



The Colony Group

MARKET PERSPECTIVES

► QUARTER THREE 2020

We are three quarters of the way through the calendar year, and already 2020 has experienced far too many unforgettable moments. The rally in equity markets, however, is one that investors will enjoy remembering. Indeed, the S&P 500, which returned +8.9% for the quarter, set a series of record highs during the first two months of the quarter. Bond market returns were more subdued, even as the Federal Reserve (Fed) announced a significant strategic change to its objectives that promises to keep rates lower for the foreseeable future.

Equity markets carried their momentum from the previous quarter into July and August. In fact, the combined second- and third-quarter returns were the strongest for the U.S. equity market since 2009. Momentum slowed in September, however, as a resurgence in new COVID cases caused the economic recovery to decelerate. September was the first negative-return month for the S&P 500 since March. Outside the U.S., equity markets produced positive returns but continued to lag, largely due to lower exposure to stronger performing sectors such as technology and healthcare. Encouragingly, participation in the equity markets' recovery broadened during the final month of

the quarter, as several lagging segments outperformed relative to the narrow list of winners that has led the recovery so far – an important and healthy development for the equity markets.

Interest rates remained relatively stable during the third quarter despite a significant shift from the Fed in its approach to managing inflation. In late August, Fed Chairman Jay Powell announced that its policy-making committee will adopt a more flexible approach to its 2% inflation target. Moving forward, inflation will be allowed to run higher than target for sustained periods of time following periods where it was below target. Under this new regime, the Fed's target rate is not expected to rise until 2023, providing extended support of the economy. While this does raise some questions about the longer-term impact of inflation, the economy continues to show little evidence that inflation is a near-term problem.

The "silly season" has many connotations, but for U.S. politics, it is the period from early summer through October of an election year, when candidates are prone to political posturing and hyperbole in an effort to attract attention and raise money.

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The 2020 election cycle is on track to be “sillier” than usual due to extraordinarily high political division and the two candidates unable to engage voters in a conventional campaign because of the coronavirus. The first of three scheduled Presidential debates did not disappoint in this regard. In the remaining sections of this quarter’s Market Perspectives we preview how markets might react to a Trump or Biden victory in November.

As investors, we are not opining on which are the “right” policies;

rather, we need to determine how these policies might impact the markets. Many commentators have endorsed the idea that Vice President Biden would be universally bad for investment markets while President Trump would be good. We take a different view, believing that the impact on the markets over the subsequent four years from either candidate will be nuanced. Each of their major policy initiatives would produce winners and losers, assuming they are able to get them passed by Congress.

