Our 2020 Outlook: A Time for Action discussed the potential for increased volatility as a result of trade disputes, Brexit and the U.S. presidential election. However, we could not have anticipated the pandemic-related volatility brought on by COVID-19—nor the economic decline into recession, liquidity strains and steep equity market decline that transpired as a result.

The global economy suffered a deep contraction during the second quarter as widespread shutdowns went into effect. But the swift and unprecedented actions of the Federal Reserve and U.S. government, as well as similar actions by other countries, have likely prevented a deeper recession and provided the liquidity and support financial markets needed to rebound. The U.S. equity market as measured by the S&P 500 rebounded over 40% after suffering a 34% peak-to-trough decline that ended on March 23. Meanwhile, fixed income markets, which experienced liquidity stresses and outflows during the height of the uncertainty, have largely healed.

Economies around the world are now in various phases of reopening with key metrics of activity confirming that a global recovery is underway. As is often the case with sharp but brief recessions, the rebound is usually of a similar magnitude. But a lot will depend on the course of the virus. With the outbreaks of COVID-19 cases in parts of the U.S. threatening to stall reopenings, what will the pace of recovery look like from here? Let’s take a look at the rebound underway and what it means for financial markets and portfolio positioning moving forward.

Economic Rebound Underway

As we look to the second half of 2020, we are confident that the worst is behind us given signs of stabilization in global manufacturing, consumer spending and functioning capital markets. China, which had locked down and reopened months before the rest of the world, continues to show signs of recovery. Its June Markit Manufacturing Purchasing Managers' Index (PMI) rose 0.5 points, up in three of the past four months, to 51.2, its highest level this year. The Eurozone’s manufacturing PMI (51.1) hit a five-month peak in July, suggesting a V-shaped recovery is underway. Manufacturing activity is also expanding in the U.S. with the latest reading at 52.6, the highest since the onset of this health crisis (Exhibit 1). Interestingly, the proportion of economies that reported month-to-month gains in their latest PMIs surged to a record-high 94%, which could indicate a positive turning point.

Key Takeaways

• V-shaped recovery most likely scenario, but dependent on path of the virus
• Central bank actions and fiscal relief supportive of recovery and risk assets
• Accommodative policy, low rates and muted inflation support equities moving higher, but expect near-term volatility
• Fixed income returns to be more muted, yield curve to modestly steepen as economy improves
• As the presidential election nears, avoid letting politics have an undue influence on investment decisions
• A balanced, active approach to investing needed to manage risks and identify opportunities that may arise in a post-COVID economy
The U.S. economy is also on the mend. After a forced lockdown, the economy lost over 22 million jobs from February through April and the unemployment rate surged to 14.7% in March, the highest rate since the 1930s. But as states move to various stages of reopening, the economy has added 7.3 million jobs over May and June and the unemployment rate has dropped to 11.1% as of mid-year. As illustrated in Exhibit 2, the number of Americans filing for initial jobless claims has declined from its peak of 6.86 million in late March, double the highest level hit during the Financial Crisis, but the pace of improvement has slowed over the last month as an increase in virus cases reemerges in parts of the U.S.
The resilience of the American consumer will be critical to the recovery. Consumer confidence is at 92.6, down from a three-month high of 98.1 in June after hitting a low of 86.7 in April. But while individuals believe that the virus will be less of an issue by the end of the year, the recent outbreaks in some states may cause a decline in confidence, which is still far from its pre-pandemic high of 132.6 in February. On a positive note, we are seeing a rebound in consumer spending, which accounts for 70% of U.S. GDP. Given the pent up demand following stay-at-home mandates, retail sales were up 7.5% in June following a 17.7% surge in May.

While the rebound in economic activity has been remarkable, the numbers may lose some momentum from here depending on how quickly recent outbreaks can be contained. We also continue to monitor consumer activity in real time on a global basis as another measure of the economy’s durability. In Exhibit 3, we highlight transportation trends by looking at driving activity in several countries. In Germany, which reopened earlier than other parts of the world and has avoided a resurgence in virus cases, activity continues to pick up. While driving trends are increasing in the U.S. overall, states such as Florida and California, where social distancing restrictions and/or a scaling back of reopening measures are needed to contain the virus, have seen a pause or decline in activity. Countries like Japan, which have been less impacted by the pandemic, did not see as dramatic a halt to individuals’ mobility and are gradually improving.

