Economic and Market Overview

Fourth Quarter 2020

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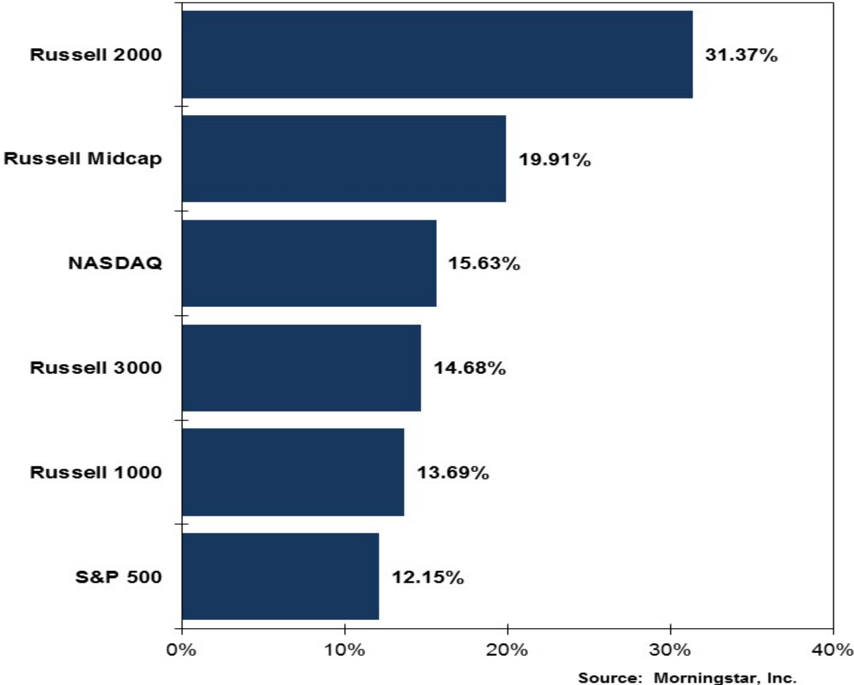
The following commentary summarizes prior financial market activity, and uses data obtained from public sources. This commentary is intended for ***one-on-one use with a client's financial advisor only,*** *as a resource to manage assets and evaluate investment portfolio performance.*

The Economy



The US economy suffered through the shortest but most severe recession on record as a result of the pandemic but is in the midst of staging a strong recovery. Agreement in Congress on a $900 billion fiscal stimulus package is expected to avert a double-dip recession. In addition, with the additional fiscal support and the increasing number of Americans being vaccinated, prospects are good that the economic recovery will be able to pick up steam by mid-2021. The Bureau of Economic Analysis released the third estimate of the third quarter 2020 real GDP, a record-setting seasonally adjusted annualized increase of 33.4%, slightly better than the prior estimate of an increase of 33.1%, and a substantial rebound from the second quarter's decline. The employment situation continued to show improvement over the past three months, with employers adding 711,000, 610,000, and 245,000 jobs in September, October and November, respectively. The November report showed an average of approximately 522,000 jobs added each month of the quarter, and that the unemployment rate fell to 6.7%. The Federal Open Market Committee (FOMC) maintained its supportive monetary policy response to the pandemic, leaving the funds rate target range of 0% to 0.25% unchanged. The central bank also reiterated that it expects interest rates to remain near zero until sometime in 2023.

