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On the Radar

FAQS ON THE MARKETS AND ECONOMY

What was the important statement that Fed Chair Powell make at the Jackson Hole Symposium?

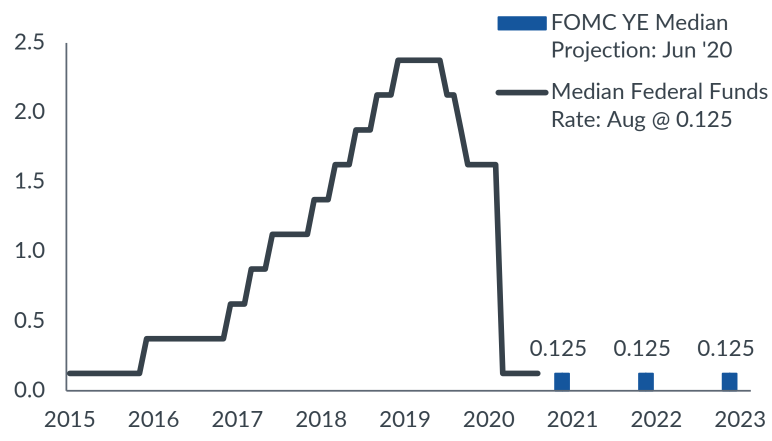
The Fed will no longer have a firm target of 2.0% on inflation. Now, the Fed will seek inflation that averages 2.0% over time (they did not give any more details). It is called Flexible Average Inflation Targeting (FAIT). It implies the Fed will allow the economy/inflation to run "hot" for a while before they believe they need to make a preemptive move to raise interest rates to quell inflationary pressures. This should allow the unemployment rate to fall further.

This new approach is a very hawkish move by the Fed. It is an aggressive strategy designed to restore the economy to full employment and bring inflation back to healthier levels.

The Fed now believes that a robust job market can be sustained without causing an outbreak of inflation. This strategy will increase the labor force participation rate, which allows for economic benefits of growth to be more widely felt — a nod to racial equity, an issue the Fed has commented on in recent months.

The Fed officially set the inflation target at 2.0% in 2012, one of the last major central banks to do so. Since then, inflation has rarely exceeded 2.0% and averaged just 1.4% for the period. Low levels of inflation are not healthy for the economy. Inflation below the target is just as bad as inflation above the target. The below-target inflation causes a drop in long-term inflationary expectations. This, in turn, can pull down actual inflation. The Fed wants a moderate and sustainable level of inflation, since it encourages investment — it provides pricing power. Also, low inflation contributes to low-interest rates, which makes it difficult to ward off economic downturns, which potentially makes them deeper and longer.

Federal Funds Rate & FOMC Projections (%)



Source: Federal Reserve Bank as of August 2020.

KEY QUESTIONS

What's behind housing's recovery?

Is manufacturing continuing its rebound?

How is state pension funding affected in the current environment?

What is the outlook for EM Asia equities?

What's behind housing's recovery?

While most areas of the U.S. economy are undergoing a gradual improvement in activity, housing is exhibiting signs of a V-shaped recovery.

This is the first recession that saw little to no impact in the housing market. Despite the devastating impact from the COVID-19 outbreak, demand has remained resilient thanks to all-time low mortgage rates that have improved housing affordability, as well as a demographic tailwind from a large wave of millennials finally entering the housing market after years on the sidelines.