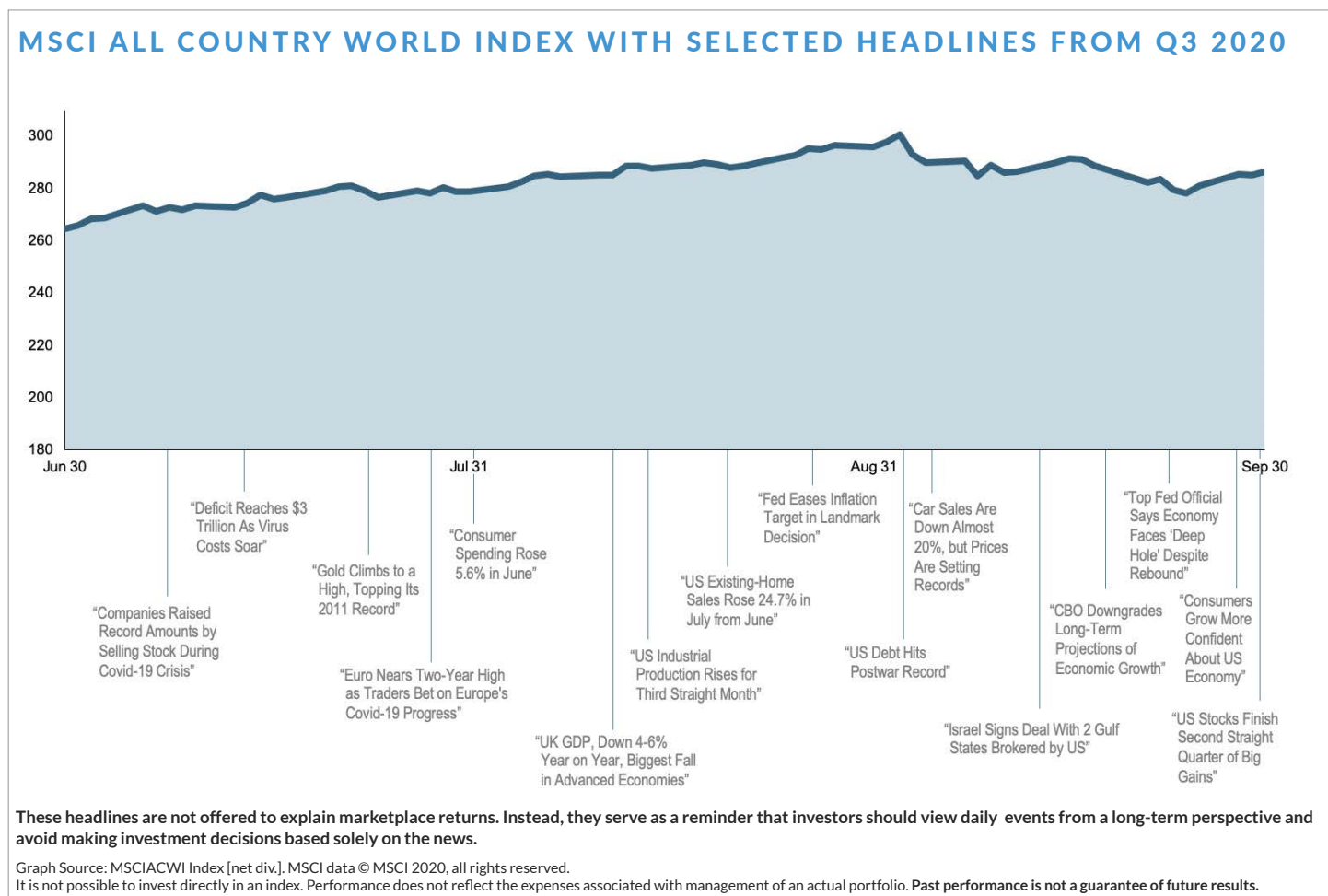
A Biden Presidency

As we suggested above, many experts believe that a Biden victory will be bad for U.S. equity markets. This is likely because some of Vice President Biden’s policies are aimed at undoing President Trump’s economic initiatives, such as tax cuts targeting the wealthy and financial deregulation, which have helped propel the market higher over his term.

Increased taxes, all else being equal, create headwinds for investors. According to Alpine Macro, Trump’s corporate tax cuts added approximately \$30 in earnings per share (EPS) to the S&P 500, representing a +20% boost to earnings growth in 2018. Biden’s tax plan, on the other hand, is expected to reduce EPS by \$13-16 or 8-10%. It is diffi-

cult to quantify the impact of Biden’s plans for increasing capital gains taxes on the markets, but this policy would undeniably make stocks less attractive on an after-tax basis.

Nevertheless, not all else is equal. Most of Biden’s proposed tax increases are designed to fund his fiscal spending initiatives. In fact, it is likely that the total of his spending programs will be far larger than any tax increases. For example, his infrastructure and clean energy programs are expected to be fiscally stimulative and, therefore, provide a boost to economic growth. The nonpartisan Congressional Budget Office produced estimates showing how changes to spending or tax policies affect national income. Fiscal spending almost always



yields a higher multiplier effect, generating a higher boost to national income for every dollar spent than tax cuts (see table). As such, we believe the net impact of Biden's policies would stimulate economic growth and corporate earnings, which is generally positive for equities.

On the surface, the Biden plan could produce some obvious winners in the stock market, including companies in the renewable energy and electric vehicles space. Material stocks would likely benefit if infrastructure spending increases. The healthcare sector, specifically managed-care stocks, could do well if Biden is able to defend and broaden the Affordable Care Act, although big pharmaceutical and biotechnology stocks may struggle with possible drug price controls. On the other hand, financial and energy stocks may suffer, as many regulations that were unwound by the Trump administration could be reinstated. We should emphasize, however, that regulation is only one component that drives a sector's or company's outlook. Energy is a notable example of outside forces overcoming regulatory tailwinds, as detailed below.

TYPE OF ACTIVITY	ESTIMATED MULTIPLIERS	
	Low Estimate	High Estimate
Purchases of Goods and Services by the Federal Government	0.5	2.5
Transfer Payments to State and Local Governments for Infrastructure	0.4	2.2
Transfer Payments to State and Local Governments for Other Purposes	0.4	1.8
Transfer Payments to Individuals	0.4	2.1
One-Time Payments to Retirees	0.2	1.0
Two-Year Tax Cuts for Lower- and Middle-Income People	0.3	1.5
One-Year Tax Cut for Higher-Income People	0.1	0.6
Extension of First-Time Homebuyer Credit	0.2	0.8
Corporate Tax Provisions Primarily Affecting Cash Flow	0.0	0.4

SOURCE: Congressional Budget Office (CBO). NOTE: The estimates above were produced for CBO's analysis of the American Recovery and Reinvestment Act of 2009.

