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Q3 2020 ECONOMIC OUTLOOK

Lift off?

In Q3 we see a race against time on multiple fronts—employment, household finances and policy—which could determine our recovery's strength and traction in 2020 and beyond. Reopening brings optimism, but with it, plenty of challenges.

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Q3 starts off at a weaker place than any quarter since WWII as a result of the COVID-19 pandemic, but with reopening has come optimism. There are important supports for our nascent recovery that could fuel a strong rebound in Q3. However, our economy also faces significant challenges that could intensify and impact growth later in 2020. Investors will need to navigate a vastly altered landscape of sky-high equity market valuations, continued uncertainty about the economic recovery, and shrinking options to find income.

KEY TAKEAWAYS

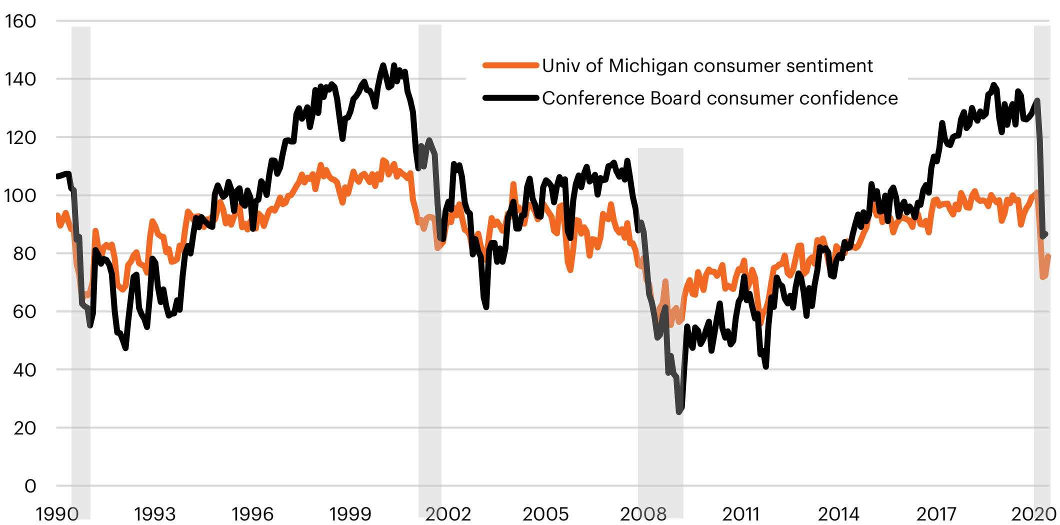
- Reopening has spurred hope that the worst economic news is in the rearview mirror.
- Lingering high unemployment could erode resilient consumer confidence.
- Acute volatility could return, driven by looming uncertainty surrounding the pandemic.

The importance of optimism

My favorite movie is “The Right Stuff,” the epic story of the U.S. space program. It ends with a crowd watching a rocket launch and zeroes in on an observer who looks up and says “Go!” in a way that captures the grand scope of opportunity and hope. To me, that comes close to how I observe the U.S. economy right now. Because while the U.S. economy entered a recession in February and our nascent recovery is starting from a place of unprecedented weakness, there is optimism that the worst is behind us and opportunity will thrive in the coming quarter.

There is good reason to be optimistic. And that’s important, because optimism is necessary for good traction to our economic recovery. Our economy is the combination of hundreds of millions of households making decisions about whether to spend or save. As the COVID-19 pandemic caused many states to issue shelter-in-place directives and caused businesses to shutter, consumers were hard-pressed to spend, even if they wanted to. Now, however, as our economy reopens, the question of whether consumer demand will be strong is paramount.

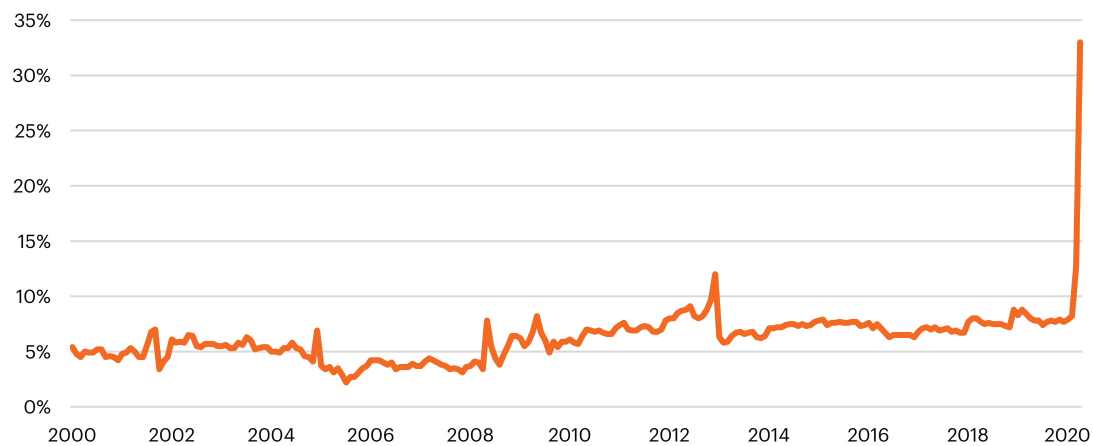
CONSUMER CONFIDENCE



Source: Macrobond, NBER, as of June 15, 2020. Shaded areas indicate NBER recessions.

There is good news. The **household balance sheet** is flush with cash as government stimulus sent the household savings rate surging to 33%. Supplemental unemployment benefits have also padded consumer wallets, offsetting some of the severe decline in wages and salaries. This solid financial position may well be helping to bolster consumer confidence. Yet there is a race against time as supplemental unemployment benefits are set to expire at the end of July. How savings and spending evolve in the face of lingering unemployment will be one of the largest determinants of the economic recovery, in our opinion.

PERSONAL SAVINGS RATE



Source: Bureau of Economic Analysis, as of June 15, 2020.

Given how rapidly the economy is changing as reopening occurs across our nation, we enlist a new set of **high-frequency indicators** to layer on top of traditional indicators. The economic data that markets have been watching for years is still highly relevant but comes out with a significant lag. High-frequency data helps navigate the regional nature of reopening and will offer guidance as to whether increased mobility is translating into higher spending. It will also help track local sensitivity to COVID-19 spread, which could be useful as concern about a second wave of outbreaks still looms as an uncertainty.

