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Capital Markets Review and Outlook

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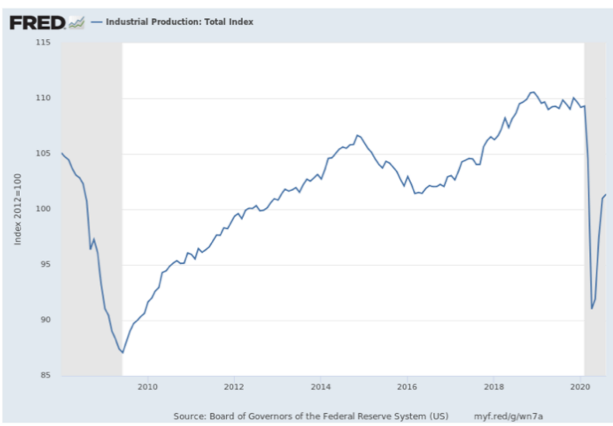
Economy and Outlook

In the final month of the 3rd quarter of the year, volatility picked up in the financial markets. In addition to the on-going global coronavirus pandemic, the upcoming and contentious U.S. presidential election has also become a focal point. The pandemic continues to exact its toll with over 35 million infections worldwide, and fatalities that have now exceeded the one million mark. The number of confirmed cases in the United States is over 7 million, while the number of people who have died from the disease is now over 210,000. The opening up of economies from the strict government-mandated lockdowns in the early days of the pandemic, together with unprecedented fiscal and monetary stimulus have resulted in a resurgence in economic growth. As the chart on the left shows, U.S. industrial production is up +11.4% since bottoming in April. Also, a key proxy for business investment, nondefense capital goods orders excluding aircraft is now above the level it reached back in January, before the covid-19 crisis. While the headline September employment report showed fewer than expected jobs gains (+661,000 compared to expecations of +800,000) for the month, the smaller than expected increase was primarily due to the decline in government employment as at-home schooling continued across large parts of the country. Of course, over 10 million jobs, representing almost half of the total number of jobs lost since March, remain to be recovered. As a result, U.S. Federal Reserve officials repeatedly emphasize the need for more government spending to help sustain the economic recovery. In an effort to break the logjam in Congress, the Democrats have pared back their stimulus figure to $2.2 trillion while the corresponding figure from the White House is at $1.5 trillion. Since negotiations are continuing, there is hope that a compromise spending package will soon be reached.



In other parts of the world, such as Europe, accelerating infection rates have forced governments to re-impose tighter restrictions which have led to a renewed slowdown in economic growth. Purchasing manager surveys for the services sector in several countries showed declining levels of activity in September. In response, European countries are extending support to businesses by lengthening suport periods. For example, wage subsidies in Germany and France are being extended by one to two years.

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Progress in vaccine development and therapeutics is increasingly positive. Just a few months ago, the timeframe for producing an effective vaccine was 18 months. Now, it is quite likely that multiple vaccines for Covid-19 may be available by the end of this year. Significant progress has also been made on the therapeutics front as seen in the reduction in mortality rates from Covid-19. Even before the deployment of a successful vaccine, an additional element that is likely to roil the financial markets is the upcoming elections for the president of the United States and for Congress. While volatility will rise in the near-term, it is critically important for institutional investors to focus on the long-term and not make knee-jerk changes in response to short-term events. A year from now, the elections will have been long over, and Covid-19 will presumably be under control. At the end of 2019, the U.S. economy was the strongest it had been in many years; this was derailed by the coronavirus pandemic, not by an underlying financial or economic problem. We are, therefore, likely to move in the direction of a more "normal world" as 2021 unfolds.

Equity Markets

After five consecutive months of strong gains, equity markets lost some ground in September as the U.S. presidential election drew closer. The broad domestic equity market represented by the Russell 3000 Index fell -3.6% in September. For the first nine months of the year, the Russell 3000 is up +5.4%. In terms of capitalization, Mid Cap (-1.9%) and Small Cap (-3.3%) outperformed Large Cap which declined -3.6% in September. However, for the third quarter as well as for the first 9 months of the year, Large Cap maintains a sizeable margin of outperformance over the other two capitalizations. In September, there was a reversal in investment performance by Style only for the Large Cap segment as Value outperformed Growth by +224 bp. However, for both Mid Cap and Small Cap capitalizations, performance by Style continued its trend this year with Growth outperforming Value by +87 to +251 bp. For the third quarter of the year as well as for the year-to-date period, Growth has outperformed Value by a substantial margin across all capitalizations as shown in the table on page 3. As is typically seen in market downturns, Cyclicals underperformed Defensives in September. While Energy (-14.5%) was the biggest underperformer, Communications Services (-6.5%), Technology (-5.4%) and Consumer Discretionary (-3.6%) were also laggards for the month. Utilities (+1.1%) and Materials (+1.3%) were the only sectors with positive returns. Year-to-date, Energy was the worst performing sector losing almost half its value (-48.1%) due to the prolonged weakness in energy prices, while the growth-heavy Technology sector was the best performer (+28.7%). Despite the rise in the U.S. dollar against most currencies except the Japanese yen, international equity markets outperformed the U.S. in September. While major equity markets in Europe dropped by -3% to -5%, the Developed Markets index, MSCI EAFE declined only -2.6% helped by the +1% rise in the Japanese equity market, the largest component (25%) of the EAFE Index. The MSCI Emerging Markets Index performed even better with a decline of -1.6% for the month. Although Brazil has been detrimentally affected by the large and rising number of Covid-19 infections which led to the sharp -7.1% decline in its equity market, other emerging markets performed better; India, Korea and Taiwan had positive returns ranging from +0.6% to +3.1%. In the third quarter, Emerging

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Markets with a return of +9.6% outperformed the broad U.S. market by +40 bp. However, year-to-date both Emerging Markets (-1.2%) and Developed markets (-7.1%) are significantly behind the U.S. equity market's +5.4% return.