A Trump Second Term

Despite many fears of a Trump presidency leading up to the 2016 election, the financial markets performed exceedingly well on his watch. As a result, a second term from President Trump is expected to be well received by the investment markets. The Trump campaign broke from tradition and did not put forth a lengthy campaign platform at the Republican convention, so his future policy initiatives are more difficult to discern. Therefore, we must rely on his track record of policies to date.

Trump is expected to continue to deregulate certain segments of the economy and push for lower taxes if reelected. Importantly, he would seek to make permanent those elements of his Tax Cuts and Jobs Act that are set to expire in 2025. While this extension is unlikely to provide a significant boost to markets, it would diminish some uncertainty for corporate executives as they create their investment plans for the next several years. The President has also discussed an infrastructure spending package, but it is notable that the administration and Congress were unable to find a compromise during his first term.

Should Trump win a second term, he would not have to worry about reelection anymore and would likely shift focus towards building a legacy. Based on polling, it seems likely that Trump would have to navigate a divided or Democrat-controlled Congress, potentially pushing his agenda towards foreign policy matters, an area where the President has greater latitude to act alone. This could cause some

angst across investment markets worldwide as trade frictions with China and, perhaps, the European Union may escalate. Recall that the market experienced volatility around the implementation of the China import tariffs.

Parsing the winners and losers from a Trump victory is a little more difficult than it is for Biden. For example, Trump has supported fossil fuel industries by rolling back regulations and relaxing drilling and mining restrictions. This has not translated into gains for those sectors, as many of these policies have helped foster additional supply and, consequently, declining commodity prices. Nevertheless, energy and financials would benefit from a more benign regulatory environment.

We have thus far focused on the candidates' influence on the equity markets, as that is where we believe their differences will have a more meaningful impact. Their policies may have a similar effect on the fixed-income markets, however. Neither candidate is showing an appetite for reining in our escalating budget deficits. Continued fiscal stimulus and an increase in bond supply could push bond prices lower and yields higher. Biden's tax policies and the Democrats' plan to increase support for state and local governments may create incremental demand for municipal bonds, helping that sector to outperform on a relative basis. On the other hand, Trump's push for deregulation within the financial sector could support the corporate debt markets.

WHAT THIS MEANS

We expect volatility to increase around the election. This one promises to be particularly tumultuous, made worse by the non-trivial possibility of a contested election. It could be that we do not know the winner until January 6, 2021, when the new Congress convenes to formally accept and count the states' submission of electoral votes. We strongly encourage clients to look past the volatility around Election Day and instead focus on a longer time horizon.

As we suggested in our introduction, this is the time during the election cycle when candidates make grandiose promises. Many of these promises will never see the light of day without the help of Congress. Therefore, despite much of the focus being on the Presidential election, we are closely watching the Senate as key to what transpires over the coming four years. With the House of Representatives expected to stay with the Democrats, the Senate could be the swing factor that determines what, if any, legislation either of the candidates will be able to push through.

Conclusion

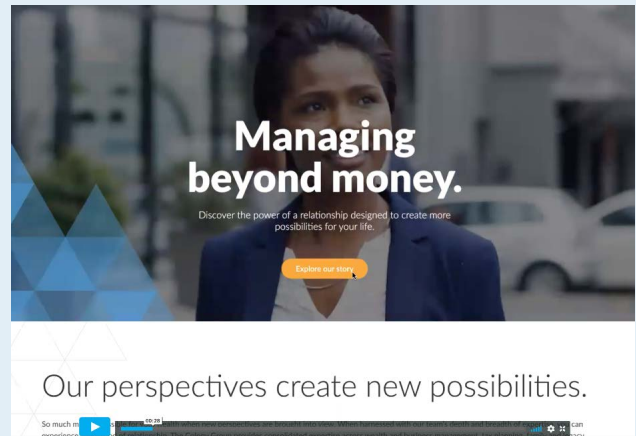
We expect more volatility over the next several months due to the heightened level of uncertainty. Investors will need to navigate a contentious election, decelerating global economic growth, and a surge in new COVID cases in many countries. Yet, we also see reasons to be hopeful. The uncertainties are most likely transitory. Indeed, we remain optimistic that the medical community will produce an effective treatment or vaccine for the coronavirus; that the economy will heal once social distancing measures are no longer required; and, lastly, that the U.S. will elect a President who will move forward with governing the country rather than slinging barbs at his competitor. While we remain vigilant and mindful of the risks, we would encourage you to read our recent blog post, "[Pessimism Sells, but Optimism Pays.](#)"

COLONY SPOTLIGHT

► The Colony Group Launches a New Website

The Colony Group is proud to announce the launch of our new website. Our digital home has been completely redesigned to provide you with an elevated experience. You will find interactive ways to learn more about our services, our latest insights, and our concierge service, [Curated by Colony](#).

We invite you to explore our virtual tour to learn more about our new website. Click on the image or this link to get started: [Colony Website Tour](#).



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