

Q3 Escaped Extremes Despite Rising Risk from Unclear Fiscal Policy, the Election and COVID-19

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After experiencing the deepest recession since World War II and possibly the sharpest economic recovery – in a classic V-shape – the market has rebounded mainly driven by the massive monetary and fiscal stimulus. However, there is growing uncertainty from contentious negotiations over the next fiscal stimulus package (CARES 2), the upcoming US election and COVID-19 that has resulted in a correction where the S&P 500 lost 9.6% between September 2, 2020 and September 23, 2020. The 30-day annualized volatility also rose from 9.8% to 20.7% in that time and reached 22.1% by the end of the third quarter. While the correction can be viewed as typical in new bull markets and the quarter still ended positively with a gain of 8.5% for the S&P 500, questions remain around how people will behave with an uptick in COVID-19 cases, the timing of the next round of stimulus, and how the outcome of the election that may not necessarily drive the overall stock market will create opportunities across assets and sectors. All of these questions just grew more concerning with Trump's positive COVID-19 test.

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Performance

Overall, assets posted solid returns in the third quarter of 2020. The S&P 500 Total Return gained 8.9% for the quarter, despite its 3.8% loss in September. Of the 78 assets measured here, only 9 lost in Q3 2020, with Alerian MLP Total Return finishing worst, down 16.3%, and was the only one with double digit losses. Other losing assets were in real assets [including S&P GSCI Brent Crude Official (Excess Return – that includes roll yield), Dow Jones Brookfield Global Infrastructure and S&P North American Natural Resources (equities)], and in international markets including the FTSE 100 (London), S&P Merval

(Argentina), BRAZIL IBOVESPA, S&P/CLX IPSA (Chile) and Hang Seng (Hong Kong). The real asset losses were heavily driven by energy as the sector is still working to get toward equilibrium by cutting the supply while demand is still struggling. Also losses in some international markets are due to a variety of struggles, ranging from Brazil's weakening real from worries about government spending to Chile's forecasted economic growth cut, while the FTSE 100 reflected Brexit uncertainty with a 20% GDP loss and an increase in COVID-19 cases, and Hong Kong has been impacted US-China trade tensions.

Although the CSI 300 Index, representing Chinese stocks, is also challenged by the trade tensions, China is becoming more self-sustaining, with over 50% of its GDP generated domestically, and experienced a V-shaped recovery with GDP growth of 3.2% in Q2 2020 year-over-year. This drove mainland Chinese investors seeking high returns to pour money into their stock market, driving it to perform best of all of the assets in Q3 2020 with a gain of 14.6%. In the US, growth continued to perform well, especially in large caps with the S&P 500 gaining 11.8%. Commodities as represented by Bloomberg Commodity Index (BCOM) also performed strongly in the third quarter, gaining 9.1%, mainly driven by returns in agriculture and livestock. It is worth noting the roll yield is still expensive, currently at -12% for the index and -23% in energy and -22% in livestock.

Exhibit 1: Third Quarter Performance Across Assets Led By China, Growth and Commodities

