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ASSET MANAGEMENT

2020 – 3rd Quarter Review & Outlook

Economic and Investment Review

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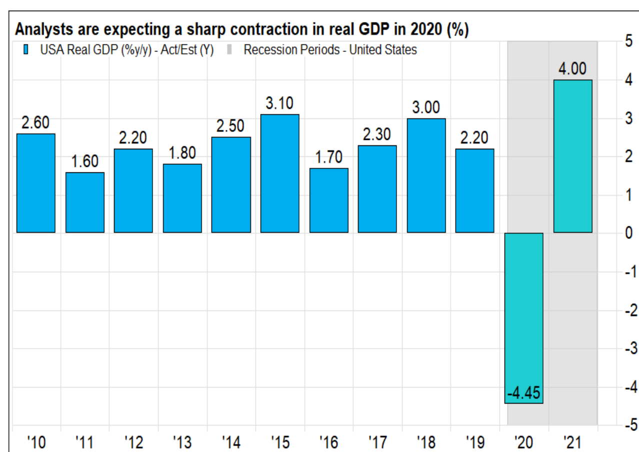
Economic Growth: The Coronavirus pandemic has taken a terrible toll. Global deaths have reached 1.14 million and U.S. deaths now exceed 223,000. The Coronavirus and related shutdowns lead to a massive decline of 31.4% in real GDP for Q2 2020 and unemployment as high as 14.7% in April. Thankfully, the severe recession appears to have been very short. The initial number for Q3 was 33.1%, indicating a strong rebound from Q2. However, growth is expected to be more gradual in the next few quarters. Estimates for Q4 and for Q1 2021 are 5.0% and 4.3% respectively. GDP is forecasted to be -4.45% for 2020 and 4.00% for 2021.

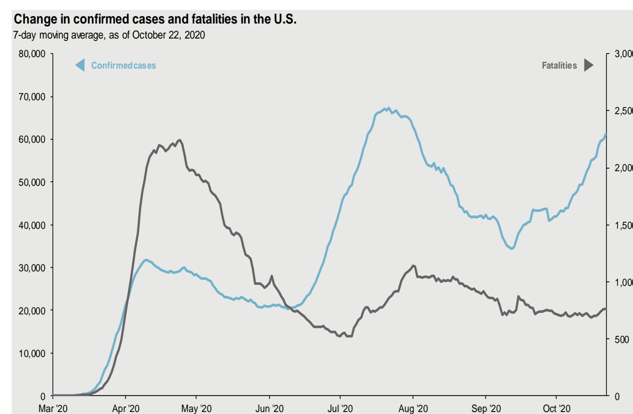


Source: FactSet

Unemployment, while still elevated, has declined incrementally since the peak in April to 7.9% in September. This is still significantly higher than the historically low, pre-virus level of 3.5%. About ½ of the jobs lost earlier this year have been regained. The speed of employment recovery has been faster than most expected but is anticipated to slow in the coming months. Some sectors such as restaurants, travel and physical retail continue to be significantly impacted by the pandemic.

Unfortunately, new cases of COVID-19 have surged in the U.S., South America and Europe in the past month or so. The surge was anticipated with students returning to the classroom and cooler temperatures in the Northern Hemisphere spurring people to spend more time indoors. In addition, the Wall Street Journal (10.26.20) reports that the U.S. is experiencing pandemic fatigue which is leading to more gatherings of friends and family and less avoidance of public places, stores or restaurants. However, there has not been a corresponding increase in fatalities.

