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The End of A Tumultuous Year and A Clearer Path Ahead

As we head into the final weeks of 2020, the economic recovery has continued its strong, if uneven, pace. Third-quarter GDP growth topped lofty expectations, expanding at a 33.1% annualized rate. Strong job growth in October brought the unemployment rate down to 6.9%, a rate much lower than most thought possible early in the year. Manufacturing activity accelerated in October, with new orders jumping to their highest level in nearly 17 years.



The election, a source of uncertainty for the markets, passed without major incident. The results took longer than normal, but it is now looking like we will have a split government. Barring any court decisions, the Democrats will take the White House, and depending on the outcome of runoffs in Georgia, the Republicans will likely retain control of the senate.

Elections sometimes cause investors to reconsider their holdings, worrying that if their preferred candidate or party does not win, it will hurt the economy. A recent study looked at how the markets have fared under the different parties. If between 1900 and 2020, you invested only under Republican administrations, a \$10,000 principal would have grown to \$100,191. Investing only under a Democrat would have returned \$429,526. Both of these pale in comparison to the growth of \$4,303,459 that would have been achieved by simply staying in the market the whole time. Directly comparing the performance of the markets under the different parties over such a timeframe is not particularly meaningful, because the parties' economic philosophies and policies have changed over the years. What the study does show, however, is that making dramatic changes to your investment strategy based on the outcome of an election is almost certainly a losing move, and instead, it is wiser to stay the course and focus on your long-term goals.

Similar studies show that a divided government is historically a tailwind for stocks, and we expect that to be the case now. Such a scenario would make it unlikely that we will see sweeping changes to health care policy and tax rates, and may incentivize bipartisan solutions to issues like infrastructure. One potential downside is that any compromised coronavirus relief package will likely be smaller than expected.

With the election behind us, the primary cause of uncertainty is the coronavirus. We received some extremely promising news recently regarding the efficacy of Pfizer's vaccine, which, with emergency

use authorization, could begin being administered before the end of the year. While this is good news, the vaccine will first go to frontline healthcare workers and high-risk individuals, and it could be well into next year before the vaccine is available to the general population. The development of new, highly effective treatments and therapeutics is also extremely good news, and should mean that, even as case numbers surge, we will not see a commensurate increase in deaths.



The spike in cases as we head into the winter could cause the momentum of the economic recovery to wane. We have seen calls for stricter measures in the parts of the U.S. where cases are spiking. It is unlikely we will see another broad shutdown, but instead more directed and limited restrictions, like bans on indoor dining. U.S. consumer spending has increased more than expected in recent months, but a surge in cases across the nation could slow spending in the fourth quarter.

Europe is also seeing a surge in cases. France and Germany recently introduced new restrictions to halt the spread of the virus, and while these are not as severe as the total shutdown implemented earlier in the year, they are concerning, and the region may slip back into a recession.

Despite a potentially tumultuous couple of weeks ahead, we remain confident in the overall direction of the economy. Third quarter corporate earnings were higher than expected, and fourth quarter estimates have been revised upward. Monetary policy should remain extremely accommodative for the foreseeable future. We may see a spike in inflation in the near-term as the resumption of economic activity pushes prices higher and stimulus spending increases the money supply, but we expect inflationary pressure to remain tepid in the long-term. We expect a full-year GDP contraction of about 4% for 2020 and anticipate growth of around 4% in 2021.

Stocks

In the coming weeks, we expect increased volatility as the stock market reacts to every piece of coronavirus news. Furthermore, the path of the economic recovery is becoming choppier. As each new report of economic data points to either negative or positive momentum, the markets could swing in response, and the surge of coronavirus cases could prove to be a definite headwind for the stock market.

We also remain cautious that speculation has become rampant. The stock market also faces risk in how concentrated gains have been during the recovery. Gains have been uneven, with the bulk going to a handful of stocks with the largest market cap, such as Microsoft, Google, Amazon, Apple and Amazon. Much of September's big selloff was due to profit taking in the technology sector spreading to the broader market.

