Madison INVESTMENTS

CLIENT COMMUNICATION

Madison Commentary Report - September 30, 2020

The most notable characteristic of stock market performance since March has been its steady rise against an economy deeply scarred by the Covid-19 pandemic. That trend reversed in the final month of this past quarter as the market suffered its worst September in almost a decade with the S&P 500® Index dropping -3.8%, bringing the quarter return for the Index to a still robust 8.9%. This effectively erased the deep loses of February and March, bringing the year-to-date return to 5.6%. In the end, the quarter followed the previous quarter's trend in terms of the best market performance being centered on the Consumer Discretionary and Technology Sectors with particularly strong contribution coming from mega-cap companies. The influence of a handful of the largest companies has been an important driver of returns: at quarter end the five largest companies in the S&P 500 represent 22.5% of the total index, surpassing the previous peak of 18% at the market peak of the technology bubble in 2000.

One notable reversal for the final month of the quarter was the outperformance of value stocks over growth stocks, reversing a trend which had produced a wide performance dispersion between these two categories. The large-cap Russell 1000® Growth Index dropped -4.8% for the month while the Russell 1000® Value Index was down -2.6%. This disparity was at odds with the powerful recent trend. For the quarter, the Russell 1000 Growth Index was up 13.2% compared with just 5.6% for the 1000 Value Index and the year-to-date gap is even more extreme. The growth-value dispersion has been even more pronounced for smaller stocks, with Russell's Mid Cap Growth Index up 13.9% for the year through September 30, while the Russell Mid Cap Value Index struggled at -12.8%, a huge gap of 26.7%. These index disparities reflect directly on how over the past six months investors have preferred certain sectors, particularly technology-driven companies, many of whose businesses have been boosted, rather than hurt, by the pandemic. The shift in September could be a sign that this trend overshot, producing excess valuations. It could also mark a sense that investors are hopeful the economy is working its way through the pandemic, a sentiment encouraged by the prospect for vaccines. On the political side, the possibility of a change in administration may have also been a driver, since the large growth companies that led the market could be adversely affected by anti-trust and tax policy shifts.

Another reason for the market pause in September was the realization that a second round of fiscal stimulus might be delayed, reduced, or even forgone. That did not affect the main engine behind the sixth-month stock rally, the Federal Reserve's aggressive stimulus which translated into lower loan rates which in turn have sparked housing and car sales.

Looking forward we see an extended period which may be described as riding out the Covid-19 and pre-to-post election storm. This period may very well turn out to be longer than is generally anticipated. It is likely we will need a globally distributed vaccine to move beyond the worldwide pandemic-sparked economic slowdown. Even as we move beyond Covid-19, the economic landscape for many sectors and individual businesses will likely be clouded at best and may take a significant period of time to clear. Many who have been laid off, furloughed or lost jobs face an uncertain future once stimulus is geared down. This may impact consumer spending, financial companies and other businesses tied to an economic recovery. And as if we needed more anxiety, we are looking at a contentious presidential election with unknown post-election complications, with potentially significant changes to the makeup of Congress. This adds to uncertainty as many companies and sectors may face higher taxes and revised regulation.

For these reasons, and for others that may yet develop, we believe retaining a finely honed risk consciousness is the way to approach today's and tomorrow's markets. The turn of sentiment in September towards more reasonably valued companies is one we find heartening and perhaps a harbinger of what we could expect through the end of the year and into 2021.

U.S. EQUITY MARKETS SOARED AGAIN IN THE THIRD QUARTER

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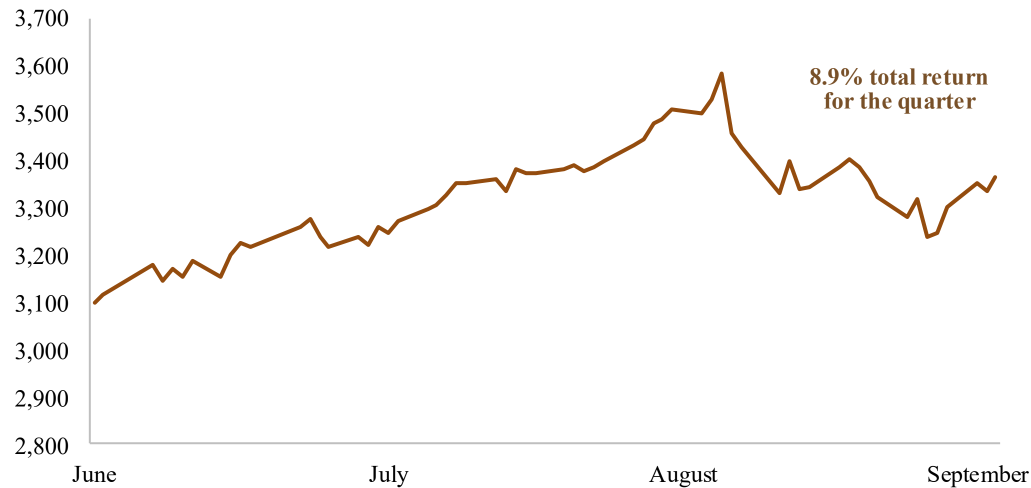
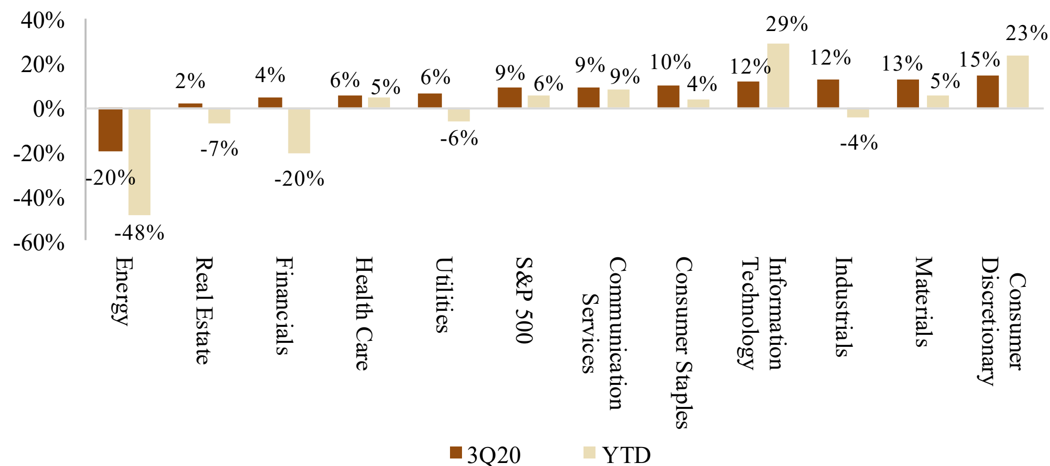


Quarter Highlights

- The equity market continued to rebound in the third quarter with an 8.9% return for the S&P 500 Index. Year-to-date, the Index is up 5.6%.
- Fiscal and monetary stimulus continues to provide liquidity and support to the financial markets.
- Interest rates remain close to zero. The Federal Reserve does not expect to raise interest rates before 2023 based on its economic forecast.
- After the worst quarter of growth ever, -31.4% GDP growth in the second quarter, the U.S. economy is now rebounding. Expectations are for +25% GDP growth in the third quarter and +5% in the fourth quarter. Unemployment continues to improve from 11.2% at the end of the second quarter to 8.4% at the end of September.
- Pandemic Unemployment Assistance benefits expired at the end of July and hopes for additional fiscal stimulus faded towards the end of the quarter, putting pressure on equities.



Sector Snapshot

- All sectors reported positive returns during the third quarter with the exception of Energy which was down -19.7%. Oil inventories grew during the third quarter sending oil prices lower once again.
- Consumer Discretionary stocks led the market again this quarter up 15.1%. The Materials, Industrials, Staples, and Technology sectors had double-digit returns in the quarter.
- Year-to-date, Technology and Consumer Discretionary sectors continue to lead the market but Communications Services, Materials, Consumer Staples, and Healthcare also have positive year-to-date returns.

