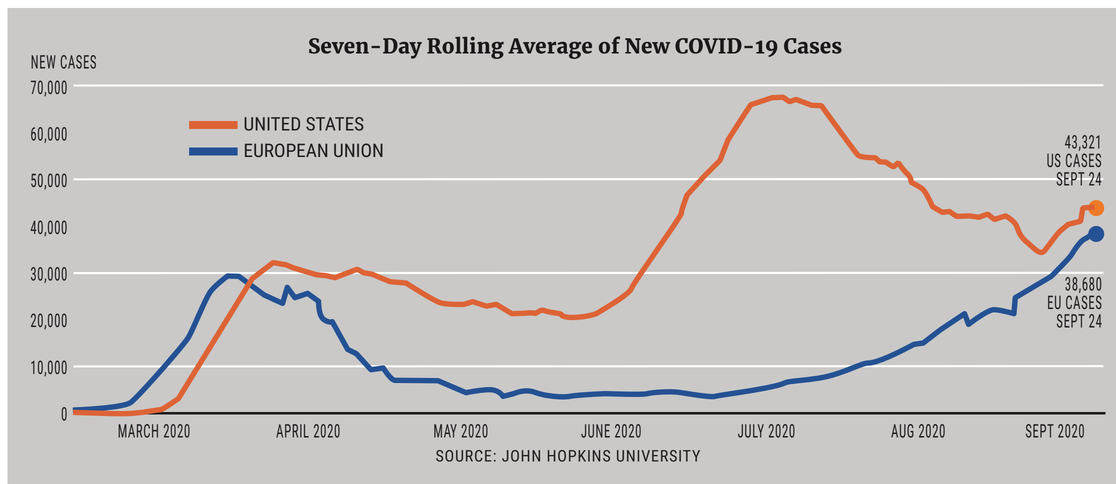
Low interest rates can fuel a credit-driven market, but will only have limited and lagged impacts on employment. Small wonder that Chair Powell has beseeched Congress to kick in a few bucks of fiscal stimulus to help him out in meeting his mandate.

THE HEALTH OF THE FIGHT AGAINST THE PANDEMIC

Let our advance worrying become advance thinking and planning.
-Winston Churchill

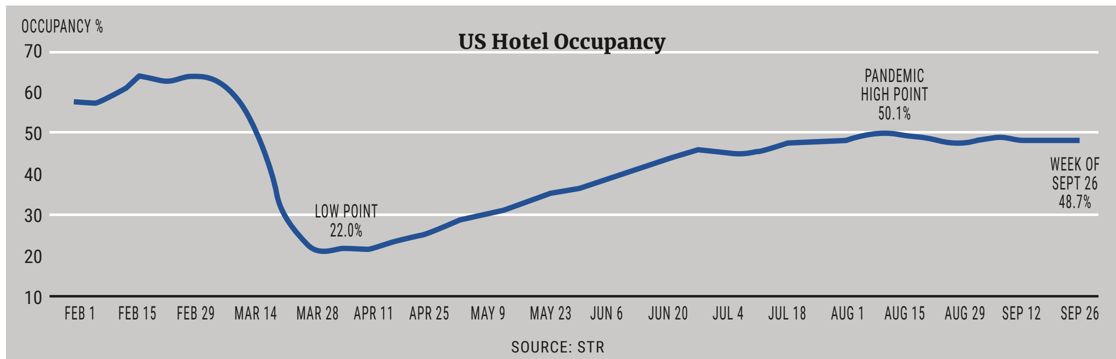
A second reason for the market's strong recovery has been the perception of progress in fighting COVID. Advances in treatment protocols, from antivirals to steroids to more targeted ventilator usage, have resulted in better patient outcomes—shorter hospital stays and more complete recovery—for many patients, even as mortality is still occurring. On the vaccine front, several vaccines are undergoing Phase 3 trials—the pace of drug development has been perhaps the most rapid in history.

Investors have focused on these positive developments, even as cases in the US spiked earlier this summer in the South and the Southwest. The data are concerning, even depressing. The US has surpassed 7 million cases and 200,000 deaths. Globally, over 33 million people have been infected with the virus, and more than 1 million people have died.



