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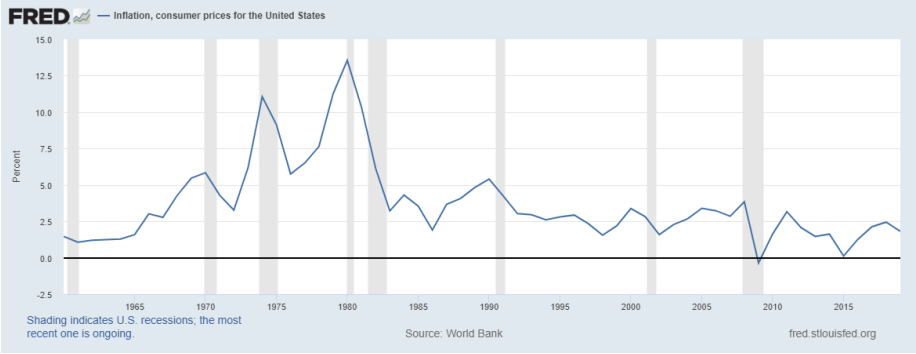
On January 4th of last year, at the annual meeting of the American Economic Association, former Federal Reserve Chairwoman, Janet Yellen, stated "I don't think [economic] expansions just die of old age", only to be upstaged by Former Federal Reserve Chairman Ben Bernanke, who completed her statement by saying that, instead, they get "murdered" by the Federal Reserve.

While Chairman Bernanke's quip was clearly intended to be more comical than insightful, a look back at the last two decades of Federal Reserve history reveals that his comment was indeed very well grounded in historic fact.

To explain, in 1977, the Federal Reserve was given a "dual mandate" by Congress of balancing what were viewed at the time as diametrically opposed forces: maximum sustainable levels of employment and sustainably low levels of inflation. Specifically, they were charged to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".

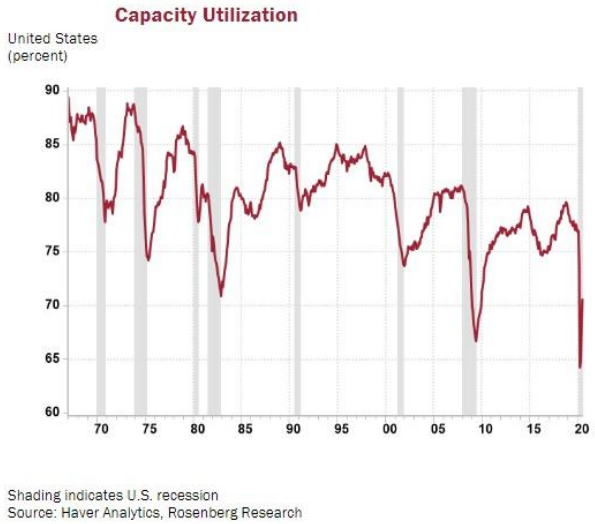
At the time, the Fed was largely guided by economic formulas, such as the Taylor Rule and the Phillips Curve, which used time-tested economic relationships to help quantify the risk of undesirable levels of future inflation, and to assist the Federal Reserve in setting appropriate levels for short-term interest rates and monetary liquidity.

However, over time, macroeconomic changes have disrupted these traditional relationships, such that low levels of unemployment and high levels of capacity utilization are no longer stimulating inflation as they have in the past. Further, the Federal Reserve was very slow to recognize and adjust to this seismic shift and, as a result, their preemptive and ultimately unwarranted steps to prevent inflation just served to end prematurely (i.e., "murder") both economic expansions and equity bull markets.



As was noted by Chairwoman Yellen at the aforementioned symposium, two things normally end economic expansions, "one is financial imbalances, and the other is the Fed." Yellen went on to say that, when the Fed is the culprit, it is generally because the central bank is forced to tighten policy to curtail inflation, and ends up "overplaying its hand".

Over recent years, the Federal Reserve has finally come to grips with this new reality, that factors such as globalization, technology, deregulation, demographics, the digitalization of the domestic economy, and the diminished impact of organized labor are ultimately proving to be much more impactful on the outlook for inflation than are the more traditional measures such as unemployment rates and how much of the economy's industrial capacity is currently being utilized.

