# Q4 2020 Economic Outlook

By the LNWM Investment Strategy & Research Group

## AN AUTUMN LIKE NO OTHER

SUMMARY: This quarter's outlook can be summed in two words: elections and pandemic. Both bring extreme levels of complexity and have significant consequences for how we manage your portfolio. Both have and will continue to cause market swings, although we believe there is light at the end of the tunnel. We think current asset prices continue to be kept afloat by low interest rates and promises of further government programs. Regarding the election, we think the scenario that will bring the greatest change is a 'Democratic sweep' of the US Senate and White House ushering a wide array of proposed legislation. Any other outcome will result in continuation of a divided government that will make meaningful legislation difficult.

> "Do you know what investing for the long run by listening to market news every day is like?
>
> It's like a man walking up a big hill with a yo-yo and keeping his eyes fixed on the yo-yo instead of the hill."
>
> **– Alan Ableson**

### TRICK-OR-TREATING OUR WAY OUT OF RECESSION

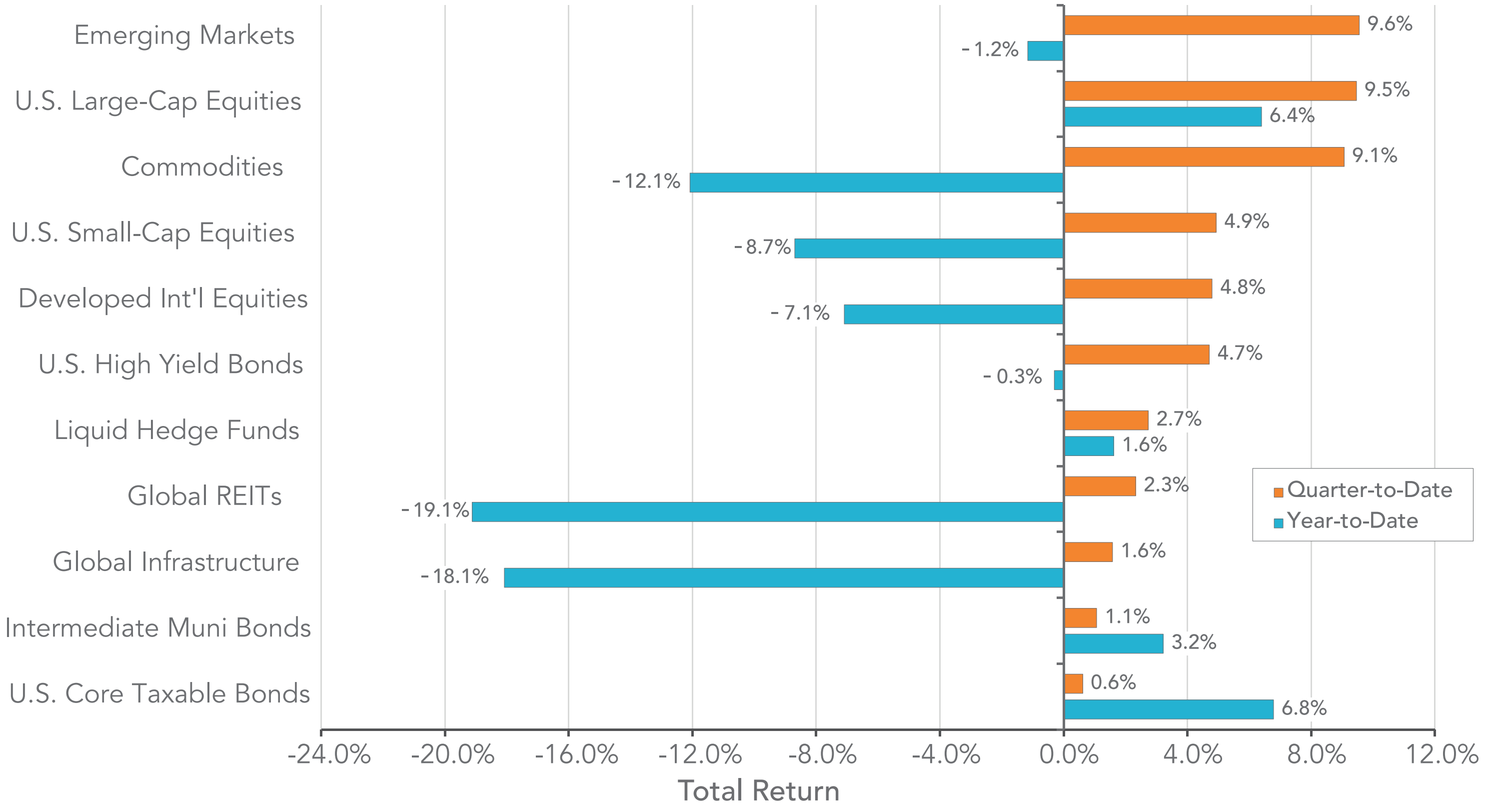
Fall is my favorite season although we are in a season like no other. Kids back to school, football and many other autumn rituals are altered this year, yet we can still take comfort in the changing color of the leaves, healing rains, and for me personally, the hope of a fast-approaching ski season. Having never been enthusiastic about Halloween (too much candy), I still plan to wear whatever embarrassing outfit my wife and kids come up with for me, and with my kids now nearing the end of their trick-or-treat careers, I am sure I will miss these days.

Fall and Halloween are perfect analogies for the current state of our economy. Like the fall colors, there is some beauty to be found; however, one cannot deny the gloom of the shorter days and the potential need to brace for the storms ahead. As with children and Halloween candy, it seems that our economy is addicted to government stimulus. Jeffrey Gundlach put it well by saying that this started with the Global Financial Crisis (GFC): "But now, in a Covid-19 world, it's GFC spending on steroids." Recently, the only thing that seems to cause equity markets to trade higher or lower is news (or tweet) that a stimulus bill is being negotiated or not. The size of proposed new stimulus seems only to grow, and the most recent proposal is at around $2 trillion. Our government is playing trick-or-treat in the greatest neighborhood in the world with an endless supply of full-size candy bars.