In the face of potential volatility in the coming weeks, we will remain vigilant in monitoring the risk tolerance and asset allocation of our portfolios, making tactical changes as needed. Over the long-term, however, we think another fiscal stimulus package and an eventual vaccine, coupled with the increased productivity and decreased cost of working from home, will lead to robust growth next year.

Fixed Income

With the Federal Reserve signaling its intention to keep rates near zero for the foreseeable future, Treasury yields are expected to remain low. Despite this, they remain an important element of a diversified portfolio, and could counter against volatility in the stock market. Historically, U.S. Treasuries are negatively correlated to the stock market, meaning that as stocks decline, Treasuries usually see higher returns. This is not guaranteed, but if we see a large sell-off in the stock market this quarter, Treasuries could potentially



serve as an important ballast protecting your portfolio. Given our concerns about a short-term spike in inflation, Treasury Inflation-Protected Security (TIPS) are also becoming more attractive. Despite U.S. Treasuries being a traditional safe harbor, they may face a headwind if the dollar falters. The dollar weakening against the euro could cause foreign investors to sour on U.S. Treasuries.

Highly rated investment-grade bonds remain our preference with regards to corporate bonds. Quality and credit rating remain extremely important in the investment-grade sector. We remain concerned about the massive amount of BBB-rated debt, the lowest rating before a bond will lose its investment-grade status and be reclassified as high-yield or “junk.” A wave of downgrades could destabilize the entire sector, so we prefer bonds with a rating above BBB.

Regardless of who ends up controlling Congress, there is a possibility that we will see a tax increase next year, 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. This will be especially important if we get a slimmed down stimulus package that does not provide funds to state and local governments.

International

The surge in coronavirus cases in many parts of the world continues to drag down the global economy. Israel became the first major nation to institute a second nationwide lockdown, and the U.K. has rolled back its reopening as cases surge. Despite setting new daily infection records, most European nations have rejected full lockdowns, opting to close specific businesses like restaurants, theatres and gyms and implementing curfews, while keeping schools and most shops open. Despite efforts to avoid total economic shutdown, the eurozone is likely to see a full-year economic contraction of 10%, and a slower recovery than other parts of the world.

China is on course to have fully recovered from the COVID-19 pandemic by year's end. However, so much of China's economy is driven by manufacturing and foreign investment that their growth potential remains limited until the rest of the world recovers. A new administration in the White House

is likely to ease tensions between the U.S. and China, and normalizing trade relations are likely to be a tailwind for the nation.

Emerging markets are also likely to closely monitor U.S.-China relations, which have implications for supply chains and trade-related growth. Many emerging nations will face major headwinds in the short-term. A precipitous drop in demand during the pandemic has hurt the economies of nations who rely on exporting commodities, and many emerging nations lack the resources to properly combat the virus. Outlooks for South and Central America are particularly pessimistic. India, whose economy was slowing even before the pandemic, saw a contraction of nearly one-quarter, the biggest drop for any of the world's major economies. Facing both an economic crisis and an ongoing health crisis, the government has enacted sweeping changes in recent weeks, hoping to spur growth. The measures have been met with mixed reaction, but economists believe that they will spur growth in the long-term.



Conclusion

Despite a potentially volatile final few weeks in 2020, we remain generally optimistic about the economy in the coming year. There is a high probability of strong returns in the stock market. The bond market is likely to be choppier, but we expect that bonds will at least return their yield. The widespread distribution of a coronavirus vaccine will boost growth domestically and globally, and we remain confident in our overall long-term investment strategy.

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- ◆ We invite all clients to schedule an online portfolio review. Because we respect your time, we offer three different meeting formats that vary in length and level of specificity. For more information or to schedule a meeting, please contact us.
- ◆ Since the start of the pandemic, Hanover employees have been working remotely, conducting meetings online or over the phone. However, we would like to remind our clients that we still have our main office in Greenville, SC and conference facilities in Atlanta, GA. We are happy to hold in-person meetings at either of these locations or any other that works for you.
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- ◆ 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. Our office is available to assist in accessing and utilizing the Black Diamond system.

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