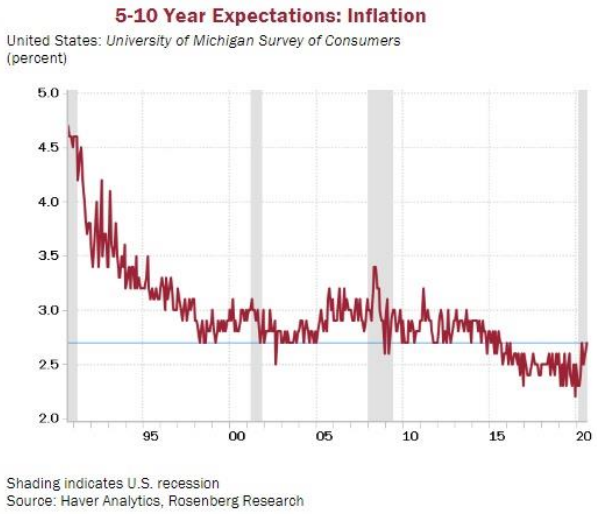


This realization has recently led the Fed to announce an array of important policy steps that should help to reduce the risk that the Fed unwarrantedly "murders" the economy in the future, thus likely prolonging future economic expansions, and even supporting higher equity, commodity and securitized real estate valuations, while simultaneously increasing the inflation-related risks most feared by bond investors.

Traditionally, the Fed has operated under the presumption that, once undesirably-high inflation is allowed to get a foothold, it is very difficult to wring out of the economy. This has historically been quite true as, once consumers start anticipating that inflation will cause them to pay even higher prices in the future, they become increasingly willing to tolerate higher prices today.

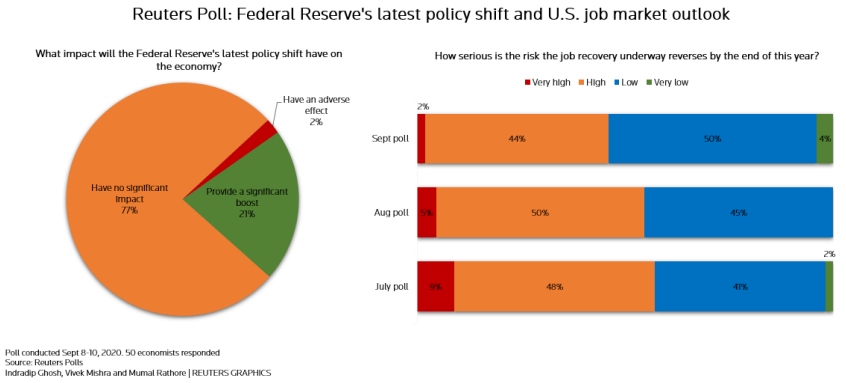
This is one of the reasons why company profits tend to benefit when there is a moderate drift higher in inflation, as it increases a company's ability to raise prices, and thus improves their profit margins.

If maintaining low levels of inflation not only preserves the purchasing power of the American consumer, which is particularly important in an era of slow wage growth, but also satisfies one of the Fed's two primary mandates, why is the Fed so determined to increase the rate of inflation? Indeed, why is it that, as was recently stated by Fed Chairman Powell, "inflation that is persistently too low can pose serious risks to the economy"?



The answer is primarily two-fold. First of all, overly low inflation can disincentivize consumers from spending now, as opposed to waiting for the potential of lower prices, which is of critical importance, when you consider that consumer spending accounts for 70% of the domestic economy. Equally problematic is that low inflation has pushed interest rates close to 0%, which deprives the Federal Reserve of its primary tool (lower rates) to stimulate the economy out of future recessions.

So, what was the specific change in Fed policy? First of all, they announced that they would no longer proactively raise rates and/or restrict money supply to slow the economy and preempt inflation, nor would they tighten monetary policy when inflation reaches their 2% target, but will instead allow inflation to exceed their 2% target, with the goal of averaging 2% over time.



The second major policy change is that they are abandoning the mandate from Congress that they equally-weight the goals of maximum sustainable levels of employment and low sustainable inflation, and are replacing it with what the Fed described as "a broad-based and inclusive goal" of not only maximum employment (even at the risk of elevated inflation), but also an economy that provides jobs and higher incomes to even the most hard-to-employ Americans.

