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MARKET REVIEW
AUGUST 2020

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THE 2020 ELECTIONS

The global COVID-19 pandemic and ensuing recession brought forth by efforts to contain the virus have dramatically changed the backdrop of the 2020 U.S. elections. Although Democrats reclaimed a majority in the House of Representatives in 2018, the consensus view heading into 2020 seemed to be that President Trump and Senate Republicans would be able to rely upon the relative strength of the domestic economy to retain control of the presidency and the upper chamber of Congress. Although President Trump's national job approval rating never sustainably eclipsed 45% during his term, according to the majority of available polling, the electoral college map provided a reasonably dependable path to a 2020 reelection via narrow victories in key swing states across the south and upper Midwest. Despite the current environment's elevated political polarization, conventional wisdom stipulated that incumbent American presidents are likely to be reelected in years when the U.S. economy is not in a recession. This was the case with Richard Nixon in 1972, with Ronald Reagan in 1984, with Bill Clinton in 1996, with George W. Bush in 2004 and with Barack Obama in 2012. In fact, only 10 standing presidents failed to win reelection in the 58 contests dating back to George Washington's 1792 campaign.

SWING STATES AND THE ECONOMY

Most recent polls indicate that Democratic presidential nominee Joe Biden has opened up a moderate, but far from insurmountable, lead on President Trump three months before the election. According to the RealClearPolitics average of national polling data, Biden's lead on the president is approximately 7% compared to just 4% in mid-January. These three percentage points of difference are widely seen as critical given that 5% is generally viewed as the maximum amount by which a candidate could lose the popular vote but win the electoral college. Biden's front-runner status in popular national polls somewhat belies narrower leads in several of the closely contested swing states. According to RealClearPolitics' polling averages, as of the first week of August, Biden has a 5% or less lead in Arizona, Florida, North Carolina, Pennsylvania and Wisconsin. These five swing states account for 85 electoral votes – or nearly 16% of the 538 total electoral college votes. Meanwhile, the President holds a slight 1.5% to 2.0% lead in both Texas and Georgia, which combine for 55 electoral votes.

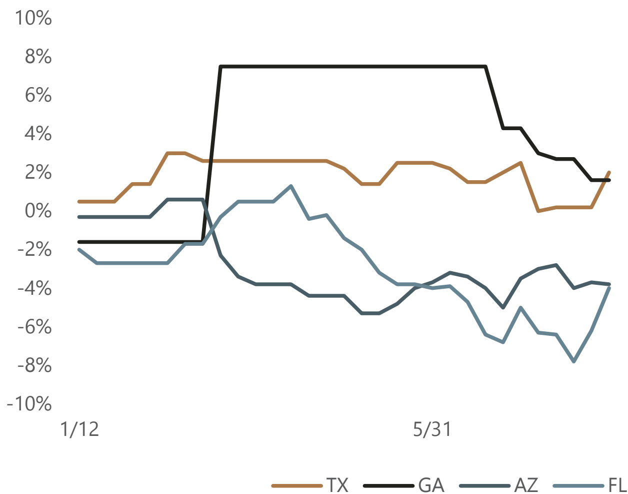
President Trump has received relatively poor favorability polling on his administration's handling of the COVID-19 pandemic according to several recent polls. Yet, until very recently, he still enjoyed at least 50% favorability on his handling of the economy according to Quinnipiac University polling. Given the President has generally received higher marks on the economy than his overall approval rating, the major risk for his reelection prospects over the final months of the campaign will likely be related to any signs that job losses related to efforts to combat COVID-19 become more entrenched than were previously expected. Additionally, another significant surge in COVID-19 infections in the fall would also probably create a formidable headwind for the President's reelection bid. The principal risk facing the Biden campaign seems to be the prospect of subdued voter turnout on election day driven by a failure to unite the Democratic party's progressive and moderate wings. For instance, the manifestation of this risk could involve the Biden campaign moving far enough toward the progressive end of the policy spectrum so that they risk the support of independents and centrist moderates in key southern and upper Midwest states.