Exhibit 3: Mobility Trends

While a return to pre-crisis economic activity by mid- to late 2021, or a V-shaped recovery, is still our base case, we recognize that a lot depends on the course of the virus from this point. Global monetary and fiscal policy responses to this pandemic have helped to prevent a deeper recession and lift sentiment. We believe central banks and governments will continue to do their part to support the recovery, especially if it shows signs of faltering. In fact, the U.S. Congress is expected to approve another round of stimulus aimed at renewing parts of the CARES Act, including relief checks, a reduced unemployment insurance supplement, small business aid and assistance for states and municipalities. The European Union (EU) has also agreed to a €750 billion recovery fund, in the form of grants and low interest rate loans to provide support for the hardest-hit European economies.
Lower-for-Longer Rates

The actions of the Fed to cut the federal funds rate to near zero and establish several lending facilities has helped to anchor short-term rates and ease selling pressures that emerged in segments of the market during the height of the volatility. These collective actions pushed yields across the Treasury and municipal bond curves lower and allowed corporate bond spreads, or the additional yield investors receive over Treasuries, to fall from elevated levels.

Exhibit 4: Treasury Yields at Historic Lows

In spite of the extraordinary amount of stimulus, we don’t believe it will cause a spike in inflation in the near term. The market seems to agree with this view. The Treasury Inflation-Protected Securities (TIPS) breakeven rates reflect what the market is thinking inflation is going to average over the next 10 years. The 10-year implied breakeven is off its March low of 0.5% and currently stands at 1.5%. The Fed’s inflation target is 2%, so we are well below that level and have been for quite some time. Longer-term, ultra-easy monetary policy and trillions of dollars of government spending could prove inflationary, and it is something we will continue to monitor.

With the Fed’s commitment to keep the federal funds rate near zero and muted implied inflation, rates at the short end of the curve should stay low for many quarters. However, intermediate- and long-term yields will most likely drift higher as the economy improves, resulting in a modestly steeper curve. We expect the 10-year Treasury note yield will range from 0.30% to 1.0% during the second half of the year, ending the year near 1.0%. Given that there is over $14 trillion in negative yielding sovereign debt, demand for U.S. Treasuries should remain strong, limiting how high U.S. rates can go.

Investors should expect more muted returns in the second half of the year in light of low interest rates and tighter credit spreads. We continue to like credit, but expect less price appreciation given the recovery in spreads has largely already occurred. Both investment grade and high yield corporate bonds offer attractive yields over Treasuries, but we remind investors that we could still see volatility in credit spreads, especially in high yield. Emerging market debt also offers higher yields in this low interest environment, but we prefer debt dominated in dollars.
Municipal bonds are another area where technical conditions have improved significantly since March. A gradual reopening of the economy, liquidity support from the Fed and improved sentiment have increased flows into the asset class. While states and municipalities will suffer short-term revenue disruptions as a result of COVID-19, we expect most will be able to manage through by relying on reserves for any lost revenue. Municipalities can also rely on state and federal support. The CARES Act resulted in states receiving $200 billion and there is the potential for additional funding in the latest bill being negotiated in Congress. For tax-sensitive investors, municipal bonds remain attractive but we continue to advocate diversification and due diligence in security selection.

**Backdrop Supportive of Equities Moving Higher**

It has been an impressive equity rally off the late-March bottom, fueled largely by the massive monetary and fiscal response that provided liquidity and confidence to the market. The roughly 44% rebound through July 24 has nearly wiped away the S&P 500's losses year-to-date, suggesting the market is pricing in a V-shaped recovery.