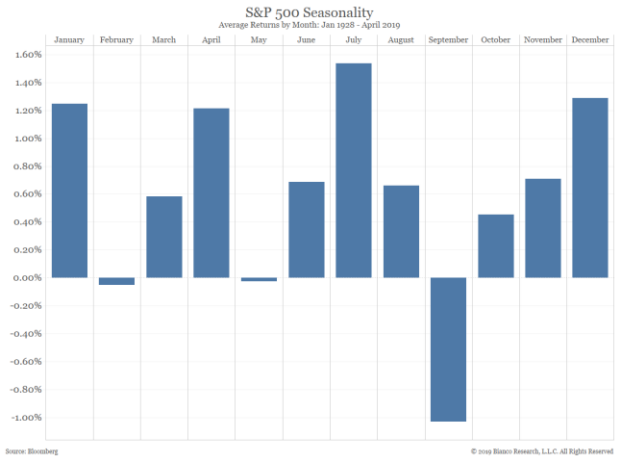
While this Fed objective is well outside of its prescribed mandate, it is essentially an acknowledgement that the only inflation produced by monetary policy over recent decades has been in the prices of financial assets, which overwhelmingly benefits the wealthiest Americans, and has thus significantly exacerbated the inequality of wealth distribution in the United States.

Importantly, this change in policy is not likely to cause an immediate increase in the inflation rate, and is instead likely, over the near term, to only impact inflation on the margin by adjusting slightly higher expectations for future inflation. To reiterate, what makes a consumer more willing to pay higher prices today is the expectation that prices will be even higher in the future.

We can already see these increased inflationary expectations having an impact in the so-called "breakeven rates" between the yield on inflation-protected Treasury bonds and that on more traditional fixed-rate Treasury bonds.

That said, Goldman Sachs estimates that it will take 10 years for inflation to reach the Fed's 2% target for average inflation, and none of the 17 members of the Fed's Federal Open Market Committee expect average inflation to reach the 2% target until 2023 at the earliest, which suggests that interest rates are going to remain anchored near 0% for at least several years, thus effectively removing one of the primary threats to both the economic recovery and what we believe to be a secular bull market in domestic equities.

However, while the policies being announced by the Federal Reserve should be a long-term bullish influence on riskier financial markets (stocks, securitized real estate and commodities), the messaging coming from just a few blocks away, where the White House and Capital are located, suggests that we should expect a period of heightened risk and increased volatility from now through the end of the year.

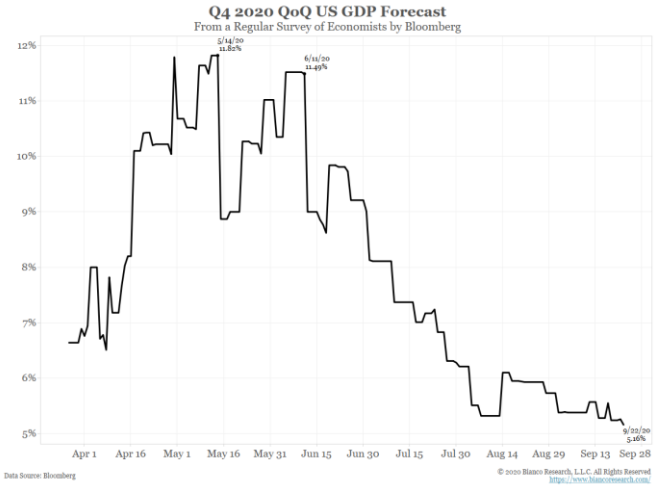


Indeed, while the Fed may be adopting a "do-no-harm" approach, the markets are still likely to face a figurative "murderers' row" of calendar events over the next few months.

The good news is that investors are about to put the month of September behind them, which is not insignificant, as September is historically the worst month of the year for equities.