U.S. New Coronavirus Cases Confirmed



Source: Johns Hopkins University CSSE, J.P. Morgan

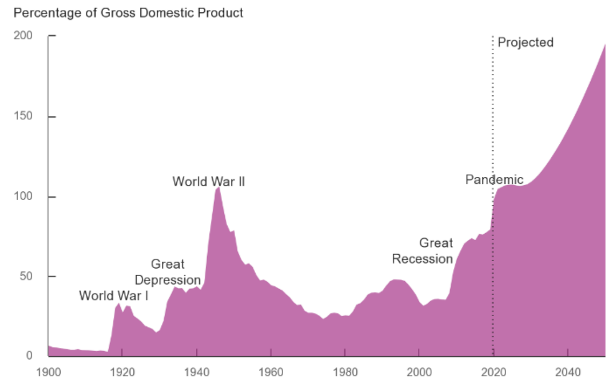
Scott Brown, Chief Economist for Raymond James, made the following related points in the October 16, 2020 Weekly Economic Monitor:

- It should be clear that COVID-19 is not going to go away anytime soon.
- Consumers and businesses are getting used to living and working under the pandemic.
- Working from home is expected to be a long-lasting change.
- In the months ahead, economic activity is expected to expand further, but will remain mixed as consumers and businesses adapt to living under the pandemic.
- There will be a number of challenges in the new year, including increased pressures on state and local governments.
- Temporary layoffs are more likely to become permanent and softness in the overall economy may lead firms to trim payrolls to reduce costs.

A number of hopeful vaccines are in or nearing phase 3 trials. There are currently four companies with large, late-stage clinical trials underway in the United States. If there are results from any of the trials in the next few weeks, FDA guidelines still call for at least two months of safety data. However, companies are already manufacturing vaccines prior to approval in an effort to be prepared to make wider distribution sooner than would otherwise be possible. It is still generally expected to take most of 2021 before any sense of normalcy can be achieved.

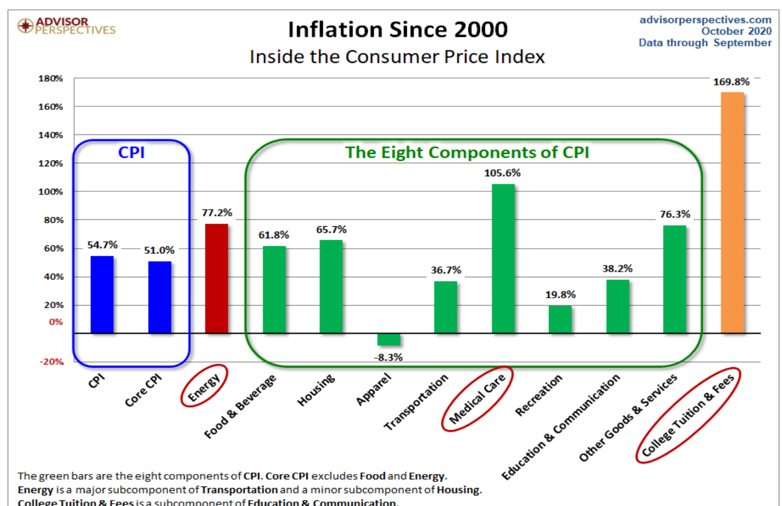
In an effort to smooth out the impact of the pandemic caused recession, the U.S. government and The Federal Reserve have taken massive fiscal and monetary stimulus measures. The massive fiscal measures have been made possible through equally massive new debt.

Dr. David Kelly, Chief Global Strategist for J.P. Morgan Asset Management, states that "a more realistic view on the federal budget over the next year suggests that the federal government will reach a new record high debt to GDP ratio by the end of fiscal 2021. While we do not believe this will result in a fiscal crisis in the next couple of years, a failure to rein in deficits and debt monetization, once the economy accelerates in the wake of a vaccine, could lead to significant problems. In particular, a sharp rise in inflation could result in higher interest rates and higher taxes and could ultimately set the stage for an economic relapse." The Congressional Budget Office projection for federal debt as a percentage of GDP is daunting.