I also think there is another type of addiction at play: Politicians from both parties who don't want to disappoint constituents have become addicted to providing bonus unemployment checks, small and large business loans (even bailouts), and continued talk of ongoing spending. Of course, we are in an election year, and politicians will tell people what they want to hear. I have heard scant mention of the ever-increasing deficit from any politician, even as the ratio of US federal debt to US GDP has moved past 100% in 2020. I've mentioned in the past that during a crisis such as Covid-19 governments should take on deficits to support those struggling. But an economy has to begin healing on its own, which can be a slower process than most would like. Our political system doesn't incentivize consideration past the current term, making the use of stimulus ever more attractive, regardless of political beliefs. Of course, even if questioned, they seem to reliably blame the 'last guy in office.'

In case it's not obvious, I am a little disenchanted with politics at the moment, and I am very concerned about the current level of division that has beset our nation. We face an ongoing pandemic, presidential and key congressional elections, stubbornly high levels of unemployment (albeit driven mostly by the Covid-19 pandemic) and continued social unrest. Yet it seems politicians of all flavors prefer to glow in the spotlight and point fingers at each other. More on the election and possible outcomes later; however, regardless of the election results, it continues to be my hope that differences can be set aside and the business of governance prevails. However, I'm not sure current social media will allow for that, nor do I have a great deal of confidence in the current slate of political figures.

**PERFORMANCE OF ASSET CLASSES 3RD QUARTER 2020 AND YEAR-TO-DATE**
(Through September 30, 2020)




Source of Data: Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services.

## COVID-19

The economic shock resulting from Covid-19 is considered by many to be the most significant since World War II. Labor markets, particularly in the service sector, are yet to rebound after disappearing almost overnight. Global trade ground to a halt and factories ceased production. Central banks and governments around the world reacted forcefully to dampen the economic impact, pushing deficits to record levels.

Since this spring, there have been significant advances in Covid-19 treatment and progress toward a vaccine. While the mortality rate has declined dramatically, the virus is far from under control, particularly in the US. Here, the number of deaths per million people is close to 600 vs. 250 in Canada and just above 100 in Germany. Of course, there are several factors at play but the stark difference in mortality rates cannot be ignored. We think a key reason for this difference is the 'politicization' of the pandemic and lack of a coordinated response in the US. In truth, Covid-19 may not be as deadly as it was once thought to be, but it certainly has no political barriers.

Globally, markets are focused on the progress the US is making toward controlling the spread of Covid-19. And this is not surprising. Data has shown that how well a country deals with the pandemic is directly related to how quickly its economy recovers. Therefore, markets will continue to price in the likelihood of lockdowns, additional stimulus, and other uncertainties until the virus is well under control. As of now, we are seeing an uptick in cases in many parts of the US and Europe. While some of this is due to increased testing, the level of testing is still below the recommended levels.

Rapid, inexpensive, and easily produced Covid-19 testing is key to reopening the global economy in the near term, in our opinion. Rapid testing is easiest to apply broadly and the approval process is less onerous relative to a vaccine. Beginning this October, Abbott Laboratories expects to produce 50 million tests per month that yield results in 15 minutes. We think this could be pivotal – Covid-negative results for everyone on a flight or a hotel, for example, can override much of the uncertainty that is keeping people from traveling.

## US ELECTIONS

While media is focused on the upcoming presidential election, equally important are several key Senate races, which could tip the partisan scales. Let's begin with the presidential election, which by most polls is Joe Biden's to lose (although I wrote something very similar about Hillary Clinton back in October 2016). As I've often discussed with clients, I don't have a crystal ball; however, I would say that as of now, markets are currently pricing in a Biden victory. The chart at the end of this Outlook (see pages 11 and 12) presents the key policy proposals of the two candidates. How many of these proposals make it through Congress will depend on Senate elections as much as on who is President.

In our view, the two most likely outcomes for this election cycle are: 1) Continuation of a divided government, with the Senate and White House controlled by different parties. In this scenario, the passage of any major legislation will be very difficult and partisan politics will continue to rule the day.

2) A 'Democratic sweep' (White House, Senate, and House). Under this scenario, passing Biden's ambitious agenda becomes far more likely and would have significant implications for healthcare, infrastructure, energy, taxes, and the Supreme Court. What's more, the US federal deficit, which will grow regardless of the election results, is likely to increase at a faster pace based on the proposed policies of the Biden camp. Nonetheless, we think a Democratic sweep would drive the most significant change in policy, and may not necessarily boost market volatility in the long run: markets tend to prefer certainty because it allows for more effective planning.

What does this mean for your portfolio? Whatever the election results, US monetary policy is likely to stay very accommodative for the foreseeable future, which will keep short-term interest rates low. These low rates have buoyed asset prices for some time, even as most companies have struggled to post any earnings growth. Thus far, inflation has remained subdued in spite of the various stimulus measures, which are theoretically inflationary. We think inflation remains muted in the very near term but the risk of higher inflation continues to increase, and we have begun positioning portfolios for that possibility going forward. In the near term, the current recovery's greatest threat remains a rebound in Covid-19 without reliable treatment, leading to renewed lockdowns.

For more on how we are positioning fixed-income allocations at a time of record low rates, I invite you to read a recent article by LNWM Senior Investment Analyst Josh Hile titled Rethinking the 60-40 Portfolio. In sum, Josh describes how persistently falling and historically low interest rates have changed the outlook for bonds and other types of fixed income, as well as their correlation characteristics relative to equities. While our current view is that interest rates are likely to remain low, yields on longer-term debt could rise from current levels, steepening the yield curve. In fact, the yield curve has gotten steeper recently as markets begin pricing in presidential policy agendas.

## WHAT WE HAVE DONE/ARE DOING

The third quarter was extremely busy for the investment team at LNWM. We added several private investments, increased our equity allocations, and launched our new hedge fund vehicle. Senior Investment Analyst Josh Hile led our effort to divest from an emerging markets manager with whom we'd had a long-standing relationship in favor of a fund that has better risk/return characteristics and is well-positioned to invest in the significant opportunities we are seeing in emerging markets.

LNWM Analyst Nathan Barnard has over the past year worked to structure the most efficient vehicle for accessing hedge funds. We've now launched that vehicle, which has seven underlying managers and is performing well out of the starting gate. Dave Baker, Director of Investment Strategy and Research, introduced a compelling opportunity for our ESG-focused clients managed by Lyme Timber: A private fund that invests in sustainable forestry management and the protection of wetlands and nearby ecosystems to help companies offset their carbon emissions.