Index	YTD 2020 Return	Q3 2020 Return	Best Quarterly Rank	Worst Quarterly Rank	Index	YTD 2020 Return	Q2 2020 Return	Best Quarterly Rank	Worst Quarterly Rank
CSI 300 INDEX	12.0%	14.6%	15	60	S&P Real Assets TR	-8.3%	2.8%	28	34
S&P MdCap 400 Pure Gw TR	10.1%	12.1%	20	82	Global Aggregate	5.8%	2.7%	38	85
S&P 500 Growth TR	20.6%	11.8%	13	34	S&P IASX 200 INDEX	-13.0%	2.6%	55	59
NASDAQ COMPOSITE INDEX	24.5%	11.0%	43	156	Pan-European High Yield	-3.4%	2.6%	35	52
S&P 500 Pure Growth TR	12.5%	9.5%	27	75	Generic 1st CL Future	-34.5%	2.4%	75	76
BBG Commodity TR	-12.1%	9.1%	42	201	EM USD Aggregate	1.9%	2.4%	55	56
S&P 500 Total Return	5.6%	8.9%	25	106	S&P SC600 Value USD TR	-22.9%	2.1%	62	40
MSCI USA IMI EXT REAL ES	-6.9%	8.5%	10	34	FTSE E/N Dev Net TRI USD	-19.7%	2.1%	36	27
S&P 500 INDEX	4.1%	8.5%	71	301	FTSE EPRA/NAREIT Gb TR	-19.5%	2.0%	39	24
S&P MdCap 400 Pure Va TR	-19.2%	8.2%	31	71	S&P MdCap 400 Value	-19.4%	2.0%	58	36
DAX INDEX	-3.7%	8.1%	27	60	Corporate	6.6%	1.5%	96	95
S&P SC 600 Pure Val TR	-27.4%	7.5%	34	68	S&P Dynamic Futures Official C	5.3%	1.5%	24	43
NYSE Arca Gold Miners TR	34.0%	7.4%	21	44	Euro-Aggregate	2.8%	1.5%	41	49
S&P MdCap 400 Growth TR	1.4%	7.0%	30	64	CAC 40 INDEX	-19.6%	1.5%	45	42
S&P 500 EqWg USD TR	-4.7%	6.7%	33	91	FTSE E/N All Eqty ReitTR	-12.3%	1.2%	121	75
NIKKEI 225	-2.0%	6.3%	71	128	U.S. Universal	6.3%	1.1%	70	53
S&P/TSX COMPOSITE INDEX	-5.5%	6.3%	61	138	Government-Related	5.0%	1.1%	56	52
S&P SC 600 Pur Growth TR	-9.3%	6.2%	40	62	Pan-Euro Aggregate	2.0%	1.0%	44	43
S&P/BVL/PeruGeneralTRPEN	-12.6%	4.9%	52	61	U.S. Gov/Credit	8.0%	0.8%	117	74
S&P 500 Value TR	-11.5%	4.8%	41	66	MSCI US REIT INDEX	-19.5%	0.7%	34	28
S&P Mid Cap TR	-8.6%	4.8%	53	64	U.S. Aggregate	6.8%	0.6%	113	66
US Corporate High Yield	0.6%	4.6%	36	113	Asian-Pacific Aggregate	-0.4%	0.4%	49	32
S&P SC600 Growth USA TR	-7.9%	4.1%	46	56	S&P GSCI Crude Oil ER	-66.6%	0.3%	77	58
Global High Yield	-0.9%	4.0%	47	76	S&P Strategic Futures TR	2.7%	0.2%	35	32
S&P/BMV IPC	-14.0%	3.9%	52	55	U.S. Treasury	8.9%	0.2%	133	58
S&P MidCap 400 EW TR	-9.8%	3.7%	60	57	U.S. MBS	3.6%	0.1%	140	39
BBG Gold TR	21.4%	3.6%	67	116	S&P GSCI Brent Crude Official	-46.3%	-0.5%	54	33
S&P 500 Pure Value TR	-27.5%	3.3%	56	46	FTSE 100 INDEX	-22.2%	-0.8%	95	53
S&P SmCap 600 EW TR	-15.1%	3.2%	20	17	S&P Merval TR ARS	-1.0%	-1.4%	65	50
S&P US 600 SC TR	-15.2%	3.2%	60	47	DJBGblnCompT	-16.2%	-2.1%	58	14
Credit	5.9%	3.2%	21	60	BRAZIL IBOVESPA INDEX	-18.2%	-3.6%	76	39
U.S. TIPS	9.2%	3.0%	24	71	S&P/CLX IPSA (CLP) TR	-22.1%	-3.8%	87	40
COLOMBIA COLCAP INDEX	-29.5%	3.0%	35	38	HANG SENG INDEX	-16.8%	-4.0%	133	53
Euro Stock 50 Pr	-14.7%	3.0%	31	56	S&P NoAmNatRes Sector TR	-31.9%	-7.6%	82	15
Treasuries	6.2%	2.8%	26	55	ALERIAN MLP TR	-46.2%	-16.3%	94	6

