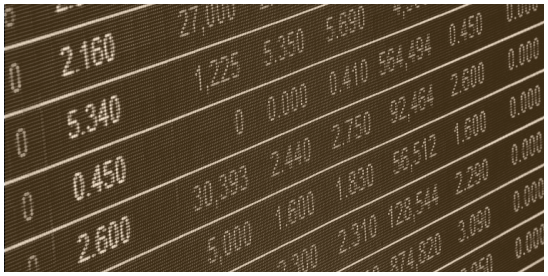
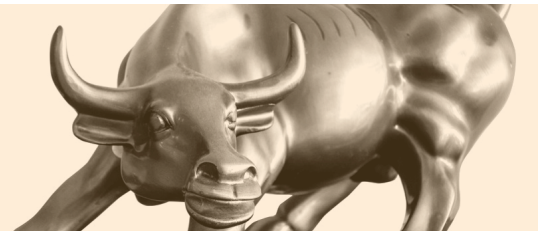
MARKET COMMENTARY

THIRD QUARTER 2020





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AT A GLANCE

Risk-seeking investors were rewarded with further solid gains in the third quarter, following second quarter's strong rebound across most major risky categories. Incoming data on the U.S. economy continued to surprise to the upside, sending economic surprise aggregates to their highest levels since early 2018, albeit with some variables reflecting an economic backdrop that continues to be challenging, most notably in the labor market. As investors focused their sights on the upcoming U.S. presidential election, growing worries of positive inflation surprises, sharp depreciations in the U.S. dollar (USD), and what the next phase of stimulative actions by policymakers will look like have all been at the top of investors' minds during the quarter.

To start the fourth quarter, President Trump's COVID-19 diagnosis has driven volatility higher, with global asset allocators seeking to discount a wider range of potential outcomes to conclude the year. According to Las Vegas betting probabilities, following the news of President Trump's positive COVID-19 diagnosis, the odds of a successful reelection bid by the president have sunk to their lowest level since betting began.

Global equity performance was broadly positive, as U.S. large cap growth equities continued their impressive streak of strong performance, particularly among large cap growth companies. Regionally, domestic equities outpaced international equities but underperformed the emerging market region slightly, with a decline in the USD serving as a tailwind for emerging markets' relative performance. Growth strongly outperformed value during the third quarter, with the energy and financials sectors weighing down the relative performance of value, while outsized technology performance propelled growth's relative total return advantage.

Despite overwhelmingly bullish sentiment across the global investment landscape, core bond returns were modestly positive, albeit trailing the more risk-oriented sectors of the market such as investment-grade corporates, high yield, and bank loans. Nominal rates were essentially unchanged, with the 10-Year Treasury note yield rising a modest 2 bps to conclude September at 0.68%, nearly 20 bps above the record low of 0.51% established in August. While nominal rates exhibited little directionality quarter-over-quarter, real rates—i.e., yields on Treasury Inflation-Protected Securities (TIPS)—declined sharply, reflecting an increase in inflationary sentiment as implied by the Treasury market. With the Federal Reserve (Fed) continuing to promote a 2% inflation target while committing to keeping short-term interest rates near zero—even once inflation finally rises above 2%—real interest rates are likely to remain in negative territory for the foreseeable future.

