First Trust

Quarterly Market Overview

Issue 83, October 2020

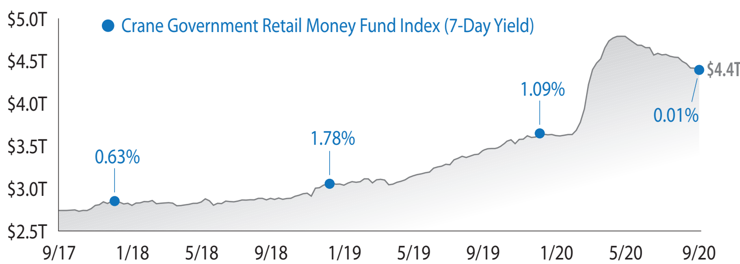
Robert F. Carey, CFA
Chief Market Strategist

Mr. Carey has more than 30 years of experience as an Equity and Fixed-Income Analyst and is a recipient of the Chartered Financial Analyst (CFA) designation. He is a graduate of the University of Illinois at Champaign-Urbana with a B.S. in Physics. He is also a member of the CFA Society of Chicago and the CFA Institute. Bob is the Chief Market Strategist at First Trust Advisors L.P., and has appeared throughout the United States and Canada as a guest on television and radio programs. These programs include: Bloomberg TV, CNBC and on Chicago's WBBM Newsradio 780's Noon Business Hour. He has been quoted by several publications, including *The Wall Street Journal, The Wall Street Reporter, Bloomberg News Service, and Registered Rep.*

We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

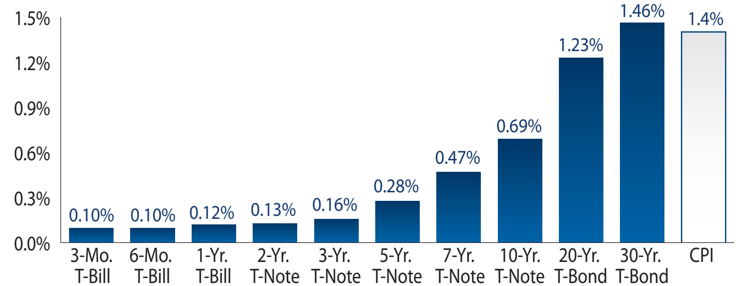
Savers and risk-averse income-oriented investors are running low on options these days

ICI All Money Market Funds Total Net Assets (9/2017 - 9/2020)



Source: Investment Company Institute (ICI). Crane Data. Weekly data points.

Treasury Bills, Notes & Bond Yields vs Inflation Rate (CPI)



Source: Bloomberg. As of 9/30/20.

"I got nowhere else to go!"

For those who do not recognize this famous quote, it is from the movie *An Officer and a Gentleman*. Filming began in April 1981 and the film was released in 1982. The quote seems to fit the narrative depicted in the chart above because many savers must be thinking that they have nowhere else to go in the current climate to generate a meaningful, low-risk current income stream, in our opinion. As indicated in the chart, the going rate on the Crane Government Retail Money Fund Index was essentially zero (0.01%) as of 9/30/20. For comparative purposes, in May 1981, the average 3-month certificate of deposit (CD), which is an alternative to money market funds, paid roughly 18.3% annual percentage yield (APY), according to data from the St. Louis Federal Reserve. Keep in mind, the trailing 12-month Consumer Price Index (CPI) was 9.8% in May 1981, according to the Bureau of Labor Statistics. Even with an inflation rate near 10.0%, savers were enjoying a high single-digit real rate of return (yield - inflation) on their money. That certainly isn't the case today.

Total net assets invested in money market funds of all types stood at $4.4 trillion on 9/30/20, up from $3.6 trillion at the start of 2020, according to data from the ICI. Total assets reached as high as a record $4.8 trillion on 5/20/20. The surge in inflows appears to have been a reaction to the onset of the COVID-19 pandemic. It makes sense that investors would seek to preserve some of their risk capital by stashing it away in money market funds, even if it means accepting little to no return. It would not be the first time investors used these funds as a short-term parking place. For now, let us stay focused on those investors whose main objective is current income.

In September, the Federal Reserve ("Fed") stated that it expects to hold short-term interest rates near zero until two things happen: (1) the U.S. unemployment rate is back to normal (around a 4.0% unemployment rate), and (2) inflation is running at or above 2.0%. Brian Wesbury, Chief Economist at First Trust Advisors L.P., notes that the Fed does not expect to achieve both goals until 2024. We believe that one of the Fed's motivations in promoting a multi-year commitment to a near zero interest rate monetary policy is to incentivize risk-taking. By holding interest rates low, the Fed is essentially disincentivizing saving. What is a saver to do?