As a team, we decided early in the quarter to lower our allocation to short-term fixed income in favor of non-US equities, which has proven additive to client portfolios. Finally, we are excited for a private real estate investment we are making on behalf of clients in partnership with our parent, the Laird Norton Company; not only is this attractive from a risk/return perspective but it will also provide much needed affordable housing in our city (176 new units). We hope this venture is the beginning of many more to come.

Given that we are fast approaching year-end, tax planning is a high priority. Our investment team continues to work with LNWM client advisors to evaluate and act on opportunities that minimize the impact of investment taxes, especially on long-term capital gains. We encourage you to contact your LNWM advisor about overall tax strategy, as it applies to investments and to your entire estate.

As I think about our positioning going forward, I try not to let the current situation (the "yo-yo" in the front page quote) bias our views; I want to keep us focused on "the hill," which in this case is the next 10 years or so. Certainly, Seattle is not the same city it was just over six months ago. How we live and work has changed and will continue to evolve in the 2020s, opening up new opportunities in investing as well in the many other ways we serve clients. As with the fall season, there is beauty to be found especially when the skies are gray.

## Q4 2020 KEY ECONOMIC DRIVERS

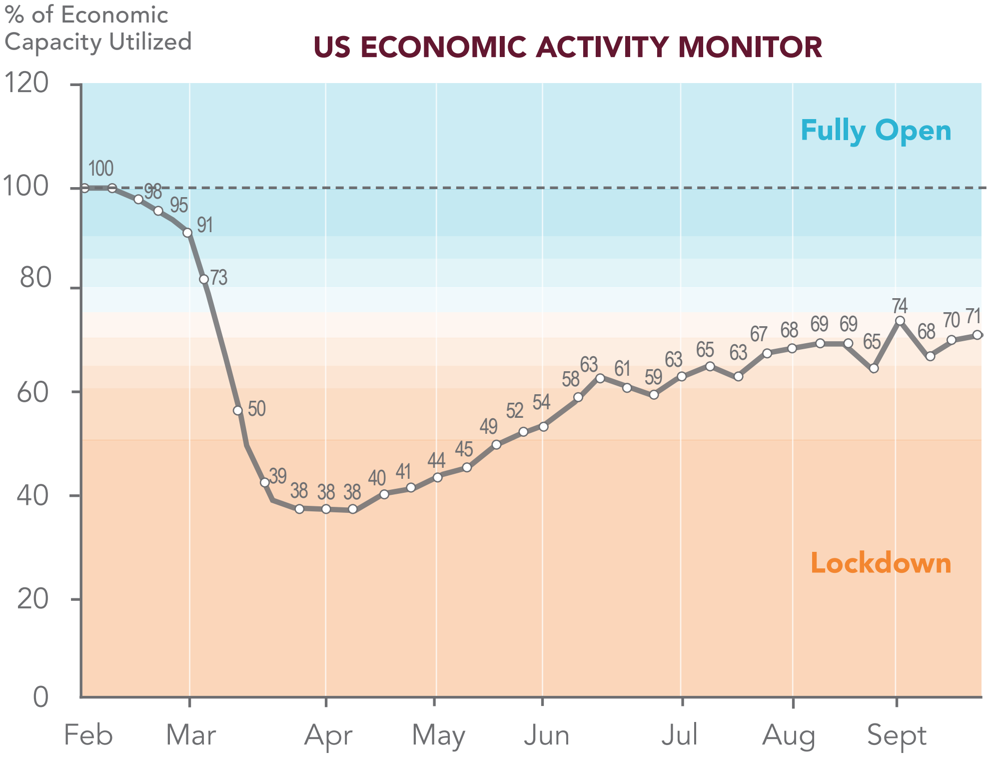
- **US Elections** – As one would expect, the current election cycle is front and center. With more than just the White House at stake, the two most likely outcomes are: 1) a divided government making significant legislative changes difficult; or 2) Democratic sweep with Biden elected President and Democrats gaining control of the Senate; we think this scenario would result in the most change over the next two years. There is a lot of discussion surrounding a contested election; we think this is a very real possibility.

- **Government Stimulus** – Markets continue to trade on the hope of more fiscal stimulus. Each time a bill is introduced, it stalls as both sides attempt to include items that have little relation to the pandemic. We think that more relief spending before year-end is necessary but the timing is unpredictable.

- **Covid-19** – An ongoing pandemic is certainly the greatest economic risk, and more importantly, a concern for our world in general. There continues to be significant progress toward a vaccine but we believe rapid testing and improved treatment will be the best near-term mitigant.

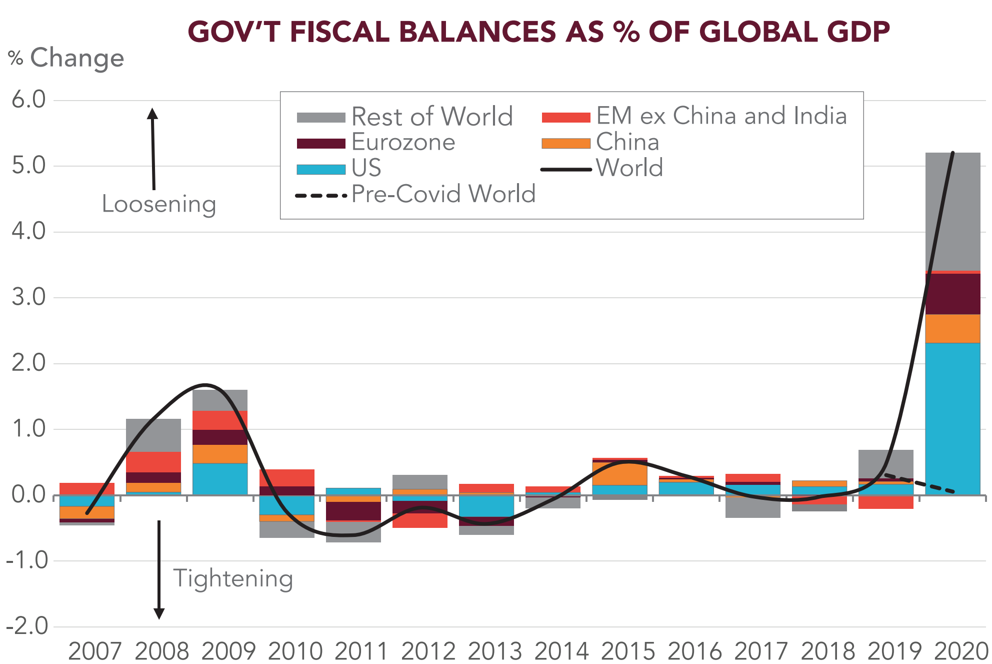
- **Corporate Earnings** – Always a focus but even more so now as investors seek to understand if the recent runup in stock prices is justified. Some very large banks have recently posted solid results giving equity markets a boost. We expect some short-term volatility as we head into the heart of earnings season.

