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Investment Review and Outlook

In the third quarter, the stock market continued to make progress recouping losses from earlier this year as a result of the global outbreak of the Covid-19 pandemic. While the stock market overall is improving, many companies and sectors continue to suffer from the more challenging long-term outlook for their business prospects. Moreover, structural changes in the economy have led investors to abandon many sectors while flooding cash into technology-related stocks.

The economy rebounded in the third quarter following a historic economic contraction in the second quarter. But a number of uncertainties remain, both political and economic. This will likely result in a cloudier outlook for the financial markets for the remainder of the year. While the severity of the Covid-19 health crisis will eventually be mitigated through medical innovation, the pace and durability of the economic expansion remain murky.

The upcoming presidential election presents some additional risk to the market outlook. But despite a sell-off in the month of September, it seems that the market is becoming more comfortable with a potential change in leadership in Washington. Historically, election transitions do not usually have a major impact on the market or the economy. More specific to this year's election, the stock market has declined only once in the year following a transition to democratic leadership over the past century.

While recent polling is showing a Biden/Harris victory increasingly likely, a close election with contested results could give investors some additional heartburn. Back in 2000, it took over a month before the democratic candidate, Albert Gore, to concede the election. In the weeks following that election, the market fell as much as 10% before the results became official.

One important factor that will undoubtedly help cushion a potential stock market decline in coming months and years is the Federal Reserve's new messaging with regard to monetary stimulus. Based on what was articulated by Federal Reserve Chairman Jerome Powell at the annual Jackson Hole gathering in August, interest rates will remain at historically low levels for at least another two years. Moreover, quantitative easing, including the purchase of Treasury and other fixed income securities will help ensure that fiscal spending packages can continue without an attendant surge in interest rates. This means that future fiscal stimulus packages will likely be larger than anyone could have imagined.

Borrowers, including the Federal Government, will benefit from the low cost of financing debt. But for investors, ultra-low interest rates may translate into more limited downside potential for equity markets as income-starved investors continue to allocate a greater percentage of portfolio assets to dividend paying stocks.

Some could argue that while current policy is an economic tonic in the short run, the United States economy may be setting itself up for some rough sledding longer term. The U.S. is already facing the prospect of structural budget deficits as the growing baby boom generation population retire and collect increasingly greater Social Security and Medicare benefits. It is becoming more difficult to envision a scenario where economic growth will be strong enough to help reduce budget deficits.

We are not as concerned about long-term structural deficits as we are the possibility of inflation creeping higher. The Federal Reserve has given the green light for inflation to exceed 2% until the economy fully recovers from the pandemic-induced economic fallout. For bond investors, increasing inflation is a growing concern. There are trillions of dollars of bonds globally with yields at or below zero. Investors who believe that rising inflation is a plausible risk need to prepare now for the potential negative consequences.

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