Epidemiologists do not share the market's sanguine attitude about progress in responding to the coronavirus. Europe's success last spring in dramatically reducing new cases has turned around, and new cases are on an upswing. In the US, case spikes this summer have rolled over but not to prior levels, and more recently have turned up again. The re-opening of the economy and the return to school and to college have led to a resurgence in cases. And there is further risk as weather cools in North America and people are increasingly forced indoors.

It's also clear that there are sizable sectors of the economy that have seen little improvement since the spring, sectors that are more profoundly impacted by the pandemic and unlikely to recover without more appreciable progress against the pandemic. Restaurants nationally are serving about 40% fewer diners than a year ago, according to Open Table. About 25% of office workers have returned; in denser downtowns the numbers are much lower—15% in San Francisco and 10% in New York City.



The travel industry remains in deep recession. Hotel occupancy is running about 32% below pre-pandemic levels. At the end of September, air travel was down 70% versus the prior year, according to data from the Transportation Safety Administration (TSA). And the Centers for Disease Control and Prevention has extended its "No Sail Order" through October 31st.

Clearly, travelers are worried.

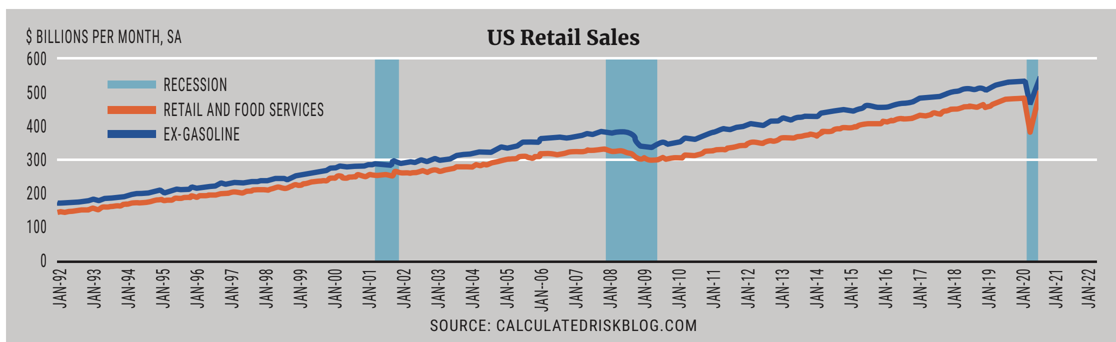
So, whether the market continues to look past short-term healthcare concerns depends critically on further good news on the vaccine front—and on the credibility of that good news. At this moment, with case counts spiking in Canada, the UK, France, and India, among others, there is ample reason to be concerned.

ECONOMIC RECOVERY: THE REAL THING, OR A DEAD CAT BOUNCE

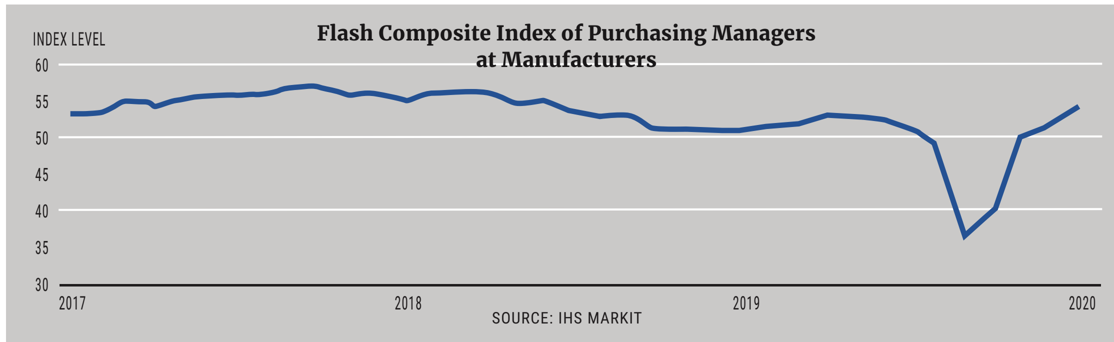
I am an old man and have known a great many troubles,
but most of them have never happened.
-Mark Twain

The third prop under the market has been economic advances following the end of widespread lockdowns to contain the pandemic. Predictions of devastating economic destruction have, happily, failed to come to fruition. And while for numerous data sets the absolute levels of economic activity have not returned to pre-crisis levels, they nonetheless reflect forward progress.