What, if any, are the investment implications of all this presidential election jockeying? In simple terms, the answer lies in the starkly disparate policy priorities put forth by the two candidates. Although President Trump has not yet provided a detailed set of policy goals for a prospective second term, most political commentators believe a reelected Trump administration would continue to focus on deregulation, a U.S.-centered approach to global trade and reductions in both corporate and individual taxes. In contrast, the Biden campaign has emphasized increased federal spending directed toward the mitigation of climate change, increased taxes on corporations and individuals in the highest income tax brackets and expanded access to health care funded through the federal government.

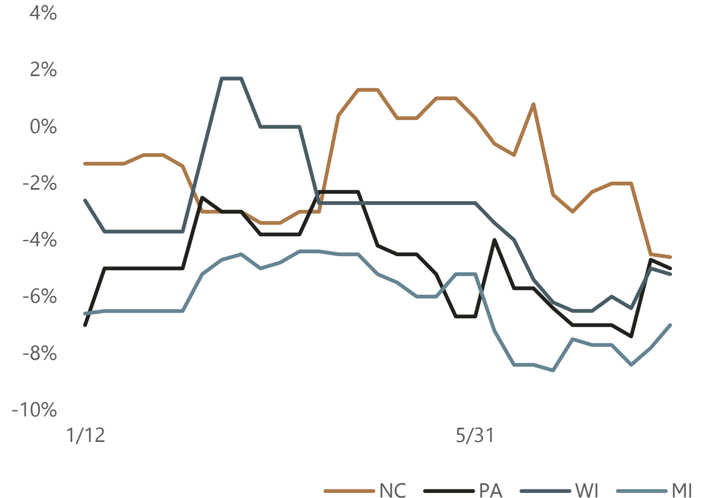
While both the Trump and Biden policy agendas create general investment implications, we think it makes sense for investors to consider the critical, but often overlooked, step of congressional control when attempting to connect the impact of presidential elections and markets. In most recent American political history, a Congressional majority held by the president's party has generally been a

TRUMP VS. BIDEN POLLING AVERAGE IN SELECTED SWING STATES

READINGS ABOVE 0% INDICATE TRUMP IS FAVORED; READINGS BELOW 0% INDICATE BIDEN IS FAVORED



Source: RealClearPolitics, Bloomberg.
Past performance does not guarantee future results.



Source: RealClearPolitics, Bloomberg.
Past performance does not guarantee future results.

requirement for the executive branch to bring its policy agenda to life through legislative action.

ALL EYES ON THE SENATE

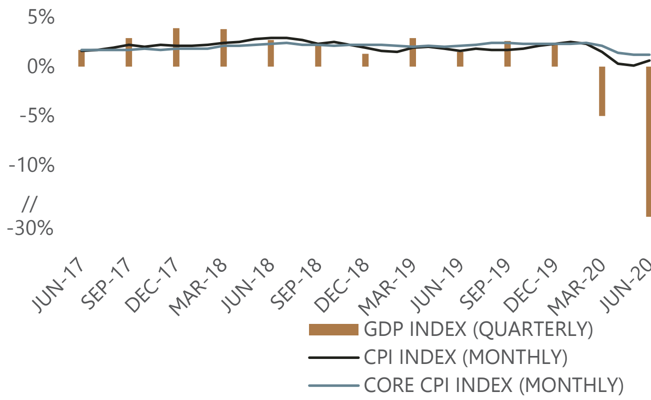
Turning to the current state of the U.S. Congress, the 37-seat Democratic advantage in the House of Representatives and 18 GOP House members set to retire before November 2020 make most election observers believe that Democrats will retain control of the lower chamber of Congress. In the Senate, however, there is a different story unfolding. The Republicans currently have a 53-47 Senate majority, but they are defending 23 of the 35 seats up for reelection. Thus, Republicans have to defend nearly twice the amount of Senate territory as Democrats in 2020. If the Democrats win the presidency, they only need to pick up three currently Republican Senate seats to gain effective control of the Senate. This is because Senate voting rules stipulate that in the event of a 50-50 tie, the tie-breaking vote goes to the sitting Vice President. If President Trump is reelected, the Democrat's magic number in the Senate is four. The Cook Political Report, an independent, non-partisan newsletter, has identified 11 Democratic-held seats as either "solid Democrat" or "lean Democrat." The Alabama Senate seat held by Doug Jones (elected in a special election for former U.S. Attorney General Jeff Sessions' old seat) is expected to be reclaimed for the Republicans by former Auburn University football coach Tommy Tuberville. Of the 23 Republican-held Senate seats, 16 are identified by the Cook Political Report as either "solid Republican" or "lean Republican." Meanwhile, 6 currently held GOP Senate seats (Colorado, Georgia, Iowa, Maine, Montana and North Carolina) are identified as "toss-ups" and the Arizona Senate seat held by Republican Martha McSally is identified as "lean Democrat."

