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ECONOMIC OUTLOOK

Summary

Following the near total shutdown of the U.S. economy beginning in March, it was understood that the GDP data for Q2 2020 was going to be historically bad. In that sense it did not disappoint, registering a preliminary -32.9% annualized decline on a quarter-over-quarter basis – more than three times worse than the prior record. More currently, the economic data has been rapidly improving as the shutdowns and regulations continue to lift, and the tone has shifted toward the hopes of a historically good GDP reading for the third quarter. Before any of that can come to fruition, there are still many questions about the overall economy that need to be answered, including two new ones that emerged in July:

1) Will Congress be able to agree on a fifth fiscal stimulus package? It seems likely that some sort of compromise will be reached. After all, these are elected officials and we are in an election year. However, with the size of the stimulus being highly contested and peak partisanship in Congress, nothing is certain. It is important to remember that the massive fiscal and monetary stimulus already injected into the economy throughout this ordeal has been a key driver behind the economic growth and recovery. Unfortunately, prior stimulus bills did not account for the virus to linger this long, so many of the original benefits have already, or will soon, run their course.

2) Where will the U.S. Dollar stabilize? During July, the U.S. Dollar Index weakened by more than 4%. With that, its purchasing power was reduced by nearly 10% since its peak in March. This is due to several factors, including the recent actions and “whatever it takes” commitment from the Federal Reserve to keep the Federal Funds Rate (and with it, the short end of the Treasury curve) near the zero lower bound well into the future. The prospect of earning very low interest rates on funds into the undetermined future has caused a flow of money out of the dollar and into other currencies. As the dollar weakens, imports become more expensive since

it will take more of those dollars to purchase goods from other countries. This tends to have an inflationary impact, and it has been a large reason for the recent move higher in commodities and precious metals.

With recent chatter from the Fed indicating that their 2% inflation “target,” which has traditionally acted more like a cap, will become more symmetrical in the future and could allow inflation (and the economy) to “run hot,” a rate hike is not being priced into the market for upwards of five more years. That could bode well for the economy into the future but the economic headwinds from the virus will continue to be with us for a while. We will likely still need an agreement from Congress for further fiscal stimulus to keep pushing toward that historic Q3 2020 GDP print.

Positives

Retail sales beat expectations for the second straight month (7.5% vs 5.0%)

Both manufacturing and service PMI's are back in expansionary territory (over 50)

The housing market remains strong (pending home sales up double digits for the second straight month)

Negatives

The preliminary second quarter GDP print was an all-time low (-32.9%)

The unemployment rate decreased slightly to 10.2% but remains very elevated

The government reported a monthly budget deficit in excess of \$850b during July

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EQUITY OUTLOOK

Summary

The “don’t fight the Fed” mantra continued in July with equity markets broadly participating in the rally. In all fairness, it is more than just the U.S. Federal Reserve, with all developed central banks providing an accommodative backdrop for equity investors. Bulls clearly remain in control and the path of least resistance remains higher. July marked the fourth consecutive month of positive returns following the selloff in the first quarter.

Large-cap momentum stocks (Apple, Amazon, Facebook, Google and Microsoft) continued their push higher over the month. Most companies have now reported second quarter earnings. While earnings results have largely exceeded low expectations, results and guidance were a mixed bag. However, the aforementioned momentum stocks continue to deliver on secular growth trends that were accelerated in the wake of the pandemic.

In spite of media headlines, the equity markets largely ignored a surge in new COVID-19 cases in the South and West. Investors were likely encouraged by the optimistic news regarding vaccine progress. The medical community has also established better treatment protocols, which appear to be keeping the fatality rate lower over the last few months.

The 2020 presidential and congressional race remains a wild card in terms of stock market reaction. Historically, the three months leading up to the election have telegraphed the outcome. Equity markets tend to favor the predictability of the incumbent and rally over those three months when the incumbent wins. When the challenger wins, markets historically

fell over that period. This trend has proven accurate 87% of the time since 1928, although this particular election is anything but typical.

Equity markets have been resilient in spite of lingering risks. While volatility is expected to continue, we continue to favor equities over other asset classes for long-term investors.

Positives

Health care and pharmaceutical industries continue to make medical breakthroughs concerning COVID-19

Many retail investors have been on the sidelines throughout the rally – the pain trade is higher

Accommodative Federal Reserve and global central bank policy

Negatives

Rising geopolitical tensions

Companies that took payroll protection loans may soon begin furloughing workers previously required to remain on payrolls to qualify for loan forgiveness

Unknowns

Market’s response to the election

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FIXED INCOME OUTLOOK

Summary

After a few months of relatively steady Treasury bond yields, there was further compression in July as ample investor liquidity found refuge from the resurgence in COVID-19 cases and elevated equity prices. The last day of the month saw yields set fresh new all-time lows across the yield curve with the exception of the 30-year bond. While the moves are just a continuation of the recent trends, breaking through the March 9 closing low on the 10-year Treasury note is significant on a technical and psychological basis. The intraday low on that day was about 35 basis points (bps), which some will look to as the next logical resistance level.

Continuing to trade in a narrow range, for the month the 2-year Treasury note dropped just 4 bps to end at about 0.11% and the 5-year slipped 8 bps to end at 0.20%. The “bull flattener” was completed with the 10-year note declining 13 bps and the 30-year down 22 bps to end July at 0.53% and 1.19%, respectively. With the soft glide lower in yields Treasury debt delivered a solid return of 1.14% for the month of July bringing the year-to-date return to 9.96%. Without bonds longer than 10 years to maturity, intermediate Treasury note returns were a more modest 0.32% for the month and 6.16% for the year. While the trend would suggest more favorable returns ahead, we believe that outsized moves are unlikely from these levels as the Fed will fight against the idea of implementing a negative overnight rate. On the other hand, in a world starved for yield, rates are not likely to climb much given the long run outlook for short rates.

Once again outsized returns came from the corporate bond market as spreads continued to compress by about 20 bps on average. In whole, the investment-grade corporate bond market delivered a monthly return of 3.25% which brought the yearly return to 8.44%. The intermediate maturity subset of that universe of bonds returned 1.50% for the month bringing the year to date number to 5.80%. Credit spreads are now about 130 bps whereas they began the year at about

100 bps. Much of the incremental yield today is due to the debt of companies in the energy sector where risks are still elevated because of the plunge in oil prices. Our efforts to buy high-quality corporate bonds outside of that sector tell us that spreads are pretty close to pre-pandemic levels. With the Fed supporting the market by buying corporate bonds and the seemingly insatiable demand for income in a low/no income world, we would not be surprised to see credit spreads narrow to the lowest level in modern history. Corporate bonds should continue to outperform over the next few months and years.

Positives

U.S. rates are still the highest in the world among large developed markets

Federal Reserve’s extended commitment to a zero rate policy will cap rates across the curve

Investment-grade corporate bond are supported by Fed purchases and investor demand

Negatives

Incremental deficits will need financing with Federal debt to grow by trillions

To ensure liquidity and flexibility, corporate debt issuance to set new record levels

Unknowns

The spread of the coronavirus and the progress toward a vaccine

Renewed trade skirmish with China