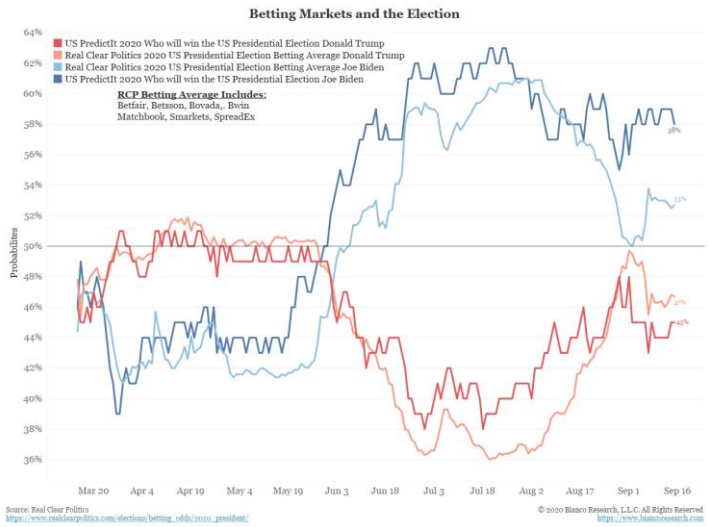
However, we are about to move into the first half of October, when mutual fund tax-loss-selling is traditionally a significant headwind for equity markets, as mutual funds sell losing positions before they conclude their fiscal year (most at the end of October), as a means of limiting the taxable capital gains that they are required to distribute to their shareholders.

There is also the upcoming battles over new fiscal stimulus and the confirmation of President Trump's new Supreme Court nominee, Amy Coney Barrett. While the Fed has already announced that they are going to keep interest rates nailed to the floor for years, they also insinuated that they are running out of tools that they can use to keep the economic recovery intact, and that they need for Congress and the White House to approve another round of fiscal stimulus. Indeed, both Fed Chairman Powell and Treasury Secretary Mnuchin just testified in front of Congress that another fiscal stimulus package is necessary to sustain the recovery.



In reference to both the Fed and the Treasury, Secretary Mnuchin said, "I unfortunately think there's not more we can do". For his part, Chairman Powell testified that "the path ahead is both highly uncertain and subject to significant downside risks" and that, "broadly speaking, if we don't get [additional fiscal stimulus], then there will certainly be downside risks". Indeed, Goldman Sachs just announced that they are cutting their estimate for fourth quarter economic growth in half (from 6% to 3%) and JP Morgan just cut it from 3.5% to 2.5%, due to the diminished prospects for an additional stimulus package.

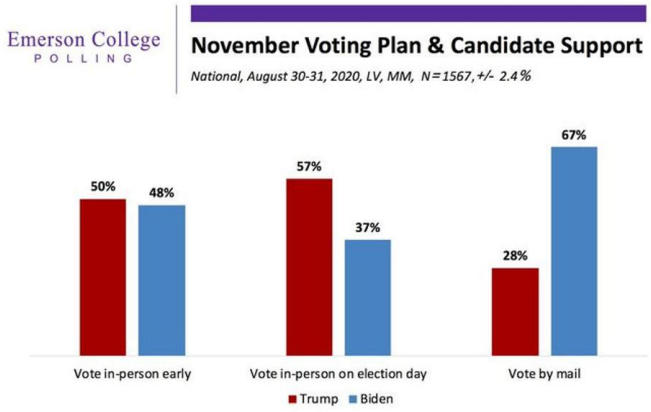
Nevertheless, there seems to be only modest prospects for Congress agreeing on anything before the election, particularly now that the debate over the confirmation of a successor for Supreme Court Justice Ruth Bader Ginsburg has so severely exacerbated the rancor between the parties. That said, Pelosi and Mnuchin are making one more attempt at negotiating a "skinny" deal, so there is still hope, which has allowed equities to stage a recent and modest rally from oversold conditions.



However, as contentious as these issues are almost certain to be, they will, in all likelihood, pale in comparison to the angst and uncertainty that will be created by the November elections, which we expect to have a potentially dramatic, albeit likely only short-term, impact on the financial markets. Indeed, with the exception of a clear-cut and non-contested victory by President Trump, and with the possible exception of the Republicans maintaining a majority in the Senate, it is hard to imagine an election outcome that is unlikely to roil the financial markets. Of interesting note, the percentage of "undecided" voters is currently only 9%, when it has historically averaged 20% at this point in the election cycle.

