Economic and Market Outlook

Third Quarter 2020

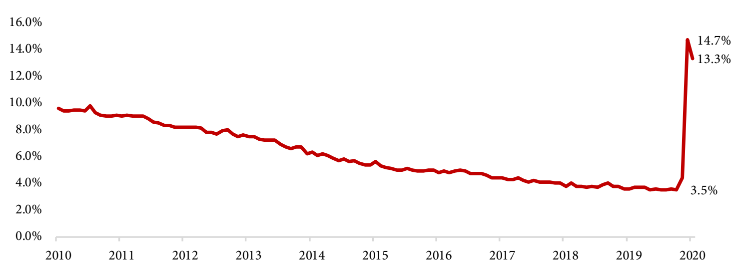
CONGRESS ASSET MANAGEMENT COMPANY

It is easy to forget that just a few months ago the U. S. economy was stronger than it had been in a lifetime. Finding qualified employees was a challenge for most businesses. Restaurants were full and air travel had never been stronger. Most people commuted to work complaining about traffic and public transportation. Our actions to curtail the spread of COVID-19 have turned the economy on its head. Now, market strategists eagerly search for snippets that indicate the economy is recovering from the constraints while hesitantly reading about new cases. Optimism abounds in the stock market while caution prevails in the bond market. As is often the case, the truth probably lies in the middle.

Since the pandemic first arrived on our shores, most everything related to our economy has reacted at hyper-speed. Restrictive economic measures squelched a robust jobs market resulting in a jump in unemployment from a generations-low 3.5% in December to 13.3% in May. Consistent gross domestic product (GDP) readings of 2-3% evaporated as the shut-down intensified. First quarter GDP measured -5.0%, with far worse readings expected for the second quarter.

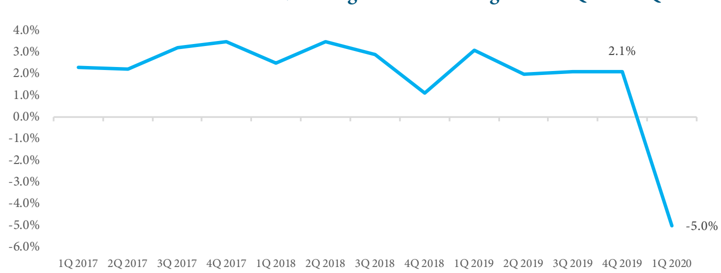
The scale of the contraction is alarming and points to the aggressive response by the Federal Reserve (Fed). It also demonstrates the importance of the federal government stimulus. The Fed's actions continue and are meant to provide financial market liquidity and support, and to bolster companies until we can fully re-open. But the Fed can't force people to spend or increase aggregate demand. The federal stimulus packages, on the other hand, were set up to get money into consumers' hands directly. Precision was sacrificed for speed, resulting in quick and substantial pay outs with little regard for effectiveness or oversight.

Unemployment Rate 2010-2020



Sources: U.S. Bureau of Labor Statistics, Federal Reserve Bank of St. Louis

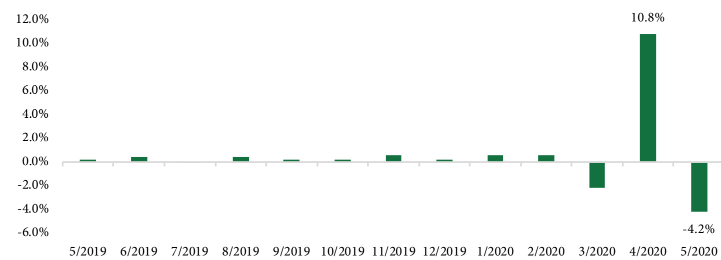
Gross Domestic Product % Change from Preceding Period 1Q 2017-1Q 2020



Sources: U.S. Bureau of Economic Analysis, Federal Reserve Bank of St. Louis

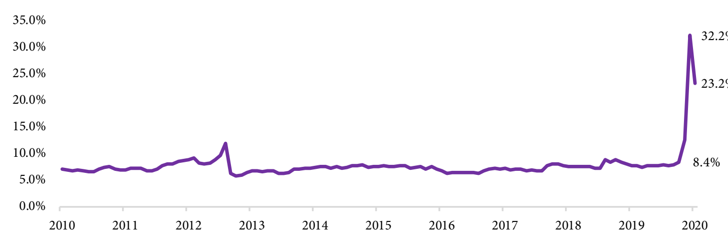
The maelstrom has upended the typical economic indicators which are backward looking and distorted by the shut down and related policy reactions. Hence, the collapse in GDP. Consumers, on the other hand, were forced to re-trench and dramatically reduced spending. At the same time, the stimulus payments bolstered April income levels. Savings soared, an unusual occurrence during a recession. The massive stimulus did much to protect the consumer in April and May. Whether job growth can recover and support the consumer in the summer months remains to be seen.