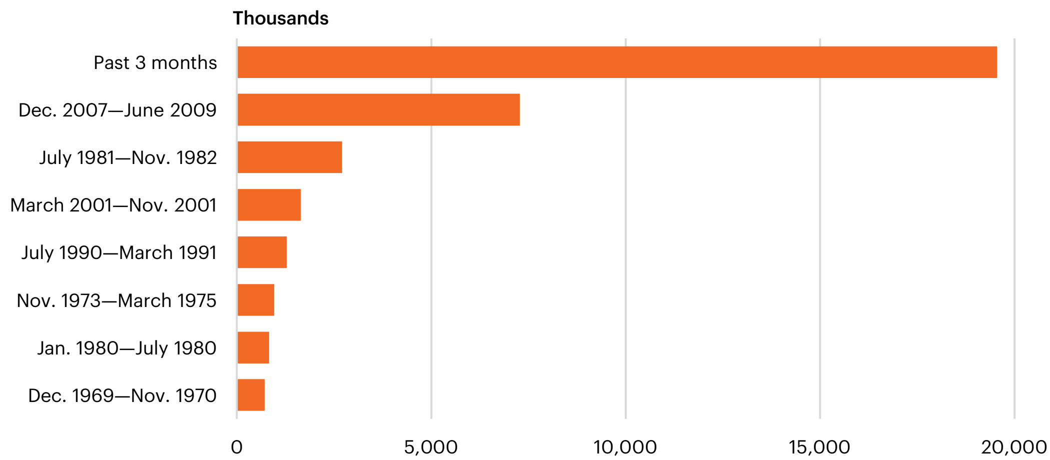
Questions about the speed, traction and trajectory of the recovery have led to some **alphabet soup:** Will the recovery be a V-shape, a W-shape or a "swoosh"? The start of the recovery has made this discussion extremely relevant. We dissect three possible scenarios but note that even a more optimistic scenario leaves 2020 GDP in negative territory. And, it is important to understand the difference between rates of change—which are swinging wildly—and levels of activity, which could remain sluggish.

The race against time

The third quarter may in many ways be more important for the longer-term outlook than the second quarter. For investors, economists and households, the almost-surreal suspended animation of the second quarter clearly indicated a growth and demand outcome that would be (some degree of) awful. After contracting -5.0% in Q1, the economy is expected to fall between -20% and -40% in Q2, a record decline. It isn't that this disastrous outcome was dismissed, exactly. Rather, most were anxious to move through it, past it and beyond it. It is increasingly hoped that April was the nadir of economic activity and the bounce we have seen so far in May and early June data is the beginning of a recovery.

Beyond this optimism, the economy faces significant weakness. The third quarter is shaping up to be a race against time to overcome these challenges before they become more entrenched and restrain growth further out. First and foremost is the high level of **unemployment.** More than anything, this is an obstacle that could hobble a robust, sustainable recovery in consumer demand. At the end of July, supplemental unemployment benefits run out, and if a significant share of jobs have not returned or new stimulus is not passed, the decline in income due to lost wages and salaries could become acute. A look at past recessions shows that employment can be slow to recover as businesses are reticent to hire when uncertainty is elevated.

PAYROLL LOSSES IN RECESSIONS



Source: Bureau of Labor Statistics, FS Investments, NBER, as of June 15, 2020.

Another race against time is PPP funds that helped small businesses retain workers during the shutdown. Now, with reopening, it is still unknown how many small businesses will survive. Businesses with 1–19 workers account for a third of all employment.

Deficits have risen as a top concern. In the near term, city and state budgets have been shattered by lost tax revenue and high payouts for unemployment benefits. This in our view is the largest near-term risk that deficits pose to our economic recovery. The corporate sector is levering up significantly, and from January to May issued over $1 trillion of debt, double the amount during the same period last year. Finally, the federal government deficit has skyrocketed, with total debt outstanding expected to hit 130% of GDP by the end of 2020. The severity of the economic crisis made significant fiscal stimulus a priority, and historically low interest rates have permitted the idea that higher debt is relatively low cost. The federal deficit grabs most of the headlines, but we see this as mostly a long-term anchor to growth.

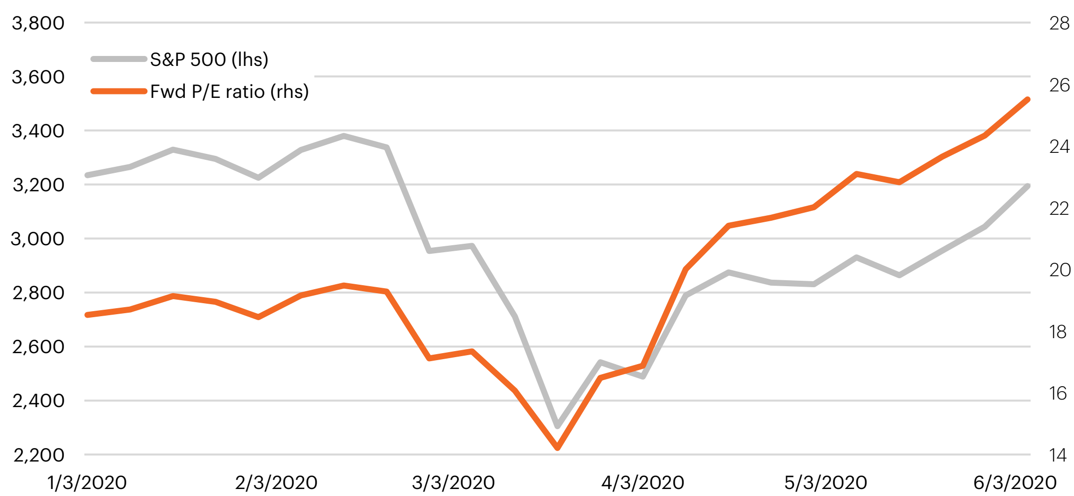
Finally, the **COVID-19 pandemic** itself looms as an enormous uncertainty, and a powerful reminder that at its core, our economy is experiencing a health crisis first and foremost. The severity and geography of the pandemic is changing, moving from a high concentration of most cases in the Northeast to more broad-based increases across the country. Issues related to the pandemic—like vaccine development, whether schools will reopen in the fall and successful antibody testing—will greatly impact the arc of our economic recovery. We also offer the important reminder that an outbreak can cause people to reduce economic activity, even when it is not formally mandated by shelter-in-place policies.

Financial markets in a post-COVID world

If the COVID-19 pandemic was the black swan of the first quarter of 2020, the equity market rally in the middle of the second quarter was perhaps another black swan, taking many investors and prognosticators by surprise. A looming feature of the equity market increase was that it occurred so effortlessly, and while the economic data was breaking records to the downside. No other question dominated more than, "Why do markets keep going up?" By mid-June, the S&P 500 was up 37% from its March 23 low, and down just -5.1% for the year. It is hard to find a comparable period when the economy was seemingly in freefall but markets were so exuberant. With signs the economy has bottomed, the notoriously forward-looking equity markets are finishing Q3 on an upswing.