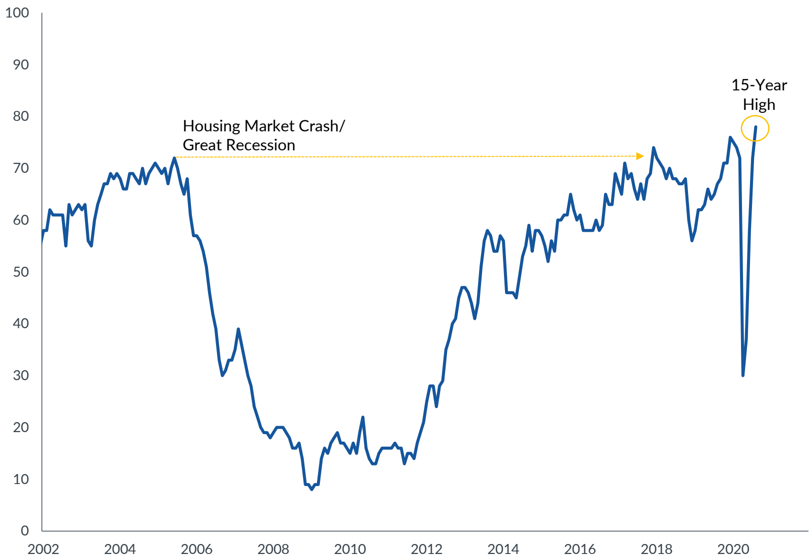
The rebound in homebuilding activity has now extended to three consecutive months, bringing starts within 5% of their pre-pandemic levels and homebuilder confidence to an all-time high that was last reached in 1988.

Looking forward, we wouldn't be surprised if housing hits some near-term turbulence. Existing home sales are now 1.7% higher from February's pre-pandemic high, setting a new post-Great Recession record, and new home sales are at their highest level since 2006. However, a good part of the recent sales pace reflects pent-up demand from the March/April shutdowns and is not expected to continue.

The resurgence of COVID-19 over June and July, combined with the recent expiration of more generous unemployment benefits and a slowing jobs recovery, may also lead would-be homebuyers to take a breather, much like higher-frequency spending data are showing.

Still, given fundamentals, we believe housing will remain solid and an important contributor to economic rebound in the year ahead.

NAHB/Wells Fargo Housing Market Index



Source: NAHB/Wells Fargo Housing Market Index. U.S. Census Bureau as of August 2020.

Is manufacturing continuing its rebound?

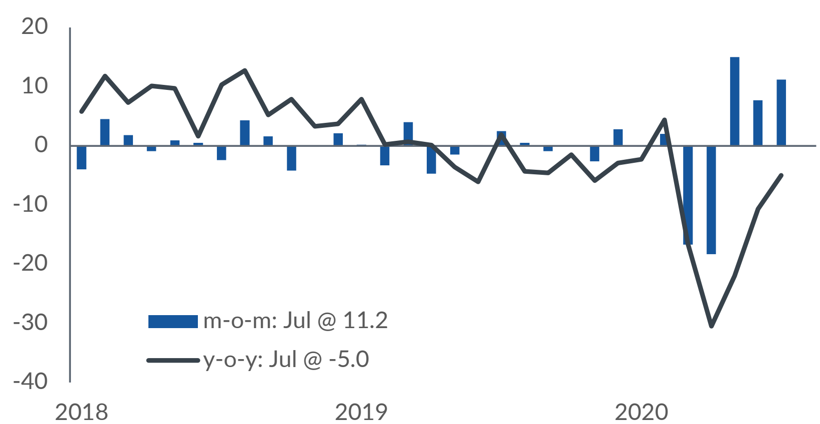
Yes, the production machine is moving back toward normal, brought on by strong demand by consumers for goods, since social distancing prevents many purchases of services. There is great strength in the areas that cater to the new COVID-19 life of social distancing. The demand for computers and communication orders has surpassed the peak levels of earlier in the year.

Just last week, it was reported that durable goods orders surged by 11.2% in July. This marks the third consecutive monthly increase (see chart). It was pushed up by strength in the transportation sector, more specifically, in motor vehicles (a 21.9% increase in July, which followed an 85.6% increase in June) and aircraft. The demand for vehicles is so strong that it is making it difficult for automakers to keep up with supply.

More importantly, Core CAPEX orders increased by 1.9%. This comes on top of the 4.3% jump in June. This is a proxy for equipment CAPEX in the GDP calculation and is showing very positive momentum.

Durable Goods Orders

% change, seasonally adjusted



Source: U.S. Census Bureau as of July 2020.