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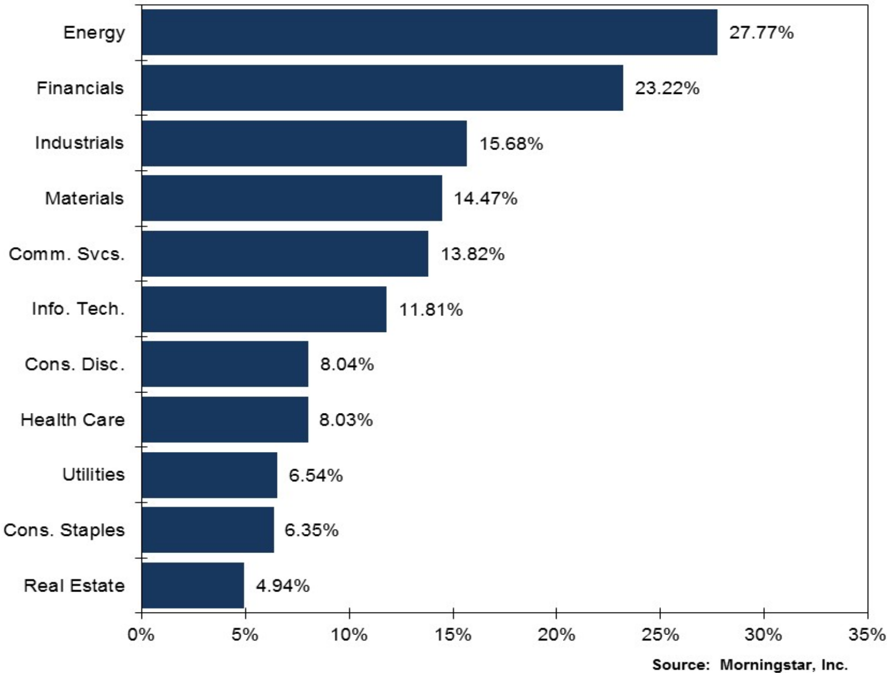
Highlights and Perspectives

GROSS DOMESTIC PRODUCT (GDP)

In the latest data available, the Bureau of Economic Analysis released the third estimate of the third quarter 2020 real GDP, a seasonally adjusted annualized increase of 33.4%, slightly better than the prior estimate of an increase of 33.1%, and of course a record-setting rebound from the 31.4% decline of the second quarter. Strength was widespread across most segments of the economy, and seen in consumer spending, most investment components, exports, and inventories. Government spending and imports partially offset these increases. Corporate profits jumped by 27.4% (not annualized) during the quarter. The so-called COVID-19 recession was the shortest and most severe in history, and while the rebound has been almost equally robust, many economists expect the economy to continue to grow in fits and starts until a more sustainable trend can take hold as lockdowns are lifted.



HOUSING

The housing segment continues to rebound from the levels seen during early in the pandemic, and despite a recent drop are hovering near their most elevated level since spring 2006. Existing-home sales for November (the latest monthly data available) rose to an annualized rate of 6.7 million units, 2.5% lower than the results from October, and up about 25.8% from year-ago levels. The inventory of existing homes was slightly more than two months of supply, lower than levels of the prior year. Existing-home prices in November increased 15.1% from November 2019. In the new-home segment, the NAHB Housing Market Index, a measure of homebuilding activity, ended the quarter at 86, its second-highest reading in history, and above year-ago levels. The short-term outlook for builders remains positive, but housing affordability is expected to decline next year as fiscal stimulus wears off and interest rates edge up.

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EMPLOYMENT

The November employment report (the latest data available) showed payroll gains that did not quite match consensus expectations. Employers added 245,000 jobs during the month, below the consensus expectations of a gain of 485,000. The job market continues to claw its way out of the pandemic related difficulties, but most of the easy gains have already been accomplished. In addition, with the virus reemerging in certain areas of the country additional lockdowns will hamper job growth. The unemployment rate in November declined to 6.7%, and the labor force participation rate edged lower to 61.5%.

FEDERAL RESERVE POLICY

The FOMC made no change to the federal funds rate target range of 0% to 0.25%, but in its statement included forward guidance to its asset purchases, which will now continue until “substantial further progress has been made toward the committee’s maximum employment and price stability goals.” In addition, the committee’s new “dot plot” – the forecast of the fed funds rate – shows a median projection of rates remaining near zero through 2023. The FOMC did not change the $120 billion of Treasuries and mortgage-backed securities purchased each month, and analysts expect this amount could increase as Congress continues to have difficulty passing additional fiscal stimulus.

INTEREST RATES

Fixed income securities’ prices on balance edged somewhat higher (and yields lower) in the quarter as central banks maintained supportive monetary conditions, and as the economy’s rebound proceeded mostly as expected. The FOMC and other central banks throughout the world maintained the aggressive policy stance in their efforts to mitigate the continuing adverse economic effects of lockdowns stemming from the pandemic. As has been the case in recent quarters, volatility in the fixed income market was benign as central bank policies has resulted in consistently low yields. The election had very little effect on the trajectory of yields, which have meandered slightly higher since early November. As mentioned above, the FOMC made no change to the previous policy steps it took in the second quarter to ensure enough market liquidity and reiterated that it sees rates remaining near zero for perhaps the next three years. As such, the FOMC is expected to maintain the target federal funds rate range at between 0% to 0.25% for the foreseeable future.