Source: FactSet

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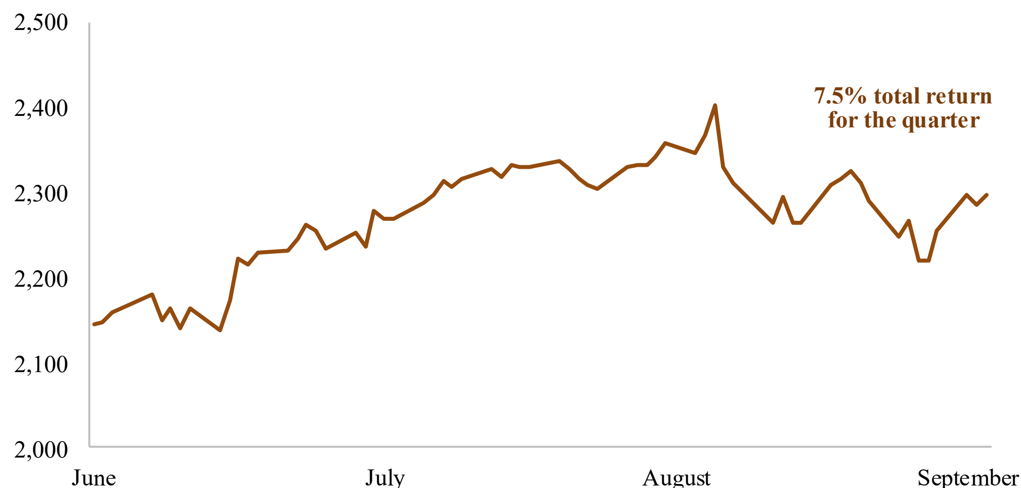

Quarter Highlights

- The equity market continued to rebound in the third quarter with a 7.5% return for the Russell Mid Cap Index. Year-to-date, the Index is still down -2.3%.
- Fiscal and monetary stimulus continues to provide liquidity and support to the financial markets.
- Interest rates remain close to zero. The Federal Reserve does not expect to raise interest rates before 2023 based on its economic forecast.
- After the worst quarter of growth ever, -31.4% GDP growth in the second quarter, the U.S. economy is now rebounding. Expectations are for +25% GDP growth in the third quarter and +5% in the fourth quarter. Unemployment continues to improve from 11.2% at the end of the second quarter to 8.4% at the end of September.
- Pandemic Unemployment Assistance benefits expired at the end of July and hopes for additional fiscal stimulus faded towards the end of the quarter, putting pressure on equities.

Source: FactSet

Sector Snapshot

- All sectors reported positive returns during the third quarter with the exception of Energy and Real Estate. Mid Cap Energy stocks are down -52% year to date. Oil inventories grew during the third quarter sending oil prices lower once again.
- Consumer Discretionary stocks led the market this quarter up 15%. The Materials, Industrials, and Communication Services sectors also had double-digit returns in the quarter.
- Year-to-date, Technology and Healthcare sectors continue to lead the market by a wide margin.

STOCKS REBOUND BUT UNCERTAINTY REMAINS

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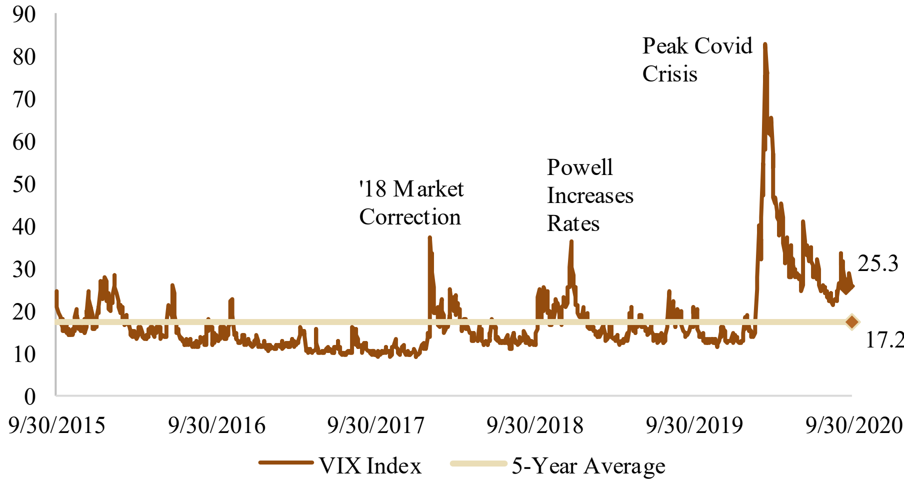

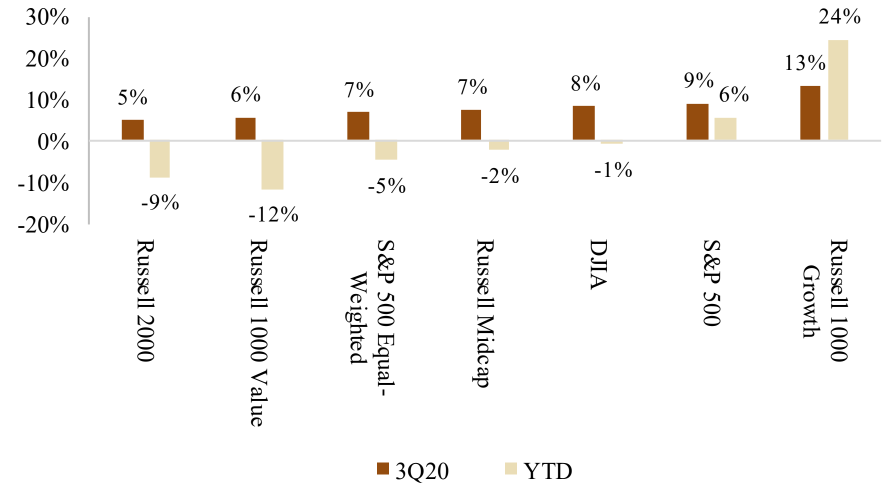

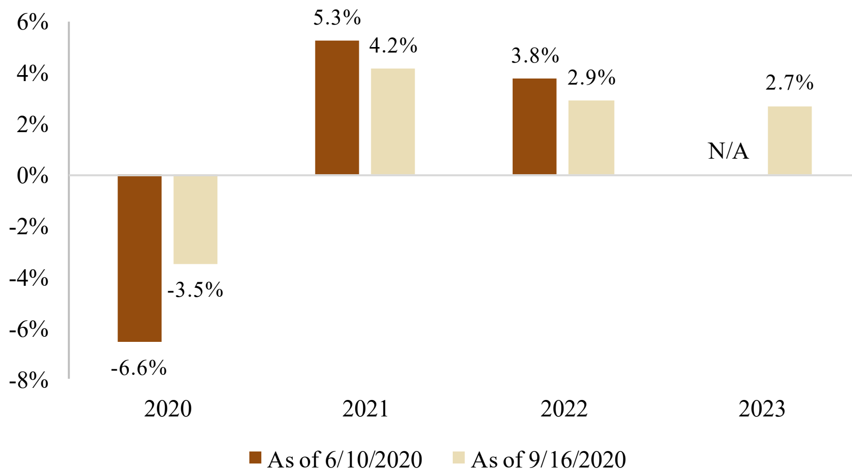

Equities were positive again in the third quarter as the economy re-opened more broadly and business conditions improved faster than expected despite the higher number of positive Covid cases. The trajectory of the recovery, however, is a key investor concern.

(Top Left) Volatility remains elevated relative to the average over the last five years, but down considerably since March. Uncertainty surrounding the election, high unemployment and the lack of additional stimulus are giving investors pause.

(Top Right) Performance across market cap ranges was more similar during the third quarter. Growth continues to outperform Value. Year-to-date performance continues to be widely varied across market capitalization and equity style attributes.

(Bottom Left) The Federal Reserve recently revised its real GDP growth forecasts. GDP growth for 2020 has been revised higher, but longer term growth forecasts have been revised downward as the Fed remains concerned about the pace of the recovery.