Many question whether the stock market has gotten ahead of itself. The S&P 500 has certainly come very far in an awfully short period of time with its price-to-earnings ratio, based on 12-month forward earnings at 22.4x as of July 24, well above its 16.1x average. While this may seem overvalued, it is common for P/Es to be elevated during an earnings recession as markets price in the earnings recovery. While it is challenging to forecast forward earnings given the lack of guidance by many companies, we anticipate earnings will begin to rebound in the second half of the year as the economy recovers. Right now, the market appears to be looking past 2020 earnings and focusing on 2021. While there are a lot of variables to consider, including a medical breakthrough, the pace of reopening and the impact of a second wave, we estimate an S&P 500 operating earnings range of $140-160 for 2021. We may not see a full recovery in earnings until 2022 as companies adapt to, and try to thrive in, the new economy.

While there are many metrics for measuring valuation, it is important to consider the relative attractiveness of asset classes. With interest rates so low, stocks look extremely attractive compared to bonds as illustrated in Exhibit 5, as they have been over the past few years. When the equity risk premium, or the yield on S&P 500 earnings less the 10-year Treasury yield, is greater than zero, stocks historically outperform bonds. It’s our view that equities can move higher from here over the next 12 to 18 months in light of low rates, muted inflation and supportive monetary policy.

**Exhibit 5: Stocks Attractive Relative to Bonds**
After such a strong rebound, however, the equity market is due for a pause. Although the 44% decline in second quarter earnings from a year ago is largely priced into the market, we may see some volatility as a result of companies’ guidance regarding the impact of COVID-19 on future earnings. Other risks that could cause a period of choppiness include the uncertainty around this latest round of infections and of course, the upcoming presidential election.

However, there are a few factors that keep us more constructive on equities: the degree of skepticism still present in the market and the amount of cash on the sidelines. Investor sentiment as measured by the Ned Davis Sentiment Index is well off its lows from March and now stands at 62, an area depicting neither optimism nor pessimism (Exhibit 6). Historically, when sentiment is pessimistic, it is a good time to invest as markets deliver attractive returns on a 12-month forward basis. The current neutral zone still suggests a pretty healthy return, as illustrated on the right-hand side of the chart. As a result of the skepticism, there is still an abundance of cash on the sidelines. The amount of cash in money market funds reached a high of $5 trillion in March before coming down to $4.2 trillion more recently, as investors began to commit some of this money. The combination of skepticism and an extraordinary amount of dry powder on the sidelines suggests that any pullback from here may present opportunities for investors to rebalance to long-term targets or put new money to work.

**Exhibit 6: Investor Sentiment**

![Crowd Sentiment Indicator](image)

As of 7/30/20. Source: Ned Davis Research.

Factoring in a Presidential Election

In addition to anticipating what the recovery will look like on the other side of this pandemic, markets also have to contend with a U.S. presidential election. Historically, the stock market has been a good predictor of presidential outcomes. In fact, the S&P 500 has predicted 87% of winners since 1928. As Exhibit 7 illustrates, if the stock market advances in the three months preceding the election, the incumbent tends to win regardless of whether they are Republican or Democrat. If the market moves lower heading into the election, the opposition party has tended to win.
Currently, the S&P 500 is flat so we will continue to monitor which direction it moves from here. But, according to PredictIt, the betting odds of a Trump reelection have been on the decline since February as the coronavirus forced the U.S. economy into shutdown. Thus, we believe that the market is starting to price in some probability of a Biden win. While it is far too early to predict any specific outcome today, it is important to remember that the market is also influenced by what party controls Congress in addition to who sits in the White House. We will continue to monitor the political front and share our perspectives on each candidates’ proposed policy priorities as well as potential market implications as the election nears. But regardless of who wins, investors should resist letting politics have an undue influence on their investment decisions and adhere to a well-thought-out investment plan aligned with their goals.

Exhibit 7: 2020 Election — Less than 100 Days Away

Positioning For a Sustainable Recovery

Although the economic recovery from here may be uneven, we believe we are at the start of a new economic cycle. This stage of an economic cycle calls for a balanced and diversified approach to investing. We believe a neutral equity positioning with a bias toward U.S. large cap stocks remains appropriate (Exhibit 8). Our early recognition that the worst was behind us in late March/early April allowed us to move up in quality by shifting from international developed equity to U.S. large caps, which has proven valuable in the short term. We also favor those companies that can thrive on the emerging trends of the new economy, such as e-commerce, sustainability and telecommuting, although we continue to believe that broad sector diversification will benefit portfolios.