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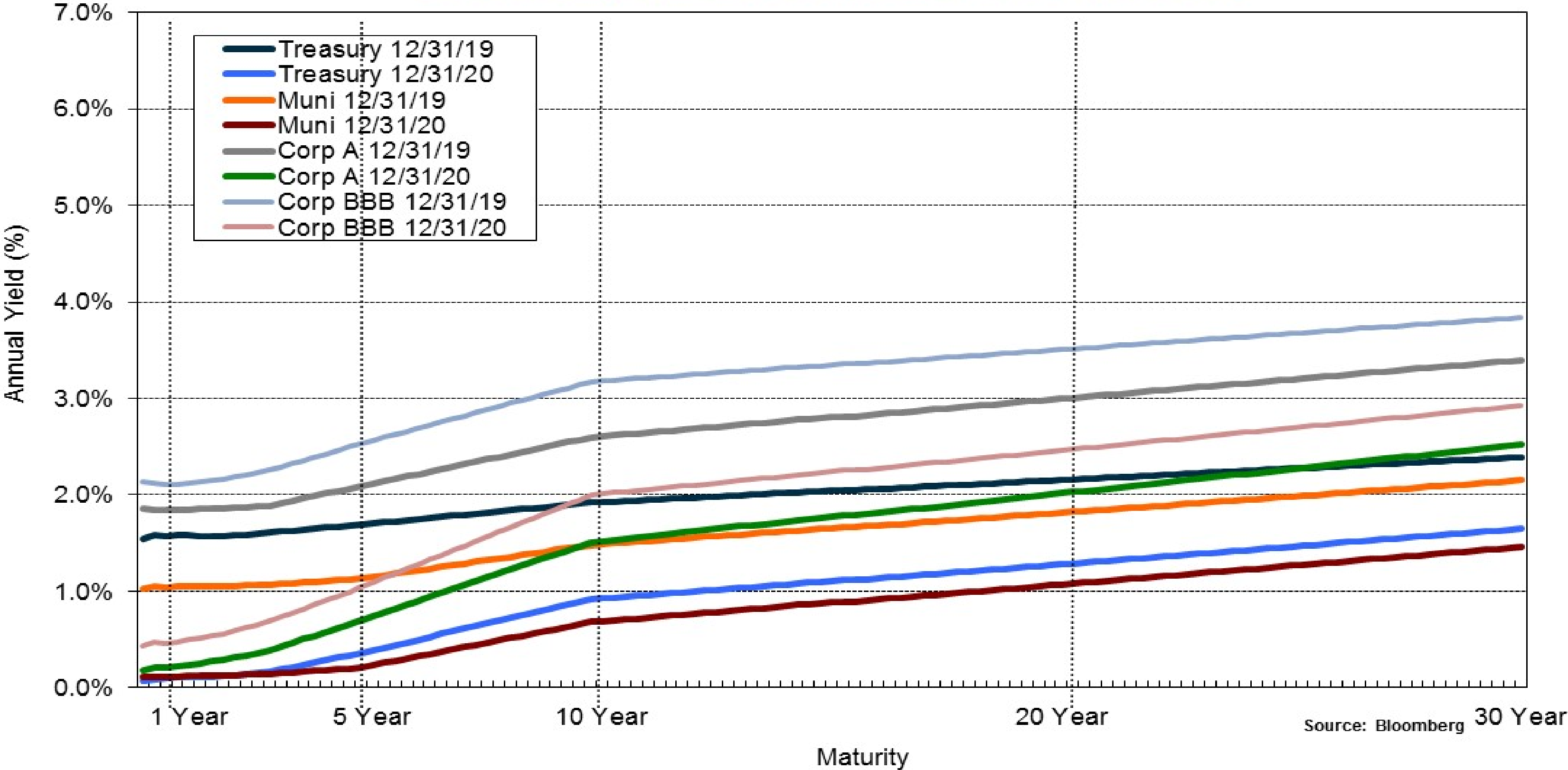

The shape of the Treasury yield curve steepened somewhat during the fourth quarter, with yields on the shortest-term maturities remaining little changed, while yields in the intermediate- and long-term segments of the curve rose modestly. Analysts believe the steepening is an indication of improvement in investor expectations for the economy. Yields declined by about three basis points on short-term maturities,

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while rising more than 20 basis points on intermediate- and long-term securities. By the end of the quarter, the yield on the benchmark 10-year US Treasury note was modestly higher, ending at 0.92%, compared to 0.69% on September 30.