Source: Congressional Budget Office

A decline in demand for goods and services brought on by the recession combined with lower oil prices has kept downward pressure on inflation. Core inflation (consumer price index less food and energy) remains subdued at just 1.73% year-over-year in September. The largest component of CPI is Housing. The year-over-year rate of change for housing has been trending around 2.0%. The next two largest components are Transportation and Food & Beverages. About half of Transportation is Energy which has been down considerably. Food & Beverages have trended somewhat above the core level. The Medical Care component of CPI has shown the greatest increase of the eight components over the past ten years.



Source: advisorperspectives.com

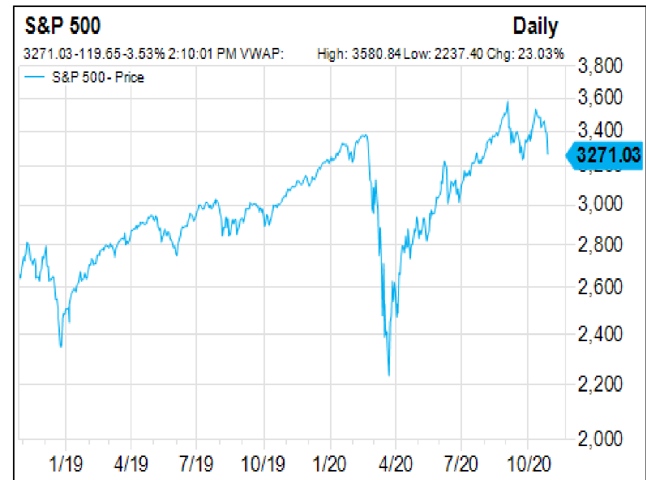
Dr. Kelly warns that "while inflation normally troughs after the end of a recession, things may be a little different this time around, particularly given the potential for further economic stimulus after the election, the continuing extra costs of operating during a pandemic and the likelihood of an economic surge following the distribution of a vaccine."

The Fed has taken the position of maintaining the federal funds rate at the current 0.0-0.25% target range until inflation exceeds the 2.0% target level for some time. Most expect that the rate will be held steady for at least the next few years. Chairman Powell has stated that the Fed isn't even thinking about thinking about raising the rate. However, if the economy and spending pick up in response to a vaccine and if the election results lead to significant additional stimulus spending, an increase in the rate of inflation could follow.

The November election may have a significant impact on small businesses. Current tax laws allow for a deduction of up to 20% of qualified business income from individual taxes. A Biden administration is expected to push for elimination of the deduction. Additionally, the Biden plan would have an impact on generational business transfer. The fear is that the next generation may have to sell a business in order to pay the tax rather than being able to continue to operate it. However, it is likely that planning options will be available to allow continued operation.

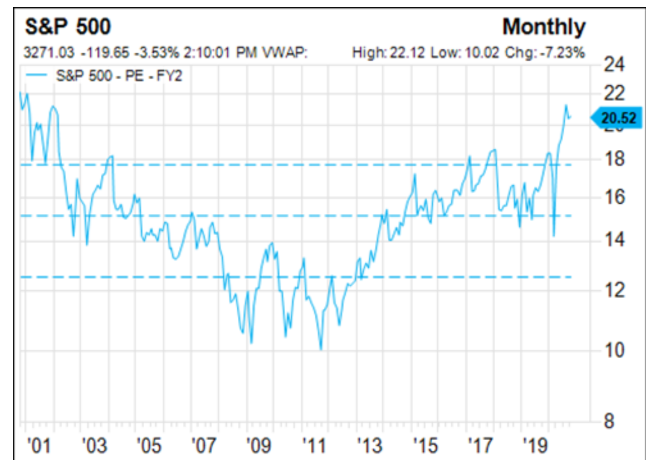
Equity Markets

Third quarter earnings reports are underway. FactSet reports that the percentage of S&P 500 companies exceeding EPS estimates for the third quarter and the magnitude of actual earnings positive differentials from estimates are at or near record levels. Still actual earnings are expected to be down 18.9% in 2020 from 2019. However, the S&P 500 is expected to report earnings growth of 30.7% in 2021. The S&P 500 reached its peak level of 3580 on September 2, 2020. The market has since sold off as it reacts to the election uncertainty and an increase in COVID-19 cases in the U.S. and Europe.