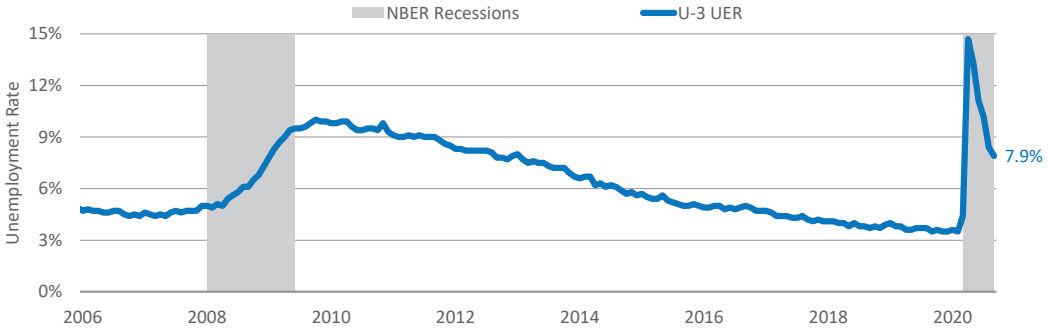
In real assets, performance for the quarter was mixed, despite mounting inflationary sentiment and the weakness in the USD. REIT returns were slightly positive, with asset allocators continuing to reflect a cautious fundamental outlook given demand uncertainties for commercial real estate—particularly office, as trends shift more toward remote-based work arrangements. Energy infrastructure performance was poor, despite positive changes in both crude oil and natural gas spot prices, as well as a general increase in investor inflationary sentiment. Fundamental questions related to the demand for fossil fuels—particularly under the potential prospect of a Democrat-led White House and/or Congress—has likely weighed on performance.

KEY MARKET THEMES AND DEVELOPMENTS

FUNDAMENTAL PICTURE CONTINUES TO IMPROVE, BUT PRESIDENTIAL ELECTION ANGST REMAINS

Most major risky asset categories witnessed positive performance during the third quarter, with a continued better-than-expected economic backdrop serving as a key pillar of support. The labor market, for example, witnessed a further decline across headline measures of unemployment, as the U-3 unemployment rate improved to 7.9% to end the quarter, nearly half of its localized high of 14.7% from April.

UNEMPLOYMENT REMAINS ELEVATED, BUT HAS IMPROVED SINCE APRIL



Data sources: BLS, NBER, Bloomberg, L.P.; Data as of September 2020

On an aggregate basis, incoming U.S. economic data further exceeded sell-side median estimates, a trend which has been in place for the majority of 2020, despite a somewhat sloppy rebound in economic activity off of the bottom earlier this year. Economic surprise indices, which compare as-reported economic data versus median sell-side estimates, sit at a two-year high, supporting an ongoing bid for risky assets that began in March.

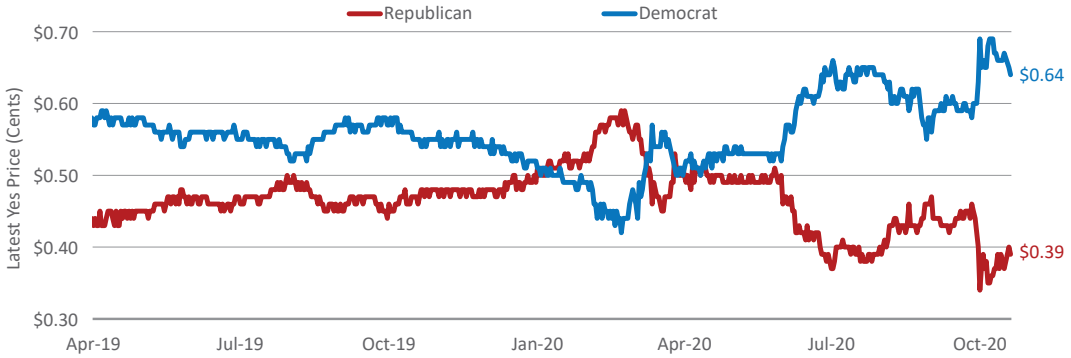
INCOMING U.S. ECONOMIC DATA CONTINUES TO SURPRISE TO THE UPSIDE

Data source: Bloomberg, L.P.; Data as of September 30, 2020

More recently, global asset allocators have grappled with how to best position their portfolios around the potential increase in volatility stemming from the November presidential election and potential delays due to absentee balloting. President Trump's recent positive COVID-19 status briefly called into question the president's capacity to not only carry out the remainder of his reelection campaign, but also his day-to-day duties as Commander in Chief. A brief stint at Walter Reed Medical Center and an energized spirit to continue rallying into election day has supported the belief that the president appears resilient. Perhaps more importantly, his contraction of COVID-19

reminded voters that the world is still grappling with the disease that has upended almost everything in 2020. Las Vegas betting odds, however, paint a different picture; on a real-time basis, the odds of a successful reelection bid by the president remain at their lowest level since betting odds began in spring 2019.