Sources: Bloomberg, Morningstar

IMPACT OF FURTHER FED AND FISCAL STIMULUS IS UNCLEAR

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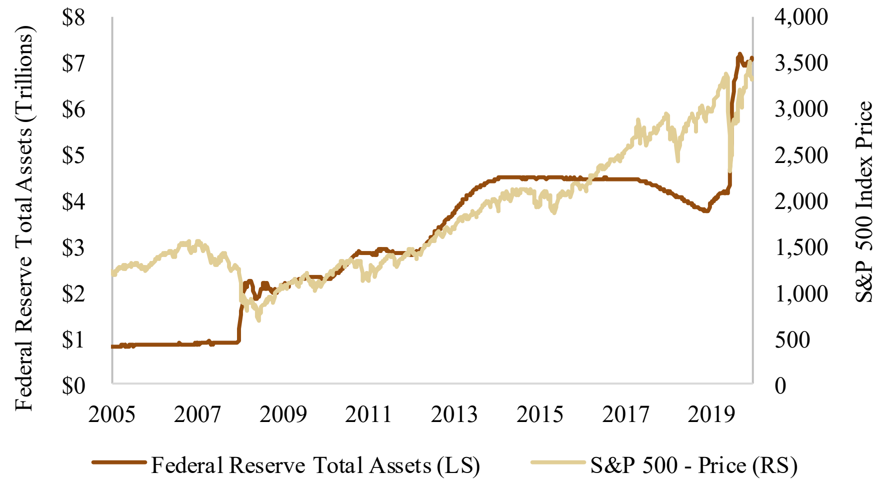
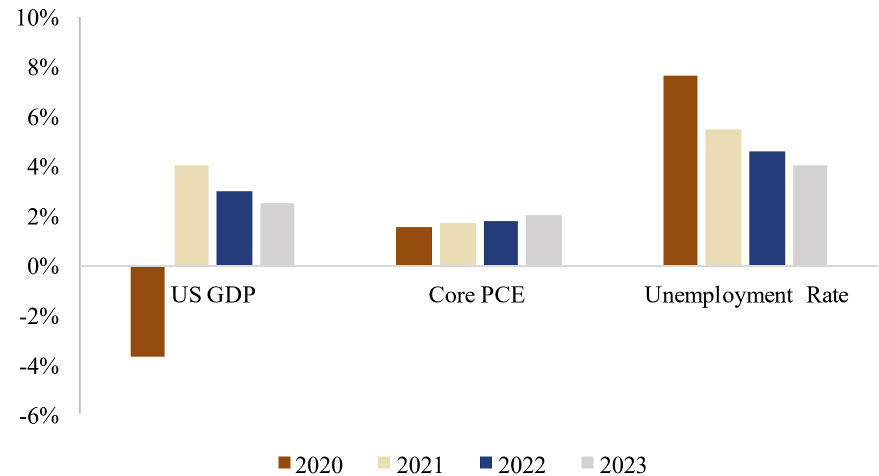
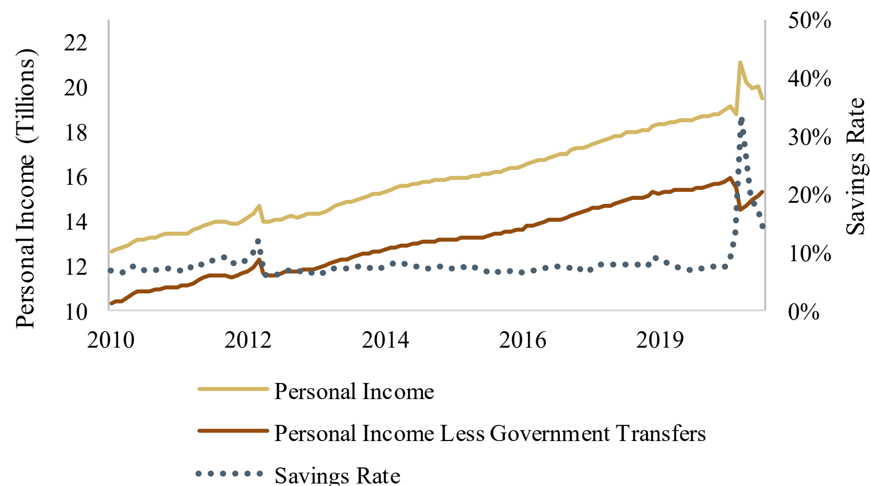


Source: FactSet



Source: Federal Reserve Board



Source: FactSet

Monetary policy remains accommodative while fiscal stimulus provided earlier this year has largely expired.

- **(Top Left)** The Fed Balance Sheet expanded to $7 Trillion early in the crisis and with a Fed Funds rate near 0%, the liquidity provided has helped risk assets continue to move higher.
- **(Top Right)** The Fed updated its long-term inflation target implying that it would not raise rates for the next few years. Fed officials have discussed allowing inflation to build and reach sustainable levels before raising rates, acknowledging its past mistakes of raising rates too soon during a recovery.
- **(Bottom Left)** The economic relief from the CARES Act (mostly in the form of Transfer Payments) has largely run its course and personal income is falling as these benefits expire. The benefits coincided with restrained spending and higher savings. While Congress will likely provide additional fiscal stimulus, questions remain around its scope, size and timing.

MAIN STREET IS STILL SUFFERING

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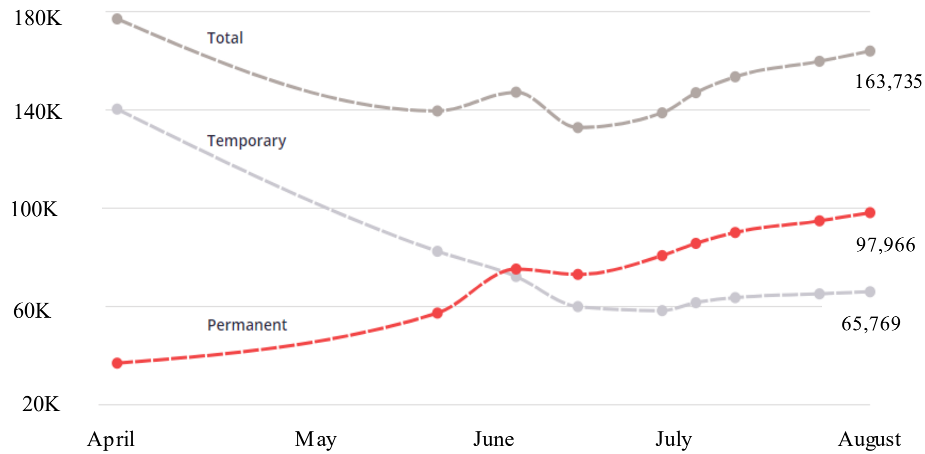
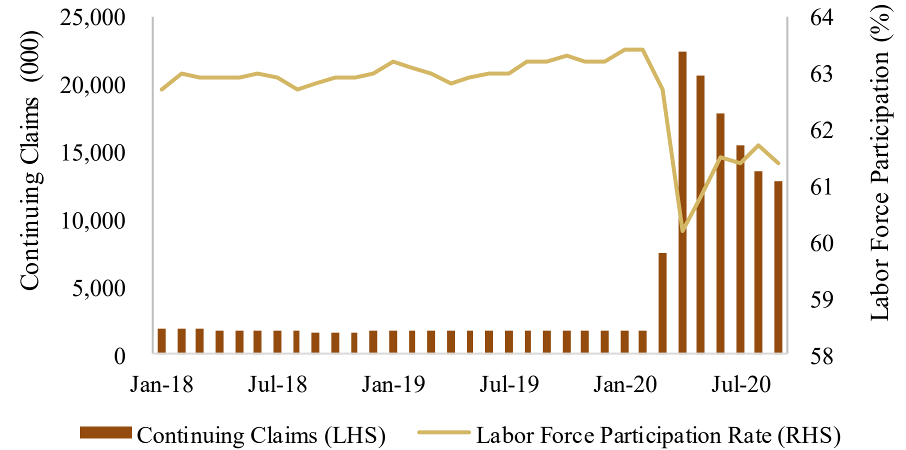
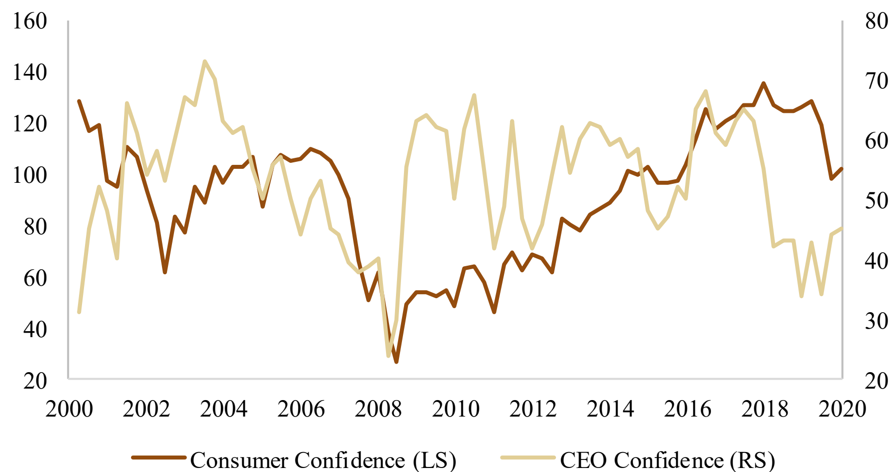


* Closures are updated through 8/31/2020. Data may lag closures because of the time taken to report and verify closures. Source: Yelp



Source: Bloomberg



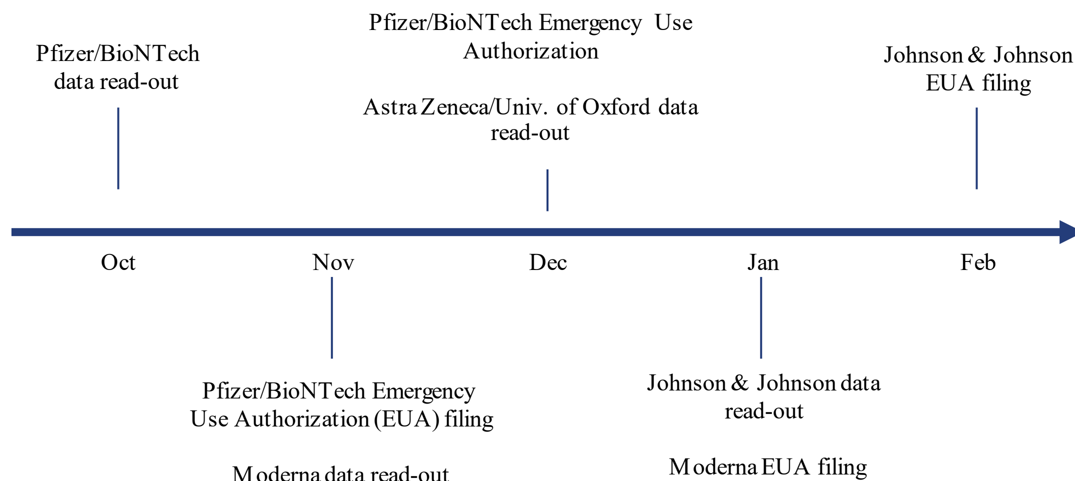
Source: FactSet

The economy is slowly recovering but major challenges remain for Main Street.

