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Monthly Market Review

November 2, 2020

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Surging Waves

Rising COVID-19 cases; cresting political waves

After an auspicious start which took the S&P 500 Index to within 1.3% of its all-time-high, equities steadily lost steam and wound up in negative territory for October. The weakness in the back half of the month can be attributed to two issues – Washington's failure to deliver a Phase 4 stimulus bill in spite of continued negotiations between Speaker Pelosi and Treasury Secretary Mnuchin, and a rapidly rising second wave of COVID-19 sweeping across Europe and many states in the U.S. The former should not really be a surprise since politicians knew that any agreement would have been too late to impact consumers and the economy ahead of the November 3rd general election. The latter was unexpected in the sense that most investors did not anticipate the situation in Europe to deteriorate so rapidly to once again force various countries into lockdowns. As a result, European stocks materially underperformed U.S. equities during the month, and the euro also lost ground to the greenback.

While Europe and the U.S. were grappling with this new wave of infection and its negative economic consequence, many equity markets in Asia and down under were flashing green for the month as these countries have done a better job in containing the pandemic. Taiwan reached an admirable milestone of 200 consecutive days without a locally transmitted COVID-19 case. In China, more than 600 million people had travelled during the country's Golden Week holidays in early October. It's no wonder Asian currencies such as the renminbi, the yen, and the Korean won all appreciated. The strength in Asian economies, especially China, also helped move base metal prices higher during the month.

The real surprise last month was that U.S. Treasury yields substantially increased in spite of U.S. equity weakness and the concern over rising COVID-19 cases. The 10 and 30-year Treasury yields jumped 18 and 20 bps, respectively. Some suspect that investors may be pricing in a blue wave, which will likely lead to more fiscal spending to trigger higher inflation down the road. However, if that were the case, precious metals should have been bid up as well. Gold was actually down a bit for the month while silver eked out a 1.8% gain.

Lastly, it is interesting to note that since 1984, the S&P 500 Index's performance in the three months prior to the presidential election had correctly foretold the result: a gain would keep the incumbent party in the White House, and vice versa. For what it's worth, the sell-off in the final week of October pulled the index down to 3269.96, 0.04% below the July 31st closing of 3271.12. I guess it portends a very close election.

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THE VIRUS THAT CHANGED HISTORY

There was an air of expectation and excitement at the port city of Brest, France on December 13, 1918. A large crowd of dignitaries and well-wishers gathered to welcome ocean liner USS George Washington escorted by an armada of 10 battleships and 28 destroyers. They waved and cheered upon seeing Woodrow Wilson, the first sitting U.S. president to set foot in Europe, arrive in his stylish top hat and frock coat. Wilson was immensely popular in Europe at the time. His "Fourteen Points" speech delivered in January of that year set the foundation for peace negotiations as it had encouraged the Central Powers to surrender in exchange for a just settlement. With the Great War having ended a month earlier, preparations were underway for the Paris Peace Conference that would begin on January 18, 1919 to define the peace terms and the new world order. Wilson had arrived early to confer with France, the U.K., and Italy in order to drum up support for his post-war vision for the world.

The peace conference involved diplomats from over 30 countries whose competing interests soon turned various negotiations into brutal tests of will and endurance. To Wilson's chagrin, France did not share his idealistic post-war vision and insisted on inflicting crippling punishment on Germany. Wilson remained confident that his principles would eventually prevail even though negotiations were deadlocked by early April with French Prime Minister Clemenceau having accused him of being pro-Germany.

Events took a dramatic turn on the evening of April 3rd, when Wilson was suddenly stricken with violent coughs that left him gasping for air. His physician first suspected an assassination attempt by poisoning, but then realized it was the dreaded Spanish Flu. The 62-year old president suffered not only high fever and profuse diarrhea, but also hallucination – he complained that the French were spying on him, and that furniture was being stolen from his hotel room. After visiting Wilson during his recuperation, Lloyd George, the British Prime Minister, observed that Wilson had a "nervous and spiritual breakdown."

Wilson never fully regained his mental and physical strength after the flu. Upon returning to the negotiation table, he started yielding to Clemenceau and eventually abandoned the Fourteen Points. Clemenceau got Wilson to agree on draconian terms that would force Germany to cede about 10 percent of its territory and pay enormous reparations. The agreement prompted John Maynard Keynes, then a 35-year-old chief representative of the British Treasury at the conference, to resign in protest. Keynes privately called Wilson "the greatest fraud on earth" and later published *"The Economic Consequences of the Peace"*, which warned that the impoverishment of Germany would sow the seeds of hatred and revolution that would eventually destabilize Europe.

