SPECIAL REPORT

PROSPECTS OF UPCOMING OCTOBER VOLATILITY

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TOM WALD, CFA®
Chief Investment Officer, Transamerica Asset Management, Inc.

President Trump's positive COVID-19 diagnosis adds more uncertainty to the month of October, which in our opinion was already shaping up to be a potentially volatile one for the equity and credit markets.

Even prior to the early morning news on October 2 that the president and first lady Melania Trump had tested positive for the virus, we felt the historically unprecedented circumstances of this year's market environment combined with anticipated news flow of high importance could potentially create an October of gyrating market volatility.

Now as we look ahead into October, a month historically known for some of the market's worst days ever, the reality of a president and presidential candidate under quarantine and treatment for a potentially life-threatening condition as the final weeks of an election campaign approach certainly presents a surreal atmosphere to investors and the entire nation, representing uncharted waters to say the least. The cumulative impact of the president's medical condition and its repercussions across numerous areas are readily identifiable but extremely difficult to quantify. From a market and investment standpoint, the president's medical condition is now unfortunately one more factor, albeit a major one, to include in the mix as we begin a month perhaps like no other in our nation's history.

In addition to President Trump contracting the virus, we have identified several other factors that could potentially develop in the month and possibly impact the markets.

These include:

- Ongoing COVID-19 infection and fatality rates
- Pending Phase III clinical data on COVID-19 vaccine candidates
- The pace of economic recovery for the remainder of 2020 and beyond
- Prospects of a new economic relief and stimulus package from Congress
- The final stretch of the presidential and congressional elections

THE EXCEPTIONALLY STRONG MARKET RETURNS SINCE LAST MARCH COULD SET THE STAGE FOR VOLATILITY DURING OCTOBER

As we know, since the initial market lows brought on by COVID-19 on March 23, the equity and credit markets have embarked upon a recovery of historical proportions. This is evident in the S&P 500's greater than 60% total return between March 23 and

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September 1. Even after a price decline of just under 5% in September, the index began October at better than 50% above the late March low. In addition, we have seen high-yield bond credit spreads narrow by more than 500 basis points during this same time, with yield differentials to comparable maturity Treasury bonds basically cut in half from 10.87% to 5.42% (ICE BofA US High Yield Index Option-Adjusted Spread). These types of dramatic upward moves, even when coming off of sizable declines such as the virus-induced sell-off of February 19–March 23, can always be subject to rapid corrections in the 10–15% range, particularly when uncertain news flow on major events are in the midst. As a rough estimate, such a correction off the early September high of 3,580 could put the S&P 500® in a range of about 3,050–3,220. The midpoint of this range would be approximately 7% below the September 30 index close of 3,363. However, this is not to say that any such downward pressure in the equity and credit markets could not ultimately provide long-term opportunities.

REPERCUSSIONS OF PRESIDENT TRUMP'S POSITIVE COVID-19 STATUS COULD BE FAR REACHING AND IMPACTFUL TO THE MARKETS

Donald Trump is not the first president to face serious health issues while serving in office, but he is perhaps the first to do so in a publicly known setting. Woodrow Wilson had a stroke, Franklin Roosevelt battled polio, and John Kennedy endured chronic back pain of immense magnitude. However, for the most part in the worlds those presidents lived in, few people knew about their conditions and those who did pretty much stayed quiet about it.

While the overwhelming majority of both President Trump and first lady Melania Trump's COVID-19 conditions are either unknown or yet to be determined, it is important at least from a market standpoint to best understand what events or scenarios could conceivably impact the markets. We have broadly identified four of them, with three being potentially unfavorable and one being potentially favorable.

These are:

Unfavorable — COVID-19 extends beyond President Trump to other high-ranking government officials, cabinet members, government officials, or members of Congress. While Washington D.C. is known for its great "corridors of power," the truth is many of its closed-door meetings, even those involving the president, often take place in tight quarters. The president's Marine One helicopter also requires close seating of its passengers. It is widely believed the president contracted the virus from Hope Hicks, one of his administration's senior counselors who had recently been traveling with him. Therefore, when considering contact tracing on the president and Ms. Hicks, and also considering the ongoing negotiations between the White House and members of Congress pertaining to the economic stimulus negotiations, a wider group of COVID-19 infections within high levels of government is by no means far-fetched. Should we see more high profile COVID-19 cases in the nation's capital, it would likely not be received well by the markets.