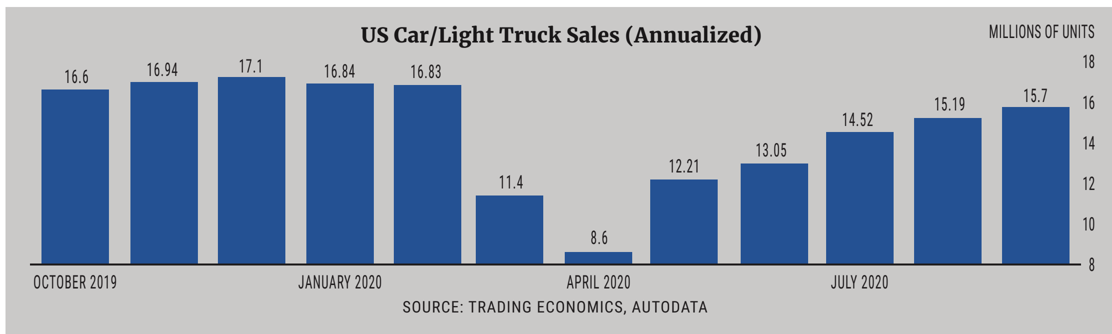
Perhaps most impressive is the strength of consumer spending. Notwithstanding bankruptcies this year of such storied retailers as Neiman Marcus, JC Penney, Brooks Brothers, J Crew and Lord & Taylor, retail sales have fully regained their pre-COVID levels. While spending was down in department stores, apparel, and gasoline, among others, it was more than made up for by internet sales, home furnishings, groceries/food at home, and sporting goods. Despite large numbers of laid-off workers, massive government transfer programs (especially the rich $600 weekly incremental unemployment benefit program) have put spending power into consumers' hands. And with that, consumer confidence has recovered to its highest level since March, according to the Conference Board.



Also faring comparatively well is the industrial economy, less hobbled by pandemic fears that have hampered personal service businesses. The manufacturing purchasing managers index, like retail sales, indicates that new orders, inventory, shipments and employment in the industrial economy have, in the aggregate, fully recovered.



Perhaps one of the most economically sensitive aspects of the industrial economy, one that connects directly to the financial health and prospects of consumers, is the automotive sector.



US light vehicle sales have risen for five consecutive months, to an annualized rate of 15.7 million cars and light trucks. Cars, of course, are a big-ticket purchase, and are also a financed purchase for the average consumer, so low rates have been a boon to the automotive sector even as sales remain below year-ago levels.

Insofar as markets are forward-looking, they see in these and other data an economy on the mend; fears of a second Great Depression are forgotten.

Still, the message from the labor market doesn't jive with this economic good news story. Taken all in all, it looks like neither a V-shaped recovery (rapid snapback to pre-pandemic levels), nor an L-shaped recovery (flat on its back for some time, following lockdowns). Some economists have pulled a "K" from the alphabet soup of recovery letters, to suggest some industries and regions fully recovering and others sinking. We have some sympathy for that perspective, worrying as we do about small business failures and the long road back for the travel, leisure and entertainment industries.

ELECTION SELECTION

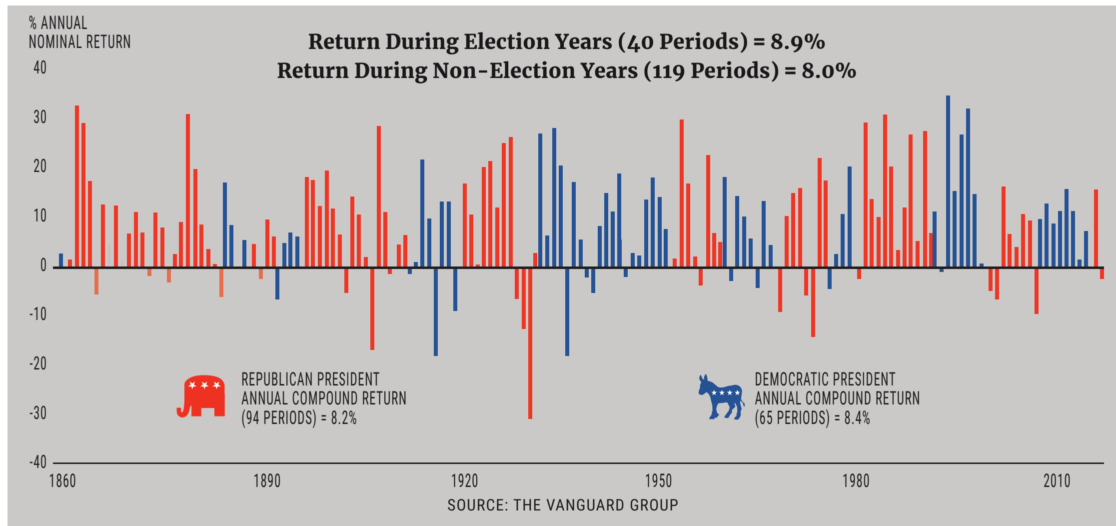
If a problem is fixable, if a situation is such that you can do something about it, then there is no need to worry. If it's not fixable, then there is no help in worrying. There is no benefit in worrying whatsoever.
-The Dalai Lama

