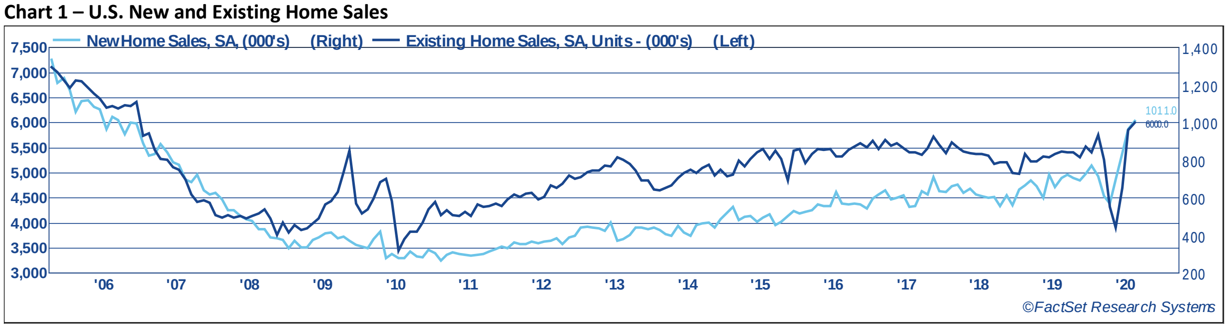
Analyzing the economy is like working on a perpetual puzzle where the pieces are constantly changing shape and size. When Covid-19 hit the nation's economy hard last March, it was as if someone walked up to the table and swiped the puzzle onto the floor. No one had a clue what the impact was going to be except that it was going to be a substantial and historic hit. Early Covid-19 monthly consensus economic estimates were all over the board and widely missed the mark on many economic data fronts. Second-quarter 2020 GDP consensus estimates where not too far off from actual as the U.S. economy posted a historic decline of -31.4% vs. the original estimate of -34.5%.

When state economies began to open back up last spring, the questions began about what shape the economic recovery was going to take? Would it be V-shaped, L-shaped, or K-Shaped? Now that six months have passed, the main body of the puzzle has taken shape but there are still many missing pieces to be found and put into place. While the stock market has been aggressively pricing in a V-shaped recovery, the underlying fundamental data suggests the economy is so far taking on a K-shaped recovery. Covid-19 has accelerated the transformation of the economy with the most glaring illustration being its impact on real estate markets.

Residential housing market trends are presently a barbell between good and bad, or the top and bottom arm of the letter K. On the top side, many residential real estate markets are experiencing explosive demand for new and existing homes from a wave of individuals seeking to transition to working remotely full-time. New and existing home sales have soared to the highest level they have been since fourth-quarter 2006 and first-quarter 2007, respectively. During the lockdowns, individuals and businesses across the nation have come to the realization that people can perform their job just as effectively working from home as at the office, and that home office can basically be from anywhere USA. People are on the move and are looking to upgrade to a lifestyle that fits them.