Equity market prices seem to have recovered handily, giving many investors the illusion of being "back to where they started" when acute volatility struck in February. But this is a false sense of security. While 12-month forward price-to-earnings valuations skyrocketed, earnings estimates took a hit, reflecting the decline in revenue and profits due to the weak economy. Equities started 2020 with P/E ratios slightly higher than their long-run average. Now, they are in the top decile, a level of exuberance last seen in the tech bubble. We explore potential supports for equities, including Fed policy and low interest rates, and why equity investors should fear complacency, particularly with valuations at current levels.

S&P 500 PRICES HAVE RECOVERED, BUT VALUATIONS HAVE SOARED



Source: Bloomberg, L.P., as of June 15, 2020.

The Fed reacted to market volatility in early February with a fast and aggressive policy response that started with the global financial crisis playbook and went significantly further. This included cutting interest rates back to zero and initiating a fresh round of quantitative easing, both of which will continue to have enormous impact on investors in the coming quarters, at least. Interestingly, as the data has improved, the Fed has shied away from declaring victory. Instead, the Fed's forecasts remain cautious about economic prospects beyond a near-term bounce. We break down the Fed's projections and policies, and what more the Fed could do if financial markets or the economy deteriorate further.

Finally, we turn to **fixed income** markets and what the historic decline in interest rates means for investors. The current interest rate landscape has been radically altered by a deflationary impulse of slower global growth and global monetary policies of lower interest rates and quantitative easing, policy responses we expect to continue for the foreseeable future. Traditional fixed income investments have performed quite handily over the past year and a half but have likely run out of runway. For credit markets, the recovery in high grade and high yield spreads has left valuations still relatively cheap compared to equities.

Household balance sheet: A critical support for recovery

KEY TAKEAWAYS

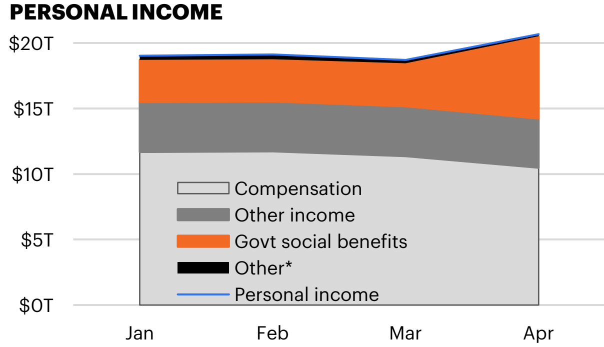
- The household balance sheet is flush with cash, which likely boosted May retail sales.
- Consumer confidence, job availability and household spending are the triple supports needed for a solid recovery.
- Whether jobs return or further stimulus arrives will be critical to watch in Q3.

Household spending has historically been about 70% of our GDP, and consumer demand will be critical to a strong economic recovery. The extraordinary stimulus (both the CARES Act stimulus payments and supplemental unemployment insurance) has made households flush with cash and caused the savings rate to surge. This is surely one of the reasons why—when stores and restaurants reopened in May—consumers were there and ready to spend.

In April, personal disposable income jumped 10.5% to a record high of $20.7 trillion. The CARES Act and other government transfers added $3 trillion (annualized) in April, doubling in size. This stimulus did an important job of offsetting the plunge in income that resulted from unemployment. Compensation fell sharply, led by wage and salary income, which plunged -8.0%.

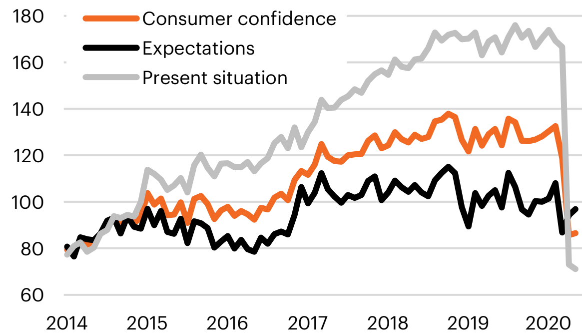
With the shutdown in March and April, consumers were hard-pressed to consume outside of what they could purchase online and at grocery stores. This combination caused the savings rate to soar to 33% in April. This is likely the high-water mark—we expect the savings rate to fall going forward. However,

PERSONAL INCOME



Source: U.S. Department of Commerce, as of June 15, 2020. Other income includes rental and investment income. Other* includes other transfer receipts and personal taxes.

CONSUMER CONFIDENCE



Source: The Conference Board, as of June 15, 2020.

supplemental unemployment benefits will likely continue to pad the household balance sheet for the next month or two.

This is the race against time, where the third quarter will determine if the surge in May consumer spending was an ephemeral flash of post-lockdown euphoria or a more meaningful return of the virtuous cycle of confidence and spending that comes from steady employment opportunities and security about the future. Consumer confidence tells a mixed story: Confidence took a significant hit as the virus made landfall in the U.S., but we are still well above levels seen in prior recessions.

But the present situation component of consumer confidence has plunged and is highly correlated with employment conditions. Despite the upside surprise of 2.5 million new jobs in May, the reality is that the dislocation in labor has been severe, with about 20 million jobs still displaced. Weekly initial claims continue to show a steady drumbeat of more than a million newly unemployed each week, a worrisome trend.

Looking into the fall, policymakers will be in the spotlight. Many are concerned that supplemental unemployment benefits are currently too generous and may disincentivize workers from looking for work. But stopping additional employment benefits altogether may create a second income shock that could undermine the nascent recovery. The Fed has been particularly vocal in warning that prematurely withdrawing support for households and the unemployed could create a fresh round of economic weakness.

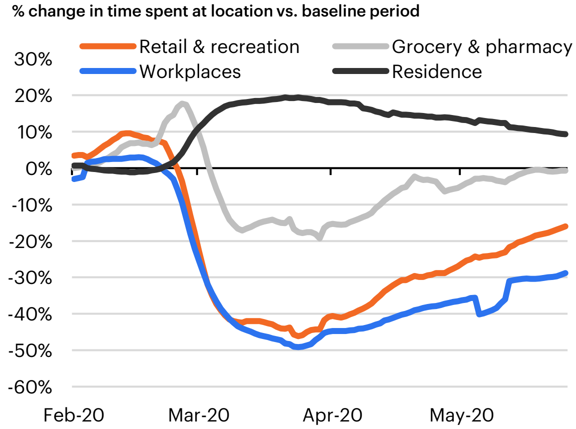
High-frequency indicators: Measuring the recovery

KEY TAKEAWAYS
- The unique nature of the COVID crisis has forced markets to consider new metrics.
- Location data shows steady improvement in activity, especially for reopening states.
- "Low-touch" activities have recovered more quickly than those that require physical presence.