Unfavorable — The president's case of the virus becomes serious and he is "unable to discharge the powers and duties of his office," as defined in the 25th Amendment of the Constitution. Under this scenario, the president would turn over day-to-day responsibilities and constitutional authority to Vice President Pence until he becomes basically fully recovered. This would also likely not be received well by the markets.

Unfavorable — The president does not return to the campaign trail or debate stage for the remainder of the election campaign. Under this scenario, the market could begin to heavily focus on Mr. Biden's proposed tax policies (see below) that call for higher marginal corporate and personal rates and less-favorable capital gains and inheritance tax treatment. This could be the case particularly if it also appears as though the Democrats may be heading toward a November sweep in holding the House of Representatives and taking back majority control of the Senate. (Please note, this is a market observation and not a political opinion).

Favorable — For whatever reason, the president's COVID-19 status directly or indirectly advances ongoing negotiations of the pending economic relief and stimulus package currently tied up in Congress. There is some probability in our opinion this could occur (see below) and if an agreement between the parties is reached on a new stimulus package in the days or weeks ahead, this would likely receive a quite favorable market response.

The president's condition is of course changing day-to-day, however investors may want to keep these potential scenarios in mind as his situation evolves in the days or weeks ahead.

TOTAL COVID-19 INFECTIONS AND FATALITIES CONTINUE TO RISE ALTHOUGH PERCENTAGE MEASURES HAVE SEEN IMPROVEMENT

In recent weeks, total COVID-19 cases have now exceeded 7.5 million in the U.S. and total fatalities have risen to above 213,000 (Worldometer, October 2). These are horrifically tragic numbers that would have seemed almost inconceivable about six months ago.

It's often difficult to talk about such awful numbers in a market context as the loss of life and/or human suffering, even in cases of recovery, obviously supersedes the financial implications. However, it is worth mentioning that against this backdrop of tragedy, percentage rates have been improving.

Specifically, fatality rates have declined to less than 3% since the virus first reached the U.S. last February and are below 2% on new cases since early June. Recovery rates now exceed 60% in total and more than 70% on new cases reported since early June. From a pure mathematical standpoint, these are trends worthy of recognizing.

However, as the tragic numbers continue to rise, the market is likely to focus more on the absolute impact of the virus since the year began rather than underlying percentage trends, even though the latter is certainly important. Therefore, in the absence of an imminent vaccine, the rising cumulative numbers of cases and fatalities could weigh on the markets during the month of October.

THE MARKET AND THE WORLD ANXIOUSLY AWAIT MEDICAL DATA ON COVID-19 VACCINE CANDIDATES

As we said in our Mid-Year Market Outlook and in commentary since, we view the successful development of a COVID-19 vaccine as the single biggest wild card for the markets and global society over the next year.

To be clear, there is nothing officially scheduled in the month ahead pertaining to the release of medical data on any COVID-19 vaccine candidates. However, with four late-stage vaccine trials now ongoing since the summer, there is in our opinion a decent probability at least some form of interim information could be released by one or more

of the sponsoring companies over the next month. These four companies — Pfizer, AstraZeneca, Johnson & Johnson, and Moderna — are all currently administering Phase III clinical trials representing the final phase necessary before submitting to the U.S. Food and Drug Administration for approval.

It's important to note that vaccines are historically difficult to develop. While safety data in Phase I and Phase II trials for these candidates have been impressive, as have anecdotal measures such as antibody development, we have yet to see any Phase III data reflecting actual medical outcomes in terms of infection rates of the virus itself.

Should such data be released to the public, in whole or in part, it will likely have an impact on the markets as anticipation has been growing and expectations appear to be high. Of course, the fact that there are four separate vaccine candidates in Phase III trials at this point increases the probability that at least one of them might prove to be successful in mitigating or potentially preventing infection of the COVID-19 virus.

Nonetheless, there is a long-standing saying among biotech and pharmaceutical stock investors that it is often best to "wait for the data," and in this case the world is certainly waiting. However, unlike most other vaccine or drug candidates in late-stage trials, these data sets are far more likely to impact a lot more than just the individual stocks involved, as the broader markets will almost certainly react accordingly to either favorable or unfavorable clinical results of any, or all, of these candidates.

3Q 2020 ECONOMIC GROWTH LOOKS TO BE EXTREMELY STRONG — HOWEVER, THE MARKET MAY SOON BEGIN TO FOCUS ON 4Q AND BEYOND

As mentioned in our Mid-Year Outlook, in 2Q 2020, COVID-19 created the worst single quarter of economic contraction since the 1930s and, in the process, managed to do what the 1929 stock market crash, Pearl Harbor, the Cuban missile crisis, and 9/11 could not.