Source: Morgan Stanley Wealth Management. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

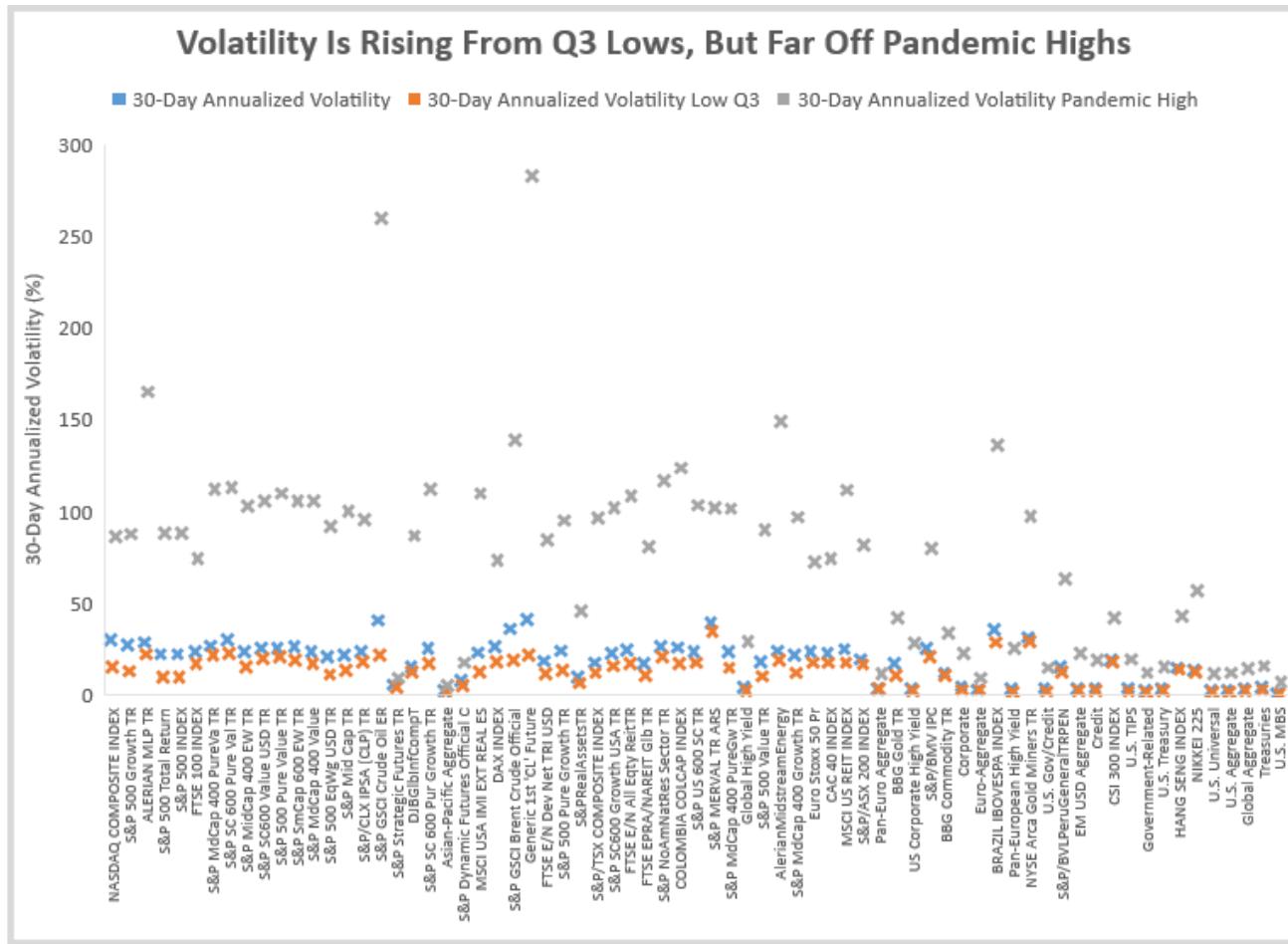
Volatility

On the surface, most of the performance for the third quarter ended uneventfully. However, as uncertainty looms from the aforementioned reasons of the pandemic, fiscal policy and elections, the volatility is picking up. At the height of the shutdown, the 30-day annualized volatility for the S&P 500 reached 88% in the beginning of April, and by September dropped to 9.8%. Now it is climbing again, and ended the third quarter at 22.1%, near where it started quarter.

While the volatility is far from the pandemic highs, currently the NASDAQ, S&P 500 Growth Total Return and S&P 500 Total Return have the highest z-scores (number of standard deviations from the mean) of volatility with the NASDAQ volatility at 1.2 standard deviations from its mean at 29.9%. The S&P 500 Growth TR and S&P 500 TR have respective volatilities of 27.1% and 22.1% with corresponding z-scores of 1.0 and 0.7. Unsurprisingly, the Alerian MLP TR index also has relatively high volatility now measuring at 28.6% with a z-score of 0.8.

Conversely, not all assets are experiencing high volatility again. 26 of the 78 measured assets have negative z-scores with current 30-day annualized volatility of the Global Aggregate, Treasuries and US MBS at levels more than 1 standard deviation below their mean volatilities. Further, Asian stocks in the Hang Seng, CSI 300 and Nikkei 225 have volatilities below their means. Even commodities as measured by BCOM have a below average volatility now at 11.9% with a z-score of -0.1, which shows the power of diversifying away from oil that still has volatility at 40.9%.

Exhibit 2: Volatility Is Rising From Q3 Lows, But Far Off Pandemic Highs



Source: Morgan Stanley Wealth Management. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

Election

Since the US election is a major contributor to the volatility in the some of the assets, here are some highlights regarding performance across the major ones (please see our two-part report, US Policy Pulse: A History of General Election Performance, Part 1 and Part 2, for the full analysis.) Of course, the past does not predict the future but history often