The nature of the COVID-19 crisis has forced economists to throw out their old playbooks and search for new ways to track activity. With things changing so rapidly, data that is released on a quarterly or even monthly basis has become less valuable. We've compiled a list of indicators that are released with higher frequency, many of which utilize "non-standard" data sources. For markets, which are inherently forward looking, these metrics are critical in providing real-time information about the direction of the recovery.

Google has begun releasing aggregated location data to track human mobility. On a state-by-state basis, we can see how quickly people are returning to workplaces, retail shops and transport stations. Looking specifically at retail and recreation, there has been significant improvement in consumers' willingness to visit these locations since a trough in mid-April, especially in states that have started reopening. This improvement translated into actual retail sales, which rose 17.7% m/m in May (but this data was not released until mid-June).

GOOGLE MOBILITY DATA
% change in time spent at location vs. baseline period



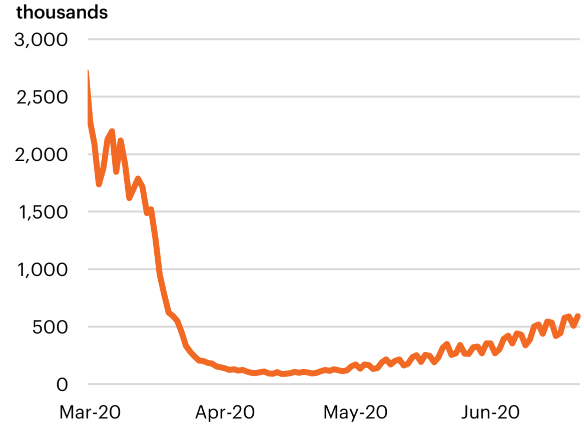
Source: Google, Macrobond, as of June 15, 2020. Baseline represents average for 1/6/2020–2/3/2020.

Along with location metrics, travel data is also critical in understanding consumers' willingness to reengage with the economy. The TSA releases daily air passenger data, which shows a rapid decline in air travel, as expected, followed by a muted recovery. In February, airports were serving roughly 2.5 million passengers per day; that fell to a low of around 100,000 and has risen since then to only about 500,000 per day. While it is difficult to avoid close physical contact in an airport, social distancing is much easier while driving. As such, motor gasoline demand has recovered more sharply after experiencing a -48% y/y decline through mid-April.

Activity that requires no physical presence, such as applying for a mortgage or starting a business, has largely regained pre-crisis levels. Residential mortgage activity, which was increasing pre-COVID thanks to record-low rates, has risen back near an all-time high after declining in March and April. Meanwhile, applications to start a new business are growing as well.

As states continue reopening, this data will be critical in understanding how consumer and business behavior is altered by the pandemic. Most of this data shows that economic activity likely hit a nadir in mid-April, and we've seen steady improvement as stores and restaurants open their doors. Additionally, this data will give markets insight into how the activity reacts to any new outbreak of COVID-19.

DAILY U.S. AIRLINE PASSENGERS
thousands



Source: TSA, Macrobond, as of June 21, 2020.

Alphabet soup: The possible trajectories of recovery

KEY TAKEAWAYS

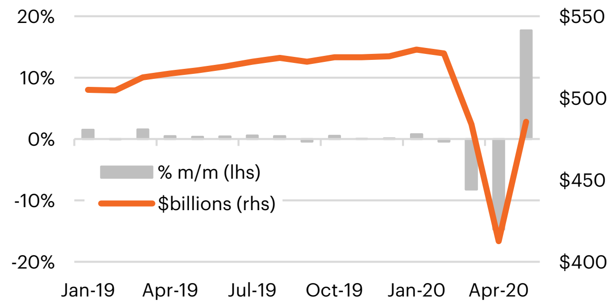
- The most optimistic (V-shaped) recovery is a low probability.
- The data, however, may confuse the issue.
- Whatever letter we assign, the risk is that a rapid rebound is only partial and fades into a more traditional demand-driven recession.

The strength and endurance of our recovery, which is in its earliest stage, is critical. Often this is summarized by a letter. The data, however, may confuse this effort to simplify a trajectory.

V-shape: This is the most optimistic of scenarios and implies a snapback of activity to pre-COVID-19 levels. While initially some data has pointed in this direction, even a strong rebound would leave GDP down significantly for 2020. The V-shape moniker is also problematic. The May retail sales report gives a good example. Looking at the strong 17.7% monthly gain, it appears as though retail sales experienced a classic V-shape recovery when sales surged. Yet the dollar amount shows sales still $44 billion below January levels.

Quirky GDP math: The rebound of economic activity in May has caused many forecasters to raise their GDP estimates for Q2. "Raise" probably deserves air quotes, because even improved estimates are still a double-digit, record-setting decline. Ironically, a better outcome in Q2 means there will be less room for a bounce in Q3. The survey of professional forecasters shows a median expectation of Q2 contraction of -32.2%. Even with a hearty bounce forecast in the second half of the year, 2020 would end down -5.6%, the worst year for growth since 1946. For reference, in 2009 the economy fell -2.5%.

RETAIL SALES REBOUND

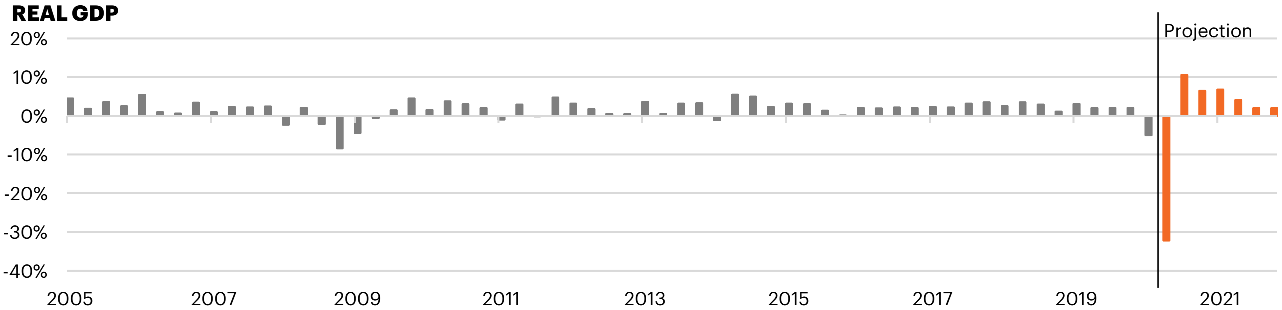


Source: Macrobond, as of June 15, 2020.