If we assume that Republican Tuberville defeats Jones in Alabama, and Republican McSally loses to her Democratic challenger in Arizona, then Democrats would likely need to win either three or four of the races in Colorado, Georgia, Iowa, Maine, Montana and North Carolina to take control of the Senate. This is important because the most likely chance for a unified government in which one party controls the presidency and both houses of Congress increasingly appears to be a so-called Blue Wave, or Democratic sweep. Alternatively, policy gridlock would most likely be the central theme of a divided government in which President Trump wins reelection and the Democrats either win or lose the Senate. Or, if the Democrats win the presidency and the Republicans retain a narrow Senate majority, policy gridlock would almost certainly dominate Washington as was the case for most of 2010 through 2016. In a Democratic sweep, a presumptive Biden administration would have its best chance at enacting its major stated policy objectives. These would likely be focused on a combination of raising corporate and personal taxes and increased government spending to finance an expansion of the public health care option and projects related to "green energy" and infrastructure improvements. More specifically, a Democrat-controlled Congress would very likely pursue at least a partial reversal of some, or all, of the provisions contained in the 2017 Tax Cuts and Jobs Act, which lowered the U.S. corporate tax rate from 35% to 21%. A unified Democratic government would also likely pursue increased regulations toward the energy and financial services industries, but take a less adversarial trade policy stance against China. It is challenging, at best, to draw clear investment implications three months before what are shaping up to be closely fought presidential and Senate races. Yet, one question that investors will probably need to more closely consider in coming months is whether or not the fiscal stimulus likely to be championed by a prospective unified Democratic government will outweigh the potential headwinds for corporate profits created by increases in tax rates and regulations that are expected to be important pieces of the Democratic policy agenda.