rhymes. Historically, Democratic administrations had higher S&P 500 average annual returns for all years in office compared with GOP administrations, outperforming by 6%. Furthermore, US equities analyzed by size, style and sector reported their strongest results on average under the Democrats, with the S&P 500 Pure Growth Total Return Index up 134.1%, the S&P MidCap 400 Pure Growth Total Return Index up 120.6% and the S&P 500 Information Technology Index up 138.4%.

However, the far-reaching strength of equities under Democratic presidents does not tell the whole story. It's also important to consider who controls the House of Representatives and the Senate. We found that Democratic control of the executive and legislative branches was more positive for markets in the first two years in office versus GOP counterparts. However, when the House and Senate were controlled by different parties, results were mixed. Value and growth stocks reported stronger average returns within the first year of a Republican

president and divided Congress, at 24% and 29%, respectively. Under a Democratic president and a divided Congress, small-cap and large-cap stock returns were stronger, 31% and 25%, respectively.

In our analysis, beyond equities, of 108 indexes covering multiple asset classes, on average, 77% performed best under Democratic presidencies, while 23% did better with Republicans. Although performance on a whole was weaker under Republican presidents, when we found that other than US equities, returns were mixed when comparing the average term performance by party and the greatest return by president. Notably, these two components do not always align. For example, the Nikkei 225 Index reported its best average term performance by party under Democratic administrations (see table). Even so, its best single-term performance was under a Republican president, gaining 160.5% during Ronald Reagan's second term. Homogenous results were also uncovered. The Bloomberg Barclays US Aggregate Index performed better under Republican presidents. Also doing better under the GOP were the Bloomberg Commodity Total Return Index and China's CSI 300 Index. When reviewing performance by individual presidential term, we found these assets also posted their strongest returns under Republicans.