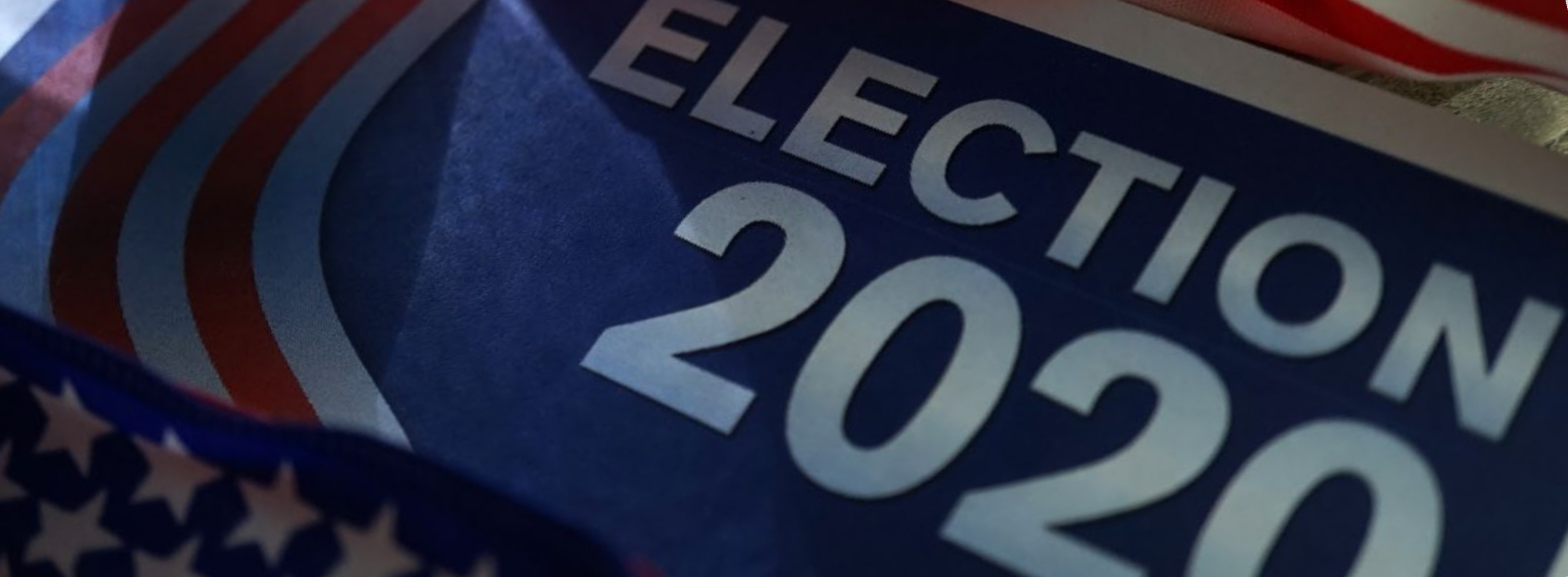
That was the bad news. The better news of course has been that following annualized gross domestic product (GDP) growth declines of -5% in 1Q and -31.7% in 2Q, current estimates for 3Q 2020 U.S. GDP growth look exceptionally strong. The Atlanta Fed is currently estimating annualized growth of better than +34%, representing a level, if achieved, that would go a long way toward making up a good bit of the contraction incurred during 1H 2020. In addition, this momentous 3Q recovery also positions U.S. GDP to potentially make a full recovery back to 2019 pre-virus levels by the end of 2021, about a full year sooner than most forecasts predicted just a couple months ago.

Yet with this sequential quarterly growth in 3Q now a known expectation to the market, increasing emphasis over the next month will likely surround 4Q 2020 GDP growth, which carries a much higher level of uncertainty. As 4Q begins, recognition of the virus's resurgence in parts of the country combined with the absence of a second COVID-19 economic relief and stimulus package from Congress could create some angst among investors as to how closely the meteoric 3Q recovery pace will continue into 4Q and beyond.

CONTINUED LACK OF PROGRESS BETWEEN THE PARTIES ON A SECOND ECONOMIC RELIEF AND STIMULUS PACKAGE FROM CONGRESS COULD FRUSTRATE INVESTORS IN THE MONTH AHEAD

The degree of economic growth in 4Q 2020 and beyond could be widely contingent on Congress' ability to pass a new relief and stimulus package somewhat similar to the CARES Act implemented in March. Over the past few months, the White House and the Democrat-controlled House of Representatives have been unable to come to terms on a dollar amount and some of the specific provisions to be included in the new legislation.