Laddering Treasuries

Historically, one of the top strategies used by savers and investors to generate more income while reducing risk during times of uncertainty, rising interest rates or what may have been perceived as persistently low rates has been to purchase multiple bonds sporting different maturities, also known as laddering. The goal is to spread the risk throughout the interest rate curve. The strategy stresses income over growth, which is why Treasuries are often considered. As is usually the case with most income-oriented investors, having a yield or targeted return in mind helps with the selection process. Remember, income-oriented investors should always be cognizant of where inflation stands as well as the direction it could be headed in. As previously noted, the Fed would prefer to see inflation running at or above the 2.0% mark. We are using the CPI as our inflation gauge in the chart above. At a base level, in order to maintain one's purchasing power, bond investors have tended to want to generate a yield that at least outpaces the rate of inflation.

Is this strategy useful in today's climate? Based on the yields shown in the chart, you don't even need to do napkin math to see laddering does not work using Treasuries. An investor would need to allocate 100% of their capital to the 30-year Treasury bond (T-bond) just to outpace the most recent trailing 12-month inflation rate of 1.4%, and that does not take into account any federal income taxes owed on the interest. The yield on the 10-year T-note is only half the 1.4% CPI rate. To put the 1.46% yield on the 30-year T-bond into perspective, it sits 340 basis points below its 4.86% average yield for the 30-year period ended 9/30/20, according to Bloomberg.

Income-oriented investors seeking higher returns may need to step out of their respective comfort zones in order to achieve their objectives. While the current climate is challenging, the silver lining is that the Fed has provided an inordinate, if not unprecedented, amount of guidance pertaining to how it intends to manage monetary policy in the years ahead. We believe this can be a unique window of opportunity for those who recognize it. Income seekers do not necessarily have to assume a full-on, risk-on mindset. They can generate higher levels of income without having to compromise too much on quality. We discuss a few of these opportunities on the next page.

Continued

If savers would be willing to accept some additional risk on a portion of their capital they would have somewhere else to go

One of the main premises that we are incorporating into our message this quarter is the belief that corporate profits and economic activity will rebound in the U.S. in 2021.

As of 10/2/20, Bloomberg's 2021 consensus earnings growth rate estimate for the S&P 500 Index stood at 24.23%, up from -19.42% for 2020.

For economic activity to trend higher in the U.S., many pundits, including Federal Reserve Chairman Powell, believe we need additional fiscal stimulus from Congress.

With respect to COVID-19, we are anxiously awaiting any medical breakthrough that will help us better coexist with this virus, because there is a good chance the virus may never go away, according to experts. In late September, Dr. Anthony Fauci, the leading U.S. infectious disease expert, said vaccinations could begin as early as November or December.

In the end, the real hope is that those areas of the economy that have essentially been shuttered over the past seven months reopen ASAP.

We offer three income-producing destinations that we believe are a potential fit for the current climate.

Utilities

Even though utility stocks, particularly electric utilities, are considered defensive in nature, they did participate in the bear market sell-off from 2/19/20-3/23/20. The broader market, as measured by the S&P 500 Index, posted a total return of -33.79% for that period, according to Bloomberg. The S&P 500 Utilities Index declined by 35.64% over the same span. While the S&P 500 Index has gone on to set new record highs, as of 9/30/20, the S&P 500 Utilities Index stood 15.95% below its all-time closing high set on 2/18/20, just prior to the sell-off. That represents potential value and it is one of the metrics that drew our attention to this sector. The next is the earnings forecast for the sector. Bloomberg's consensus 2021 and 2022 earnings growth rate estimates for the S&P 500 Utilities Index stood at 5.5% and 5.3%, respectively, as of 10/2/20. Those are up notably from the 0.9% estimate for 2020. Lastly, the dividend yield stood at 3.45% as of 9/30/20.