ECONOMY

GDP AND CONSUMER PRICES

JUNE 2017 THROUGH JULY 2020

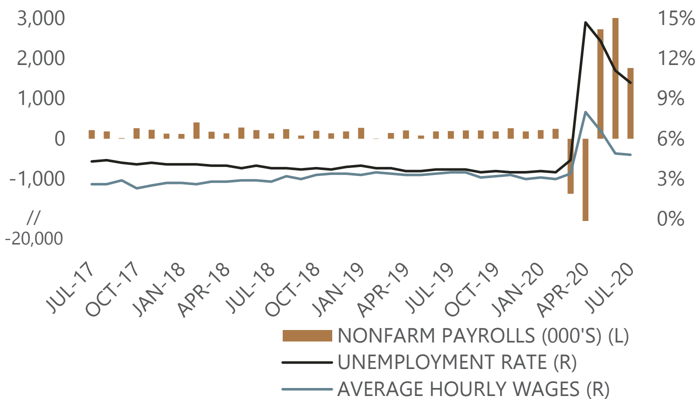


Source: Bloomberg

- U.S. real gross domestic product (GDP) contracted at an annualized rate of 32.9% in the second quarter, the largest quarterly contraction on record. The steep drop in economic activity was better than the median economists' projection for a 34.7% decline.
- Economists forecast a rebound in economic activity in the second half of 2020 with growth of 18.0% and 6.5% in the third and fourth quarters, respectively; the full-year growth estimate stands at negative 5.5%.
- The Core Consumer Price index (CPI) was up 1.2% in June from a year earlier, matching May's gain. The unchanged reading followed three consecutive monthly declines in year-over-year inflation. Muted inflation provides support for the Federal Reserve to continue its accommodative policy.

LABOR MARKET

JULY 2017 THROUGH JULY 2020

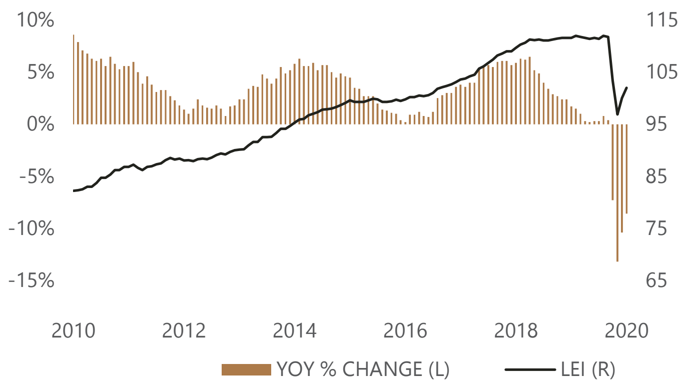


Source: Bloomberg

- Nonfarm payrolls increased by 1,763,000 in July, which surpassed the median estimate of 1,480,000 in a Bloomberg survey of 71 economists. The combined job gains for May, June, and July have totaled roughly 9.3 million, the most jobs created in a three-month period in U.S. history.
- The unemployment rate of 10.2% in July also topped the consensus estimate of 10.6%. The slowdown in hiring during July compared to June's addition of 4.8 million jobs was likely related to the recent resurgence in new COVID-19 cases in many states. Although total employment still remains well below February's high-water mark, the partial recovery in the labor market in recent months is encouraging.

LEADING ECONOMIC INDICATORS

JUNE 2010 THROUGH JUNE 2020



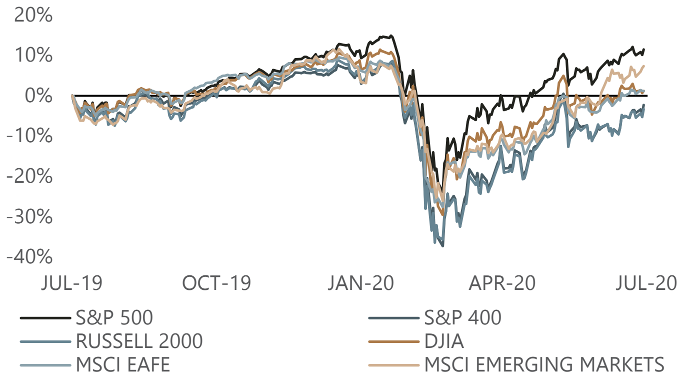
Source: Bloomberg

- The Conference Board Leading Economic Index (LEI) increased in June for a second consecutive month with a 2.0% gain. The main contributors to the LEI's rebound were declining initial jobless claims, an increase in average hours worked in manufacturing, and the rally in stocks.
- Another positive item from the June reading was that seven of the ten indicators increased during the month. The laggards included the Leading Credit Index, new orders for consumer goods, and consumer expectations for business conditions.
- During the first half of 2020, the LEI was down 8.4% as weakness among the indicators became more widespread. Further recovery in the labor market and improving business conditions could help the LEI's rebound continue in the second half of the year.