- **(Top Left)** Small businesses continue to be challenged as consumers stay home. According to Yelp, the number of closed businesses has increased since June and permanent closures have steadily increased since the start of the pandemic.
- **(Top Right)** Over 22 million American jobs were lost during early stages of the pandemic and 12.6 million remain unemployed today. The recent decline in the Labor Force Participation rate means fewer working age people are actively seeking work which skews the stated unemployment rate. The lower participation rate may indicate a more tenuous economic recovery.
- **(Bottom Left)** Consumer Confidence remains low relative to where it started the year while CEO Confidence has improved in recent months despite expectations for increased layoffs. Allstate, Goldman Sachs, Disney, Ralph Lauren and the airlines have all recently announced layoffs. Companies are also reducing capital spending to help navigate uncertain economic conditions.

VOLATILITY EXPECTED TO REMAIN ELEVATED THROUGH 2020

Potential Vaccine Timeline (Estimates of Leading Phase III Candidates)



Source: World Health Organization; JP Morgan

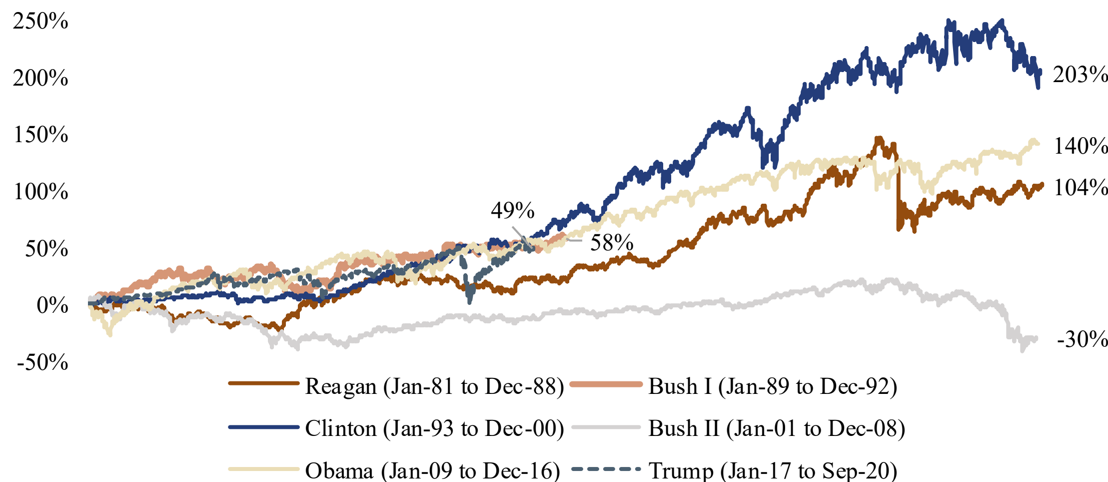
The Coronavirus Pandemic

- A Covid vaccine is key to returning to some semblance of normal life in the U.S. There are more than 35 vaccines being evaluated in humans today with over 150 in preclinical development.
- If the current leading vaccines have positive data read-outs, a vaccine could be approved under Emergency Use Authorization by the end of the year. Pfizer/BioNTech appears to be the front-runner.
- The U.S. Government has contracted for 800 million vaccine doses from the leading developers with options for an additional 1.6 billion doses.
- There are many unknowns: Are the vaccines safe? How long are they protective? How many doses will be needed? Will Americans get vaccinated?

The 2020 Presidential Election

- It's common knowledge that the markets hate uncertainty. Historically, volatility in the stock market is elevated in the months leading up to a U.S. Presidential election. Volatility in 2020 has been high, attributable to the uncertainty from the pandemic as well as the polarizing impending Presidential election.
- In the November election there are numerous topics garnering significant domestic and global attention. Specific to the U.S. economy, critical policy issues could include (1) Taxation, (2) Fiscal Spending, (3) Regulation, and (4) Trade.
- Investors are well-served to remember that stock returns depend on multiple factors, many of which are outside the control of any administration. The stock market has gone up and down under all presidents, but over time, the trajectory has been positive.

S&P 500 Returns During Presidential Cycles Since 1981



Source: FactSet

THE MARKET SEEMS TO BE LOOKING BEYOND THE VIRUS

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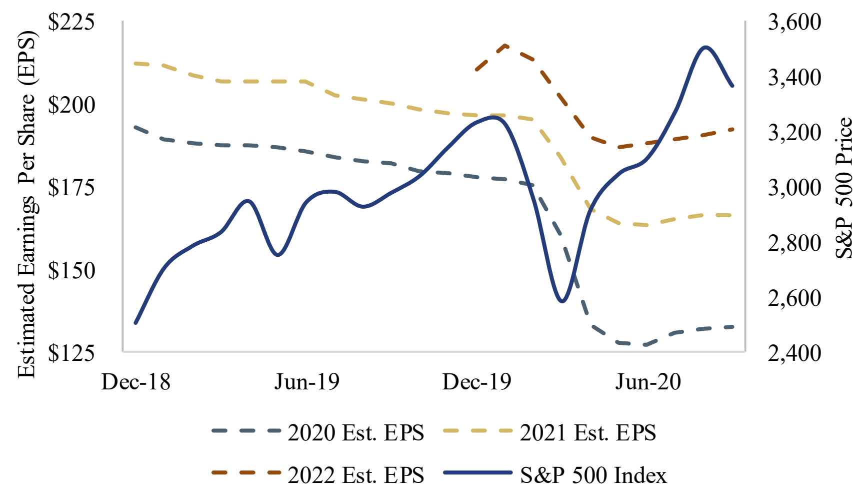
- **(Top Left)** The market has rebounded and advanced as a result of the quick monetary and fiscal stimulus response to the onset of the Covid-19 pandemic and ensuing recession. Very low interest rates have also made equities attractive. Earnings estimates, however, have not fully recovered as the economy is taking longer to emerge from the economic shutdown. This has driven an expansion in the market's price-earnings multiple relative to history.
- **(Bottom Left)** Using 2021 estimated earnings when valuing the market assumes the economy will return to a more normalized environment post-election with the expectation that Covid-19 conditions improve and a vaccine is approved. Current consensus estimates for the market reflect a strong earnings recovery in 2021 and 2022.
- **(Bottom Right)** With the economy in the process of re-opening, earnings estimates have stopped declining and have now stabilized over the last three months. But it is clear that the economic shutdown erased approximately one year of earnings growth. The market seems to be discounting an earnings recovery but at historically high valuations and with a clouded outlook, investors should remain vigilant.

S&P 500 Level Implied by Price to Earnings Combinations

		Price/Earnings Multiple				
		12x	14x	16x	18x	20x
	$ 190	2,280	2,660	3,040	3,420	3,800
	$ 180	2,160	2,520	3,040	3,420	3,800
S&P 500	$ 170	2,040	2,380	2,880	3,240	3,600
Earnings	$ 160	1,920	2,240	2,720	3,060	3,400
per Share	$ 150	1,800	2,100	2,400	2,700	3,000
	$ 140	1,680	1,960	2,240	2,520	2,800
	$ 130	1,560	1,820	2,080	2,340	2,600

S&P 500 Top Down Estimates	
	Mean
2019A	$ 164.60
2020E	$ 132.30
2021E	$ 166.20
2022E	$ 192.30