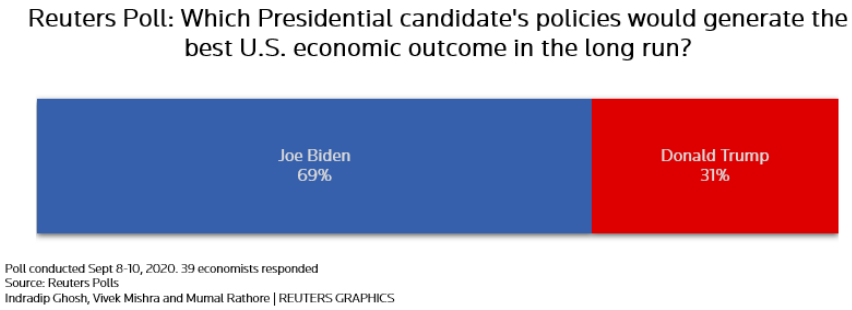
If President Trump loses, which is clearly the expectation of the polls and betting markets going into the first presidential debate, he has already made it very clear that he will do everything in his power, including litigation and potentially even encouraging violent protests to stay in power, particularly as he has consistently refused to commit to a "peaceful" transfer of power if he were to lose.

Complicating matters is the increasing probability that President Trump will appear to have an overwhelming victory on election day, since in-person voting, unlike mail-in ballots, will be counted almost instantaneously, and because polls show that Democrats are much more likely to vote by mail.



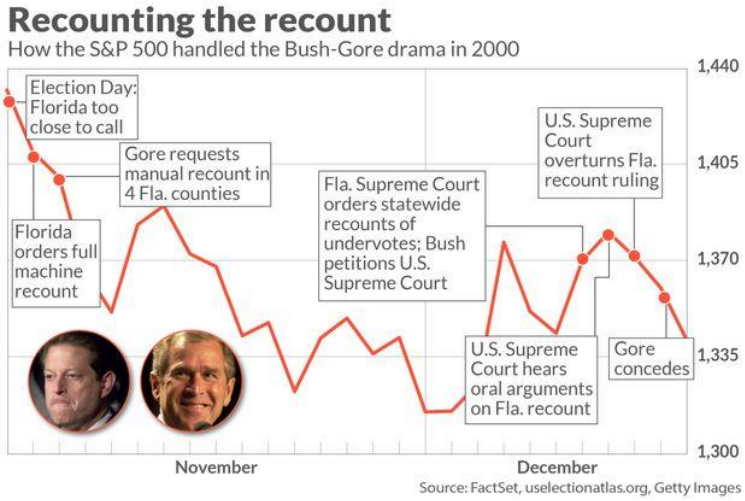
Over the past week, the President has made speeches in Atlanta, Georgia and Newport News, Virginia where he said that postal ballots were a "scam" and that "we are not going to lose this, except if they cheat.". He went on to say that "we do want a very friendly transition. But we don't want to be cheated. And be stupid ... And we know that there were thousands and thousands of ballots that made the difference through cheating. We're not going to stand for it."

Further, according to Politico, "dozens of lawyers from three major law firms have been hired [by Republicans]. Thousands of volunteer attorneys and poll watchers across the country have been recruited. Republicans are preparing pre-written legal pleadings that can be hurried to the courthouse the day after the election, as wrangling begins over close results and a crush of mail-in ballots".



While Wall Street clearly prefers Biden over Trump, as evidenced by the fact that the securities and investment industry has donated only $10.5 million to Trump's presidential campaign, as compared to the $51.1 million donated to the Biden campaign, there are two things that make it likely that stocks will initially do better under a perceived Trump victory. The first is that a Trump victory is less likely to be as heavily contested by the Democrats than a Biden victory would be by the Republicans. Markets absolutely hate this type of election uncertainty, as was evidenced very clearly during the "election indecision" of November, 2000.

The second reason is that history suggests that there is likely to be a knee-jerk selling reaction to a Biden victory, not because investors believe that he would be an inferior president, but because of his plans to increase the tax rate on capital gains, which has historically motivated investors to lock in profits at the lower tax rate by selling assets before the new rate goes into effect.