- **Monetary Policy** – The Federal Reserve has been fairly quiet lately after taking extraordinary measures in response to Covid-19. Nonetheless, the Fed indicating it has no intent to move interest rates higher in the next several years has given markets comfort and aided liquidity.



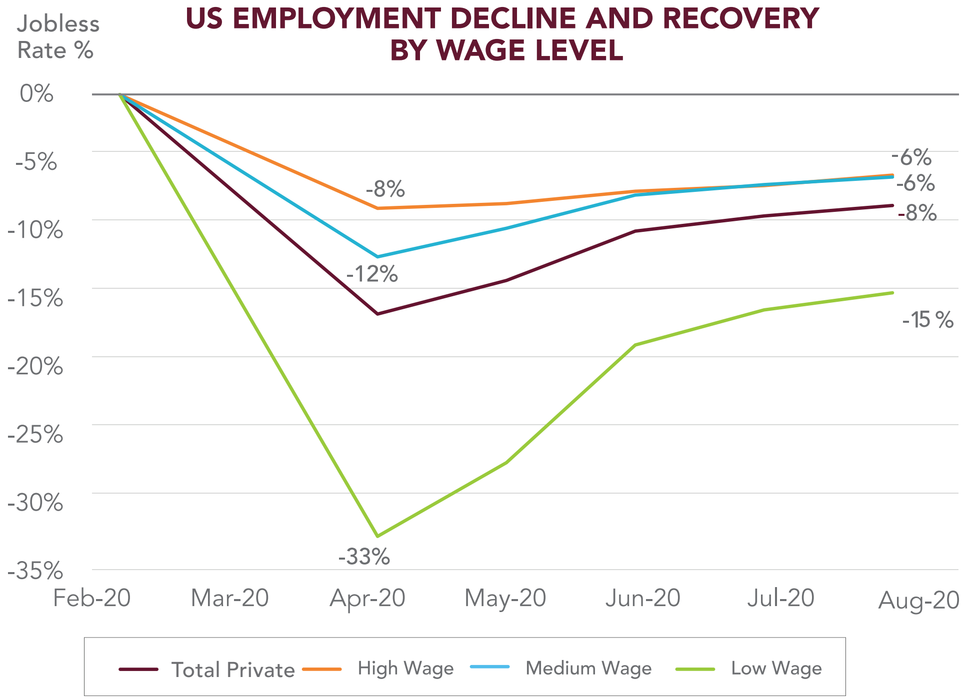

Source of Data: Goldman Sachs Global Investment Research.

The US economy has rebounded quite a lot since spring but still has a way to go. The chart shows how quickly economic activity declined in the US once businesses shuttered and people stayed home in March. While economic activity has improved since then, with Covid-19 cases dropping initially, the pace of the recovery has been slow and modest since the middle of June when virus cases began to rise again nationally.




Source of Data: UBS, Haver, European Commission, CBO.

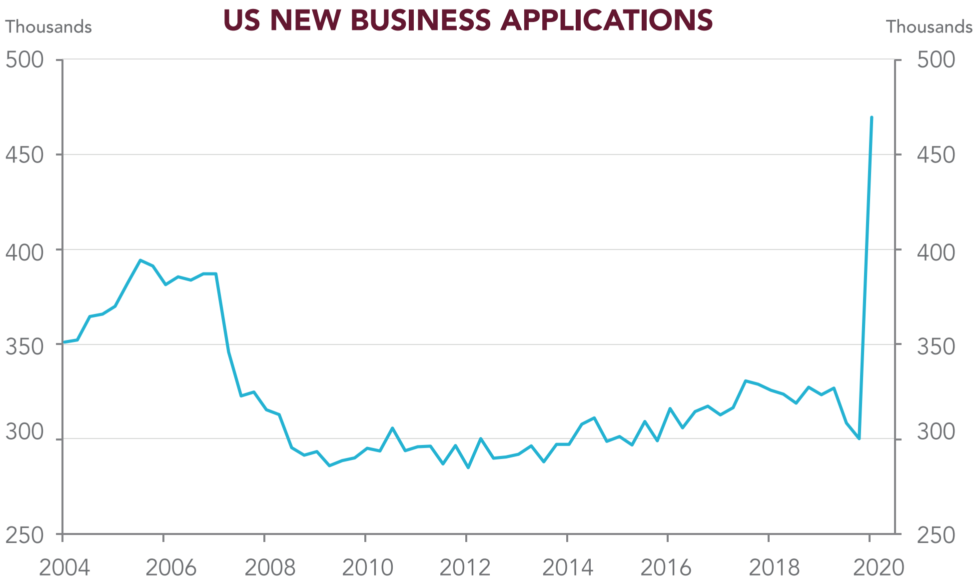
The combined financial resources provided by governments around the world to blunt the economic impact of Covid-19 are tremendous in scope and size, as the chart at left indicates. Relative to the Great Financial Crisis of 2008-2009, the response has been uniform and occurred in short order. Will this be enough or is still more needed?




**High-Wage** = Information Services, Utilities, Finance, Prof Services And Mining/Logging;
**Medium-Wage** = Wholesale Trade, Construction, Manufacturing, Education/Healthcare, Transport;
**Low-Wage** = Retail Trade, Leisure/Hospitality. Data as at August 31, 2020.