S&P 500 Index vs. Earnings Expectations



Sources: FactSet, Bloomberg

MACROECONOMIC SCORECARD: SEPTEMBER 30, 2020

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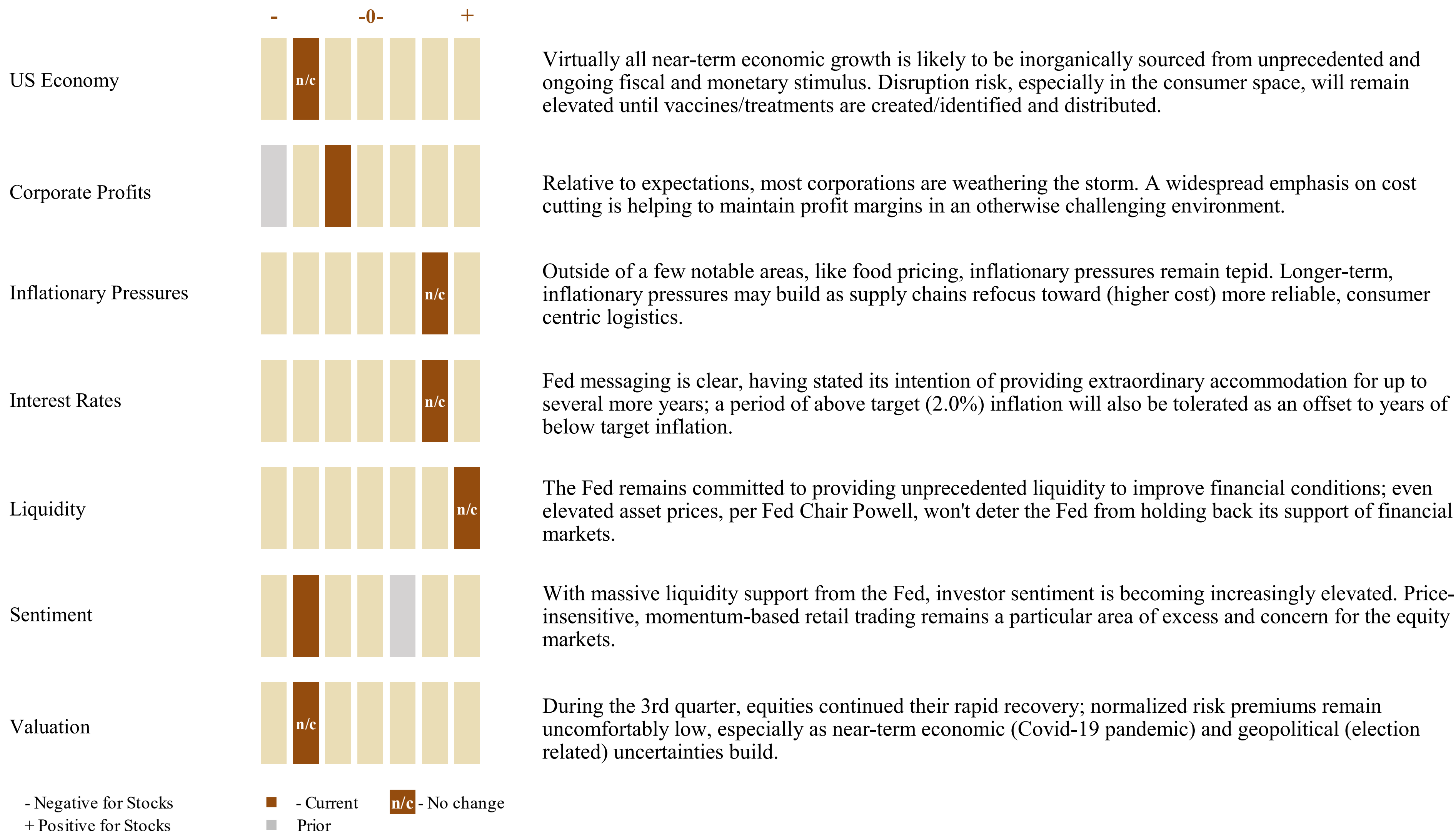
Benefitting from massive fiscal and monetary stimulus, global economies are showing signs of stabilization. Risk assets were encouraged by this notable economic progress and stocks were rewarded in the third quarter. Significant pandemic-related challenges remain, especially for industries and sectors that rely on human interaction.



MADISON MACRO VIEW: THIRD QUARTER 2020

News Influencing Markets

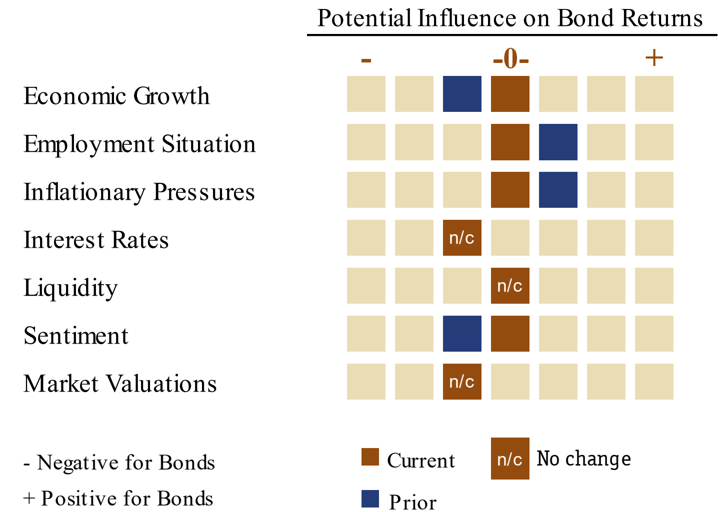
Potentially Positive for Bond Returns

+ A fall/winter acceleration (i.e. second wave) of Covid-19 infections could throttle back reopening progress, increasing the appetite for safe haven assets.
+ Political pre-election haggling or uncertainty around the election outcome could potentially defer much needed fiscal support while we wait for an impactful vaccination program.
+ The Fed's "whatever it takes" approach to policy could lead to an unexpected shift toward previously eschewed actions such as adopting negative yields or yield curve control measures.

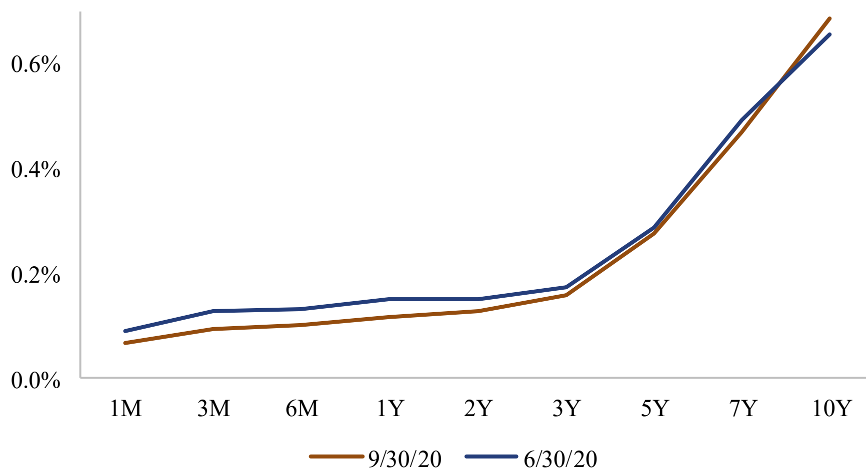
Potentially Negative for Bond Returns

– The continued path of reopening the economy and medical breakthroughs on a vaccination and treatments should ultimately accelerate a return to economic normalization and higher interest rates.
– Longer maturity rates typically rise during periods of expanding federal budget deficits, thereby causing the yield curve to steepen.
– The Fed's shift to average inflation targeting reflects their desire to raise measured inflation and future inflation expectations, both of which could pressure rates higher.