As in recent quarters, the yield on the 10-year Treasury traded within a relatively narrow range, meandering between 0.68% on the low end of the range and 0.98% on the high end. While the trend was toward slightly higher rates in the quarter, the confined range was again a result of the FOMC's communication that it expects rates to remain low for the foreseeable future. Against this backdrop, the yield on the 3-month Treasury Bill settled at 0.07% at the end of the quarter, down about three basis points from the end of the previous quarter. The yield on the 5-year Treasury Note ended the quarter at 0.36%, compared to 0.28% on September 30, and as mentioned above, the yield on the 10-year Treasury Note was higher at 0.92%, compared to 0.69% over the same period. The yield on the 30-year Treasury Bond was modestly higher, ending the period at 1.65%, compared to its beginning level of 1.46%. Inflation expectations were also higher, with the Fed's gauge of five-year forward inflation expectations exceeding the level of 1.66% on September 30.

Total returns on fixed income securities were higher, with slightly positive returns in almost every segment of the market. One exception was the Bloomberg Barclays Treasury 5-7 Yr. Index, which declined by -0.5% for the quarter. The Bloomberg Barclays US Credit Corporate 5-10 Yr. Index gained +2.4% during the three months. High yield securities, which often follow the performance of equities, rallied, posting a return of +6.5%. Municipals also posted solid results in the quarter, as the Bloomberg Barclays Municipal Bond Index advanced by +1.8% during the quarter. Prices of non-US fixed income securities were sharply higher in the quarter, as the Bloomberg Barclays Global Aggregate ex-US Index gained +5.1%. Emerging markets bonds posted solid gains, with the JPM EMBI Global Index edging higher by +5.5%.

EQUITIES

Stocks posted a third quarter of strong gains following the sell-off in 2020's first quarter. Many broad indexes have now rallied by more than 65% since they bottomed in March. Market analysts have cited the recently released vaccines as a catalyst for stocks' strong results. Effective vaccines increase the potential to begin eliminating lockdowns and bringing more segments of the economy back online. After declining in the weeks leading up to the election, stock indexes thereafter trended steadily higher through the end of the year. In addition to investors being encouraged by the speedy development of a vaccine, the market also seems to be digesting the fact that the world seems to be learning to live with the virus. While governors in some states maintained stringent lockdown protocols, an increasing number of studies and data from other states with lighter restrictions seem to indicate lockdowns may not be effective. When the quarter ended, the S&P 500 Index had advanced +12.2% and finished with a gain for the year of +18.4%.