Fixed Income Markets

The decline in equity markets generated a bid for the safety of U.S. Treasury securities and pushed Treasury yields lower in September. While the front-end of the Treasury yield curve was little changed, yields on long maturity Treasury securities declined by 3 bp with the 10-year and 30-year maturities ending the month at 0.69% and 1.46% respectively. The yield on the 5-year Treasury note was unchanged at 0.28%, while the 2-year note was lower in yield by 1 bp to 0.13%. For the month, the Treasury yield curve flattened with the 2-year/30-year spread narrowing by 2 bp to +133 bp. Since the beginning of 2020, the coupon curve has steepened +52 bp. In line with the weakness in equity markets, investment grade corporate bond spreads widened 6 bp in September leading to an underperformance of -38 bp over duration-matched Treasuries. The corporate quality curve and credit curve both steepened for the month as BBB-rated bonds underperformed Single-A rated Issues by -4 bp, and long maturity bonds underperformed short and Intermediate Issues by an average of -38 bp. Like the equity markets, Energy was the worst performing investment grade sector with an excess return of -129 bp, while Transportation (+11 bp) and Technology (-3 bp) were outperformers. The Investment Grade Index generated a total return of -0.3% for the month, and +6.4% year-to-date. As expected in the risk-off market environment in September, the High Yield sector performed worse than the Investment Grade sector as the average high yield spread widened by 40 bp resulting in an underperformance of -107 bp (in excess returns terms) for the overall sector. Despite this underperformance, the quality curve flattened with Single-B and Caa bonds outperforming the higher quality Ba sector by an average of +120 bp. On a total return basis, the best performing sectors for the month include Aerospace/Defense (+1.4%) and Airlines (+0.9%), while Oil Field Services (-6.1%) was the worst performer. The High Yield sector had a total return of -1% in September as its higher coupon was more than offset by the significant widening in spreads. This reduced the High Yield Index's year-to-date return to +0.6%. Although yields in several international government bond markets declined in September by more than the decline in U.S. Treasury yields, the FTSE non-US WGBI Index underperformed the U.S. government bond market as the U.S. dollar rebounded strongly against most currencies for the month. In September, the FTSE non-US WGBI index lost -0.4% compared to the +0.1% increase for the U.S. government bond market. International bond markets had a strong third quarter with a return of +4.9% compared to just +0.2% for the U.S. However, on a year-to-date basis, the U.S. government bond market's return of +8.8% is +290 bp ahead of the international bond market despite the -2.4% decline in the U.S. dollar index in 2020. The currency decline was more than offset by the significant narrowing in the yield spread differential between the U.S. and international bond markets this year.

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		Returns as of 9/30/20 (In %)					
		Month	Q3	YTD	1 Year	3 Years	5 Years
Russell 3000®	US AllCap Equity	-3.6	9.2	5.4	15.0	11.7	13.7
Russell 1000®	US Large Cap Equity	-3.7	9.5	6.4	16.0	12.4	14.1
Russell 1000® Growth	US Large Cap Growth	-4.7	13.2	24.3	37.5	21.7	20.1
Russell 1000® Value	US Large Cap Value	-2.5	5.6	-11.6	-5.0	2.6	7.7
Russell Midcap®	US Mid Cap Equity	-2.0	7.5	-2.4	4.6	7.1	10.1
Russell Midcap® Growth	US Mid Cap Growth	-1.4	9.4	13.9	23.2	16.2	15.5
Russell Midcap® Value	US Mid Cap Value	-2.3	6.4	-12.8	-7.3	0.8	6.4
Russell 2000®	US Small Cap Equity	-3.3	4.9	-8.7	0.4	1.8	8.0
Russell 2000® Growth	US Small Cap Growth	-2.1	7.2	3.9	15.7	8.2	11.4
Russell 2000® Value	US Small Cap Value	-4.7	2.6	-21.5	-14.9	-5.1	4.1
MSCI ACWI ex-US	Global Equity ex-US	-2.5	6.3	-5.4	3.0	1.2	6.2
MSCI EAFE	Global Developed Mkts Equity	-2.6	4.8	-7.1	0.5	0.6	5.3
MSCI EM	Emerging Mkts Equity	-1.6	9.6	-1.2	10.5	2.4	9.0
Bloomberg/Barclays US Agg	US Core Fixed Income	-0.1	0.6	6.8	7.0	5.2	4.2
Bloomberg/Barclays US Interm. Agg	US Intermediate Fixed Income	0.0	0.5	5.2	5.7	4.2	3.3
Bloomberg/Barclays US Credit	US Corporate Bonds	-0.3	1.5	6.4	7.5	6.2	5.7
Bloomberg/Barclays US MBS	US Mortgage Backed Securities	-0.1	0.1	3.6	4.4	3.7	3.0
Bloomberg/Barclays US Corp HY	US High Yield	-1.0	4.6	0.6	3.3	4.2	6.8
FTSE Non-US WGBI	Global Fixed Income ex-US	-0.4	4.9	5.9	5.9	3.6	3.9