Chart 1 – U.S. New and Existing Home Sales

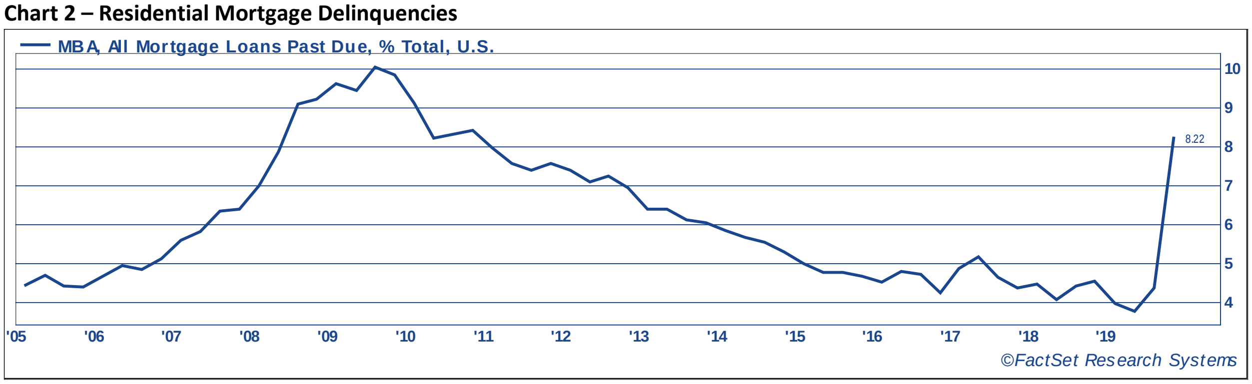


For whatever the motivation is, individuals now have job location flexibility. The technological mechanisms that allow for such flexibility are software advances, increased bandwidth, and an abundance of cloud capacity. If this were 10-15 years ago, the decision to shelter-in-place and work from home would have been a disaster as the technology and capacity was not as advanced then as it is today. The lockdowns have greatly accelerated trends that were already taking place. From an economic perspective, the secular transformations taking place will lead to the growth of existing and new industries and to the decline or demise of other industries.

On the downside of the residential real estate equation is the fact household delinquencies have risen sharply since mid-March. According to a Mortgage Bankers Association (MBA) second-quarter 2020 survey report, an estimated 4.2 million homeowners were in forbearance on their mortgage loans.

Additionally, the MBA reported on August 17 that the delinquency rate for mortgage loans on one-to-four-unit residential properties (including loans in forbearance) increased to a seasonally adjusted rate of 8.22 percent of all loans outstanding. This is the highest quarterly delinquency rate since second-quarter 2011. Generally speaking, forbearance of conventional mortgage payments can be deferred in six month increments for up to a year. If the forbearance period does in fact end in the first quarter of next year, we expect home defaults and foreclosures to rise but not to the extent of the 4.2 million people currently in forbearance as it is likely, and hoped, that many will find employment.

Chart 2 – Residential Mortgage Delinquencies



Similar to the residential mortgage market, the commercial real estate market has been severely impacted from the shelter-in-place mandates as 30-Day Commercial Mortgage-Backed Security (CMBS) delinquencies rose to 9.60% as of 2Q20, which is the highest reading in history, including the recent Great Recession. More specifically, a recent MBA report cited "the Covid pandemic had a dramatic and immediate impact on lodging and retail properties." With the tsunami of people seeking to work remotely, as evidenced by the strong housing demand, we expect office property delinquencies to rise in the second half of this year as well.

Like the real estate market, the labor market recovery seems to be K-shaped as well whereby higher educated, higher-wage, knowledge-based workers are currently less impacted while less educated, lower-wage, service-oriented workers are more greatly affected. Since losing 22.2 million jobs last March and April, the labor market has gained back 51.4% of the jobs lost or 11.4 million jobs, and the unemployment rate has dropped from 14.7% in April to 7.9% in September. The number of people presently unemployed stands at 12.6 million with another 6.3 million people who are working part-time but want to work full-time.

After posting the largest monthly job gain in history of 4.8 million jobs in June, the pace of monthly job gains has slowed each of the past three months calling into the question the strength of the economic recovery. Additionally, weekly initial jobless claims continue to remain extremely elevated. As the Fed recently noted, "those least able to shoulder the burden have been hardest hit." With much heavy lifting still to do on the labor front, the Federal Reserve has been doing everything it can to stimulate the economy and expand employment.

In September, the Federal Reserve employed average inflation targeting and updated its forward guidance on the expected path of the Fed funds rate. The new inflation measure will involve average inflation targeting where the Fed would allow the economy to run hot and for inflation to run higher than the 2% target without taking timely actions to quell higher inflation rates. Inflation rates have been muted for the past two decades and the Fed is now concerned that weak demand and low oil prices may put downward pressure on inflation. Their tepid inflation forecast shows inflation not reaching the target rate of 2% until 2023.

The Fed's updated forward guidance forecasts the fed funds rate to remain unchanged though 2023. Essentially, short- and long-term rates are expected to remain low for the foreseeable future and this was evident this past quarter as treasury yields barely moved with the 2-year and 10-year bond yields remaining stable.

In response to the economic lockdown last March, the Fed took aggressive action and lowered the Fed funds rate to 0.25% and subsequently implemented many additional policy measures to provide market liquidity and the flow of credit. Investment and non-investment grade credits spreads moved lower (tightened) again last quarter and municipal and high yield bonds saw stronger investor demand as reflected in the bond returns below.