PRESIDENTIAL ELECTION BETTING ODDS



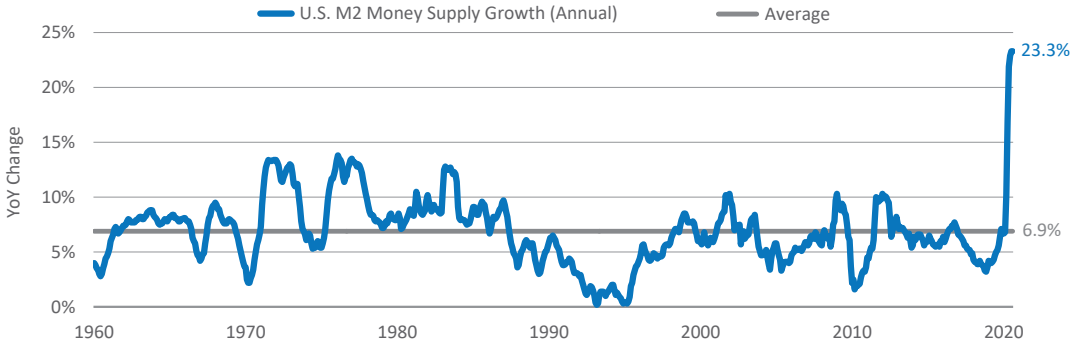
Data sources: predictit.org, Bloomberg, L.P.; Data as of October 20, 2020

RISKS OF POSITIVE INFLATION SURPRISES ON THE HORIZON

A natural (and predictable) reaction to the unprecedented levels of monetary and fiscal stimuli set forth by policymakers in 2020 includes the concern for positive inflation surprises, which, presumably, would result in an abrupt tightening of current accommodative measures, likely sending risky asset prices lower. During the quarter, the Fed adjusted their flexibility around the management of their 2% inflation target, adopting an "average inflation targeting" protocol in which they committed to maintaining supportive policy even once the 2% inflation bogey has been reached, following a period where inflation persistently missed the 2% goal.

This tweak in the Fed's management around their inflation mandate, combined with a rise in some of the key ingredients in inflation, has led some to conclude runaway inflation is right around the corner. Indeed, annual money supply growth is tracking the sharpest acceleration on record, at more than 23% year-over-year through August. Nevertheless, deflationary forces in the form of a lowered labor force participation rate, an aging demographic, slowing population growth, and a ballooning federal debt burden are abundant.

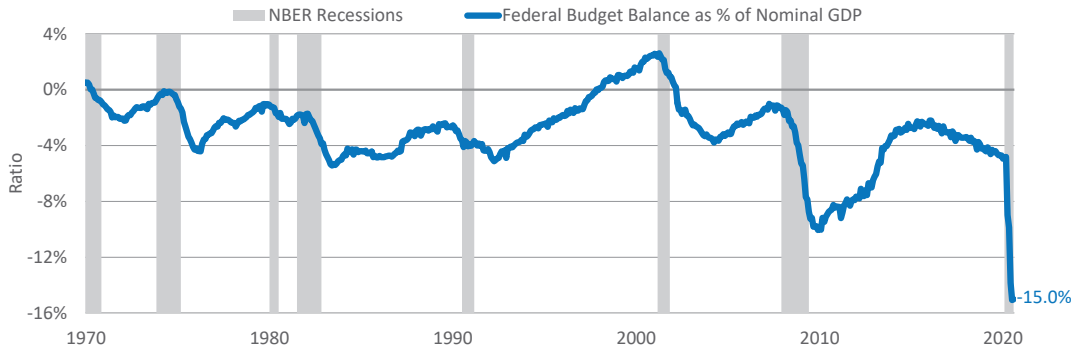
U.S. MONEY SUPPLY GROWTH HAS SURGED IN 2020



Data sources: Federal Reserve, Bloomberg, L.P., NBER; Data as of August 2020

A surge in government spending due in large part to historical fiscal stimulus against the sharpest contraction in economic activity since the Great Depression has driven the federal budget deficit relative to nominal GDP ratio to the weakest level on record, at -15.0% through August. The sharp drop-off in this key fiscal health measure has increased fears of a disorderly rise in inflation through the currency debasement channel, a likely contributor to the run-up in the price of gold this year.

