Record Highs?
The Coronavirus is having unexpected consequences for the economy, markets, and everyday life. The social, economic, and political events of 2020 have unfolded in unprecedented and, in many cases, perplexing ways. On one hand, the economy is rebounding thanks to substantial monetary support from the Federal Reserve Bank. $3 trillion in fiscal stimulus from the federal government, and the easing of public health restrictions. On the other hand, 12.6 million Americans are unemployed, another 5.0 million have left the labor force, multiple industries are in distress, the pandemic continues, U.S.-debt-to-GDP is near record highs, and the Federal budget deficit is -15% of GDP. Given this set of facts, would you guess the stock market would be UP 4% year-to-date and near record highs? Welcome to 2020! While government borrowing and deficit levels are reaching concerning levels, creating challenges for future generations, we agree with the Fed that now is not the time for fiscal conservatism. This quarter’s commentary will explain why.

Fixed Income Performance
Fixed Income yields remain near historic lows as the 2-year and 10-year Treasuries entered the quarter yielding 0.16% and 0.66%, respectively. Given the low level of interest rates, returns within fixed income were driven by corporate credit spread compression during the quarter. Below are highlights on fixed income performance during the quarter:

- The 10-Year Treasury yield started the quarter at 0.66% and ended the quarter at 0.69%. Treasury prices remained relatively flat as yields stayed within tight ranges. Treasuries across the curve were modest gainers during the quarter.
- Investment grade and high yield credit experienced gains during the quarter as investors drove credit spreads tighter in their search for yield. The Bloomberg Barclays U.S. Credit index returned 1.5% while the U.S. Corporate High Yield Credit index returned 4.6%. High yield was the best performing fixed income segment as spreads tightened from 644 basis points at the beginning of the quarter to 541 basis points at the end of the quarter.
- Leveraged loans/ floating rate appreciated due to credit spread tightening as the S&P/LSTA U.S. Leveraged Loan 100 Index returned 3.5%.
- Municipal bonds appreciated with a return of 3.1%. Bond index generated a 1.2% return for the quarter. High yield was the best performing fixed income segment as spreads tightened from 644 basis points at the beginning of the quarter to 541 basis points at the end of the quarter.

The Fed’s Argument for More Stimulus
Despite historic measures by the Fed and trillions in fiscal stimulus already allocated by Congress in 2020, Federal Reserve Chairman Jerome Powell recently implored legislators to commit even more funds to economic stimulus. Below is an excerpt of his argument made before the National Association for Business Economics on October 6th:

“...a prolonged slowing in the pace of improvement over time could trigger typical recessionary dynamics, as weakness feeds on weakness. A long period of unnecessarily slow progress could continue to exacerbate existing disparities in our economy. That would be tragic, especially in light of our country’s progress on these issues in the years leading up to the pandemic. The expansion is still far from complete. At this early stage, I would argue that the risks of policy intervention are still asymmetric. Too little support would lead to a weak recovery, creating unnecessary hardship for households and businesses. By contrast, the risks of overdoing it seem for now to be smaller. Even if policy actions ultimately prove to be greater than needed, they will not go to waste. The recovery will be stronger and move faster if monetary policy and fiscal policy continue to work side by side to provide support to the economy until it is clearly out of the woods.”

According to the Fed, the economic recovery is at risk of either stalling or continuing at a pace that is insufficient to help those most in need of it. Given societal tensions over racial disparities and the disproportionate impacts of the pandemic on minority communities, it seems the Fed believes the short-term gains achieved from additional stimulus will outweigh the long-term cost of growing economic divides and the burden of government debt. We agree with this strategic calculation.

Higher paid workers have fared much better in the pandemic than low-wage workers. Based on data from ADP, the Fed’s staff estimates that at the end of April, 41% of workers in the bottom income quartile had lost their jobs, compared with only 15% for the upper three quartiles. According to the U.S. Chamber of Commerce, employment in the financial and information services industries, including banking, real estate, and telecommunications, saw some of the fewest job losses in the recession. Furthermore, the recovery has been strikingly uneven. Employment in higher wage industries such as technology and software has recovered quickly while employment in the services industries, including travel, entertainment, hospitality, and food, has continued to retreat.

The country doesn’t need prolonged economic misery for those that can least afford it added to the health, social, and political tensions that are threatening societal stability. In our opinion, the best bang for the stimulus buck is to focus on supporting lower income populations and small business operators. Extending and enhancing unemployment benefits would be a great start. We believe the argument that these payments entice people to not work is ill-founded. Researchers at Yale University who reviewed scheduling and time clock data for small businesses write: “We find no evidence that more generous benefits dis-incentivize work either at the onset of the expansion or as firms looked to return to business over time.” New research from economists at the University of Chicago and New York University offered the same conclusion. Workers know that benefits, even if extended, aren’t permanent. The stability of long-term employment is preferred to government support even if the support payments are higher in the short term. Furthermore, workers understand that long-term unemployment diminishes job skill and income potential.

Another way to effectively target stimulus is to support industries disproportionately impacted by the pandemic. Restaurants, for example, have been severely pressured by government restrictions and necessary social distancing. While some have been aided by outdoor dining, cold winter weather is likely to diminish this lifeline for many. Additionally, independent operators don’t have the resources to quickly shift business models to online ordering, take-out, and delivery. Perhaps a modified PPP program targeted at small businesses and depressed industries would be best suited to support these segments through the near term and help them evolve for the longer term changes in consumer behavior.