Many investors are experiencing considerable consternation regarding the outcome of the rock-'em sock-'em battle of the septuagenerians. Does a Trump defeat undo stock market gains as the perceived business-friendly Administration exits stage right? Does a Democratic sweep mean higher taxes, less economic growth, and lower

stock prices? Does a record number of mail-in ballots assure the inability to declare a winner for days or even weeks after November 3rd? Worse than any of these: could we really have a constitutional crisis if election results are not accepted? Will we face a crisis in public confidence?

The easy call is to expect more volatility as we count down to Election Day, and in the perhaps-likely turmoil in the immediate aftermath. Short-term volatility may be uncomfortable to live through, but it only matters to traders, not to long-term investors.

Our crystal ball is as dark as yours when it comes to forecasting the election outcome. We'll deny we've said this if we get called out, but from an investing perspective elections don't carry the same importance they do for other aspects of American life. As the chart below from The Vanguard Group reflects, even with perfect foresight knowing an election outcome would not guide you as to how to invest.



The data indicate that over time market performance is not driven by the party in power. So go ahead, gnash your teeth as you contemplate perhaps the ugliest election season of our lifetimes…but don't mess with your portfolio, with your asset allocation, if your long-term goals are unchanged.

CLIMBING THE PROVERBIAL WALL OF WORRY

Whatever is going to happen will happen, whether we worry or not.

-Ana Monnar

Among the hoary truisms on Wall Street is the expression that stocks climb a wall of worry. It describes the oft-observed, counter-intuitive phenomenon of rising stock markets during periods of economic or financial turmoil or stress.

Today, that proverbial wall has been built up to a seemingly astounding height. We have touched on some of the bricks that comprise the wall, but the full list is overwhelming. Among the most prominent: the long-term effects of the enormous debt accumulation, the potential for a double dip recession, the effect of financial repression (monetary policy that sets interest rates below inflation) on savers and fixed income investors, growing income and wealth inequality, loss of confidence in institutions.

SOURCE: BLOOMBERG TV

There is also evidence of speculative excesses in markets: billions of dollars raised for 'blank check' SPACs (special purpose acquisition companies) which raise capital for the purpose of acquiring a company that hasn't even been identified; and IPOs that rocket into the stratosphere, such as cloud data warehousing firm Snowflake—its shares rose 115% on its first day of trading, even as the company has yet to report a profit. Equally so in the bond market, where investors hungry for yield have enabled both investment grade and junk-rated borrowers to borrow at a record pace this year, according to the Wall Street Journal.

That said, the wall of worry is always there. Sometimes it seems harder to scale, as it may now, but investors don't make money by acting out of fear and hiding in cash. Long-term investors need to be thoughtful, to set an investment strategy, to allocate their assets consistent with their risk tolerance and time horizon, and then allow time in the markets—not market timing—to do its work. That's how you'll have a portfolio that's just like the vaccines we're yearning for—safe and efficacious—so you'll have a clean bill of financial health.

And then? Then it's time to recall that almost seventy years later, *MAD* continues to feature the physiognomy of Alfred E. Neuman on its cover. So why not be like the enduring, time-tested Alfred E. Neuman? Why not say, "What, me worry?"

PEAPACK PRIVATE

Wealth Management

500 HILLS DRIVE, SUITE 300, BEDMINSTER, NJ 07921
TEL (908) 234-0700 • WWW.PEAPACKPRIVATE.COM

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