INVESTMENT MANAGEMENT

BOK FINANCIAL

Third Quarter 2020

ECONOMIC & MARKET REVIEW

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Chief Investment Officer
BOK Financial

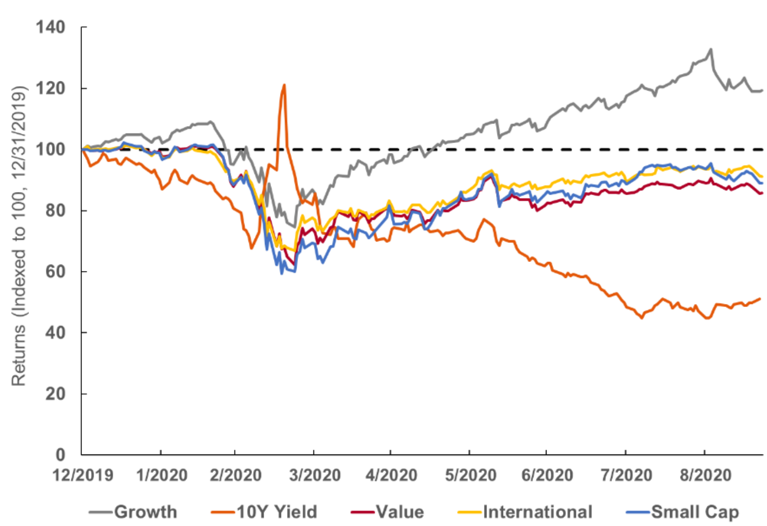
J. Brian Henderson was named Chief Investment Officer on May 1, 2020. Mr. Henderson started his career with BOK Financial in 1991, and has held multiple leadership roles across the investment management team during his tenure.

Time to Change Horses Midstream?

Riding on the backs of extraordinary U.S. fiscal and monetary policy support, domestic stocks overall continued their sharp recovery from the March lows to post positive gains for another quarter. The S&P 500 Index dashed towards a new all-time high of 3,588 in early September before finishing the third quarter up 8.9%. Sprinting alongside the rise in U.S. large cap equity indices has been the sharp snap-back in overall economic activity, which is providing encouraging fundamental support for these lofty equity levels early in the recovery. The pace of rehiring over the past five months has exceeded expectations, and 3rd quarter U.S. GDP growth could be up well over 20%. These are impressive early gains so far for both stocks and the economy. But not so fast – we still have a long stretch to go before we finish this race towards full recovery, and there are some hurdles we have to get over on the track ahead.

Taking a closer look at the rise in the economy and stock market, investors will see how uneven this recovery has been. The residential housing sector is booming with limited supply and record low mortgage interest rates, yet small businesses – particularly ones reliant on travel, entertainment, and face to face consumer services – are still in a lame state. Yes, the S&P 500 Index recently made new all-time highs, but did you know that the average stock in the index is still down on the year? The S&P 500 Index's average stock, major international indices, small and midcap stocks, high yield credit, and value equity styles have all stumbled out of the recovery gates due to COVID-19.

Uneven Recovery in the Stock Market



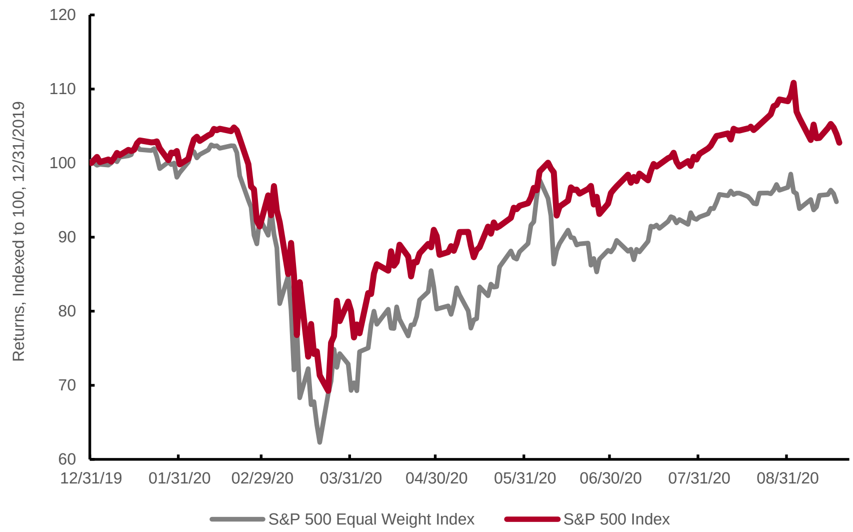
Key Points

- COVID-19 trends continue to dictate the pace and extent of economic reopening.
- The recovery in the economy and financial markets has been uneven.
- The Federal Reserve's new monetary policy framework leads to 0% short-term rates and more quantitative easing for longer.
- More fiscal stimulus expected over the medium-term.
- The financial markets are bracing for increased volatility around national elections. Overall, policies support growth in 2021.