At present, House Democrats have crafted a $2.2 trillion package, but negotiations with Senate Republicans and the White House have remained in a pseudo state of limbo with reports of optimism and disappointment crossing paths on what almost seems like a daily basis. Key sticking points



holding up progress toward a deal include about a trillion dollar difference in the total price tag of a package (Republicans are more in the $1–$1.5 trillion range), as well as agreement on how much unemployment insurance should be granted displaced workers and how much funding provided to state and local governments.

It is likely the market will want to see key elements of any new stimulus legislation include provisions such as direct payments to individuals and families, unemployment insurance, the continuation of the Paycheck Protection Program for small businesses, and further aid to the airline industry. For the most part these provisions seem to be basically agreed upon, however dollar amounts of them are not and this continues to threaten passage and implementation in a timely manner.

Ironically, there has quickly emerged a school of thought that President Trump's contraction of the virus may now actually improve the odds of a deal being reached. The thinking here is threefold. First, the White House and Senate Republicans may be willing to raise the overall price tag of the stimulus package now that COVID-19 has directly hit the highest office in the nation. Second, with President Trump likely to be sidelined from any participation in the negotiations, Treasury Secretary Steven Mnuchin, who some believe is more willing to increase the overall size of the stimulus, may now play the predominant role in the negotiations with House Speaker Nancy Pelosi and her Democrat colleagues. Finally, as the election nears, there appears a strong likelihood former Vice President Biden may move further ahead in the polls as President Trump is off the campaign trail, leaving the White House with little choice but to get a deal done by Election Day. While these theories are all logical, it remains to be seen if any of them, or anything else, will help to solidify this seemingly all too elusive agreement.

As the economy and stock prices have recovered impressively and historically since the depths of late March when the CARES Act was passed, the lack of a new fiscal stimulus package has not appeared to greatly bother investors. Yet there is no guarantee that will continue to be the case should negotiations continue to flounder, particularly as virus cases rise and an increasing market focus moves away from this past 3Q and toward 4Q 2020 economic growth estimates.

WITH THE ELECTION KICKING INTO THE FINAL STRETCH, TWO MAJOR DEVELOPMENTS COULD HAVE MARKET IMPACT

Just a few short days ago, it appeared the 2020 presidential election was continuing down a path of contentious fireworks unparalleled in modern political times. This high temperature rhetoric between the two candidates had of course reached a fever pitch during the September 29 debate between Messrs. Trump and Biden as the emotionally charged and uncontrolled atmosphere of interruptions and insults during that event was unprecedented when compared to all previous presidential debates over the past 60 years.

However, with President Trump in quarantine and Mr. Biden perhaps content to stick close to his Delaware home once again, the worst of this heated campaign warfare may be over, particularly if the two remaining debates are not held. Of course, we are in a wait-and-see mode on all of this.

But as we know, 2020 has not been like any other in the lifetimes of most people alive today, and there is probably no reason to believe the ultimate storyline influencing the outcome of this upcoming election will prove to be the same either. With Mr. Biden having expanded his polling lead over President Trump (Real Clear Politics running average) nationally and in key battleground states even before President Trump's positive COVID-19 test, there is some thinking he could soon run away with the race by quickly building an insurmountable lead in the next couple of weeks. While this is certainly a distinct possibility, there remains the prospect of a vaccine hanging in the balance as well as the question of polling inaccuracies nationally and in key battleground states perhaps facing a repeat performance of 2016. Thus, both campaigns are still likely to remain on edge until election day.

With this highly unusual backdrop, there are two scenarios capable of increasing market attention as November 3 draws closer.

The prospect of unresolved results on election night followed by an extended vote count or contested election. Perhaps what the market had been fearing most from the upcoming election was the notion of unresolved results without a victor declared on the night of (or morning after) November 3. This could occur due to a combination of close voting results across a series of battleground states (such as Florida, North Carolina, Ohio, Pennsylvania, Iowa, Michigan, and Wisconsin) as well as uncounted tallies of mail-in ballots. Under such a scenario, legal positioning would be sure to follow from both sides possibly elongating the process of determining a winner for weeks or even months.

There is a high probability the markets will not appreciate any sort of delayed outcome or contested election as they likely will see no friend in electoral uncertainty and would probably react unfavorably to an extended or drawn out post-election day vote count or disputed outcome. Given recent polling trends and President Trump's medical condition, we now see this scenario as less likely, though the probabilities of delayed or contested election results should become more evident by the end of October.