EQUITY

TRAILING 12-MONTH EQUITY RETURNS

PRICE APPRECIATION, JULY 2019 THROUGH JULY 2020

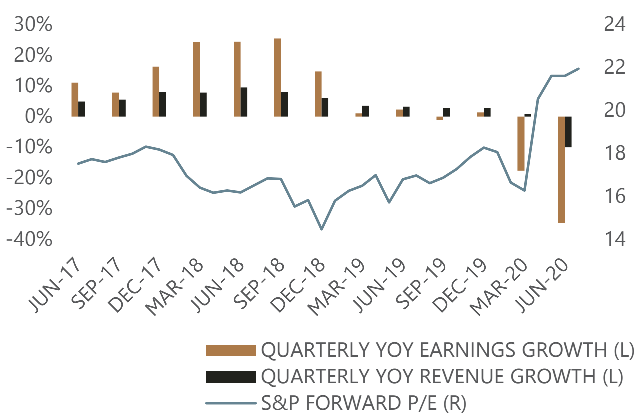


Source: Bloomberg. Past performance is no guarantee of future results.

- Despite the recent resurgence of COVID-19 cases in the U.S., equities continued to rally for a fourth consecutive month in July. The S&P 500's 5.64% return in July bumped the index back into positive territory for the year and within 4% of its all-time high reached in February. Meanwhile, the technology sector heavy Nasdaq Composite extended its performance this year to 20.40% with a 6.85% gain in July.
- Equities' impressive performance in July was supported by optimism about COVID-19 vaccine prospects and better-than-feared second quarter earnings results. Promising early trial data for four COVID-19 vaccines raised hopes for a virus treatment potentially before year end.

S&P 500 YOY EARNINGS & REVENUE GROWTH

BY QUARTER, MARCH 2017 THROUGH JULY 2020

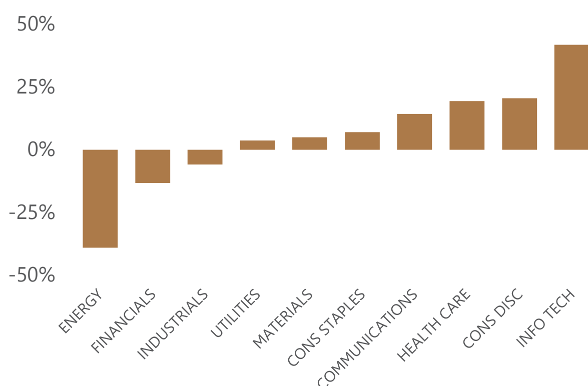


Source: Bloomberg

- S&P 500 companies are reporting second quarter earnings well above analysts' reduced expectations. Among the 63% of S&P 500 companies that have reported thus far, 84% reported earnings above analysts' estimates. This is the highest earnings beat percent since at least 1992 and above the 63% long-term average.
- Earnings are on track for a 35.95% year-over-year decline, around 20% better than analysts' initial estimate for a 43.64% decline. Revenue growth of negative 10.06% is above analysts' estimate for a 10.97% decline.
- Analysts have revised their earnings expectations upward for the second half of the year and project earnings declines of 23.43% and 11.89% in the third and fourth quarters, respectively.