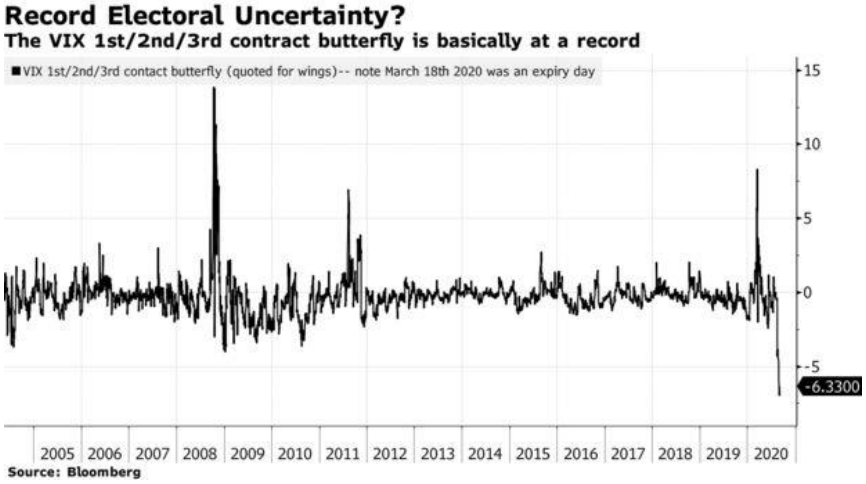


For example, when the capital gains tax rate went from 20% to 28% in 1986, it led to a 60% increase in the realization of capital gains (i.e. selling). Similarly, in 2013, when the capital gains rate jumped from 15% to 23.8%, the realization of capital gains increased by 40%.

Historically, every 10% increase in the capital gains tax rate has catalyzed to 7% change in capital gains realizations, which suggests that Biden's proposed 66% effective increase in the rate, could lead to a 45% to 50% increase in capital gains-related selling. This could catalyze a significant, albeit likely only short-term, equity market decline. However, this would likely present an attractive buying opportunity as, after the initial decline, stocks actually finished up on the year in 1986 and were essentially flat in 2013, despite the large tax increases.

Another seemingly inevitable factor that is likely to cause short-term distress for the markets is the high probability that the election outcome will remain uncertain for days (if not weeks or months). As noted, markets despise this type of uncertainty.

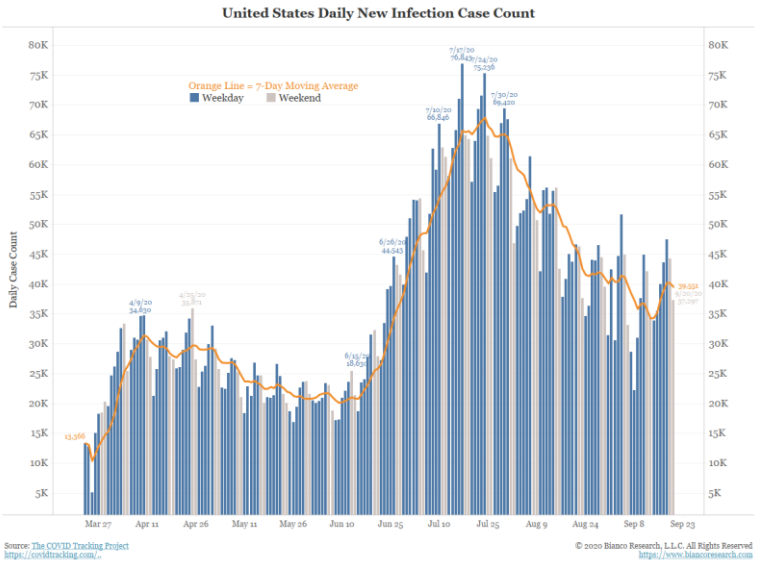
The firm, Good Judgement, just put together a team of analysts with reportedly exceptional forecasting track records, which assigned only a 16% likelihood that either presidential candidate will concede by the end of the election week, a 43% chance that we will not know the winner until Thanksgiving, and a 37% chance that the presidential election will not be decided until sometime between late November and Inauguration Day.



We should note that not all firms share this concern about a delayed outcome and its impact on the markets. While the futures markets are already pricing the election as the most expensive event in history to hedge against (for stocks, bonds, currencies and even gold), and while UBS views it as a major source of risk, Goldman Sachs believes that the outcome will be known much sooner than most expect, which will keep market-related risks rather moderate. For our part, we tend to agree with the UBS perspective.