W-shape: Otherwise known as a double dip, the W-shape is not uncommon during recessions, particularly if they are longer. Quarter by quarter, GDP has risen then fallen again in 6 out of the last 10 recessions. Given the circumstances of the Q2 decline, we would expect that level of growth to be the low of economic activity. But the concern is that a robust bounce in the second half of the year could stall if shutdowns recur, or the economy faces further stress that amplifies the problems of high unemployment or weak consumption and investment.

The swoosh: This is the camp that most see as the greatest probability. The optimism of reopening gets the spending economy a fair way back from the deep freeze of the shutdown, but the consistent presence of the virus will continue to impact some sectors and cause activity to be more cautious. Part of this is because jobs are unlikely to fully return, leaving the jobless rate higher than it was in January. Certain industries will be unevenly impacted, like travel and restaurants. Finally, regionally our economy may experience vastly different recoveries. Low oil prices, for example, create a larger headwind for some communities.

REAL GDP



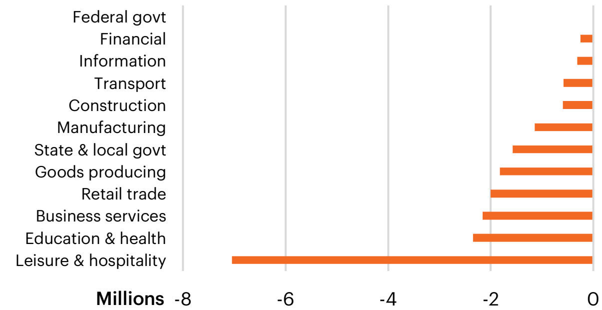
Source: Bureau of Economic Analysis, as of June 15, 2020. Projection is Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, Q2 2020, May 15, 2020.

Unemployment: The race against time

KEY TAKEAWAYS

- We are optimistic that the unemployment rate peaked in April at 14.7%.
- History tells us that hiring can be stubbornly slow to return during recessions.
- The biggest risk to our recovery is that jobs do not return quickly or fully.

MARCH–MAY JOB LOSSES



Source: Bureau of Labor Statistics, FS Investments, as of June 15, 2020.

There is perhaps no more visceral indication of economic distress than unemployment. The speed and severity of the employment dislocation that began in March has been truly unprecedented. Yet with reopening has come rehiring. In April, the unemployment rate hit 14.7%, a post-WWII high, but in May recovered to 13.3% as 2.5 million jobs were gained. Unfortunately, this is but a fraction of more than 20 million jobs lost.

The fact that job losses were both severe and front-loaded to the start of the recession makes this a unique situation. A look at prior recessions shows that unemployment typically starts low and rises throughout a recession. In fact, in the last three recessions, the jobless rate peaked after the end of the recession. In other words, when the economy is weak, companies are cautious to hire.

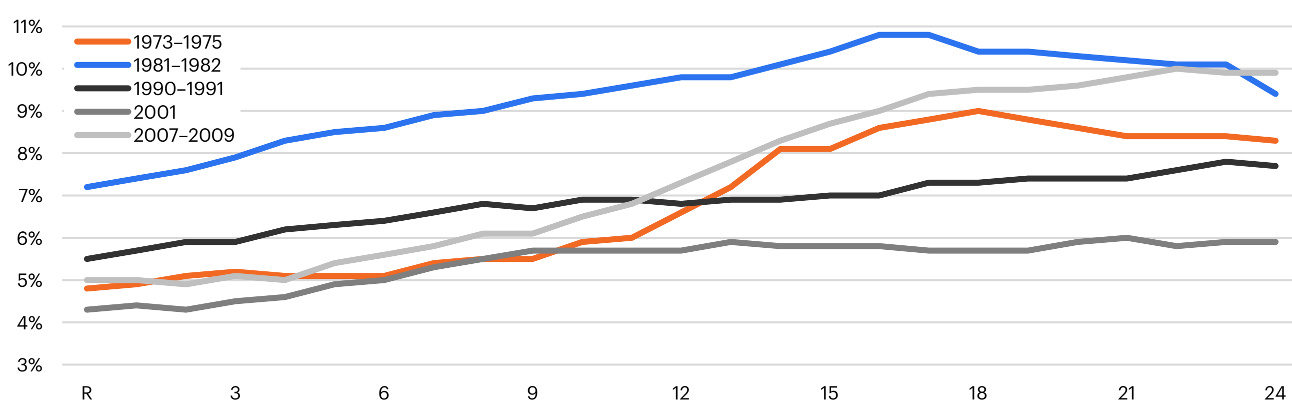
Job losses during this recession have dwarfed prior recessions. In the 2007–2009 recession, 7.5 million jobs were lost—total—over the course of the entire downturn. As reopening broadens, we would expect jobs to continue to return. Yet getting "back to normal" will vary significantly by industry. Restaurants, travel, sports and entertainment look unlikely to see a full rebound. These jobs employ over 15 million workers. If even three-quarters of those jobs return (an optimistic assumption), that still implies an unemployment rate of over 7%, far above the 3.5% seen in February.

This is why we view unemployment as another race against time. At the end of July, current supplemental employment benefits are set to expire. PPP funding was meant to keep small business employees on during the shutdown, and much of this funding will run out in late June. The risk is that as we reopen, fewer jobs may return. Indeed, there is still very real concern that some meaningful portion of small businesses may not survive. Businesses with 1–19 workers account for 35% of jobs.

Employment is vital because consumer confidence, and therefore household consumption, is inextricably linked to job availability and income. While consumer confidence has not fallen nearly as far as during prior recessions, lingering unemployment would likely cause further erosion in how households view their economic situation.

Ideally, this could inform policy. Further incentivizing employers to hire or retain workers may help our economy avoid the unemployment rut we have seen in prior recessions.

UNEMPLOYMENT RATE DURING RECESSIONS



Source: Bureau of Labor Statistics, NBER, FS Investments, as of June 15, 2020. R = start of recession plus each month thereafter.

Deficits: Do they matter anymore?

KEY TAKEAWAYS

- Federal deficits are set to soar, but low interest rates and Fed QE limit near- and medium-term risks.
- City and state budget deficits, however, could have a more immediate and meaningful negative impact to the economic recovery.

The U.S. government deficit is set to soar, raising questions about whether it will hinder our economic recovery. While the deficit is a long-run concern, low interest rates and Fed QE policies have enabled the government to undertake significant stimulus with little downside risk, for now. But deficits are not limited to the federal government. Corporations are levering up, and corporate debt outstanding has surged. More pressing is the fallout to cities and states, where budgets have been gutted. This could pose a more immediate challenge to our recovery.