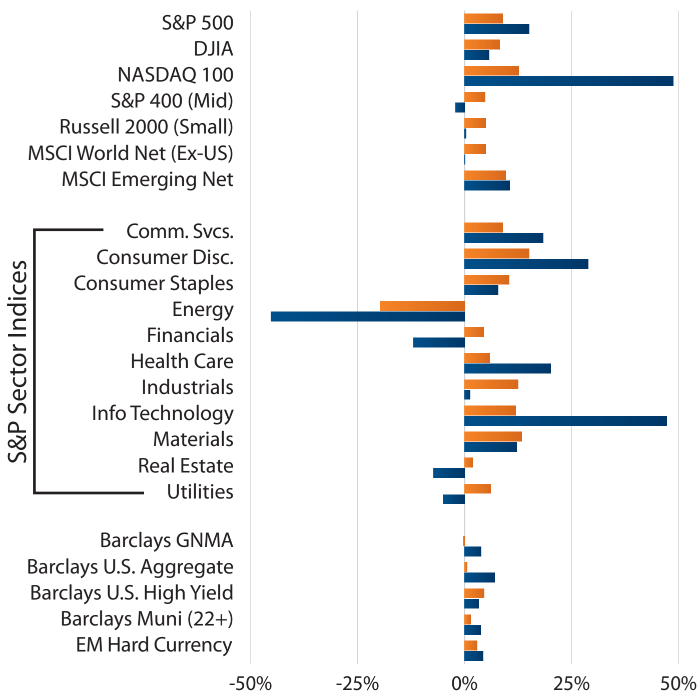
Banks

Banks have struggled to meet their earnings expectations the past two quarters due to the ongoing economic fallout from the COVID-19 pandemic. Some banks are global in scope. The Federal Deposit Insurance Corporation (FDIC) announced that U.S. commercial banks and savings institutions insured by the FDIC reported aggregate net income totaling $18.8 billion in Q2'20, down 70.0% from the $62.5 billion posted in Q2'19. The FDIC, however, noted that liquidity and capital levels are strong. Here is another potential opportunity if things turn for the better in 2021. As of the close on 9/30/20, the S&P 500 Banks Index was 37.59% below its all-time high set on 1/2/20, and its dividend yield stood at 4.21%, according to Bloomberg. Bloomberg's consensus 2021 and 2022 earnings growth rate estimates for the S&P 500 Banks Index stood at 47.9% and 31.1%, respectively, as of 10/2/20, a huge rebound from the -53.3% estimate for 2020.

Equity REITs

The backstory with equity real estate investment trusts (REITs) is that they have also fell victim to the fallout from the COVID-19 pandemic. Some of the areas hit the hardest have been retail stores, shopping centers and regional malls, lodging/resorts, office space and apartments. We should note that out of all of these subsectors, retail-related REITs have been struggling for at least the past couple of years due to increased competition from e-commerce. Equity REITs would be a big beneficiary of another round of COVID-19 stimulus, in our opinion. Even in this difficult climate there are a few sectors that have performed well in 2020. They include Data Centers, Infrastructure and Self Storage. As of the close on 9/30/20, the FTSE Nareit All Equity REITs Index was 20.32% below its all-time high set on 2/14/20, and its dividend yield stood at 3.84%, according to Bloomberg and FTSE™. REITs have raised $89.8 billion of new capital in the first nine months of 2020 – a sign of strength, in our opinion.

Total returns for Q3 and past 12 months (9/30/20)



Sources: Bloomberg and Barclays. ***Past performance is no guarantee of future results.***

A Look Ahead:

A year-over-year earnings comparison in U.S. dollar terms (per share). The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.

Index (Weighting In S&P 500)	**Q4'20E**	Q4'19A	**Q1'21E**	Q1'20A	**2020E**	2019A
Communication Svcs. (10.8%)	**2.06**	2.11	**2.08**	1.70	**7.06**	8.25
Consumer Disc. (11.6%)	**7.38**	9.68	**7.36**	3.97	**22.30**	39.48
Consumer Staples (7.0%)	**7.67**	8.17	**7.42**	7.35	**30.57**	30.50
Energy (2.1%)	**0.66**	0.46	**1.71**	-9.16	**-17.38**	16.09
Financials (9.7%)	**6.74**	11.75	**7.21**	-1.09	**20.16**	43.44
Health Care (14.2%)	**17.00**	13.19	**19.20**	13.89	**62.60**	55.62
Industrials (8.3%)	**5.46**	8.12	**6.34**	3.87	**15.05**	35.48
Information Tech. (28.2%)	**20.85**	18.12	**18.31**	14.29	**66.39**	62.92
Materials (2.6%)	**4.06**	3.69	**4.63**	3.28	**14.72**	17.05
Real Estate (2.6%)	**0.95**	1.74	**1.02**	1.65	**4.61**	7.00
Utilities (3.0%)	**3.15**	3.09	**4.36**	3.40	**15.33**	15.66
S&P 500 Index	**35.51**	39.18	**36.79**	19.50	**113.84**	157.12
S&P 400 Index (Mid-Cap)	**23.52**	22.19	**23.26**	16.68	**68.86**	94.98
S&P 600 Index (Small-Cap)	**10.70**	4.41	**9.84**	-19.74	**-7.35**	30.68

Source: S&P Dow Jones Indices (9/29/20). Sector weightings as of 9/30/20.
There is no guarantee past trends will continue or projections will be realized.

All charts and tables herein are for illustrative purposes only. Indices do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Indices are unmanaged and an investor cannot invest directly in an index.
The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.