HANOVER ADVISORS

Charting the Path Ahead

Following steep losses in the immediate aftermath of the coronavirus, the stock market saw a swift recovery, making up much of the losses and, in some cases, reaching new highs. Despite the rebound in the stock market, the broader economy saw a historic 32.9% decline in GDP in the second quarter. While we anticipate a return to positive growth in the third quarter, it is unlikely that we will return to pre-pandemic levels of economic activity for at least 6-12 months. We had previously forecast that the economic recovery would be two-phased, with an initial rapid bounce, followed by a more gradual climb. It is clear that we are now in the second phase, but the ultimate trajectory of the recovery remains unclear.

The path of the recovery depends primarily on two variables: the spread of the virus and the actions that policymakers take in response. Both the fiscal and monetary response to the pandemic have been rapid and robust. Congress is still debating what the next round of stimulus will contain, but economists generally expect a spending package substantial enough to boost economic momentum.

The efficacy of economic stimulus is tempered somewhat, however, by the actions of the American consumer. Consumer sentiment has fallen in recent weeks, as the American public is bombarded with news about the virus's surge in certain regions. Luckily, most experts agree that this is the initial wave of the virus, rather than a second wave, and these hot spots are already beginning to see a decline in new cases. The most important data point is that, even in these hard-hit regions, the mortality rate has remained extremely low.

It is extremely unlikely that any country institutes a nationwide lockdown, but we do expect to see the virus flare up in various regions throughout the world, requiring highly directed, regional responses. Reticence on the part of the consumer to engage in certain activities, such as those that require large crowds or face-to-face transactions, is likely to continue, but will ebb and flow as new treatments are developed and work on a vaccine continues. All of this means that the economic recovery will continue to be uneven. Certain regions and sectors will perform well, and others will lag. Uncertainty will remain high and periods of volatility are likely to persist.

One additional source of uncertainty is the upcoming election. Despite recent polling, we expect the race will tighten as the election draws closer. The improving economy will shrink the polling gap, as will the improving conditions with regards to the coronavirus. The recent flare ups in places like Florida and Texas have already begun to see a decrease in new cases, and the rate of hospitalizations and deaths, which lag a few weeks behind, is expected to similarly rollover. The market would likely fare better under the incumbent, if only because it is already a known quantity. Should the Democrats take the White House, or take control of the Senate, there would be a period of heightened uncertainty in the market until it becomes clear how the new administration will approach the economy,

Despite all this, we are still bullish on the long-term prospects of the U.S. economy, as well as much of the global economy. Indices that track business activity in the service sector have shown the American recovery to be more rapid than many expected, and the same indices show a similarly robust rebound in Europe. While it is impossible to predict the exact path that the economic recovery will take, we remain focused on our long-term investment strategy and will continue to monitor and assess risk through asset allocation models.

U.S. Stocks

One of the primary drivers of the stock market's impressive rally has been the swift, accommodating actions of the Federal Reserve. In an effort to ensure liquidity in the market, the Fed has pumped unprecedented amounts of money into the economy. This has resulted in not only the impressive rally but may also spur inflation.

Though it remains unlikely that we will see runaway inflation, the Fed's actions and the massive economic stimulus make it more likely that we will see a spike in the inflation rate in the near future. Such an increase in inflation may lead to an increase in interest rates, which could have negative consequences for the stock market. We anticipate that such a spike would be short-lived however, and we expect inflation to remain tame in the long term.

While we are optimistic about the stock market's prospects, this optimism must be tempered with caution. There are some short-term risks, such as stretched valuations and disconcerting levels of speculation. Wall Street may have been too optimistic about pricing in a rapid recovery. There also remains the possibility of a second wave of the virus. We may see a retracement in the stock market in the coming months, but we remain focused on the long term, and will continue to monitor risk and asset allocations so that we can tactically react as needed. In this market, we continue to prefer U.S. equities over international ones, but we are beginning to add more foreign equities to our holdings. We had been previously underweight on international stocks, but as the dollar loses some of its strength, they become more attractive because gains can be enhanced by currency appreciation. We also prefer large cap stocks over smaller ones, as they have better access to capital through their ability to borrow globally.

Fixed Income

Returns for most fixed income vehicles are positive for the year, thanks again in large part to the actions of the Federal Reserve. The central bank's swift cuts to interest rates and unprecedented buying of assets averted a liquidity crisis. A strong economic rebound in the second half of the year could cause the Fed to reconsider current rates, but we expect them to remain low for the foreseeable future.