Exhibit 3: Presidential and Party Performance Is Mixed for Major Asset Classes

Index	Republican Term Avg.	Democratic Term Avg.	Average Difference	Best Term	Worst Term	Best Presidential Term	Worst Presidential Term
CSI 300	77.7%	28.7%	49.0%	111.8%	28.2%	George W. Bush (2)	Barack Obama (1)
Bloomberg Commodity Total Return	46.0%	34.1%	11.9%	204.6%	-37.2%	Richard M. Nixon (2)	Barack Obama (2)
Bloomberg Barclays US Aggregate	31.2%	24.1%	7.1%	55.3%	7.4%	George H.W. Bush	Barack Obama (2)
Hang Seng	20.5%	97.9%	77.4%	259.8%	-62.0%	Jimmy Carter	Richard M. Nixon (2)
Euro STOXX 50	-11.4%	68.2%	79.5%	139.3%	-37.8%	William J. Clinton (2)	George W. Bush (1)
S&P Real Assets	14.3%	50.2%	35.9%	91.6%	8.7%	Barack Obama (1)	Barack Obama (2)
S&P 500	16.5%	46.5%	30.0%	205.5%	-77.1%	Franklin D. Roosevelt (1)	Herbert Hoover
Nikkei 225	18.6%	28.5%	9.9%	160.5%	-47.0%	Ronald Reagan (2)	George H.W. Bush

Note: Red indicates Republican presidency and blue indicates Democratic presidency.

Source: Morgan Stanley Wealth Management as of Aug. 31, 2020. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

The US Dollar

Despite the rising volatility and uncertainty surrounding the election, the correlations between assets have dropped during the third quarter. Notably high yield dropped from 0.7 to 0.4, and commodities dropped from 0.4 to 0.1. However, the S&P Real Assets have hit an all-time high 30-day correlation with the S&P 500 just when inflation and diversification are needed. While we have been discussing inflation and assets that can hedge against a stock market decline throughout the year, one of the more interesting markets to watch now is the US Dollar.

While there are many forces driving a falling dollar including the unprecedented stimulus and the Fed's willingness to tolerate higher inflation in its move to target average inflation, the news of Trump's positive COVID-19 test introduces another level of uncertainty. This may support the dollar as it tends to respond in times of trouble. However, the rise might be temporary and in the longer-term, positioning for a falling dollar makes sense.

Historically a falling dollar has benefitted growth stocks the most despite the size. On average for every 1% year-over-year the US dollar fell, the S&P 500 rose 2.9% and the S&P 500 Pure Growth rose 4.5%, the most of any asset measured. Only the S&P GSCI Crude Oil ER (excess return that includes roll yield) falls with a falling dollar, and it falls on average 1.3%. This is important since oil is priced in dollars, it moves generally oppositely, which is shown in Exhibit 4 where the crude oil contract rises on average 2.1%. This means the roll yield has been so

dilutive, it erases the benefit of oil to hedge a falling dollar. Notably, the S&P GSCI Crude Oil ER also drops with a rising dollar, losing 3.9% on average for every 1% dollar decline year-over-year.