With the economy in deep distress in March, the government acted quickly to push through several large stimulus packages. This included almost $3 trillion in stimulus spending and deferred tax payments. The federal deficit is now expected to rise to almost 20% of GDP on a monthly basis, or over 130% total debt outstanding, far surpassing anything since WWII.

At the same time, the over $1.5 trillion in Treasuries purchased by the Fed from mid-March to early May are a powerful counterweight keeping interest rates low. Can this go on indefinitely? U.S. Treasuries hold a unique place in the global economy as a vehicle for central bank reserves. With interest rates widely expected to stay low, servicing interest rate debt seems manageable.

Corporations are also issuing record levels of debt. Corporate debt issuance was over $1 trillion in the first five months of the year, a 94% increase over the same period last year, a new record. Corporations are taking advantage of low interest rates to lever up but, unlike the federal government, do not have the same unlimited ability to run deficits. At some point, either due to market conditions or economic pressure, companies may need to de-lever, which will directly impact how much they spend on investment and hiring that contribute to growth.

Yet most critical to our economy right now is the damage that has been done to state and local governments. Budgets have been shattered by the need to pay out unemployment claims. City and state government spending accounted for 10.6% of GDP in 2019—more than federal spending. City and state governments employ 20 million workers. In May, when the overall employment picture improved by 2.5 million, city and state governments shed over 500,000 jobs.

City and state government spending fell sharply after the 2007–2009 recession. Local government spending didn't become a support for the economy until 2014, five years after the last recession ended. Now, with local budget deficits arguably much worse, the drag on our recovery could be significant. This is something that will bear close watching. Some in Congress are pushing for the federal government to do more to help fill the budget gap of local governments, which would help.

While the federal budget deficit tends to get most of the attention, it is state and local budget shortfalls and, to a lesser degree, corporate debt that could more meaningfully hinder our economic recovery.

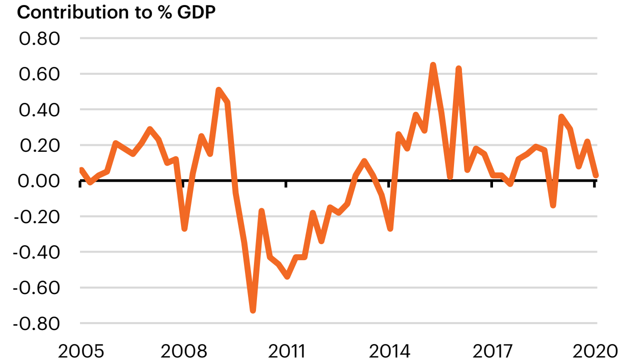
DEFICITS HAVE SKYROCKETED

Annual federal deficit, % GDP

Source: Macrobond, BEA, CBO, as of June 15, 2020. Projections based upon CBO estimates of 2020 and 2021 and zero growth of GDP.

STATE AND LOCAL GOVERNMENT

Contribution to % GDP



Source: Bureau of Economic Analyais, as of June 15, 2020.

COVID-19: The big unknown of our recovery

KEY TAKEAWAYS

- The evolution of the pandemic will continue to dictate the arc of the recovery.
- We continue to believe that reopening will be uneven and could suffer some setbacks.
- Markets remain sensitive to COVID-19 news, which could continue to be a source of volatility.

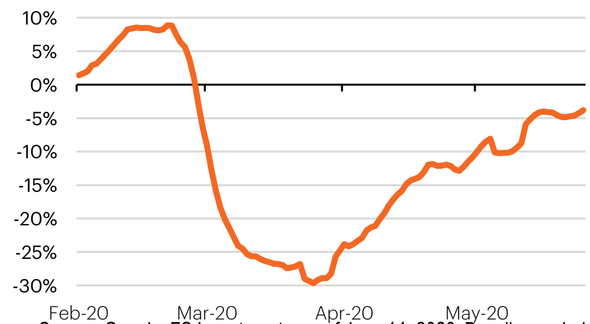
The COVID-19 pandemic's arrival on U.S. shores was the catalyst for the recession that began in February. Going forward, we expect the evolution of the pandemic to continue to drive how completely the economy can reactivate, and therefore it will be the ultimate determinant of the arc of the recovery. For investors, markets continue to be sensitive to news of pandemic, both positive and negative.

The outbreak of COVID-19 in the U.S. caused widespread economic activity to grind to a halt. Yet while the shutdown impacted virtually the entire country, the initial outbreak was focused in a few relatively small regions (densely populated but geographically small). As new cases have receded in the Northeast, an early and devastating hot spot, the outbreak has begun to worsen in places that saw few cases in March or April.

But cases across the U.S. continue to increase. This has given rise to a fervent discussion of whether we are in a second wave of the pandemic, or simply the continuation of the first wave.

OUT-OF-HOME MOBILITY

Average vs. baseline, states that never had a statewide stay-at-home order



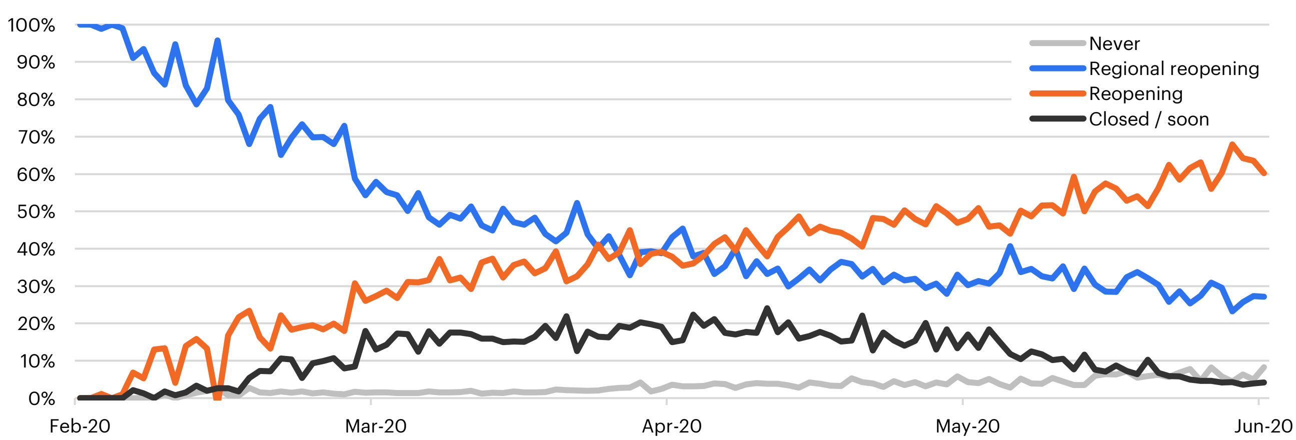
Source: Google, FS Investments, as of June 14, 2020. Baseline period is 1/3/2020–2/6/2020.