Our preference for investment-grade corporate bonds remains, but with an added emphasis on credit rating. BBB-rated bonds, which make up the bulk of the market, carry an added risk. As the economy recovers, there will inevitably be winners and losers, and many companies could potentially see their credit rating fall below BBB. This would reclassify their bonds as high-yield, or "junk," forcing selloffs and accruing steep losses. For this reason, we prefer investment-grade corporate bonds that are rated above BBB.

That said, with yields so low, investments in existing high-yield bonds are looking more attractive. Projections that we find reliable show that over the next 10 years, U.S. credit bonds are expected to generate returns between 1.8% and 2.8% and carry a median volatility—meaning the level of risk associated with the investment—of 6.1%. Comparatively, U.S. high-yield corporate bonds are projected to have returns of 4.8% to 5.8% with a median volatility of 11.4%. This means that high-yield bonds are likely to see notably higher returns with only a slight increase in the risk level.

There is a strong possibility that taxes will increase next year, either because of the outcome of the election or because of the massive debt being accrued by coronavirus relief spending. The prospect of higher taxes makes muni bonds and their tax-free income more attractive. However, selectivity and careful attention to the credit rating and economic health of the municipality issuing the bond is more important than ever. While most municipal bonds have strong credit ratings, the impact of the lockdown will weigh heavily on municipal budgets, so downgrades, and potentially even defaults, remain a possibility.

U.S. Treasuries remain attractive as a hedge against another possible downturn in the stock market. Our portfolios were overweighted with these heading into the downturn, which served us well. U.S. Treasuries historically perform well during periods of turmoil in the stock market.

In terms of duration, we feel mid-term is the most advantageous. Long-term would be the best hedge against another downturn in the market, but in the case of a stronger-than-expected recovery, interest rates could increase, making long-term holdings riskier.

Commodities

Our preferred commodity is gold. Investors looking for a safe investment have pushed gold to record highs in recent weeks. In an environment of high inflation and currency depreciation, gold can be a good way to maintain the purchasing power of one's investments. Furthermore, because gold, like silver, is both a precious metal and an important industrial commodity for many electronics, as the global economy improves and manufacturing recovers, demand will remain high.

International Markets

Economists and analysts were concerned about a global economic slowdown even before the pandemic began. Five of the G7 countries ended Q4 2019 with zero or negative GDP growth. The coronavirus accelerated and magnified the weaknesses in much of the world's economies and led to a deep global recession. Estimates show that the eurozone economy may contract by as much as 20%. The good news is that this recession looks to be extremely short, and there are already promising data that most of the world's advanced economies are poised for a strong recovery in the remainder of the year and early part of next year.

Central banks around the globe have enacted massive economic stimulus programs, and global stocks have recovered most of their losses. However, there are still ample reasons to be cautious. The market may have already priced in a robust recovery, and anything that falls short of the lofty expectations could roil the global markets. Increasing trade tensions between the U.S. and China have the potential to upset a global economy just getting back on its feet. Finally, the possibility of a second wave, or fear of a second wave, could make consumers less willing to spend. We have already seen demand ebb and wane in China as new pockets of the virus flare up.

Conclusion

For the remainder of the year, we will be focusing on the allocation of our stock holdings, concentrating on large cap U.S. stocks, but also rebalancing with an eye toward international stocks. At the same time, we are considering more defensive hedges like ownership of intermediate U.S. Treasuries and gold, as well as Treasury Inflation Protected Securities (TIPS) to guard against inflation. Unknowns such as the path the virus takes or uncertainty surrounding the election—not necessarily regarding the outcome, but because of the huge number of mailed ballots, we may not know the result for days or even weeks—mean that we expect periods of increased volatility.

Despite this, we remain relatively optimistic. We believe that the worst is behind us with regards to the virus and expect a strong recovery in the fourth quarter which will continue into 2021. Though there is a high degree of uncertainty and potential risk, we see no reason to reconsider our long-term strategy. Instead, we will continue apace, closely monitoring risk and reconsidering asset allocations and building defensive hedges if the need arises.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).

- **New enhancements to our portfolio reporting system**. All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.

- As a reminder to our clients that Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, HanoverAdvisorsInc.com, for detailed contact information.

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.