Table 1 - Fixed Income Index Total Returns – as of September 30, 2020

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays Aggregate	-0.05	0.62	6.79	6.98	5.24	4.18	3.64
Barclays Inter Gov't/Credit	-0.01	0.61	5.92	6.32	4.43	3.39	2.91
Barclays Municipal	0.02	1.23	3.33	4.09	4.28	3.84	3.99
Barclays High Yield	-1.03	4.60	0.62	3.25	4.21	6.79	6.47

The Fed's aggressive steps, along with fiscal policy action taken such as the CARES Act passed by Congress last March, provided much needed financial support to households and businesses negatively impacted by the Covid-19 crisis.

Stock markets have rallied strongly from the support of recent monetary and fiscal policy actions, but investors expect more on both fronts. After rallying for five months in a row, stock markets retreated in September on lack of breadth in the rally, disappointment that the Fed did not announce or imply additional monetary policy initiatives, by the lack of progress for Congress to pass additional economic relief measures, and on doubts about the strength of the economic recovery. Still, stock markets had strong third-quarter returns but are mixed on a year-to-date basis with the tech-heavy NASDAQ being the strong positive outlier.

Table 2 – Stock Index Total Returns – as of September 30, 2020

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	-5.10	11.24	25.33	40.96	21.05	20.63	18.12
S&P 500	-3.80	8.93	5.57	15.15	12.28	14.15	13.74
Dow Jones Industrial	-2.18	8.22	-0.91	5.70	9.98	14.02	12.69
MSCI Emerging	-1.60	9.56	-1.16	10.54	2.42	8.97	2.50
MSCI Developed	-2.60	4.80	-7.09	0.49	0.62	5.26	4.62
S&P 400	-3.25	4.77	-8.62	-2.16	2.90	8.11	10.49
Russell 2000	-3.34	4.93	-8.69	0.39	1.77	8.00	9.85

The rally in U.S. stock markets has not been as broad-based as we would like to see and mainly concentrated in a handful of big tech names knows as the FAMANG stocks (Facebook, Apple, Microsoft, Amazon, Netflix, and Google). These six stocks comprise roughly a 25% market weight in the S&P 500 and have greatly benefited from the shelter-in-place mandates and investor enthusiasm. On a year-to-date basis, of the eleven sectors within the S&P 500 Index, five remain in negative return territory with two sectors posting very strong returns.

Table 3 – S&P 500 Index Sector Total Returns – as of September 30, 2020

Sector	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Information Technology	-5.37	11.95	28.69	47.23	28.10	27.18	20.50
Consumer Discretionary	-3.62	15.06	23.38	28.89	20.48	17.03	18.17
Communication Services	-6.47	8.94	8.60	18.37	9.31	10.59	9.43
Materials	1.34	13.31	5.47	12.19	6.22	12.18	9.42
Health Care	-2.15	5.87	5.01	20.11	11.08	11.88	15.40
Consumer Staples	-1.48	10.38	4.13	7.79	9.04	9.40	11.77
Industrials	-0.76	12.48	-3.99	1.32	4.53	10.84	11.58
Utilities	1.13	6.14	-5.68	-4.97	7.53	10.33	10.68
Real Estate	-2.04	1.92	-6.78	-7.28	6.67	7.92	10.49
Financials	-3.48	4.45	-20.22	-11.87	-0.14	7.82	9.69
Energy	-14.51	-19.72	-48.09	-45.24	-20.42	-9.70	-3.16

In some respects, 2020 periodic U.S. stock returns are indicative of the changes, both structurally and cyclically, that are taking place in the U.S. economy. They are also reflective of investors utter disregard to the level of uncertainty and challenge still facing the U.S. economy relative to current fundamental valuations. Let us not forget the upcoming elections and the potential impact these outcomes may have on the markets as well. We continue to employ a cautious tactical approach with a modest underweight to stocks and overweight to bonds and cash.

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Sources: FactSet, U.S. Department of Labor, Mortgage Bankers Association, and Federal Reserve