Equity Markets Indices[1]	9/30/20 Price	10/30/20 Price	MTD Change	YTD Change
MSCI All Country World	565	551	-2.5%	-2.5%
S&P 500	3363	3270	-2.8%	1.2%
MSCI EAFE	1855	1780	-4.1%	-12.6%
Russell 2000®[2]	1508	1538	2.0%	-7.8%
NASDAQ	11168	10912	-2.3%	21.6%
TOPIX	1625	1579	-2.8%	-8.3%
KOSPI	2328	2267	-2.6%	3.2%
Emerging Markets	1082	1103	2.0%	-1.0%
Fixed Income				
2-Year US Treasury Note	0.13%	0.16%	3	-142
10-Year US Treasury Note	0.69%	0.88%	19	-104
BBG BarCap US Agg Corp Sprd	1.36%	1.25%	-11	32
BBG BarCap US Corp HY Sprd	5.17%	5.09%	-8	173
Currencies				
Chinese Renminbi (CNY/$)	6.79	6.69	-1.5%	-3.9%
Brazilian Real (Real)	5.61	5.75	2.4%	42.5%
British Pound ($/GBP)	1.29	1.29	-0.2%	2.4%
Euro ($/Euro)	1.17	1.16	0.6%	-3.7%
Japanese Yen (Yen/$)	105.48	104.66	-0.8%	-3.6%
Korean Won (KRW/$)	1169.60	1135.15	-2.9%	-1.8%
U.S. Dollar Index (DXY)	93.89	94.04	0.2%	-2.4%
Commodities				
Gold	1886	1879	-0.4%	23.8%
Oil	40.2	35.8	-11.0%	-41.4%
Natural Gas, Henry Hub	2.53	3.35	32.7%	53.2%
Copper (cents/lb)	303	305	0.5%	9.0%
CRB Index	149	145	-2.5%	-22.1%
Baltic Dry Index	1725	1283	-25.6%	17.7%

Source: Bloomberg

Wilson signed the Treaty of Versailles on June 28th and returned to the U.S. on July 8, 1919. Two days later, he presented the treaty to the Senate for ratification. The long journey and the flu had taken a visible toll on the president as he bumbled through his 40-minute address. Sensing a cold reception to the Treaty and the League of Nations, he embarked on a grueling 8,000-mile journey across the U.S. to drum up popular support. On October 2nd, Wilson suffered a near-fatal ischemic stroke that left him bedridden and partially paralyzed. While Wilson's inner circle downplayed his illness in public, many knew the president was in bad shape. For the remaining 17 months of his presidency, nearly all communication to and from Wilson was relayed through the First Lady Edith Wilson.

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Wilson was awarded the Nobel Peace Prize in 1920. However, as a lame duck president with failing health, he was unable to get the Senate to ratify the Treaty of Versailles and the U.S. never joined the League of Nations. By the autumn of 1922, just as Keynes had predicted, the punishing "Carthaginian peace" had crippled the German economy and led to hyperinflation. The economic woes enabled a heretofore little-known right-wing fringe party called the Nazi to expand rapidly by appealing to the unemployed. In November 1923, the Nazi Party even staged an unsuccessful coup d'état in Munich. A month after Wilson's passing in February 1924, Nazi leader Adolf Hitler was put on trial for the failed coup, and he turned it into a publicity stunt that bolstered his standing. The rest, of course, is history.

In the parlor game of counterfactual speculations, we wonder how history would have unfolded had Wilson not been infected with the Spanish Flu. Would he have stuck to his principles to effectuate a more sustainable peace? Come to think of it, that insidious virus was responsible for far greater carnage over a much longer period of time.

THE SECOND WAVE

101 years after President Wilson's affliction from the Spanish Flu, which was kept secret from the American public at the time, President Trump caused a stir around the world with his announcement on October 2nd that he had come down with COVID-19. Reactions ranged from shock, sympathy to mockery. Thanks to advances in modern medicine, he enjoyed a miraculous recovery in spite of his age and weight. The fact that Regeneron Pharmaceuticals' soon-to-be approved monoclonal antibody treatment worked like a charm on Trump was great news on the therapeutic front. However, do not expect the drug to be widely available during the early phase of the rollout since its quantity will be limited, and the therapy has to be delivered intravenously in a hospital.

In the meantime, with temperatures turning colder and daylight hours diminishing by the day in the Northern Hemisphere, we are seeing a surge in health-related issues from COVID-19 to depression. Many countries are once again beset with surging daily new COVID-19 cases and rising hospitalizations. The Czech Republic, once hailed as a role model for its handling of the pandemic in the spring, now confronts a national crisis with shortages of medical personnel. Ireland became the first European nation to re-impose a national lockdown which started on October 22nd and will last six weeks. France followed with a four-week lockdown. Targeted regional restrictions were also re-initiated in several other European countries, including Sweden, which was trying to tough it out with a herd immunity strategy. Regrettably, much of the COVID-19 resurgence can be attributed to behavioral issues – many people still don't take it seriously, and some policymakers continue to deal with it as a political rather than public health issue. By contrast, countries such as China, South Korea, Taiwan, and New Zealand have managed to contain COVID-19 and daily lives have largely returned to normal.