Exhibit 4: Growth Stocks Benefit Most From A Falling Dollar

US Dollar Market Capture Ratios (10-Years)					
Index	Downside	Upside	Index	Downside	Upside
S&P 500 Pure Growth TR	-450.6	211.1	S&P/TSX COMPOSITE INDEX	-169.6	-56.4
NASDAQ COMPOSITE INDEX	-418.1	235.5	US Corporate High Yield	-168.8	112.9
S&P 500 Growth TR	-403.0	240.0	NYSE Arca Gold Miners TR	-153.8	-139.1
S&P MdCap 400 PureGw TR	-393.3	109.9	FTSE E/N Dev Net TRI USD	-149.4	116.6
S&P SC 600 Pur Growth TR	-383.2	143.3	HANG SENG INDEX	-142.9	-13.7
S&P SC600 Growth USA TR	-380.4	182.8	S&P/CLX IPSA (CLP) TR	-141.9	-161.4
S&P MdCap 400 Growth TR	-369.0	169.8	FTSE 100 INDEX	-138.6	-60.1
DAX INDEX	-357.2	-0.2	Pan-European High Yield	-137.6	125.0
S&P 500 Total Return	-341.3	210.2	S&P/ASX 200 INDEX	-131.9	-56.3
S&P US 600 SC TR	-340.8	162.1	EM USD Aggregate	-125.7	108.7
S&P 500 EqWg USD TR	-331.2	190.7	Credit	-119.7	53.8
S&P Mid Cap TR	-325.7	161.9	Global Aggregate	-98.3	25.7
S&P 500 Pure Value TR	-322.4	147.9	Corporate	-98.0	104.3
S&P/BVLPeruGeneralTRPEN	-320.2	-133.6	Treasuries	-95.8	12.5
S&P MidCap 400 EW TR	-311.3	146.3	MSCI US REIT INDEX	-81.7	118.8
S&P Merval TR ARS	-303.8	-135.9	BBG Commodity TR	-71.8	-181.5
S&P SC600 Value USD TR	-299.7	141.1	U.S. TIPS	-70.5	64.1
S&P 500 INDEX	-292.6	168.3	U.S. Universal	-70.1	80.9
S&P MdCap 400 PureVa TR	-277.2	116.2	U.S. Govt/Credit	-63.0	83.1
S&P MdCap 400 Value	-276.0	151.0	CSI 300 INDEX	-61.8	43.3
S&P 500 Value TR	-267.3	176.1	U.S. Aggregate	-59.8	77.2
S&P SC 600 Pure Val TR	-229.0	67.1	COLOMBIA COLCAP INDEX	-55.7	-214.3
CAC 40 INDEX	-228.6	-57.4	Government-Related	-55.0	71.2
DJBGIBlnfCompT	-211.9	145.7	S&P/IBMV IPC	-49.4	-99.6
Generic 1st 'CL' Future	-205.1	-255.5	U.S. MBS	-49.4	63.0
FTSE E/N All Eqty ReitTR	-198.9	210.9	U.S. Treasury	-42.5	72.9
NIKKEI225	-198.4	83.6	BRAZIL IBOVESPA INDEX	-35.8	-177.6
Euro Stoxx 50 Pr	-195.2	-84.2	Euro-Aggregate	-34.5	92.8
Global High Yield	-189.6	92.4	Asian-Pacific Aggregate	-33.5	49.2
S&P GSCI Brent Crude Official	-187.2	-277.5	S&P Strategic Futures TR	-32.5	19.2
BBG Gold TR	-183.5	2.2	Pan-Euro Aggregate	-29.6	102.5
S&P NoAmNatRes Sector TR	-181.4	-98.9	ALERIAN MLP TR	-7.3	-0.9
S&P RealAssets TR	-177.3	63.1	S&P Dynamic Futures Official C	-6.6	-19.2
FTSE EPRA/NAREIT Gb TR	-170.3	121.0	S&P GSCI Crude Oil ER	129.5	-386.5

Source: Morgan Stanley Wealth Management. Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment.

Conclusion

Although the third quarter continued to show improvement in many areas despite the correction, there are many unknowns going into the fourth quarter that can drive volatility higher. Now that Trump has tested positive for COVID-19, we might expect even more risk than we might have based on past elections. The likelihood for

reopening is probably reduced and the consumer behavior even without lockdowns may change from the news. However, the chance for a fiscal stimulus deal may have increased, not just from the president's illness, but from the weaker than expected job growth that may indicate some economic weakness. If the volatility rises as we expect, investors may also continue to feel comfortable in the big names (FAANGs) and index concentration may become greater, furthering the need to diversify into smaller stocks and use active managers.

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