Fixed Income Scorecard



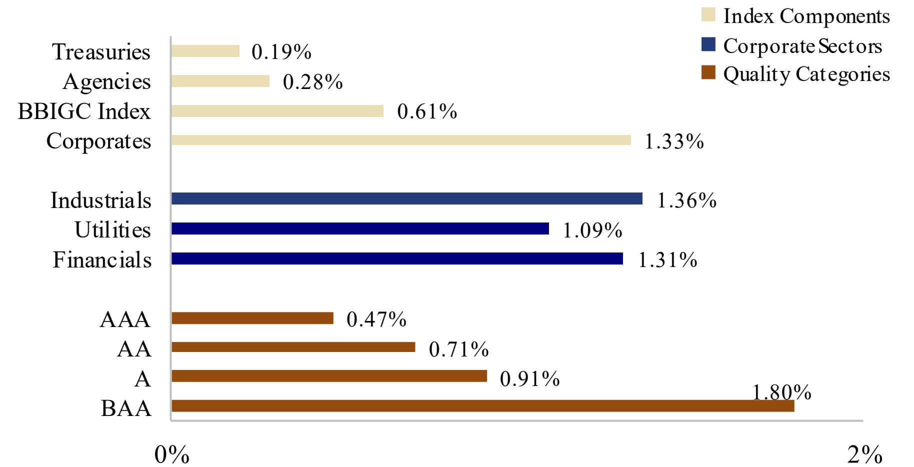
Treasury Yield Curve Comparison



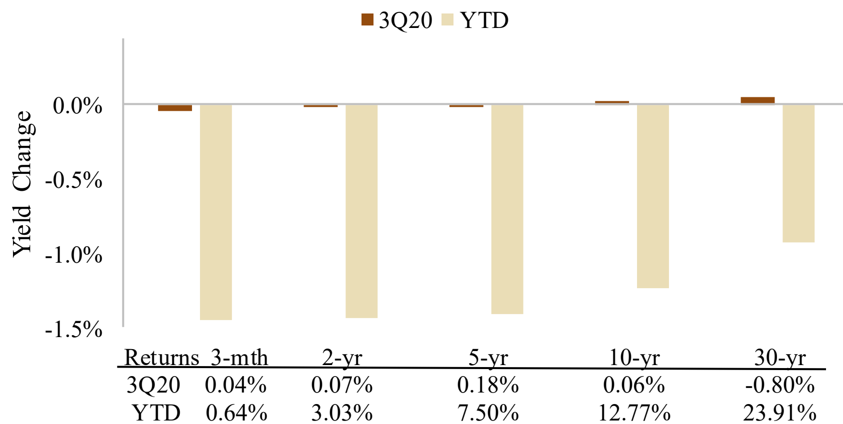
10-year U.S. Treasury Yield

Sources: Bloomberg, Madison

Asset Class	Market Sector	3Q20	YTD
Money Market	3-month Tbill	0.0%	0.6%
Fixed Income	Intermediate Gov/Credit	0.6%	5.9%
	US Aggregate (1-30 yr)	0.6%	6.8%
	Municipal Bonds (1-30 yr)	1.2%	3.3%
	EM Aggregate	2.4%	1.9%
	TIPS (1-10 year)	2.5%	6.7%
	US High Yield	4.6%	0.6%
Equities	S&P 500 Index	8.9%	5.6%
	Russell 3000 Index	9.2%	5.4%
Int'l Equities	MSCI Europe, Asia, Far East	4.9%	-6.7%
	MSCI Emerging Markets	9.7%	-9.8%
Commodities	Crude Oil (Brent)	-0.2%	-42.7%
	Gold	3.6%	21.4%
	Commodities	9.0%	-12.4%

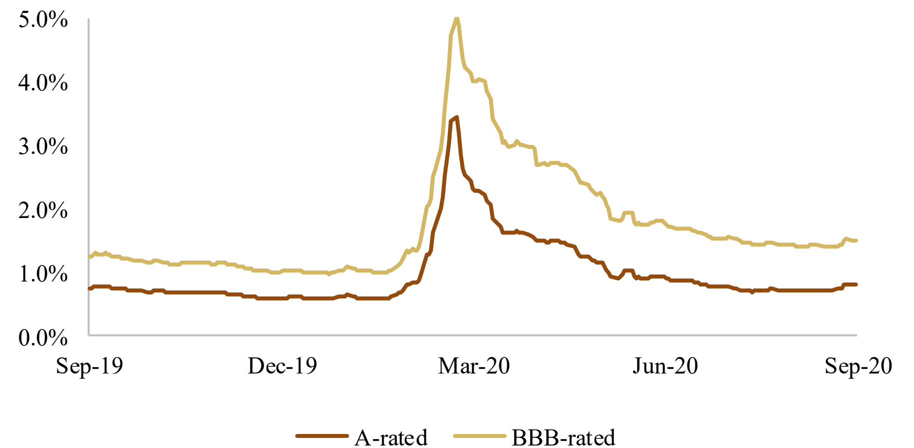


Source: Bloomberg



Returns	3-mth	2-yr	5-yr	10-yr	30-yr
3Q20	0.04%	0.07%	0.18%	0.06%	-0.80%
YTD	0.64%	3.03%	7.50%	12.77%	23.91%

Source: Bloomberg



Source: ICE Data Indices

ECONOMY SLOWLY RECOVERING ALTHOUGH CHALLENGES CONTINUE

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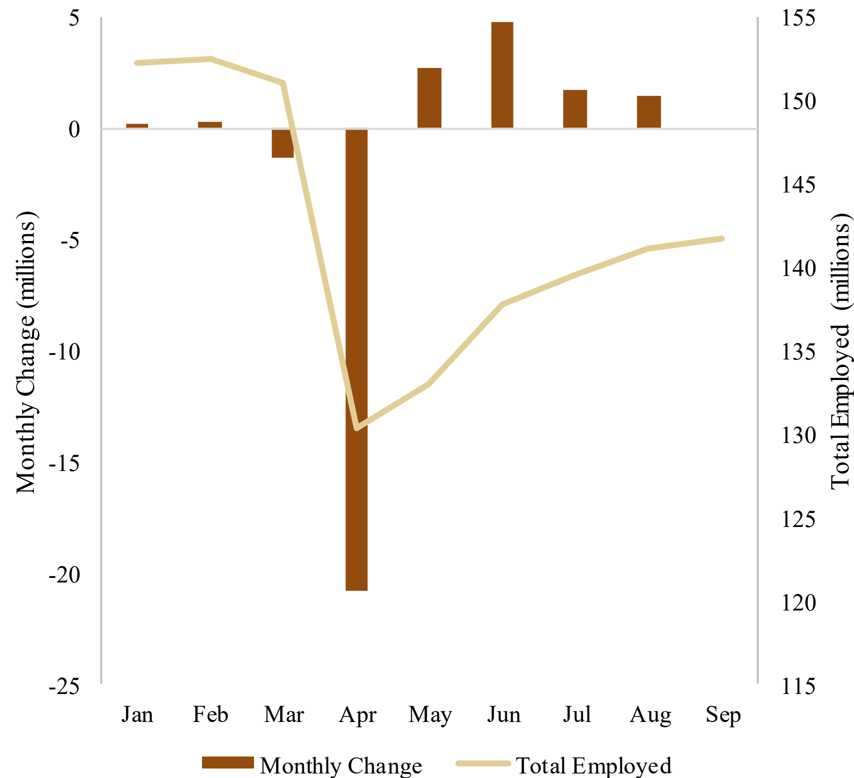
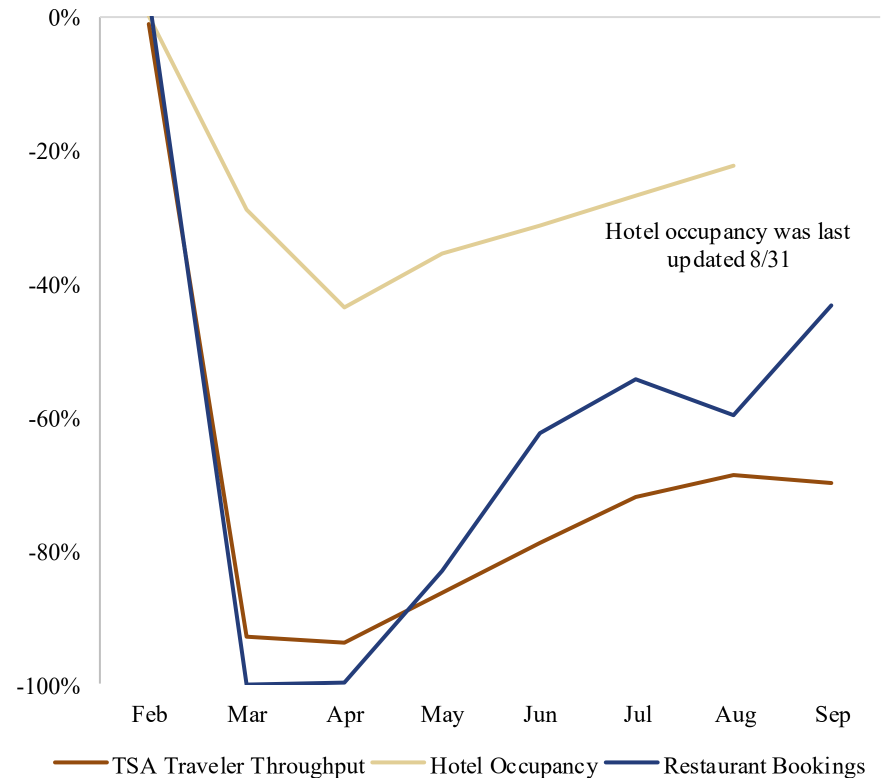


Sources: Bloomberg



Sources: TSA, Statista, OpenTable

- Over 22 million American jobs were lost during early stages of the coronavirus outbreak.
- Since the end of April, U.S. employers have rehired about 50% of unemployed workers.
- However, the pace of rehiring has decelerated since June as many businesses remain closed or face significant reopening challenges.

- Airlines, hotels, and restaurants have struggled to regain traction as business and personal travel remain subdued while many restaurants remain closed or operating below capacity.
- The U.S. Bureau of Labor Statistics reports the Leisure and Hospitality sector has hired about 4 million workers after shedding more than 8 million jobs during March and April.
- According to the Bureau of Economic Analysis, accommodation and food services contributed -4.4% of the -31.4% annualized drop in second quarter GDP.