How is state pension funding affected in the current environment?

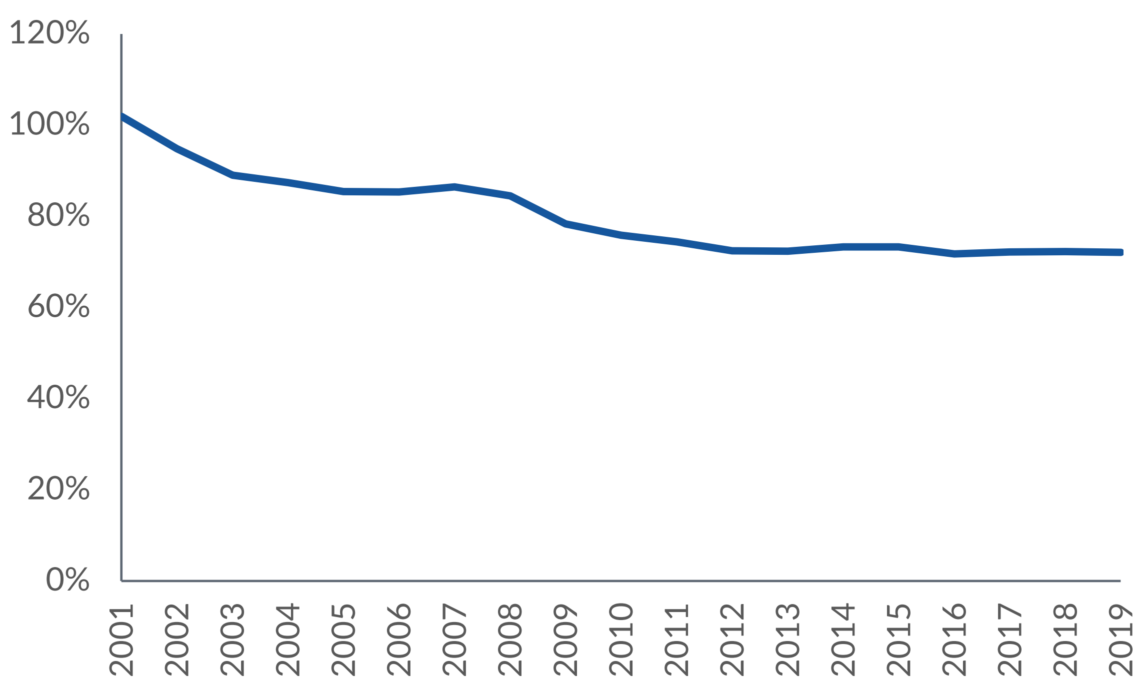
Implications of the current public health crisis and economic dislocation will likely weaken the funding discipline of some state pensions over the intermediate term as budget deficits collide with the need to increase contributions to offset fluctuations in plan asset performance. However, each pension plan is unique, and the environmental and social impact of COVID-19 on assets/resources will differ within the sector as well. Nevertheless, state governments face significant challenges and will likely contemplate a range of options to achieve budget balance through various fiscal engineering measures.

Since the financial crisis of 2008-09, there's been more focus on improving the long-term transparency and sustainability of plans — an emphasis on increasing the funded status, decreasing market risk and reducing contribution deferrals. For example, Connecticut recently lowered the long-term expected return assumption (i.e., discount rate) of its Teacher's System to 6.9% (from as high as 8.5%). In New Mexico, legislation minimized the cost of living adjustments for retirees and raised employee contribution rates. In other cases, some plans incorporated more risk-sharing between the sponsor and employee participants.

However, to alleviate stress, some states may seek budget relief by reversing some of the progress made in previous years. Colorado, for example, will suspend a $225 million supplemental pension distribution in FY 2021 to help close a projected gap; this will add to future funding pressure. California, which favorably modified elements of plan design/structure throughout the past few years, paid extra into CalPERS and CalSTRS in FY 2020 to accelerate funding progress. However, the state was creative in the FY 2021 budget by converting a portion of previous supplemental payments (from budget surplus) used to lower the unfunded liability into a “pre-payment” of contributions for the next three years.