S&P 500 SECTORS 12-MONTH PRICE RETURNS

JULY 2019 THROUGH JULY 2020



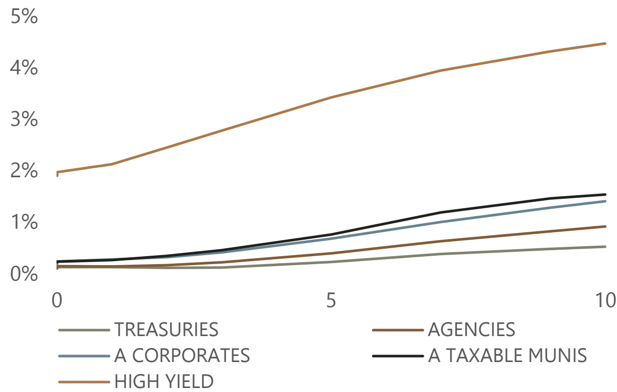
Source: Bloomberg

- Ten of the 11 S&P 500 sectors posted returns in July around 4% or higher. Consumer discretionary was the best performing sector with a 9.00% gain in the month. The sector was once again led by e-commerce giant Amazon (AMZN) and homebuilders Lennar (LEN) and D.R. Horton (DHI).
- Utilities' 7.81% gain in July was the second best among S&P 500 sectors. Utilities and health care are the only sectors on track for positive earnings growth in the second quarter.
- Energy was the only sector with a loss in July. The energy sector's revenue is on pace for a 51.40% contraction in the second quarter due to lower oil prices and reduced energy demand amid the work-from-home environment.

FIXED INCOME

CURRENT YIELD CURVES

YIELD CURVES AS OF JULY 2020

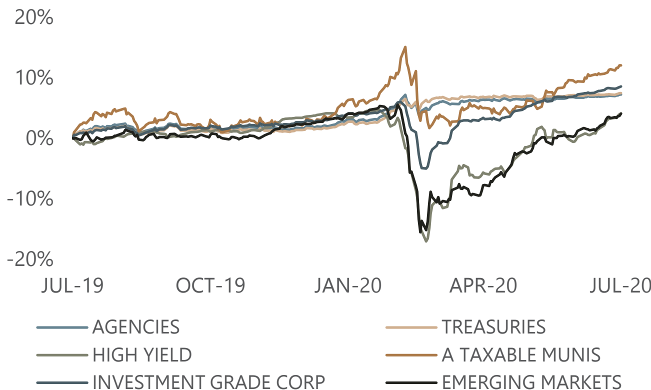


Source: Bloomberg

- The U.S. Treasury curve shifted lower in July amid increasing COVID-19 cases in the U.S. and greater economic uncertainty related to lockdown measures.
- Credit spreads over Treasuries begin to widen around the two year maturity and increase further toward the longer end of the yield curve.
- Yields on below investment grade bonds have increased significantly more than the other bond segments shown in the accompanying chart amid the COVID-19 pandemic. Economic uncertainty related to lockdown measures has led bond investors to favor higher quality corporate credits.

12-MONTH RETURNS, TAXABLE BOND SEGMENTS

JULY 2019 THROUGH JULY 2020

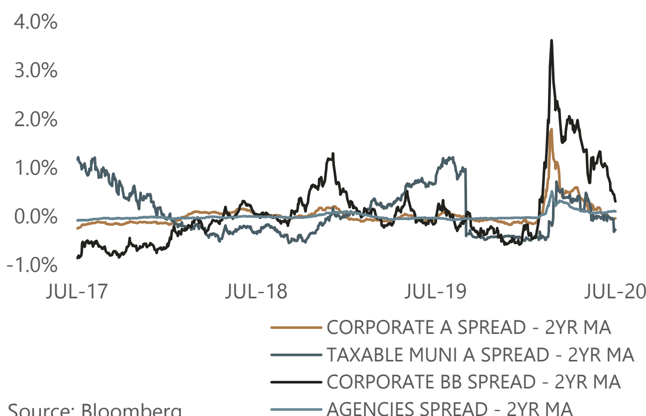


Source: Bloomberg. Past performance is no guarantee of future results.

- The pandemic has led to better relative performance in investment grade sectors which each generated a return over 7% during the last twelve months. Meanwhile, non-investment grade sectors posted more modest twelve-month returns between 4.0%-4.5%.
- A-rated taxable municipals have led the bond market over the last twelve months with a return of 12.1% compared to the 8.6% return for the second best performing sector, A-rated corporates.
- A-rated taxable municipals, Treasuries, and agencies are the only sectors in the accompanying chart that have experienced a positive price return for at least 12 months.