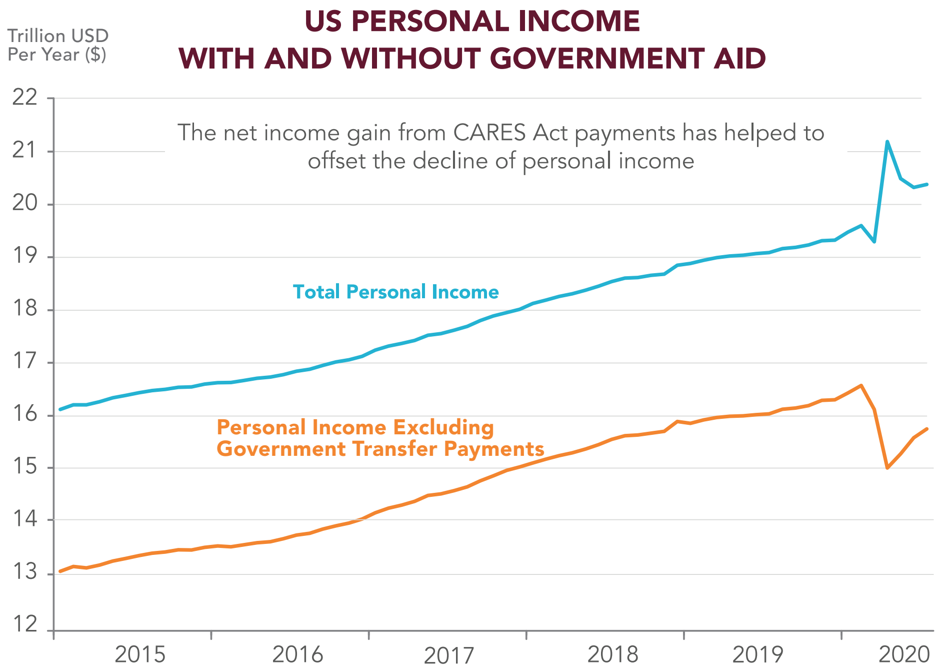
**Source of Data:** Bureau of Labor Statistics, Haver Analytics.

The impacts of Covid-19 have been felt unevenly by US consumers. Those with the lowest incomes, hospitality workers in particular, saw the highest jobless rates following the initial shock of the economic shutdown. In a world marked by Covid-19 for the foreseeable future, it is difficult to envision employment for that lowest income bracket improving dramatically in the near term, although there are some signs for optimism. The services sector as a whole started adding jobs in early October.



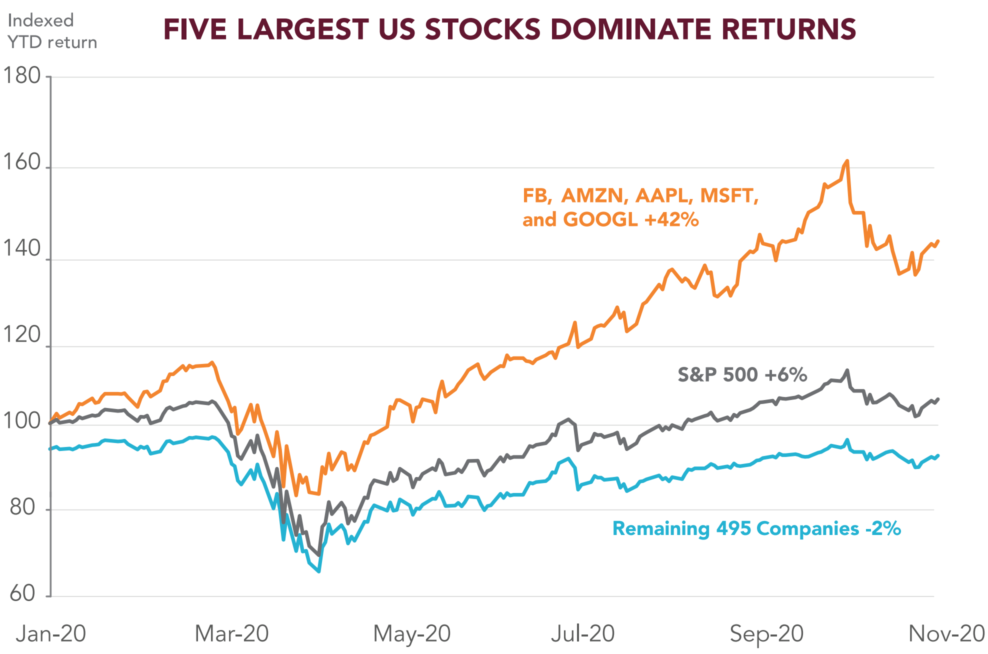

**Source of Data:** Department of Commerce, Goldman Sachs Global Investment Research.

Applications to start a new business are a leading indicator for potentially lower unemployment. The level of new business starts surged in the 3rd quarter to the highest level ever. Part of this could be explained by backlog of unprocessed business licenses due to the Covid-19 shutdown as well as business owners closing down during Covid-19 and opening up again. It's also likely that many people had more time to work on business plans during Covid-19 and found new opportunities, which explains a portion of the startup surge and is an encouraging sign as we move into 2021.