CONSUMERS HAVE INCREASED SPENDING, YET MAINTAIN AN UNUSUALLY HIGH SAVINGS RATE

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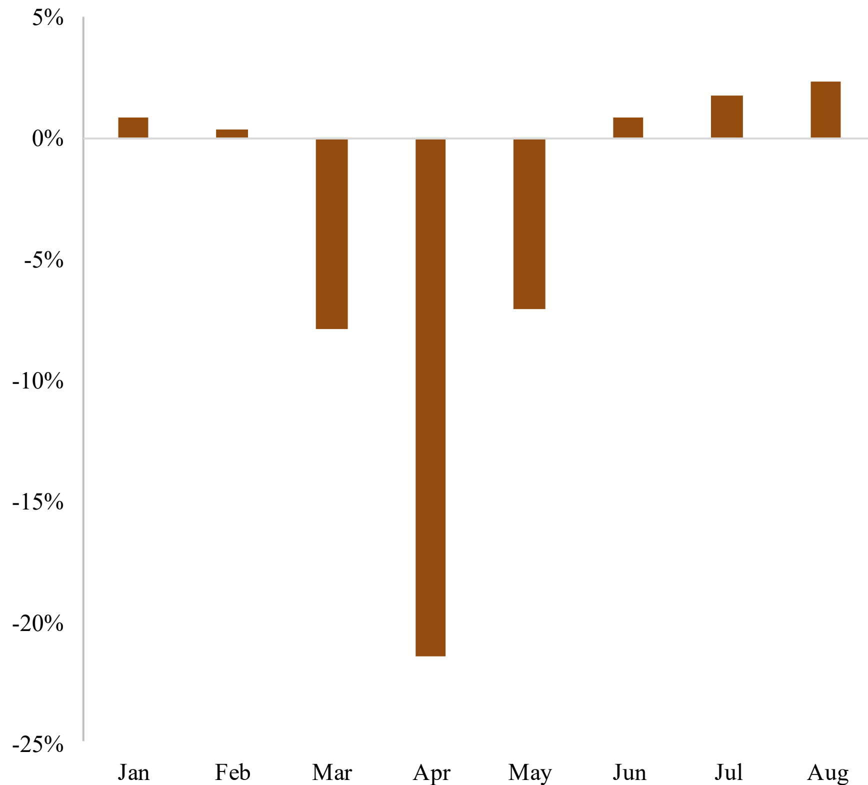
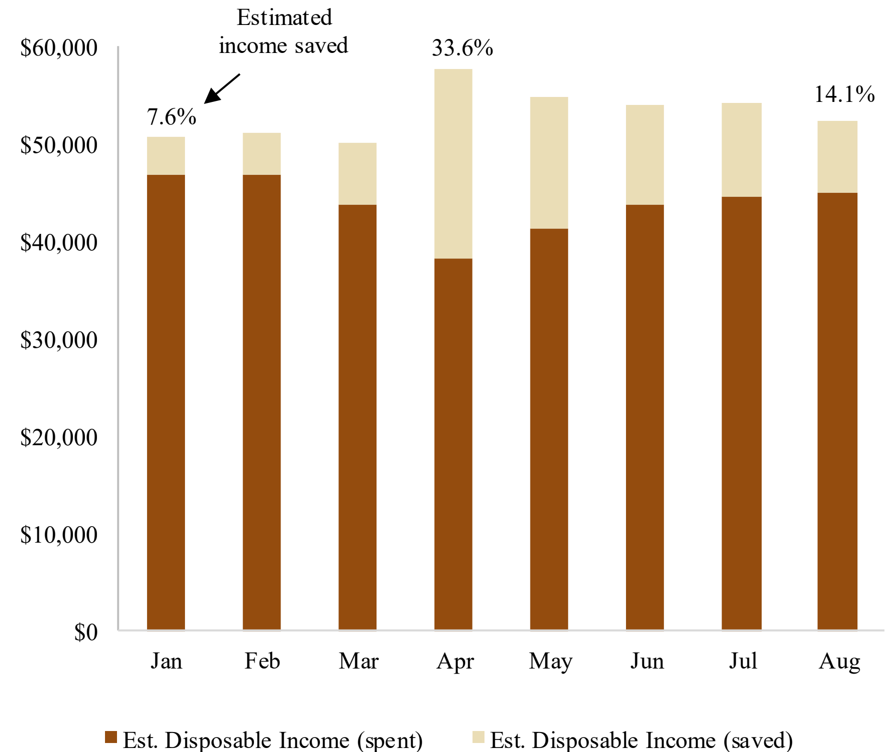
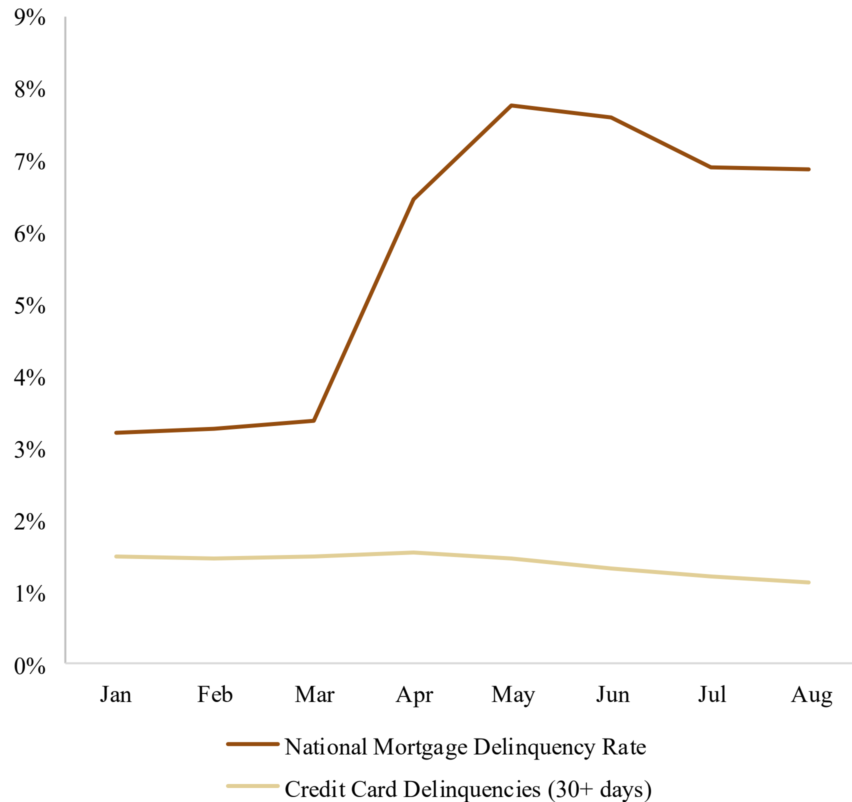




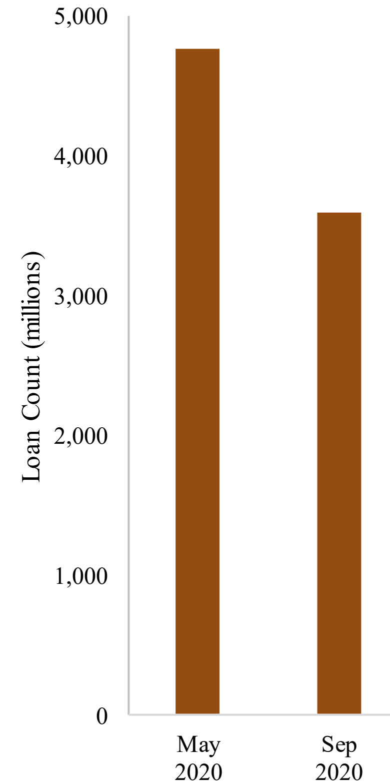
- Consumer spending declined significantly during the first and second quarters as essential parts of the economy slowed substantially or shutdown.
- In June, the retail and food services sales sector managed to rebound to prior year-end levels as consumers adapted to the new spending environment.
- Economic growth in the coming quarters is likely to depend heavily on consumer spending since consumers usually account for nearly 70% of total GDP.

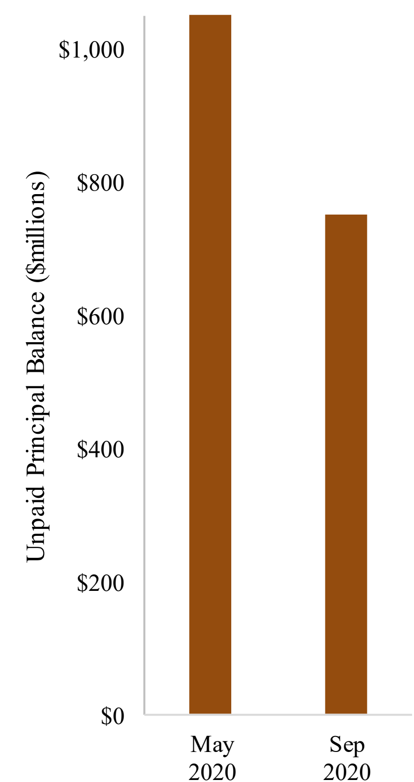
- Disposable income per capita rose in April as the federal government began implementing the Coronavirus Aid, Relief, and Economic Security (CARES) Act.
- As part of the CARES Act, many households received a one-time stimulus payment while unemployed workers received an extra $600 benefit per week.
- The average financial wellbeing of households appears to have improved as evidenced by the notable increase in the personal savings rate.