Personal Income 2019-2020



Sources: U.S. Bureau of Economic Analysis, Federal Reserve Bank of St. Louis

Personal Saving Rate 2010-2020



Sources: U.S. Bureau of Economic Analysis, Federal Reserve Bank of St. Louis

To better measure the current economic environment analysts have turned to non-traditional, high frequency indicators that offer an accelerated snapshot, albeit with less rigor than traditional measures. Consumer engagement with restaurants and traditional shopping venues is increasing. Pent up demand, better weather, and restlessness are driving people outdoors. Activities deemed "safe" are drawing attention while activities deemed "risker," such as air travel, remain lackluster.

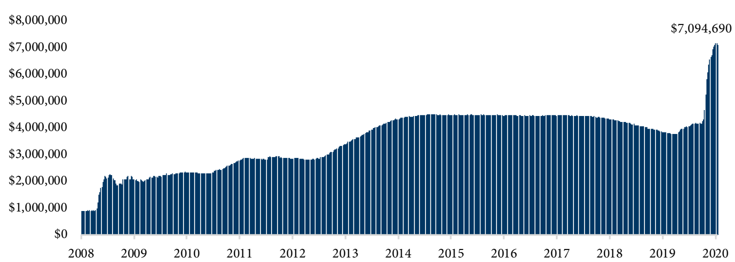
Companies are wading deeper into re-opening. Corporate spending focused on improving communication tools such as networks and collaborative software continued throughout the lock down period. Spending on safety equipment and measures to allow re-opening are now accelerating. Bolstered by the Fed and government support and strong credit markets, companies are flush. The strong cash position should support the necessary corporate investment that allows firms to stay relevant in our competition driven system. Undoubtedly, some entertainment and travel activities will take longer to return preventing a full recovery until safety is more assured.

While difficult to see at this moment, some habits and practices developed in response to the pandemic may be laying the groundwork for future technologies and growth. Telemedicine, for example, may be a cost effective alternative to traditional doctor's visits. Video conferencing and remote work arrangements may be cost efficient and environmentally friendly.

Even as consumer and business spending begins to improve, challenges remain for state and municipal governments where shrunken tax receipts are beginning to bite. We anticipate another fiscal stimulus program to help localities weather the storm. In this charged political environment, however, the size and timing remain uncertain.

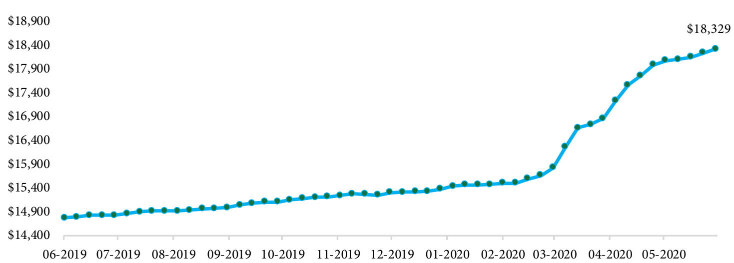
The scope and severity of the economic collapse continues to demand Fed attention. The Fed initiated or expanded nine programs over the past few months. One result: the Federal Reserve balance sheet will likely reach $9 trillion by year end, more than double its size during the Financial Crisis. The expanded balance sheet supports financial assets by directly buying bond issues and improving stocks comparative risk adjusted return. The Fed actions have also enlarged the money supply by close to 25% over the past year. These assets are parked in bank accounts and money market funds that the Fed hopes will either be spent or invested as consumers and businesses feel more comfortable.

Federal Reserve Balance Sheet (in Millions of $) 2008-2020



Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis

M2 Money Stock (in Billions of $) 2019-2020



Sources: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis

Combined, the effects of the federal government stimulus plans and the Federal Reserve actions will have long-term consequences for taxes, spending, inflation, and other government policies. The current low level of interest rates, however, mitigates the immediate concerns. Inflation, a key driver of interest rates, remains subdued and is unlikely to rise materially as energy prices and wage pressures have subsided.

The stock market's recovery from its March lows was exceptionally fast. Similar to the post 2008 financial crisis, the recovery was spurred by the Fed when it backstopped the markets by claiming new financial powers, forcing investors to re-interpret risk and re-engage with stocks. Today is similar, except the Fed has expanded its powers and become a larger force. Investors, recognizing the uniqueness of the situation, are looking past 2020 earnings and looking for consistent progress in the re-opening process. Regional spikes of infections or a second wave could alter the market's path.

The pandemic and our comprehensive response have tested our country's mettle. But COVID-19 is a global experience, sparing no country or market. The U.S. response was not perfect, and in many cases we failed to protect our most vulnerable. We are great at self-criticism, however, and in the long run our abilities to adopt and change will be to our collective benefit. To be sure, our domestic financial markets are the most liquid, fair, and safe in the world. COVID-19 will pass in time and the U.S. economy will recover. Maintaining a three to five year time horizon is more important now than ever.

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