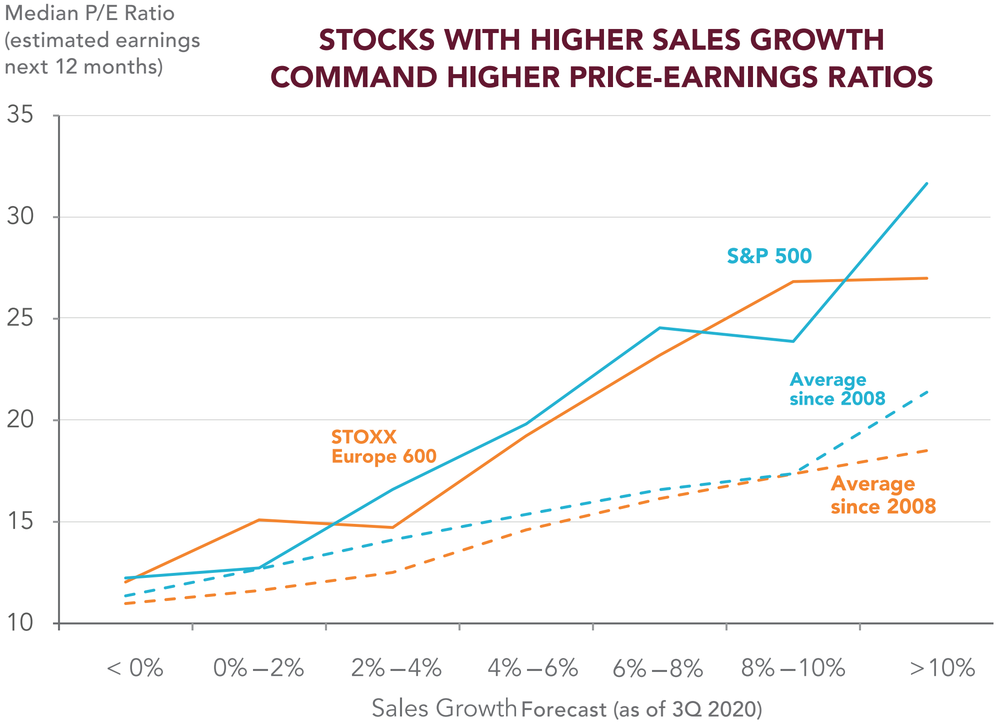

**Source of Data:** Bureau of Economic Analysis.

In the US, the CARES Act passed by Congress in spring 2020 was effective in making up for lost wages and keeping personal income on trend. However, as time has passed and the government benefits have elapsed without extension, wages remain depressed without the commensurate support of organic business growth. With Covid-19 disruption estimated to last well into 2021, another round of stimulus is likely necessary to avoid a delay or step back in the recovery.



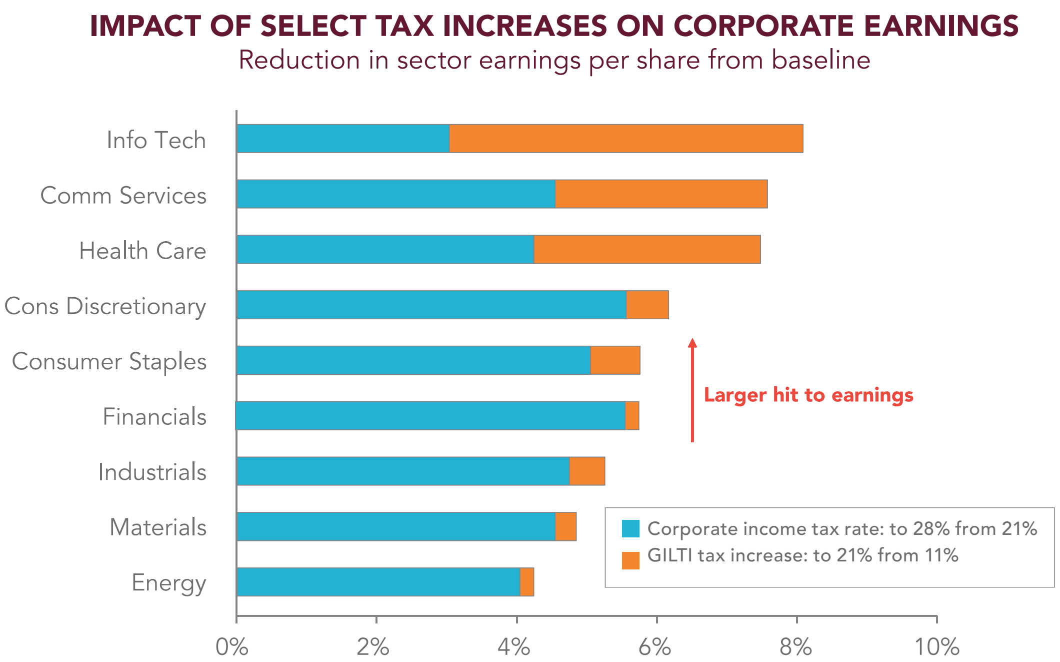

**Source of Data:** Goldman Sachs Global Investment Research.

The five highest-valued stocks in the US market -- Apple, Microsoft, Amazon, Google and Facebook -- collectively make up 23% of the S&P 500 Index, the highest concentration on record. Their shares have gained a weighted average of 42% this year (through 9/30/2020). By comparison, the 495 other stocks in the S&P are down 2% during this period. This concentrated, narrow performance could make market gains harder to come by unless there is a broader market recovery that lifts cyclicals (economically sensitive stocks) in the fourth quarter and into 2021.




**Source of Data:** Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

Large growth stocks have been outperforming value stocks (slower growth, less expensive) for a long time, both in the US and abroad, and this has continued into 2020. The scarcity of growth businesses has led investors to pay a high premium for companies that can continue to grow, especially in difficult environments (i.e. large US technology companies, healthcare and consumer staples). Low interest rates and low inflation, which are expected for the next few years, make the net present value and future cash flows of growth businesses all the more attractive.

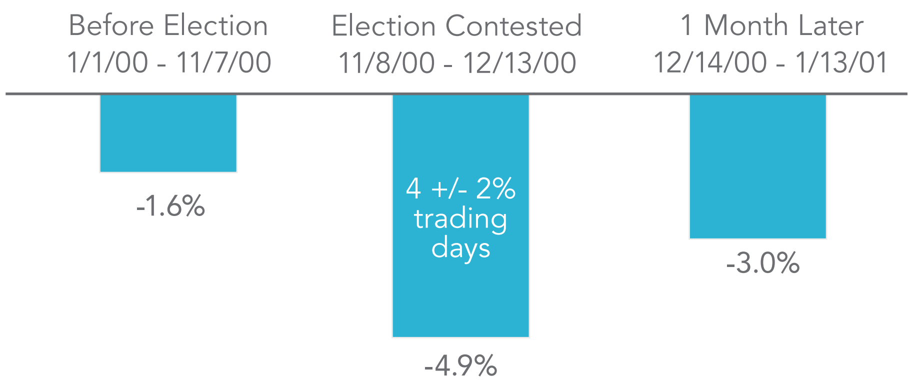



**Source of Data:** Goldman Sachs Global Investment Research.

A Democratic "blue sweep" in the November elections could result in new tax policy that causes significant disruption to some of the best-performing sectors so far in 2020, such as technology and healthcare. The Democratic reforms include raising the US corporate rate back to 28% (21% currently), a minimum corporate tax rate, and higher taxes on "GILTI," the income earned by foreign affiliates of US companies on patents, trademarks, copyrights and other intangible property. As investors reassess earnings forecasts across industries, this could lead to sector rotation.