Many plans continue to rely on risky asset allocations to achieve their long-term expected return. Consequently, volatility in asset performance, particularly equities, could weigh on funded ratios and future funding trajectory. The S&P State Pension Funding Survey notes median returns for FY 2019 were 5.9% (below median assumed rates of 7.2%). In FY 2020, CalPERs, viewed as the pension bellwether, achieved a preliminary net return of 4.7% versus its assumption of 7% (plan FYE is June 30, 2020). All else being equal, a rise in unfunded liabilities from asset underperformance will require a phase-in of higher contributions in the future. We expect most states to manage their burdens, but continue to monitor all pension plans for continued progress toward full funding over time.

Actuarial Funded Ratio for State and Local Pensions, 2001-2019



Source: Public Plans Database.

What is the outlook for EM Asia equities?

We believe both the near-term and long-term outlook for EM Asia equities continue to be attractive.

In the near term, Asian economies are expected to be among the first to recover globally from the COVID-19 crisis amid billions of dollars in stimulus and relatively effective virus containment.

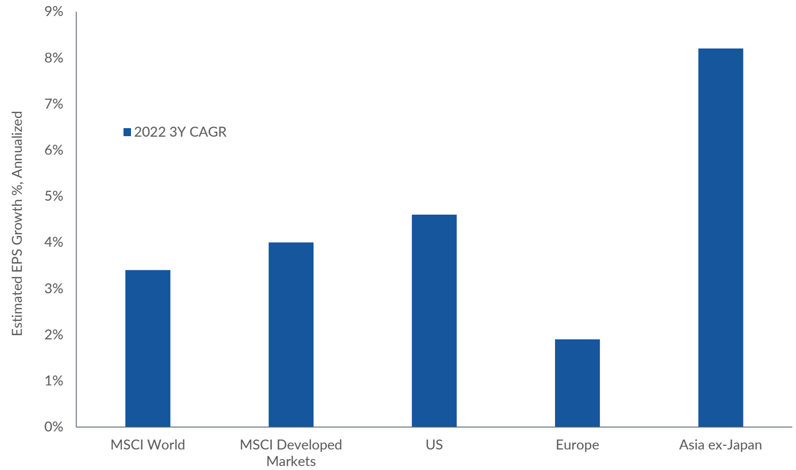
Bright spots have already emerged, such as improving Chinese data for consumer demand and industrial output, as well as sizeable rebounds in June PMIs across the region.

At the same time, most of Asia's emerging markets are better equipped to manage any potentially resurgences in the virus, given a strong testing and contact tracing infrastructure in place.

Persistent low interest rates in the U.S. are also a positive, helping take pressure off EM central bankers, strengthening Asian currencies and reducing costs on emerging market companies with dollar-denominated debt.

For long-term investors, our proprietary 4PS Framework analysis continues to indicate the investment opportunity is compelling. The region's growth outlook remains resilient, supported by robust demographic and urbanization trends and high investment rates. EM Asia also boasts a superior earnings growth profile, particularly versus other non-U.S. developed markets, and remains attractive relative to other geographies.

3 Year Forward Earnings Growth (2020-2022)



Source: Bloomberg Finance, LP, iFAST.

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Investing in international markets carries risks such as currency fluctuation, regulatory risks, and economic and political instability.

Emerging markets involve heightened risks related to the same factors as well as increased volatility, lower trading volume, and less liquidity. Emerging markets can have greater custodial and operational risks, and less developed legal and accounting systems, than developed markets.

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Investments in emerging markets bonds may be substantially more volatile, and substantially less liquid, than the bonds of governments, government agencies, and government-owned corporations located in more developed foreign markets.

Returns include the reinvestment of interest and dividends.

Investing involves risk, including the loss of principal.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money.

Past performance is no guarantee of future performance.

Index Definitions

NAHB Housing Market Index is a gauge of builder opinion on the relative level of current and future single-family home sales.