States that opened more fully, many at the start of May, are seeing an uptick in cases. To some degree, this reflects the fact that almost half of all states fall into this category. In other words, the share of new cases in fully reopened states corresponds to the share of their population in the country.

Yet the trend is alarming. Concern about the epidemic could still impact economic activity. Mobility data shows that even states that never had a mandated shutdown saw a significant decline in activity. This is a powerful reminder that uncertainty still looms, and citizens may opt to self-quarantine.

Finally, markets remain hypersensitive to COVID-19 news, both positive and negative. Expect volatility to remain a feature of the pandemic landscape with breaking news of vaccines, antibody tests and outbreaks.

SHARE OF NEW COVID-19 CASES



Source: National Governors Association, CDC, FS Investments. Seven states bucketed in "Never" did not close or have shelter-in-place policies. "Reopening" represents states that reopened entirely at a state level, mostly on May 1. "Regional reopening" includes states that are opening by county or locality. Three states are closed or opening soon (as of June 1, 2020).

Equity markets: Looking toward a post-2020 recovery

KEY TAKEAWAYS
- Fed policy action has been key in supporting equity markets.
- Markets expect a quicker rebound in earnings after 2020.
- Sky-high valuations present risks for investors.

There is contrariety in the fact that the S&P 500 will likely record its best quarter in over two decades while the U.S. economy is set to log its deepest 3-month contraction in modern history. This illustrates not only the powerful policy support that markets have enjoyed since the COVID-19 crisis began, but also the optimism that has surrounded the economic reopening.

It is no coincidence that the speed and magnitude of the fiscal and monetary policy response was matched by that of the market rebound. Fiscal support has helped blunt the record drop in economic activity that has been brought on by the virus, while Fed programs have kept interest rates at record lows and aided credit flow to businesses.

Another factor supporting equity markets is a feeling that this crisis is more "temporary" than the global financial crisis. So far, earnings expectations for this year have plummeted more than -28%, almost the same as the decline seen in 2008. However, back in 2008 markets had a much bleaker view of the future—EPS expectations for 2010 fell -26% from their pre-crisis peak. Market participants believe the hit to earnings this time will be more fleeting, as EPS estimates for two years from now (2022) have only dropped -13% from their pre-COVID levels. This speaks both to policy support and the market belief that activity can rebound more quickly from this exogenous shock.

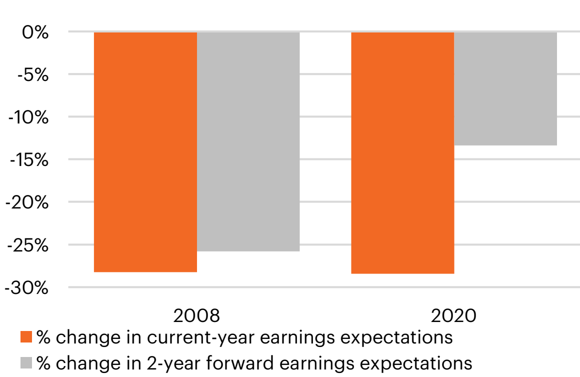
The third major factor supporting equity markets is the growing dominance of mega-cap technology firms. Just six tech firms in the S&P 500 comprise nearly a fourth of the total index market cap. These six companies have together returned 19.7% YTD, compared to -4.2% for the entire S&P 500 and -12.1% for the median stock. By and large, these large tech firms have strong balance sheets and resilient business models, and their outsize influence has been the driving force behind the market rebound.

While these are real and significant supports for equity markets, tremendous risks remain. The most obvious is the path of the pandemic. As we've seen on multiple occasions, markets are extremely sensitive to any signs of a renewed outbreak. While it may be unlikely that full stay-at-home orders are reinstated, mobility data shows that people significantly reduced their activity in March and April, even in states that never employed a lockdown.

Additionally, equity valuations appear quite high. The S&P 500 is currently priced at 24.5x 12-month forward EPS, which is near a two-decade high. Record-low interest rates have certainly pushed investors up the risk spectrum, which has benefited equities. However, market pricing should theoretically reflect risks and uncertainty, and there is inherent risk when stocks are at sky-high valuations and economic uncertainty is so pervasive.

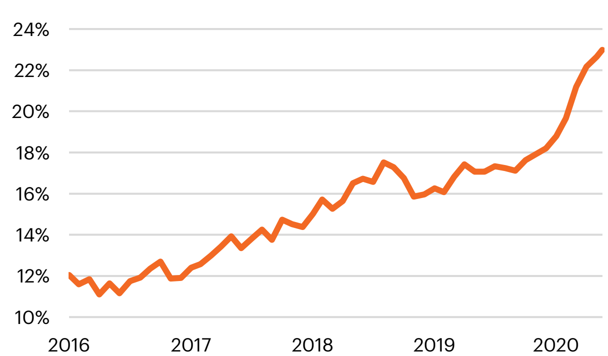
EARNINGS HIT EXPECTED TO BE SHARP BUT BRIEF

% change in EPS estimates, GFC vs. COVID-19 crises



Source: Bloomberg, FS Investments, as of June 19, 2020.

FANG+ STOCKS, % OF S&P 500 MARKET CAP



Source: Bloomberg, as of June 17, 2020. FANG+ stocks include Facebook, Apple, Amazon, Alphabet, Netflix and Microsoft.

Fed policy: A pessimistic outlook is fueling a liquidity binge

KEY TAKEAWAYS

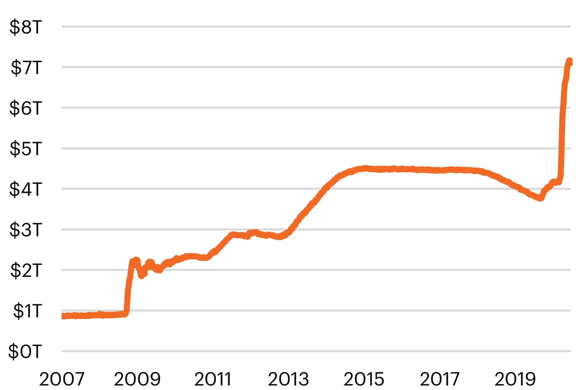
- Fed QE and other policies have offered significant support to financial markets.
- The Fed's outlook remains glass half-empty, and policymakers are committed to further support.
- The Fed has discussed other tools, including yield curve control and forward guidance.

In our Q2 outlook, we wrote that the Fed's policy response to the COVID-19 pandemic was "everything and the kitchen sink." For financial markets, the speedy, aggressive, multipronged support for a variety of asset classes seems to have done the trick. Markets have experienced a strong—some would say almost effortless—rebound in the face of an extremely weak economy.