## S&P 500 RETURNS DURING CONTESTED PRESIDENTIAL ELECTION OF 2000

JAN. 1, 2000 - JAN. 13, 2001



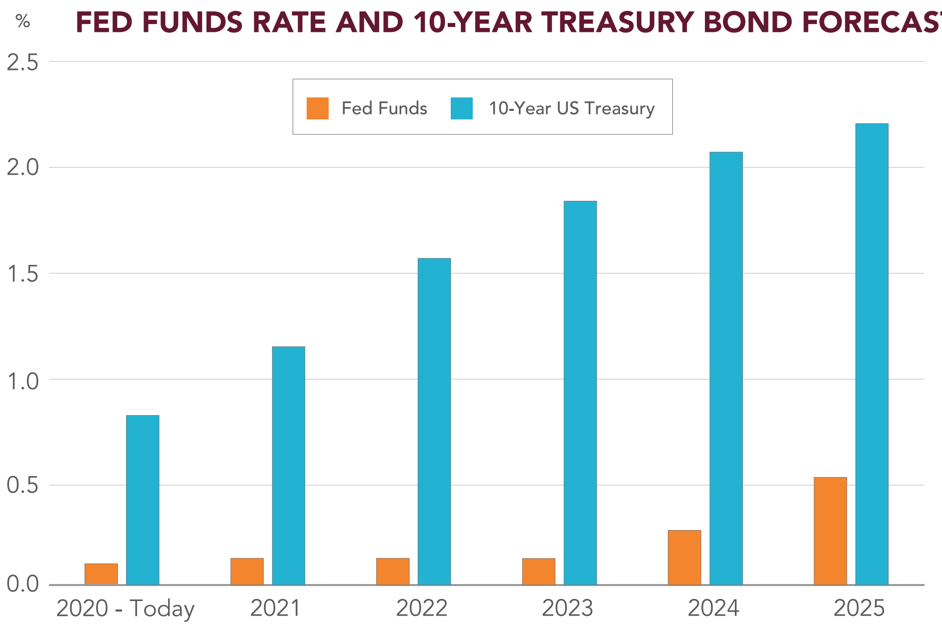

### TIMELINE IN 2000

Nov. 7: Election day
Nov. 8: Gore retracts concession
Nov. 16: The Florida Supreme Court permits manual recounts
Nov. 27: Gore sues to contest election in Florida
Dec. 12: US Supreme Court stops Florida recounts
Dec. 13: Gore concedes

**Source of Data:** Morningstar.

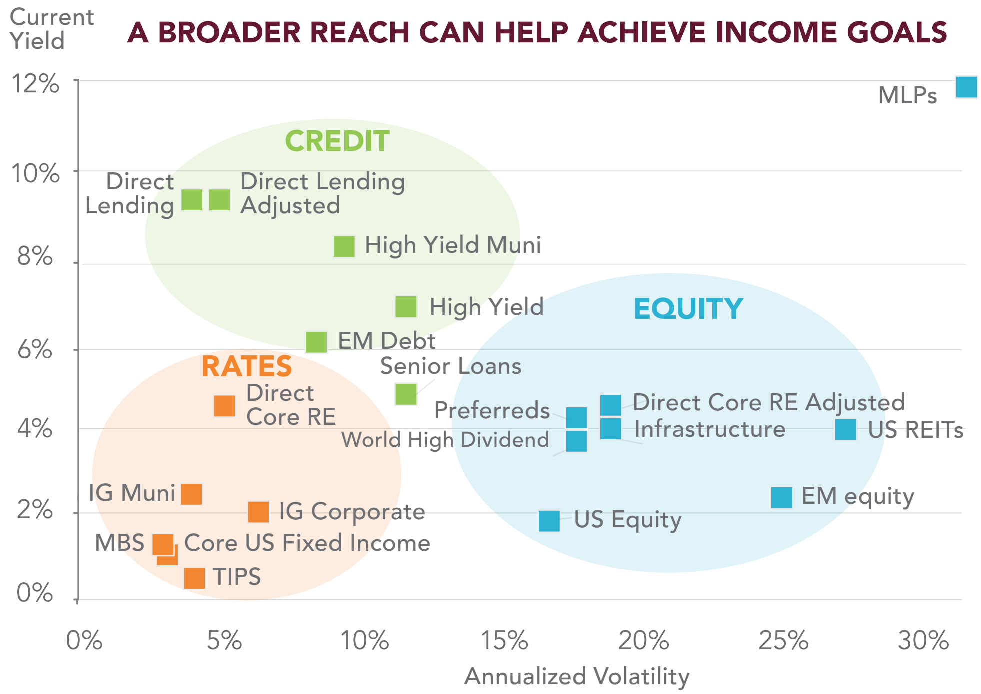
What if the US presidential election is contested by either candidate? In Bush vs Gore in 2000, we have a precedent that indicates how markets might react if we see another contested election this fall. As now, in November 2000 the US economy was in a slump but for much different reasons. In the roughly month-long period of uncertainly preceding the Supreme Court decision, US equity markets were volatile and finished down nearly 5%.

## WHERE ARE SHORT AND LONG INTEREST RATES HEADED? FED FUNDS RATE AND 10-YEAR TREASURY BOND FORECASTS




**Source of Data:** Oxford Economics, Bloomberg.

Short-term interest rates (the Fed funds rate at left) and longer-term rates (the yield on 10-year Treasury bonds at left) are expected to remain well below where they began 2020. The Fed has committed to keeping the short-end of the yield curve down and to let inflation run hot. If there is a "blue sweep" in the November election, the risk of accelerated inflation based on proposed Biden policies has us concerned that longer-term rates could rise more quickly than anticipated.




**Source of Data:** Nuveen's Global Investment Committee (GIC).

With interest rates hovering at historical lows and fixed income returns forecast to be muted, we are reevaluating our allocation to fixed income – the size of the allocation as well as its components. While most of the diversification benefits of high-quality bonds should remain intact, investors will likely need to look to other asset types, such as infrastructure and direct lending, to secure portfolio return and income objectives while accepting a higher level of realized volatility and risk.