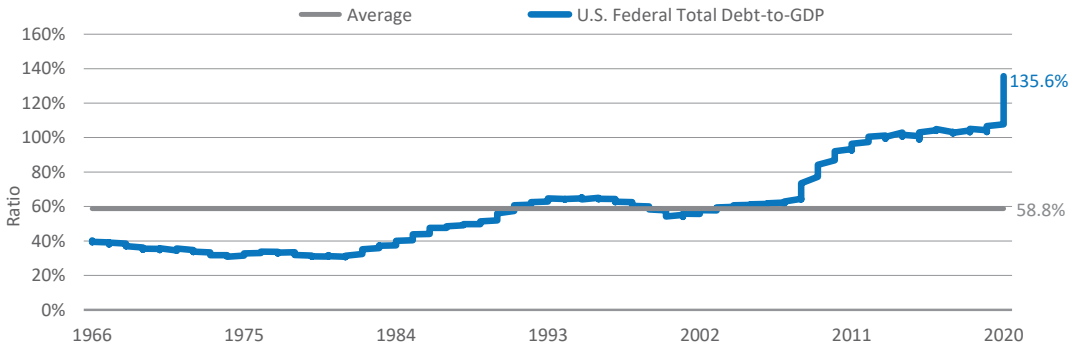
FEDERAL BUDGET BALANCE AS A PERCENT OF NOMINAL GDP



Data sources: U.S. Treasury, NBER, Bloomberg, L.P.; Data as of August 2020

A ballooning federal debt burden, which recently crossed 135% of GDP at the public sector level, may serve as a counterbalance to the perceived rise in pro-inflationary forces in 2020. This ratio fails to include the trillions of dollars in off-the-balance-sheet unfunded liabilities, including social security, Medicare, and Medicaid. Some academic research has pointed to an inverse relationship between marginal debt increases and subsequent economic growth rates, potentially pointing to lackluster trend growth rates in the years to come. Seasoned investors, however, likely respect the loose connection between economic performance and asset class returns.

U.S. FEDERAL DEBT BURDEN CONTINUES TO MOUNT



Data sources: U.S. CMB, Bloomberg, L.P.; Data as of April 2020

END-OF-YEAR OUTLOOK AND CONCLUDING THOUGHTS

Positive momentum across most major global risky asset categories in second quarter 2020 carried over into the third quarter, buoyed by better-than-expected incoming economic data, supportive monetary and fiscal measures, and a weakening USD. The headline unemployment rate, for example, reached nearly half of the localized high in April by quarter-end.

President Trump's COVID-19 diagnosis in early October has influenced polls and betting odds surrounding the election. With less than one month remaining of his reelection campaign, this diagnosis calls into question the remaining planned debates as well as pausing the large rallies that have characterized his recent campaign trail. Las Vegas betting odds of a successful reelection bid by the president have soured in recent weeks, particularly following the president's positive COVID-19 status.

Against the backdrop of unprecedented levels of policy stimulus—and promises of additional measures, should economic performance disappoint—as well as a potential changing of the guard at the White House, fears of positive inflation surprises have spiked. This may prove to be a temporary phenomenon, however, should recent pro-inflationary forces succumb to the growing secular forces placing downward pressure on inflation.

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Published October 2020.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

The Bloomberg Barclays Capital Aggregate Bond Index is a benchmark index made up of the Barclays Capital Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed market country indexes included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey* and United Arab Emirates.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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