MORTGAGE BORROWERS CONTINUE TO EXHIBIT STRAINS WHILE CREDIT CARD DELINQUENCIES DECREASE



Sources: Bloomberg, Black Knight





Sources: Black Knight

- Since March, mortgage loan delinquencies have spiked upward from 3.39% to 6.88%. Much of this increase is attributable to borrowers seeking payment relief through forbearance plans.
- In contrast, credit card delinquencies have trended downward since March, perhaps the result of spending declines due to disruptions throughout the economy. (Note: A few credit card companies offer limited emergency forbearance.)

- The number of mortgage loans in forbearance plans have declined since the peak in May.
- However, a large portion of the $800 billion in outstanding forbearance plans are scheduled to end prior to year-end.
- Absent an incremental federal relief plan, job gains, and/or extended mortgage relief, some of these loans may end up in foreclosure.

U.S. INTEREST RATES COULD RISE

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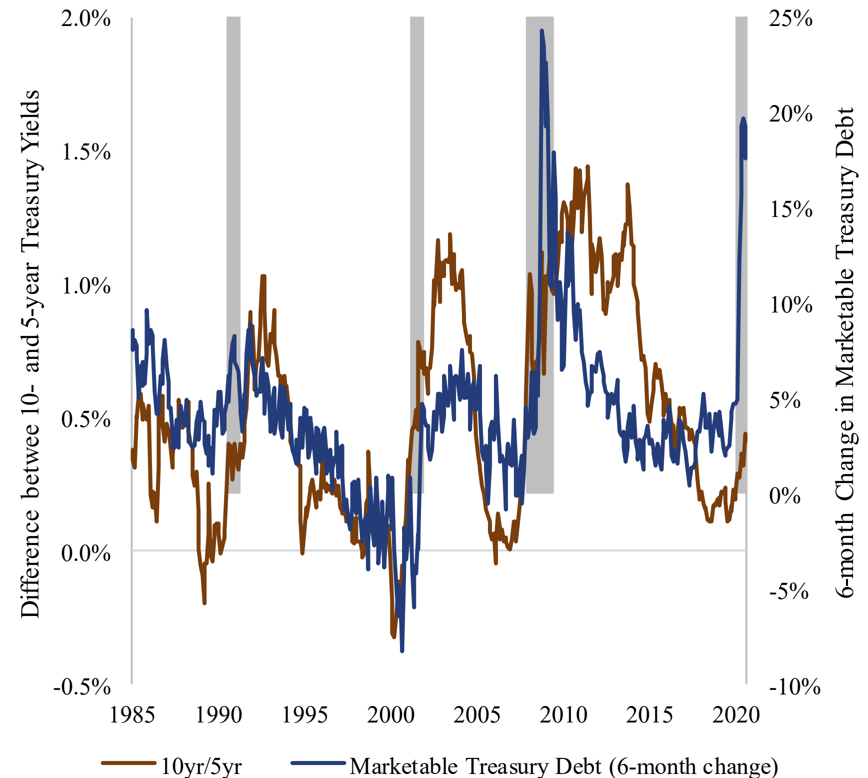

Sources: Bloomberg,

- Treasury bonds have become less attractive to foreign buyers as U.S. interest rates have declined much more than comparable global rates.
- Year-to-date, the U.S. 10-year yield has fallen by roughly -1.23% while comparable Euro area, Japan, and China rates changed by -0.34%, 0.03%, and 0.00%, respectively.
- Should the interest rate differentials persist or constrict further, foreign demand could diminish at a time the Treasury Department finds it necessary to issue additional debt.

- Total U.S. Treasury public debt has ballooned to nearly $27 trillion, an increase of more than $3 trillion since the onset of COVID-19.
- The Congressional Budget Office projects deficit spending during the next two years will range from $1.3 trillion to $1.8 trillion.
- History suggests increased Treasury issuance tends to coincide with both recessionary periods and a widening of interest rates between longer and shorter maturities (e.g. steeper yield curve).
- Although short-term rates could remain near-zero for a prolonged period, a steeper yield curve may provide investors with an opportunity to lock-in incremental yield by extending maturities.

ELECTION UNCERTAINTIES MAY CONTRIBUTE TOWARDS INCREASED VOLATILITY

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Potential Presidential Election Issues

Volatility Comparison
Bonds (MOVE) versus Equities (VIX)

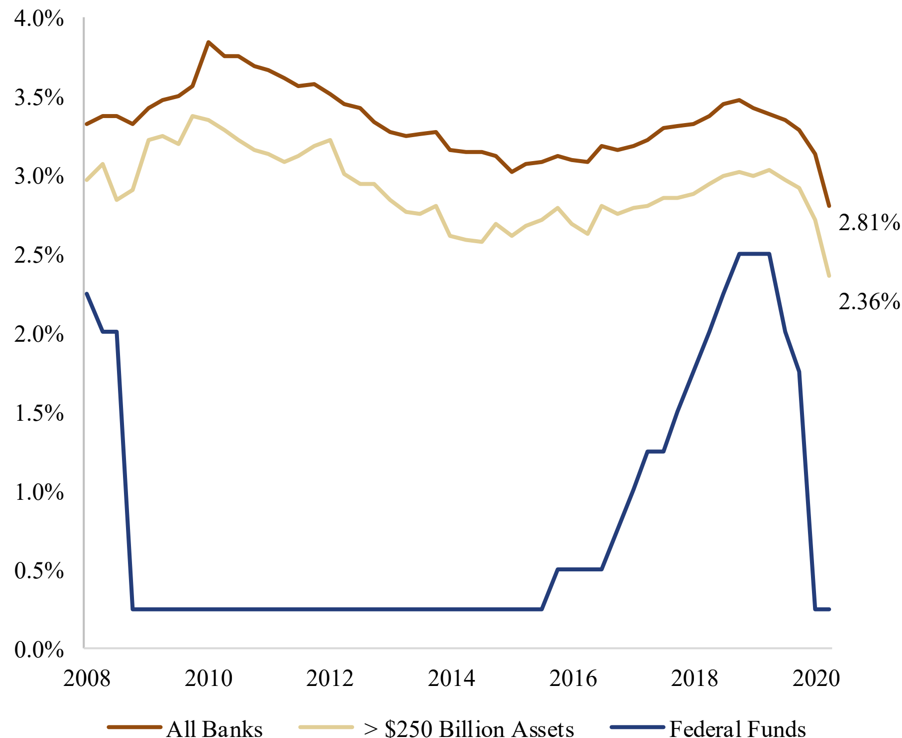
Sources: Bloomberg

- There are numerous topics prone to surface as the presidential election draws near, some of which may attract global attention.
- Specific to the U.S. economy, the critical policy issues could include (1) Taxation, (2) Spending, (3) Regulation, and (4) Trade.

- The vast election uncertainties could lead to an upsurge in volatility for both the equity and bond markets.
- Currently, equity market volatility is above its long-term average while bond market volatility is well below its long-term average.
- This suggests bond investors may have become complacent, pacified by both the Fed’s likely commitment to maintain a low rate environment for the next 2 to 3 years as well as the central bank’s support for most fixed income asset classes.

BANK MARGINS ARE HOLDING UP DESPITE LOW INTEREST RATES WHILE RISKIER CORPORATE ISSUERS ARE PAYING MORE

Madison INVESTMENTS



Sources: Bloomberg

Sources: ICE Data Indices

- A healthy U.S. banking system remains paramount as the economy recovers.
- By and large, banks are well-capitalized due to regulatory changes stemming from the 2008 financial crisis. Yet, near-zero interest rates may continue to pressure bank margins.
- Of concern is the possibility for banks to restrict lending activities due to an inability to maintain favorable margins and/or engage in riskier activities to boost profits.

- The risk premium between non-investment grade and investment grade bonds dropped early in the second quarter before increasing in recent weeks due to worries about the economic recovery.
- The degree of spread difference is often an early indicator of corporate financial health, a factor that considers both corporate earnings and an issuer's ability to service debt.
- Investment grades spreads are currently near their ten-year average, in contrast to high yield bonds which are above their ten-year average. In our opinion, positioning creditworthy issuers at appropriate valuations will be key to long-term performance.

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The Bloomberg Barclays Global Aggregate Bond Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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The Bloomberg Barclays US Treasury Inflation-Linked Bond Index measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.

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