If the aforementioned risks were not sufficient to cause significant angst on Wall Street, we believe that there is also a significant risk of a second coronavirus surge as we enter the fall. Indeed, one can argue that it is already starting.

As of September 27th, 21 states (Alabama, Alaska, Colorado, Idaho, Maine, Michigan, Minnesota, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, South Carolina, South Dakota, Texas, Utah, Washington state, Wisconsin and Wyoming) have seen an increase in cases of at least 10% on a week-over-week basis, 18 states are holding fairly constant, while only 11 states (Arizona, Louisiana, Tennessee, Georgia, Florida, Virginia, Maryland, Connecticut, Rhode Island, Vermont and New Hampshire) have seen a decline of 10% or more. All numbers are via Johns Hopkins University.



Further, according to of the University of Washington's Institute for Health Metrics and Evaluation (IHME), the U.S. could see "an explosion of Covid-19 cases in the fall and winter as people exercise less caution and spend more time indoors".

According to the Institute's director, Dr. Chris Murray, their model shows a "huge surge" expected to begin in October "and accelerate in November and December", and that the country, which "is currently seeing about 765 daily deaths from Covid-19, [could see] that number …jump to 3,000 daily deaths by late December".

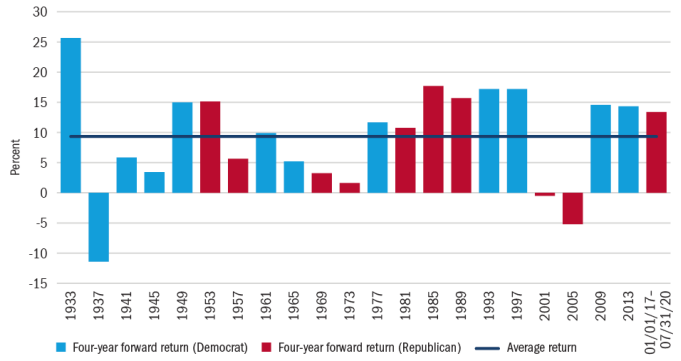
While we do expect for the markets to face a variety of potentially "Herculean" tasks over the near term, that does not necessarily mean that one should try to "time the markets", in an effort to avoid such short-term risks, starting with the fact that "timing the markets", while potentially highly profitable, is very difficult to do well with any consistency.

There is also the fact that the current tax code punishes more tactical investors by taxing short-term capital gains at a much higher rate than are long-term capital gains (on positions held for more than one year). There is also the fact that the aforementioned risks are already well known, as is evidenced by the very high costs currently associated with hedging portfolio risks around the election, and that markets rarely discount the same news twice.

This is in sharp contrast to the 2000 election turmoil, which was wholly unanticipated, and thus largely unhedged. In addition, it is historically true that the stock market, in particular, has tended to rally strongly starting almost immediately after the election, as election-related uncertainty is replaced by political certainty.

Look beyond election-year volatility for a longer term view on stock market performance

Annualized S&P 500 returns for the four years following an election, 01/01/33–07/31/20



Source: Columbia Threadneedle Investments. Past performance does not guarantee future results. The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. It is not possible to invest directly in an index.

From our perspective, there is certainly a strong argument for long-term investors to just ignore the anticipated volatility of the next few months, as it is ultimately likely to be just a "blip" on a long-term investment chart.

Similarly, we believe that there is a prudent argument for investors who are more concerned with maximizing returns/protecting gains than minimizing taxes to raise cash going into this potentially volatile time period, with the goal of putting that money to work at lower prices.

While we acknowledge that it is unusual for markets to sell off significantly in response to events that are so well anticipated, there are exceptions to this rule that can provide very profitable opportunities for more tactical investors. We would point to late February and early March of this year as one such example, as the coronavirus started its spread from Asia to Europe, and ultimately to the U.S.

We believe that either approach is both reasonable and justifiable, and that the greatest risk to investors is actually borne by those who start off planning to hold through the anticipated volatility, only to panic and raise cash after much of the potential damage has already occurred: a scenario that has regularly repeated itself throughout history. As such, in our opinion, the fourth quarter is likely to be a time when it is important for investors to determine their strategy early on, and to maintain it through year-end.

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