Policy Shift at the Fed...Goodbye Preemptive Tightening
As previously mentioned, the recovery to date is best described as two-tiered. White collar workers with college degrees have quickly retraced losses post-shutdown. Less educated workers, especially those in services industries, have lost ground that had been regained to some extent prior to the pandemic. It’s these workers the Fed is concerned about, and for good reason.
For decades the Fed has described its mandate as maximum employment and stable prices. Historically, the biggest problem our economy faced was high and rising inflation. Expansions typically ended because inflation began overheating and the Fed essentially forced recessions through rate increases in order to bring prices under control. In recent years, however, inflation has consistently run below the Fed’s longer run target of 2%. Nevertheless, the Fed has continued to conduct monetary policy similarly to the way it has in the past. In the recovery following the financial crisis of 2008, the Fed repeated its pattern of preemptively tightening monetary policy when employment reached estimates of maximum levels in order to “get ahead” of anticipated wage inflation.

Beginning in 2018, however, the Fed began its first public review of its monetary policy framework. The reason for this review was essentially two-fold. First, the Fed recognized that levels of potential economic growth, interest rates, and inflation have declined substantially in recent years. Consequently, estimates of the neutral federal funds rate, the rate consistent with the economy operating at full strength with stable inflation, have declined towards zero (the effective lower bound). This limits the Fed’s ability to stimulate the economy in economic downturns. Additionally, persistently low levels of inflation below the Fed’s longer-run target risked anchoring inflation expectations at levels reinforcing a disinflationary cycle. The second reason for the Fed’s framework revision was the recognition that the record-long expansion following the financial crises led to an exceptionally strong labor market benefitting historically disadvantaged communities.

These factors led the Fed to announce two meaningful changes in its monetary policy framework, each impacting one side of the Fed’s dual mandate. First, the Fed’s decisions on monetary policy will be informed by its assessments of “shortfalls” of employment from maximum levels versus the previous framework which emphasized “deviations” from maximum levels. The wording change is subtle, but the impact on policy decisions going forward is likely to be meaningful: the Fed will be less concerned about inflation when employment is at or below estimates of maximum levels. On the price stability side of the Fed’s mandate, the Fed’s strategy will seek to achieve inflation that “averages” 2 percent over time. Thus, following periods of inflation below 2 percent, monetary policy will “aim to achieve inflation moderately above 2 percent for some time.” In other words, the Fed will no longer preemptively tighten, and will allow inflation to exceed 2% in order to bring the average over the long run to its target level.

Core PCE inflation has consistently fallen below the Fed’s 2% yoy target

The COVID-19 lockdown recession disproportionately impacted lower-income workers and Americans in minority communities. Service sector jobs have been decimated. This drew attention to a well-known fact: recessions hit unskilled labor hardest and expose gaps in economic and social mobility. Narrowing those gaps is now an explicit goal of the FOMC’s new framework. In a society struggling with negative economic and social forces, we need to error on the side of promoting growth versus restricting inflation. It’s the right posture from both human and economic perspectives.

**Economic Review**

Economic data has tracked largely ahead of our projections. GDP declined at a -31% rate in Q2 but is tracking towards a sharp rebound in Q3. The Bloomberg consensus estimate for growth in Q3 is 29.3%. Forecasters expect growth to normalize at the 4.0% level in Q4 and remain above trend at 3.7% in 2021. The economy has been supported by robust activity in rate-sensitive sectors such as housing and autos. Nevertheless, given continued restrictions resulting from the pandemic along with rising case counts, we believe estimates for above-trend growth in 2021 are too optimistic.

After 22 million jobs were eliminated in March and April combined, employment numbers recovered some ground as the economy reopen. Approximately half of the job losses, 11.4 million, have been recovered. The unemployment rate declined from 14.7% at the peak in April to 7.9% in September. Adjusting for declines in labor force participation, unemployment levels would be in the double-digits. For perspective, unemployment peaked at 10.0% in the 2009 recession.

Interest rates remained largely stable at low levels in Q3. The 10 year treasury yield increased 3bps in the quarter to 0.69% and has traded between 0.50% and 0.75% for most of the pandemic. The 2 year yield declined 2bps to 0.13%. The yield curve slopes upward beyond 3 years, anticipating a Fed on hold through 2023. Inflation (as measured by CORE PCE) declined from 1.6% in February to 0.9% in April, but has inched back up each month, reaching 1.6% in August. Oil prices recovered from approximately $20 per barrel in April, averaging $43 in Q2, but are still below pre-pandemic levels above $60. We do not expect a significant increase in inflation or interest rates in the near term.

**Outlook and Strategy**

In an abnormal world, fixed income behaved normally during the third quarter. We believe the Federal Reserve will continue to keep the federal funds target rate at 0.00% to 0.25% for the foreseeable future. However, fundamental underlying credit risks are very much in play. We continue to like both Investment Grade and High Yield corporate debt but expect only limited spread tightening for the balance of the year. Volatility will remain in the market until a vaccine is developed for the coronavirus. We do not expect the virus to simply go away and we continue to manage investment risks with regard to public health.

We are long-term investors who look for investments in companies that have staying power. Experienced management teams, like experienced portfolio managers, know how to manage through a storm. Our consistent returns are the result of our investment process and our team. We work hard day in and day out with a focus on our fiduciary duties to our clients. Thank you for allowing us to serve you.

Should you have any questions on strategy, performance or business development, please do not hesitate to contact us.

**Thank You**

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