# PRESIDENTIAL CAMPAIGN POLICIES

| | JOE BIDEN | DONALD TRUMP |
|---|---|---|
| Personal Tax | • Increase top individual tax rate for taxpayers with incomes above $400k to 39.6% from 37%<br>• Tax long-term capital gains and qualified dividends at the ordinary income tax rate for incomes above $1mn<br>• Impose payroll tax on wages earned above $400K<br>• Cap the value of itemized deductions for high earners | • Extend the individual income and estate tax provisions included in the 2017 Tax Cut and Jobs Act (TCJA)<br>• Reduce payroll taxes<br>• Reduce capital gains tax rate<br>First term policy actions:<br>• Reduced most individual income tax rates, including the top marginal rate to 37% from 39.6%<br>• Increased the standard deduction and eliminated the personal exemption<br>• Expanded the child tax credit<br>• Raised the exemption on the alternative minimum tax |
| Corporate Tax | • Increase the corporate income tax rate from 21% to 28%<br>• Impose a minimum 15% tax on US-based corporations with a book profit of $100mm or higher<br>• Offer a Manufacturing Communities Tax Credit to businesses that experience large workforce layoffs | • Offer "Made in America" tax credits to companies bringing jobs back to the US<br>• Introduce 100% expensing for essential industries that bring jobs back to the US<br>• Expand Opportunity Zones<br>First term policy actions:<br>• Lowered the corporate income tax rate to 21%<br>• Allowed for repatriation of foreign profits at reduced rate<br>• Eliminated the corporate alternative minimum tax |
| Trade | • Increase federal spending on goods made by US workers by $400bn<br>• Take aggressive enforcement actions against China and rally US allies to pressure China and other trade abusers<br>• Confront foreign efforts to steal US intellectual property<br>• Establish a "claw back" provision to force companies to return public funds when they move jobs overseas | • Enact trade deals<br>First term policy actions:<br>• Imposed tariffs on Chinese imports; Phase 1 trade deal<br>• Signed US-Mexico-Canada Agreement (USMCA) to replace NAFTA<br>• Signed revised FTAs with South Korea and Japan<br>• Withdrew from the Trans-Pacific Partnership (TPP)<br>• Imposed tariffs on steel and aluminum imports on national security grounds<br>• Implemented domestic safeguards for solar panels and washing machines |
| Infrastructure | • Create a $2tn clean energy and infrastructure fund to be deployed during the first term with a focus on transportation funding<br>• Invest $300bn in domestic R&D to improve US systems (clean energy, public health, telecoms and infrastructure) and promote domestic production<br>• Expand broadband, or wireless broadband via 5G, to all Americans | • Invest in America's infrastructure<br>• Establish a national high-speed wireless internet network/ invest in 5G networks |

Source: Goldman Sachs Global Investment Research.

# PRESIDENTIAL CAMPAIGN PROPOSALS

| | JOE BIDEN | DONALD TRUMP |
|---|---|---|
| Energy | • Achieve carbon neutrality in the US by 2050<br>• Achieve a carbon-pollution free power sector by 2035<br>• Rejoin the Paris Climate Accord and rally other nations to increase their emissions reduction targets<br>• Impose a carbon adjustment fee against countries that are failing to meet their climate and environmental obligations<br>• Expand several renewable-energy tax credits and end subsidies for fossil fuels<br>• Invest in the US automobile infrastructure, including 500K electric vehicle charging stations<br>• Upgrade 4mn buildings/weatherize 2mn homes in 4 years | • Continue deregulation<br>First term policy actions:<br>• Withdrew from the Paris Climate Accord<br>• Repealed the Clean Power Plan<br>• Lifted the ban on oil and gas exploration in the Arctic National Wildlife Refuge, US coastal waters, and elsewhere<br>• Rescinded most of the 2016 Methane Waste Prevention rule limiting venting and flaring on public lands |
| Immigration | • Establish a roadmap to citizenship for unauthorized migrants currently in the US<br>• End the practices of keeping immigrants in long-term detention, separating families, and conducting large-scale raids to arrest unauthorized migrants already living and working in the US<br>• Reinstate the DACA program<br>• Increase the number of employment-based visas granted each year and eliminate country-based quotas<br>• Raise yearly cap on refugees admitted to the US to 125K<br>• Reverse the expansion of the "public charge" rule | • Block illegal immigrants from becoming eligible for taxpayer-funded benefits<br>• Establish mandatory deportation of non-citizen gang members<br>• End sanctuary cities<br>• Prohibit American companies from replacing US citizens with lower-cost foreign workers<br>First term policy actions:<br>• Implemented ban on travel of citizens from 7 countries to the US that was expanded to cover 13 countries<br>• Attempted to end the Deferred Action for Childhood Arrivals (DACA) program<br>• Prioritized border-wall construction<br>• Instituted "zero tolerance" policy on illegal border crossings<br>• Lowered yearly cap on refugees admitted to US to 18K |
| Healthcare | • Provide individuals with the ability to purchase a public health insurance option like Medicare<br>• Eliminate income-level cap on tax credits for individuals purchasing insurance on government exchanges and lower the limit on the cost of coverage<br>• Lower the Medicare eligibility age from 65 to 60<br>• Allow for direct Medicare negotiation of drug prices<br>• Spend $125bn over 10 years to scale up drug addiction treatment and other prevention and recovery programs | • Reduce prescription drug prices<br>• Lower healthcare premiums<br>• End surprise billing<br>• Cover all pre-existing conditions<br>• Protect veterans and provide them with high-quality healthcare and services<br>First term policy actions:<br>• Repealed the individual mandate created by the Affordable Care Act |

Source: Goldman Sachs Global Investment Research.

## ABOUT THE AUTHOR

**Gino Perrina**, Ph.D., CFA is the Chief Investment Officer at Laird Norton Wealth Management and has more than 15 years of experience in investment analysis, strategy and risk management. Prior to joining LNWM in November 2015, Gino was a Managing Director at BlackRock Inc. in New York City, responsible for managing risk in the firm's alternative asset portfolios (+$100 billion in total investment). He was also Managing Director of Research and Risk Management at BlackRock Alternative Advisors (2006 to 2010), Head of Fixed Income Research at Russell Investments (2010 to 2012) and a fixed income analyst and portfolio manager at Microsoft and IAC/InterActive Corp.

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With more than $5 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 600 individuals, families, business leaders, private foundations and nonprofit organizations.

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