A potentially higher tax environment should Biden emerge victorious and the Democrats regain control of the Senate. In the event Joe Biden is indeed elected president and the Democrats pick up a net gain of three seats or more in the Senate, giving them majority control (a high probability given 23 of the 35 seats up for election are Republican incumbents), the market could find itself focusing on the prospect of a higher tax environment, as has already been signaled by the Biden campaign. In particular, this could pertain to higher marginal corporate and personal tax rates, capital gains rates, less-favorable inheritance tax treatment, and possibly limiting 401(k) contribution tax deductibility, all of which have been formally declared as new tax policy objectives by the Biden campaign. All else being equal (and granted there is a lot of "all else" to take into consideration), the market could soon take a hard look at this potentially higher tax environment should we be looking at a Biden White House and Democrat majorities in the House and Senate as legislation is brought forward during 2021 and 2022.

With former Vice President Biden's electoral chances most likely continuing to improve in the aftermath of the September 29 debate and President Trump's diagnosis, this scenario could begin to receive greater market focus as the days of October move forward.

LONGER-TERM CATALYSTS AND CRITERIA SHOULD STILL BE TAKEN INTO ACCOUNT AS ANY NEGATIVE MARKET IMPACTS DURING OCTOBER MAY WELL PROVE TO BE OPPORTUNITIES

All taken into account, October could be somewhat volatile and the extremely strong returns in the stock and credit markets over these past several months could lend themselves to augmenting a short-term sell-off. That said, we remain constructive and optimistic for equities and credit over the long-term horizon based on several criteria.

These include:

The economic recovery still appears to be moving faster than originally expected. Even as the economy experiences a lower rate of growth during 4Q 2020 as compared to the recently concluded 3Q, it could still likely wind up achieving a complete recovery back to pre-virus 2019 aggregate GDP levels by the end of 2021, representing a strong upgrade from expectations of just months ago.

Corporate earnings also appear to be recovering ahead of pace. Corporate profit expectations for S&P 500 operating earnings per share in 2021 are now honing in at about +28% annualized growth (FactSet Earnings Insight), thus potentially exceeding pre-virus 2019 levels in the upcoming calendar year. This is also ahead of what was anticipated just a few months ago.

Federal Reserve accommodation in the form of a zero Fed Funds rate and large-scale open-market asset purchases will likely remain in place until at least 2023 and probably longer. In looking out over what could be at least a few years, we believe there is a high probability Fed monetary stimulus continues to facilitate an environment of close to zero short-term interest rates, historically low long-term rates, and ongoing open-market Treasury bond and mortgage-backed security purchases of about $1.4 trillion annually. In our opinion, continuously low short- and long-term rates combined with Fed-driven liquidity are likely to prove favorable to the markets as the economy and corporate earnings continue to improve.

Stock valuations still appear more than reasonable given expected earnings growth and low long-term interest rates. As we have said before, one cannot simply take current stock earnings multiples off depressed levels of profits and compare them to past history in determining whether equity prices are cheap or expensive. We feel a more appropriate method is to look at an expected recovered level of corporate profits and compare that earnings yield to current long-term interest rates, which at the present time are still teetering on the edge of historical record lows. With 10-year Treasury yields closing out September below 0.70%, stocks and credit-focused bonds should be valued with this level of longer-term interest rates taken into account.

SUMMARY

Given the highly anomalous characteristics experienced so far in this battle-tested year of 2020, there could be some buckle-up time during the upcoming month of October. With this in mind, we encourage making the determination as to whether any downside volatility in the month ahead might translate into longer-term opportunities, as we believe could well turn out to be the case.

THOMAS R. WALD, CFA®

CHIEF INVESTMENT OFFICER
TRANSAMERICA ASSET MANAGEMENT, INC.

Tom oversees investment and mutual fund development and the sub-adviser selection process. He heads Transamerica's investment thought leadership with advisors, clients, and media. Tom has more than 25 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania.

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1801 California Street, Denver, CO, 80202, USA

Glossary

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The ICE BofAML Option-Adjusted Spreads (OASs) are the calculated spreads between a computed OAS index of all bonds in a given rating category and a spot Treasury curve.

The 10-Year US Treasury Bond is a US Treasury debt obligation that has a maturity of 10 years.

The federal funds rate is the interest rate banks charge each other for overnight loans to meet reserve requirements.

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