QUARTERLY REPORT

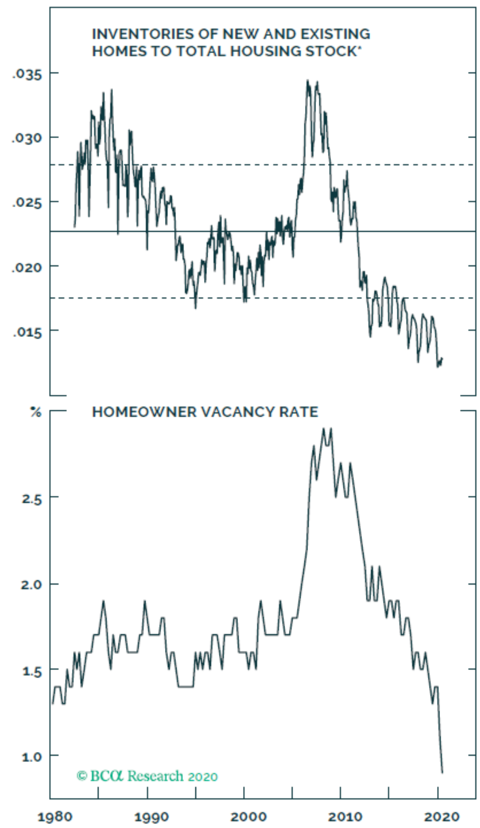
INVESTMENT PERSPECTIVE

30 September 2020

The recovery in financial markets continued in the third quarter with the S&P 500 and Russell 2000 Value rising 8.9% and 2.6%, respectively. While the markets continued to improve, the rate of the recovery in the economy has started to slow. With a delay in additional stimulus for households and the poor results of the Treasury's Main Street Lending Program, the recovery in the services sector has started to moderate. Conversely, the industrial recovery remains strong boosted by the need to rebuild inventories and strong demand for housing that has left the supply of homes at record low levels. Without additional shocks to the economy, we expect the inventory rebuilding process to last several months and hopefully jumpstart a broader self-reinforcing recovery. While the strength in the housing market is very encouraging, we need a rapid supply response of new homes to prevent home price appreciation from slowing or reversing the housing recovery **(Chart 1)**.

CHART 1

A Tight Housing Market



*SOLID LINE DENOTES SERIES MEAN; DASHED LINES DENOTE MEAN +/- ONE STANDARD DEVIATION

During the September Federal Reserve meeting, Chairman Powell reiterated the Federal Reserve's commitment to maintaining easy monetary conditions until inflation is sustainably above 2%. Chairman Powell also encouraged an increase in fiscal stimulus. After decades of reliance on monetary stimulus, the economy and capital markets suffer from excess leverage, malinvestment and structural imbalances that hamper the effectiveness of monetary tools. Post the election, regardless of the outcome, we expect fiscal policy in close coordination with the Federal Reserve to take center stage in driving economic growth.

The last bout of loose fiscal policy was combined with tight monetary policy, which sustained U.S. Dollar strength. The next round of loose fiscal policy will likely be combined with loose monetary policy, which will pressure the U.S. Dollar. Should such economic policy be pursued, and successfully increase nominal GDP growth, it will represent a fundamental shift in the underlying economic conditions that have not been witnessed in years. Such a shift in the economic environment will likely lead to increased market volatility and broad changes in market leadership.

After a volatile start to the year as fixed income markets responded to Covid-19, the third quarter was relatively quiet. Both Treasuries and corporate bond spreads traded in a narrow range during the quarter with the Bloomberg Barclays Aggregate Index finishing the quarter up 0.6% and 6.8% year-to-date.

Credit spreads began the quarter at +142 basis points over Treasuries and tightened to +128 by quarter end. While credit spreads did tighten quarter-to-quarter, spreads were even tighter in August at +118 over Treasuries. Three factors contributed to credit spreads widening off the August low. First, the market began to price in the possibility that there may not be a second fiscal package before the election. Second, the market began to factor in a second wave of Covid-19 in response to Europe's outbreak and the recent increase in U.S. cases. Finally, there was record new corporate bond issuance this quarter, which makes 2020 the highest year on record for new corporate bond issuance. We continue to manage our portfolios with a shorter duration than the benchmark with an overweight allocation to higher quality corporate bonds.

Municipal bonds continued to perform well with the ICE BofA 1-10 Year AAA-A Municipal Index returning 0.8% for the quarter and 3.1% year-to-date.

VAUGHAN NELSON
INVESTMENT MANAGEMENT
600 Travis, Suite 3800
Houston, Texas 77002-2928

713.224.2545
888.888.8676
713.247-9534 fax
www.vaughannelson.com