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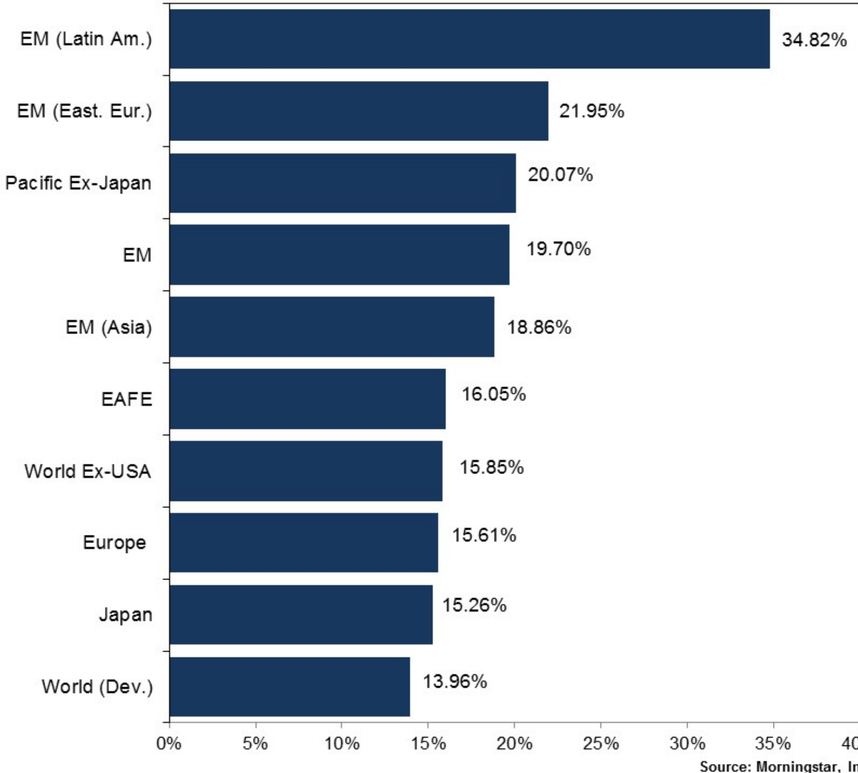
Performance of each of the eleven primary economic sectors was positive during the quarter, although there was significant performance dispersion among the sectors. Energy, Financials and Industrials were the strongest performers on a relative basis, generating returns of +27.8%, +23.2%, and +15.7%, respectively. The Real Estate, Consumer Staples and Utilities sectors were the poorest relative performers, posting returns of +4.9%, +6.4%, and +6.5%, respectively.

The Russell 1000 Index of large capitalization stocks generated a +13.7% total return. Within the large cap segment, value stocks outperformed growth stocks. Small cap stocks, as represented by the Russell 2000 Index, outperformed large caps, and finished the quarter with a total return of +31.4%. Small cap value outperformed small cap growth. The NASDAQ Composite, dominated by information technology stocks, finished the quarter with a gain of +15.6%. The Dow Jones Industrial Average of 30 large industrial companies advanced by +10.7%.

Real Estate Investment Trusts (REITs) were higher during the quarter, with the DJ US Select REIT Index up +12.9%. Commodities also posted solid gains, with the Bloomberg Commodity Index adding +10.2% for the quarter.

International stocks also delivered robust gains during the quarter, and generally performed in line with US equities. The MSCI ACWI Ex-USA Index, which measures performance of world markets outside the US, rose by +17.0%. The MSCI EAFE Index of developed markets stocks advanced by +16.1%. Regional performance was positive for the quarter. Latin America was the strongest performer on a relative basis, with a return of +34.8%. China was the poorest relative performer, advancing +11.2%. Emerging markets performance was strong, as the MSCI Emerging Markets Index was higher by +19.7%.



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Outlook

Many economists and analysts had expected the US economy to have a difficult year in 2020, but it turned out much worse than anyone could have anticipated, and in hindsight was one of the most challenging in the nation's economic history. Among the contributors to the difficult environment was of course the onset of COVID-19 and the resulting lockdowns that resulted from trying to contain it; the rancorous presidential election cycle; and a slew of geopolitical issues such as the long-running Brexit negotiations and a trade war with China. While the economy is not totally out of the woods yet, the consensus expectation among economists is that 2021 should show a marked improvement. In addition to the pandemic being likely to wind down, the approved vaccines should enable states to more aggressively open. In addition, a Biden administration is expected to try to deescalate the political rancor that has prevailed this past year. There is a significant amount of pent-up demand for the products and services that have been avoided over the past nine months, and economists believe that higher income households will be able to increase spending. While the recovery has been v-shaped, the economy has a way to go to fully return to pre-pandemic levels, and it is anticipated that it could take multiple years to completely recover. But the US economy is extremely resilient, and absent policymaking missteps, should continue to make positive strides. Given that with the onset of winter there has been an uptick in virus cases, economists believe that the first half of 2021 may be sluggish, but that the second half of the year should see an improvement. The recently passed stimulus package is expected to provide additional fiscal support to the recovery. Economists are optimistic that the recovery from the pandemic will be much shorter than the time it took the economy to recover from the financial crisis.

