The Potential Impact of Current Events on the Economy and Capital Markets

Q&A | December 2020

There are various risk factors and moving parts that should be considered when it comes to proper asset allocation. To better understand the firm's views concerning a range of topical issues, we conducted the following Q&A session with Floyd Simpson III, CFA, CFP and Surya Pisapati, CFA. Floyd is a senior managing consultant and works with clients across the country to develop and implement multi-asset class strategies for their portfolios. Surya serves as the lead for global equity manager research within the multi-asset class management team. She is responsible for both manager selection and oversight.

The election has left us with what appears to be a divided government. What are your thoughts on this and its potential impact on the economy and capital markets?

Simpson: A divided government should, at least in theory, bring about more moderate government solutions when it comes to stimulus, spending and other legislation. A greater compromise between the two major political parties should also, we posit, lead to less volatility in our economy and capital markets. Incidentally, we are also optimistic when it comes to trade. We think that Joe Biden's comments and platform of renewing old alliances have the potential to stimulate both the domestic economy and, by extension, the capital markets.

All of this, of course, comes with a couple of caveats. First, it assumes that the Republican party will retain the Senate and win at least one of two seats in the Georgia run-off elections in January. It also assumes that more extreme Congress members (on the left and the right) do not control the dialogue or hold substantial sway over the legislative agenda. Those are two big "ifs."

Do you think that COVID-19 will continue to dominate the market's mindset throughout 2021?

Pisapati: The uncertainty around the coronavirus spread, containment efforts, effective vaccine development and the subsequent economic reopening led to substantial volatility in the capital markets throughout 2020.

That said, as governments roll out vaccination campaigns in early- to mid-2021, we believe that the focus of investors will begin to shift from the virus to the resurgence in manufacturing and services activity. Remember that there is a fair amount of pent-up demand from households and corporates given the muted economic activity we witnessed in 2020, which could in turn, translate into higher demand in 2021.

What do you see as far as the prospect for additional fiscal stimulus given the results of the election and the recent uptick in virus cases throughout the U.S.?

Pisapati: We believe that we are now in what some might term a "K-shaped" recovery. In other words, certain segments of the labor market are struggling to make ends meet as the shutdowns disrupt their livelihood. However, those deemed "essential" or heavily influenced by technology before this period are likely to continue to do well despite the virus and related economic shutdowns.

The recent decline in the growth of non-farm payrolls, increase in continuing unemployment claims and improved dialogue among Democrat and Republican leadership leads us to believe that we should see additional stimulus measures being passed relatively soon. However, the problem is how long it may take Congress to pass further stimulus measures and distribute relief to the public. The issue or concern is that the executive orders and CARES Act provisions

expire at the end of the year. And so, the bottom line is that time is of the essence when it comes to fiscal stimulus.

We should also mention that as the new administration is sworn in next year, we could see further fiscal outlays/stimulus programs in some form, perhaps in increased infrastructure spending. It seems infrastructure is an area where both parties are willing, at least to some capacity, to work together.

With regard to fixed-income securities, what do you see as the biggest areas of opportunity and concern in the year ahead?

Simpson: In looking at the year ahead, our biggest concern is the low rate of expected returns for this asset class. The bottom line is that the current interest rate environment does not bode well for duration-based assets.

We are still positive on spread sectors within fixed-income and see an opportunity to add alpha through allocation to credit risk in a diversified manner. We argue that the hunger for yield has created an insatiable appetite for higher-yielding assets. But with covenants being generally a bit weaker than in the past, it necessitates a keen eye on risk management.

On the topic of monetary policy globally, what trends can be expected and how might the investment community be impacted?

Pisapati: The COVID-19 pandemic led to unprecedented policy action from several central banks. In the U.S., the Federal Reserve cut interest rates and embarked on various lending/asset purchasing programs that helped provide liquidity in the marketplace. Central banks took similar actions across the globe in an effort to spur economic activity. We expect this accommodative monetary policy to continue as the recovery unfolds across the world. We further believe that accommodative policy action will not be discontinued until the broader global economy, which is still quite fragile, reaches a sustainable growth level.

Simpson: In addition to what Surya mentioned, one concern we have is that many emerging market economies could struggle with higher debt loads when central banks eventually reduce or eliminate their accommodative policy. While most economies have entered this recession with better current account deficits than seen during past crises, economies that printed money when rates were low could see inflation increase if they are not able to financially recover in a timely fashion.

For more information, please contact your PFM relationship manager.

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