Global diversification remains important, but we maintain an underweight to international developed equity given our initial expectation that the U.S. will fare better in the recovery. We have a small underweight to emerging markets equity in light of how many developing countries have been hard hit by this pandemic, oil price volatility and the inability to have a coordinated policy response. But we continue to monitor how countries manage the coronavirus, growth opportunities, currency exchange rates and relative valuations as we determine potential tactical shifts within equities.
Although we have cautioned that fixed income returns will likely be more muted in the back half of the year, the asset class continues to play an important role as a source of diversification during periods of equity market volatility. Within our small underweight to fixed income, we continue to advocate a well-diversified, high-quality bond portfolio, coupled with actively managed, satellite fixed income solutions, as yield remains important in these uncertain times. We believe the ability to apply careful, rigorous research and credit analysis will enable us to identify buying opportunities in this challenging environment.

We also have a slight overweight to diversifiers to buffer against the expected volatility without the interest rate sensitivity of bonds. Long/short strategies and absolute return hedge funds have the opportunity to generate positive returns regardless of market direction. Private markets should play an increasingly important role in diversified portfolios as they are better positioned to take advantage of the changes appearing in the new economy. In particular, there continue to be opportunities for private companies as recent events further accelerate the growth of technology-related business models within cybersecurity, telehealth, online platforms, remote learning, digital payments, workforce collaboration tools and the intersection of cloud computing and mobile devices.

For investors who have additional capital to put to work but are hesitant to enter the market at this strong rebound, customized hedging solutions allow investors to gain exposure to the potential growth in the market while protecting against volatility.

Exhibit 8: Asset Class Positioning — Investment Strategy Committee Recommendations

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<th>Equity</th>
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As of 7/1/20.
Outlook

Overall we believe the worst of the economic data is behind us and that the global economy will rebound to pre-crisis levels by mid- to late 2021. We will have to continue to monitor whether our anticipated V-shaped recovery turns into a square root because of social distancing and rollback steps needed to contain the recent virus outbreaks. However, we believe progress on the science front to find a vaccine and the resilience of the American consumer will ultimately prevail.

In our view, easy monetary policy, low rates, muted inflation and a conservative earnings estimate create a favorable environment for stocks to move higher over the next 12 to 18 months. However, investors should be prepared for additional volatility and potential pullbacks from here as the market digests an earnings recovery, the potential for additional stimulus, progress on the vaccine front and the upcoming U.S. presidential election. To successfully navigate what’s ahead, investors will need an active approach to investing that considers top-down, forward-looking views as well as a bottom-up perspective that is able to discern those industries, sectors and companies that can thrive in this post-COVID economy. During this unprecedented period, we will continue to provide the insights and strategies needed to uncover opportunities, manage risks and help you reach your long-term objectives.
Leo P. Grohowski
Executive Vice President
Chief Investment Officer

Leo Grohowski is chief investment officer of BNY Mellon Wealth Management. He leads all investment strategy and investment management functions for the wealth management organization.

Mr. Grohowski joined BNY Mellon in 2007 and has more than 30 years of industry experience. Previously, he was with US Trust, Bank of America, where he was chief investment officer, responsible for investment solutions and the end-to-end investment process, including portfolio management and investment strategy for Private Wealth Management clients. Prior to his role at US Trust, he was the chief investment officer for Deutsche Bank in the Americas, overseeing more than $250 billion in assets. From 1999 to 2002, Mr. Grohowski was chief investment officer of Deutsche Bank Private Banking, serving as chairman of the Global Markets Strategy Committee and Domestic Investment Strategy group, and head of Investment Products and Services for the DB Alex Brown unit. In 1996, Mr. Grohowski joined Bankers Trust where he served as a senior trust investment officer of the Private Bank and head of the U.S. Investment Strategy group. He was with HSBC Asset Management from 1988 to 1996 and was named chief investment officer in 1993, after heading the U.S. Equities group from 1988 to 1993.

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