Policymakers will need to weigh the trade-offs between lockdowns and their economic tolls. We know the former will be effective in reducing new cases, as Israel has demonstrated in their second nation-wide lockdown that started in mid-September. However, the economic hits will continue to pressure household income and public finance. Here in the U.S., a nationwide lockdown is out of the question, but there will be more targeted measures which will slow economic activity during the winter months. With the next round of fiscal support still up in the air, investors should brace for a potentially difficult winter in spite of continued progress in therapeutics and vaccines. That said, to quote Percy Bysshe Shelley, "If Winter comes, can Spring be far behind?" Our base case remains that the economic recovery will become sustained when effective vaccines become available in the not-to-distant future. While Johnson & Johnson and AstraZeneca have recently experienced some hiccups in their phase 3 trials, Pfizer and Moderna appear to be on track to get the emergency use approval by year end. Pfizer has embarked on the biggest ever vaccine distribution effort with the aim of delivering 100 million and 1.3 billion doses in the remainder of 2020 and 2021, respectively.

CONFIRMATION BIAS

The most contentious and arguably consequential U.S. election in the modern era is finally coming to a close. Many people are emotionally drained, but there will more roller-coaster rides ahead as results are released state by state. Most polls and the betting market are predicting a blue wave -- Nate Silver's *FiveThirtyEight* gives Democrats an 90% chance of winning the presidency and a 76% chance of controlling the Senate. The President's supporters, however, are clinging to the hope that there are enough "shy" Trump voters in swing states to once again humiliate pollsters. Indeed, there is a clear enthusiasm gap between Trump and Biden supporters, and the two candidates have exhibited very different levels of energy in the closing days of the campaign. However, the seeming lack of enthusiasm for Biden may not matter to some as many voters are motivated by their loathing of the President.

It's unfortunate that American politics has become so visceral and polarizing. It's getting hard to have a conversation on politics these days without offending someone. When it comes to consuming or disseminating political news, most of us prefer information that confirms our own views rather than disconfirming evidence that would disrupt our ideological safe space. This so-called confirmation bias is understandable for individuals, but

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dangerous for some professions. It would be malpractice for professional investors to cherry pick data when making investment decisions. Similarly, it is unacceptable for the media, especially those claiming an unbiased stance, to openly censor materials in favor of or against one side during an election. To many on both ends of the ideological spectrum, Twitter and Facebook might have crossed that line when they censored the New York Post's exposé on the Bidens. Some users who attempted to share the links to the articles were blocked. Twitter had also refused to unlock the New York Post's account unless the tabloid removes its controversial postings.

Why is this an important issue for investors? Social media companies have thrived under the protection of Section 230 of the Communication Decency Act of 1996. The law basically said online platforms are not responsible for what users post, thus enabled the likes of YouTube, Facebook, and Twitter to build up their businesses by aggregating user generated contents with no legal liabilities. Congress has intended the law as a *"protection against online censorship"* to make the Internet *"a forum for a true diversity of political discourse."* In recent years, however, progressives have been complaining that social media companies have not weeded out disinformation fast enough, and conservatives griped that they have frequently been unfairly censored. Trump and Biden, have both called for the repeal of Section 230. The censorship of New York Post may just accelerate the repeal process, especially if President Trump somehow ekes out a victory. Depending on how much of the Section 230 protection is reworked, it will have profound impact on the business model of some of the most valuable companies.

ELECTION WATCH

Despite most pundits' prediction of a Biden victory, polls in several swing states have been narrowing of late, which implies rising odds of a contested election or delayed result. The battleground states of Pennsylvania and North Carolina will count mail-in ballots received by November 6th and 9th, respectively. There is a chance that the control of the Senate may not be decided until the Georgia run-off on January 5th. With financial markets abhorring uncertainty, we could see a period of rising volatility, although it will likely only be temporary. Once the dust settles, markets should adjust to the expected policy initiatives and their consequences.

In the near-term, the least desirable outcome may be a split government between a Biden Presidency and a GOP majority in the Senate. It would usher in much gridlock and limit the size of the fiscal stimulus. That said, the check and balance would also reduce the scale of Biden's tax hikes. In the case of a blue sweep, markets may rally on the expectation of a large stimulus deal to be enacted in early 2021. Some investment strategists espoused the view that the Biden Administration will forgo raising taxes next year since the economy will still be in the throes of the pandemic. I suspect it is just an example of the Street's typical bullish confirmation bias. Democrats will most likely raise taxes to fund their various initiatives from green energy to infrastructure.

Lastly, if President Trump pulls off a Truman-vs.-Dewey type of miracle, markets will likely soar on the expectation of more imminent fiscal stimulus before year end, and on the assurance that tax and regulatory policies will remain business friendly. However, given the deep division in America, about half of the country will be very upset regardless of who wins, leading to inevitable social unrest. Will President Trump, no longer having to run another election by then, be magnanimous and inclusive to diffuse the tension? Now is the time for real leadership to bridge America's social, political, economic, and racial chasms and heal the nation literally and figuratively.

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