The Fed's mandate, however, is to achieve full employment and price stability, not a market rally. Given that its estimate of full employment is 4.1%,[1] the Fed is far from declaring victory. This was driven home by Fed Chair Powell's semiannual testimony to Congress in mid-June, where he described some initial economic stabilization but noted "significant uncertainty remains about the timing and strength of the recovery."

At the June 9–10 FOMC meeting, the Fed issued its first economic projections since the pandemic-induced shutdowns, and its outlook is more pessimistic than the consensus. In 2020, the Fed expects GDP to contract -6.5% and for the unemployment rate to be 9.3%. The rate projection shows the Fed expects to hold the federal funds rate at 0.00%–0.25% through 2021, at least.

FED BALANCE SHEET



Source: Federal Reserve, as of June 15, 2020.

FOMC economic projections

	2020	2021	2022	Long term
GDP	-6.5%	5.0%	3.5%	1.8%
Unemp.	9.3%	6.5%	5.5%	4.1%
Inflation	0.8%	1.%	1.7%	2.0%
Fed funds	0.1%	0.1%	0.1%	2.5%

Source: Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 10, 2020. Median projections shown.

All of this leads us to expect Fed support to continue for some time. It has also raised the question: Is there a limit to Fed QE? The short answer is, "apparently not." At the last FOMC meeting, the Fed indicated that Treasury and MBS purchases would continue at least at their current rate of $120 billion per month ($80 billion of Treasuries and $40 billion of MBS). We expect the balance sheet to continue to grow into 2021.

The Main Street Lending Program (MSLP) is high on our watchlist in Q3 and beyond. Though the program was announced in April, it is still in the earliest stages of adoption, a process that took time given its unprecedented nature. Unlike the PPP, which was geared toward small businesses and provided loans that could be forgiven if criteria were met, the MSLP is really geared toward middle market companies, with a minimum loan size of $250,000. There are still looming questions about how this program will evolve, including concerns that banks will be less incentivized to participate in these loans and that companies may not find the terms attractive.

Finally, there are still some tools left in the toolkit. The Fed has discussed yield curve control—pegging or driving long-term rates lower or near zero. While Fed officials continue to talk down the likelihood of negative rates, prominent former Fed wonks and other economists have kept up a steady drumbeat of raising this as a policy option that could be considered.

1 There are multiple estimates of full employment. We use the median long-term unemployment rate from the most recent FOMC economic projections.

Fixed income: Welcome to the income desert

KEY TAKEAWAYS

- Interest rates have settled near historic lows.
- As benchmark rates have gotten boxed in by policy and the recession, traditional income could dry up from here.
- We expect income to remain a challenge for investors for some time.

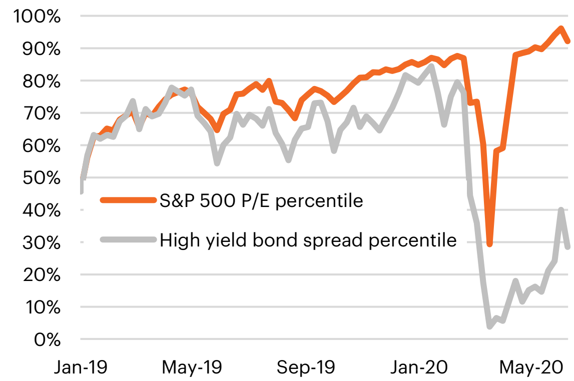
If equity market prices may, on the surface, seem to be largely back to where they started the year, the interest rate landscape has radically changed. Interest rates—already on a multidecade decline—had fallen through 2019 as the Fed cut rates and growth expectations cooled. The global pandemic caused a global policy response, with central banks slashing rates and initiating QE programs that purchased government bonds. All of this sent interest rates down even further. In the U.S., with the short end of the yield curve anchored at zero, the 10-year Treasury has settled into a range of 0.55%–0.75% for most of May and June.

Where do we go from here? Likely not very far. For rates to rise, there would likely need to be a meaningful surge in inflation expectations. This is unlikely. For now, deflation is a far greater concern, and both market and survey measures of inflation expectations are falling. And if long-term rates did rise appreciably while the economy was still weak, the Fed would likely quickly engage in additional QE to reduce rates.

On the downside, Treasury rates may be unlikely to fall much further. Yes, they could reach zero if the Fed adopts yield curve control as a policy and decides to peg long-term rates lower. Another deep market sell-off could certainly push U.S. Treasury yields down further—even into negative territory—if only briefly.

This leaves the investor with a traditional fixed income investment that has performed quite handily over the past year and a half, but has likely run out of runway. More importantly, with duration rising, the price sensitivity of these bonds to changes in interest rates has risen notably. All of this leaves traditional fixed income investments with potentially high exposure to market volatility and virtually no income.

CREDIT VS. EQUITY VALUATIONS

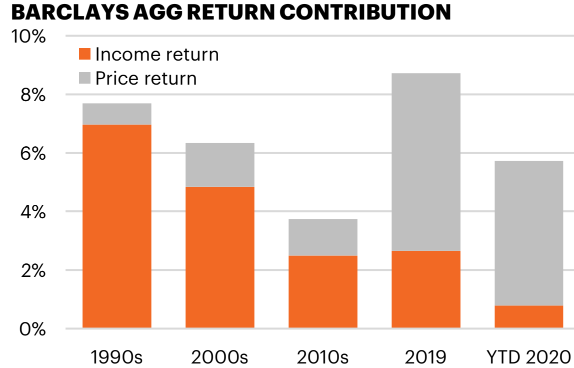


Source: Bloomberg Finance, L.P., FS Investments. S&P 500 equity, 12/31/1984–6/15/2020. High yield is represented by ICE BofAML U.S. High Yield Index, 12/31/1996–6/15/2020.

Where does this leave credit markets in Q3? Fed policy support has provided a meaningful lift through both low rates and directly via the Secondary Market Corporate Credit Facility, which is buying high grade bonds. This has reinforced the sentiment that while the magnitude of the impact from the pandemic is severe, the duration could be short. All of this has combined to push forward P/E ratios for the S&P 500 to their 92nd percentile valuation going back to 1985.

If we apply this level of optimism to credit markets, there could still be upside for U.S. high grade and high yield bonds. Spreads have tightened notably since bottoming on March 23, but high yield valuations are in just the 29th percentile. 100 bps of further spread tightening from here is not an unreasonable assumption and would leave high yield still in the bottom half of historical spread history and quite wide relative to current high P/E ratios for equities.

BARCLAYS AGG RETURN CONTRIBUTION



Source: Bloomberg Finance, L.P., as of June 15, 2020.