Q3 Performance	
S&P 500	8.9%
Russell 2000	4.9%
Barclays Aggregate Bond	0.6%
MSCI EAFE	4.8%
MSCI Emerging Markets	9.6%

Ever since the Federal Reserve rang the bell with 0% interest rates in March, mega-cap technology stocks and 30-year Treasury bonds broke out early with returns of over 20% this year. At first, it may seem like an odd pair for both U.S. Treasury bonds and technology stocks to be performing so well together, but these two sectors have been racing higher on similar investor preferences for high credit quality, strong balance sheets and long duration assets in an environment of depressed inflation, secular sales growth, and negative real yields. While not reflective of the same composition of the U.S. economy, the technology sector represents approximately 30% of the S&P 500 Index, one of the highest concentrations amongst most of the major core equity indices, and a handful of these dominant mega-cap stocks are up over 30% on average this year. With such a large portion of the S&P 500 Index hitched to these crowd favorites, it's not surprising the headline index is doing so well this year. The rest of the stock and credit market pack has been lagging, which has held back returns for broadly diversified portfolios.

Growth of Technology Allocation in S&P 500 Index Driving Headline Index Higher



Is it time for a change in leadership?

The outperformance of large cap growth stocks has actually been going on for the past decade, which makes them hard to dismount since we are likely to eventually return to the slow 2-2.5% pre-pandemic economic growth rate of the past 10 years. By pulling forward years of increased demand for digitization and online technology services during the pandemic, growth stocks now appear to be priced near perfection while trading at extreme levels relative to value stocks. At the same time, a few key fundamental factors are falling into place that could broaden out the recovery in 2021. In June, we penciled in a COVID vaccine for 2020 as a potential long shot, and we favored large cap growth stocks. Since then several medical advances in development have been announced on virus treatments, testing, and then for the ultimate trifecta, better than even odds for a vaccine. There is a real possibility that a COVID vaccine receives FDA approval for at least emergency usage in 2020, and then broader distribution to global populations during the 2nd and 3rd quarter of 2021. There are currently over 100 vaccine candidates in development, including more than 30 in clinical trials, and three leading contenders that are likely to announce their phase three results before the end of the year. While complexities with distribution are likely even if a vaccine were approved, news of a successful vaccine could have a profound positive impact on the financial market's cyclical growth outlook, boost the lagging equity market sectors, and further steepen the bond market curve.

Investors are holding tightly onto their portfolio reins to get through the November elections, with the potential for a leadership change in the White House and Congress causing volatility in the markets. COVID-19 has muddied the track, but the stock market has been a good tip sheet for calling previous presidential election winners. If the S&P 500 Index is higher in the three-month period before the election (from August 3rd), the incumbent party has won; if the stock market is lower in the 3-month period, the opposition party has won. This has been true in every presidential election since 1984, and 87% of the time since 1928. In a sense, it's a good thing the markets are not taking the elections lightly and volatility is high. Despite Biden's current lead in the polls, the markets are expecting a near photo finish in which it might take days to determine the winner. The implied volatility priced into the S&P options markets on election day and the week afterwards is in the 3-7% range. The betting polls currently have Biden winning the presidency and the Democrats taking over a slight majority in the Senate. While there is a lot of angst right now about the potential outcome of the elections, we remain confident in the continued recovery in the economy. With a 17% personal savings rate, consumers are chomping at the bit with a lot of pent-up demand, waiting on the sidelines to re-engage once COVID-19 abates. A Democratic daily-double with a Biden presidency paired with a Democratically-controlled Congress likely would lead to higher corporate and individual tax rates, yet the baseline recovery in the U.S. economy coupled with his $3 trillion fiscal stimulus spending plans would likely overwhelm the negative impacts from higher taxes. If Trump surprises us all again in November, then expect no change in corporate taxes, a smaller fiscal stimulus spending plan, a major relief trade in traditional energy and financial stocks, and keep an eye out for a tougher stance against China.

Finally, no financial market update is complete without mentioning the Federal Reserve, which has been and continues to be the primary driver of market trends. During the third quarter, Chairman Powell unveiled the Fed's new monetary policy framework, which will now target an average 2% inflation rate over time with the unemployment rate riding side-saddle. In other words, regardless of how low the unemployment rate may get in the future, the Fed is going to keep future Fed rate hikes bridled up until inflation is comfortably in a sustained 2% zone. While we likely don't have to worry about any interest rate hikes until 2023 at the earliest, this new framework has very significant implications for where future market leadership will be. To make up for past periods of inflation well below 2%, the Fed will let the economy grow beyond capacity to let inflation run above 2% for some period of time in order to achieve a 2% average. Since Greenspan, then Bernanke, and Yellen, the Fed's monetary policy framework has been to be pre-emptive with rate hikes, and not allow inflation to build. Per Chairman Powell, this old framework did lead to longer economic cycles, but eventually it led to large financial market imbalances. Assuming higher inflation can actually be created in this highly-indebted, globally competitive economy, the new policy likely leads to higher market volatility, steeper yield curves, and a weaker U.S. dollar, all else being equal. Regardless, we expect future hand-offs from public support of the economy and markets to the private sector, as well as rotations towards new leadership, to be choppy.

Disclosures

Chart data source: Bloomberg

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