SPREAD VS. TREASURY LESS 2-YR MOVING AVG

JULY 2017 THROUGH JULY 2020



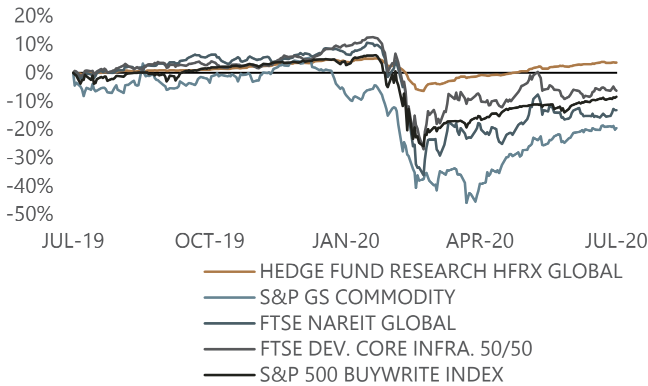
Source: Bloomberg

- Of the fixed income sectors shown in the accompanying chart, agencies and BB-rated corporate bond yield spreads over similar maturity Treasuries are above their two-year averages as of the end of July. Only the highest quality sector, agencies, experienced spread tightening during the month.
- Spreads for all the fixed income sectors shown in the accompanying chart are wider than prior to the onset of the COVID -19 pandemic. BB-rated corporate bond spreads have experienced the most spread widening.

ALTERNATIVES

ALTERNATIVES, 12-MONTH RETURNS

JULY 2019 THROUGH JULY 2020

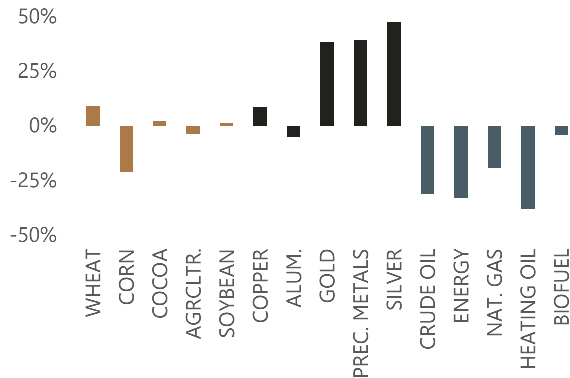


Source: Bloomberg. Past performance is no guarantee of future results.

- The dispersion of returns between the higher beta commodities and global real estate asset classes tracked in the chart at left and their more interest rate sensitive and hedging-oriented counterparts has narrowed in recent months.
- The global hedge fund asset class has navigated the bear market in global stocks and subsequent rally relatively well. The HFRX Global Hedge Fund Index declined 1.3% from the February 19 market peak to July 31 compared to a 3.7% decline for the MSCI All Country World Index.
- Across the hedge fund landscape, event-driven, commodity-focused and fixed income-focused strategies generated the best returns thus far in 2020.

COMMODITIES, 12-MONTH SPOT RETURNS

JULY 2019 THROUGH JULY 2020



Source: Bloomberg. Past performance is no guarantee of future results.

- Precious metals were the clear standouts across the commodity complex in July, as gold advanced 10.9% and silver surged over 34.0% during the month.
- Gold continues to benefit from elevated global economic uncertainty driven by the COVID-19 pandemic and negative real rates across most of the developed world. More recently, gold, along with all commodities traded in U.S. dollars, has benefited from a period of weakness in the greenback which began in mid-May.
- Led by copper, industrial metal prices exhibited buoyancy in July related to optimism about economic reopenings in major economies across Asia and Europe. Copper, which is primarily utilized in highly cyclical industries, including construction and machinery manufacturing, is the world's third most widely used metal after iron and aluminum.

ATG Trust Company
1 South Wacker Drive, 24th Floor
Chicago, Illinois 60606
atgtrust.com

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There are risks involved with investing including possible loss of principal and the value of investments and the income derived from them can fluctuate. Investing for short periods may make losses more likely.

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