Brandon Thomas, *Co-Founder* and *Chief Investment Officer,* Envestnet

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INDEX OVERVIEW

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The **Dow or DJIA** (Dow Jones Industrial Average) is an unmanaged index of 30 common stocks comprising 30 actively traded blue chip stocks, primarily industrials, and assumes reinvestment of dividends. The **NASDAQ Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **S&P 500 Index** is an unmanaged index comprising 500 widely held securities considered to be representative of the stock market in general. The **DJ US Select REIT Index** is a subset of the Dow Jones Americas Select RESI and includes only REITs and REIT-like securities (The Dow Jones US Select Real Estate Securities Index (RESI) represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded in the US). The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks prices of futures contracts on physical commodities on the commodity market and is designed to minimize concentration in any one commodity or sector. The **MSCI EAFE Index** is recognized as the preeminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East. The **MSCI Emerging Markets Index** is a free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. The **MSCI ACWI Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging markets country indices. The **MSCI Emerging Markets (EM) Eastern Europe Index** captures large and mid cap representation across four emerging markets (the Czech Republic, Hungary, Poland, and Russia) countries in Eastern Europe. With 52 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country. The **MSCI EM (Emerging Markets) Latin America Index** is a free float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The **MSCI ACWI Ex-US Index** is a market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI) and designed to provide a broad measure of stock performance throughout the world, except for US-based companies. The **MSCI China Index** captures large and mid cap representation across China H shares, B shares, Red chips, and P chips covering about 85% of this China equity universe. The **Bloomberg Barclays Municipal Bond Index** is an unmanaged index comprising investment-grade, fixed-rate municipal securities representative of the tax-exempt bond market in general. The **Bloomberg Barclays Global Aggregate ex-US Index** is a market-capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most US-traded investment- grade bonds are represented. Municipal bonds and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The Index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in the US. The **Bloomberg Barclays US 5-10 Year Corporate Bond Index** measures the investment return of US dollar-denominated, investment-grade, fixed-rate, taxable securities issued by industrial, utility, and financial companies, with maturities between 5 and 10 years. Treasury securities, mortgage-backed securities (MBS), foreign bonds, government agency bonds, and corporate bonds are some of the categories included in the Index. The **Bloomberg Barclays Capital US 5-7 Year Treasury Bond Index** is a market-capitalization-weighted index and includes Treasury bonds issued by the US with a time to maturity of at least 5 years, but no more than 7 years. The **Russell 1000 Index** is a market-capitalization-weighted benchmark index made up of the 1000 largest US companies in the Russell 3000 Index (which comprises the 3000 largest US companies). The **Russell 2000 Index** is an unmanaged index considered representative of small cap stocks. The **Russell 3000 Index** is an unmanaged index considered to be representative of the US stock market and measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The **Russell Midcap Index** is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The **Housing Market Index** (HMI) is based on a monthly survey of **NAHB** members designed to take the pulse of the single-family housing market. The survey asks respondents to rate market conditions for the sale of new homes at the present time and in the next six months, as well as the traffic of prospective buyers of new homes. The **JPMorgan Emerging Market Bond Index** (EMBI Global) tracks total returns for traded external debt instruments in the emerging markets and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The **CBOE Volatility Index** (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index.

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DEFINITIONS

The **Federal Open Market Committee** (FOMC) is the monetary policymaking body of the Federal Reserve System. The **federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The **European Central Bank** (ECB) is the central bank for Europe's single currency, the euro. The ECB’s main task is to maintain the euro's purchasing power, and thus price stability, in the euro area. The euro area comprises the 19 European Union countries that have introduced the euro since 1999. The **Gross Domestic Product** (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. The **Bureau of Labor Statistics** (BLS) is a unit of the United States Department of Labor. It is the principal fact-finding agency for the US government in the broad field of labor economics and statistics and serves as a principal agency of the US Federal Statistical System. The **Bureau of Economic Analysis** (BEA) is an agency in the US Department of Commerce that provides important economic statistics, including the gross domestic product of the US. It is a governmental statistical agency that collects, processes, analyzes, and disseminates essential statistical data to the American public, the US Congress, other Federal agencies, state and local governments, business, and labor representatives. The **PCE (Personal Consumption Expenditure) Index of Prices** is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data, including US Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures, and is essentially a measure of goods and services targeted towards and consumed by individuals. Sector performance is represented by the **Global Industry Classification Standard (GICS)** sectors, developed by Standard & Poor’s and MSCI Barra.

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