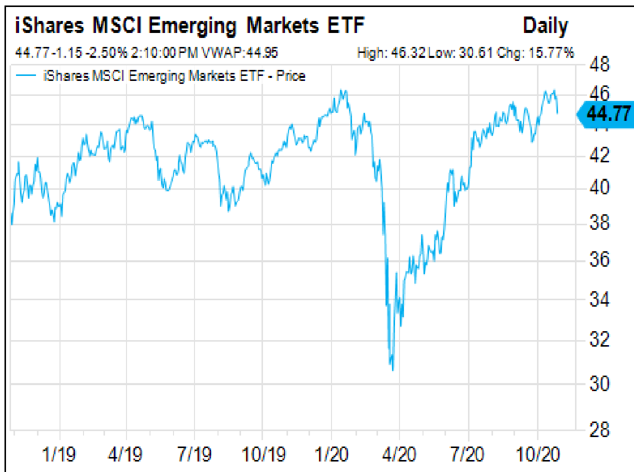
Source: FactSet

The S&P is at 3,300 as of this writing. The 12-month consensus target price for the S&P 500 is 3845. This target price indicates a 16.5% upside from current levels. The Price/Earnings multiple required to reach the target price is 23.3X the 2021 EPS estimate and 20.1X the 2022 EPS estimate. The P/E multiples remain significantly above long-term averages. However, some multiple premium appears warranted due to the historically low interest rates and strong growth in some economic sectors.



Source: FactSet

Developed markets around the world have traded off in similar fashion; however, emerging markets have been less impacted. A number of emerging market countries have been more successful in dealing with the virus and have been able to increase economic activity. There is a movement to reduce reliance on China in the supply chain and diversify to other EM countries.



Source: FactSet

The S&P 500 was up 8.93% in Q3, 5.57% year-to-date and 15.15% for 1 year through September 30. The pattern of large cap growth stocks out-performing their value counterparts remained in place. Mid cap and small cap stocks moved up nicely in Q3 but continue to lag large cap stocks. There are a number of reasons for the current small cap under-performance. Small cap stocks are generally thought to be more economically sensitive. They may suffer more in an economic downturn but may also benefit more from a recovery. Large companies are typically more diversified and margins are generally higher than for small companies. This may provide large cap stocks with a bit more flexibility and more protection from economic downturns. Also, small cap stocks have more exposure to financials and less exposure to technology than large cap stocks.

2020 Q3 Returns

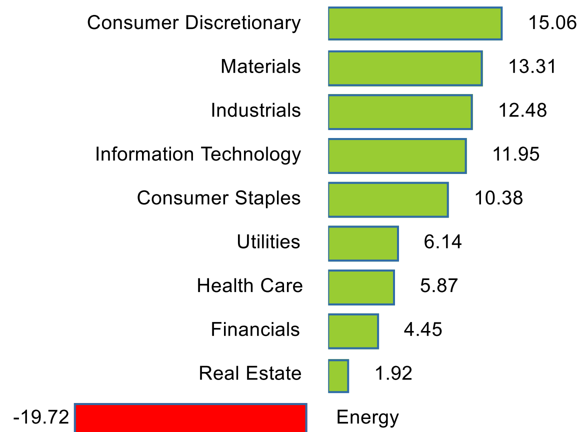
EQUITY	Q3 2020	YTD 9.30.20	1 Year 9.30.20	3 Years Annualized
S&P 500	8.93	5.57	15.15	12.26
S&P 500 Value	4.79	-11.47	-2.67	4.17
S&P 500 Growth	11.75	20.61	30.55	19.05
Dow Jones Ind Avg	8.22	-0.91	5.69	9.96
S&P Mid Cap 400	7.46	-2.35	4.54	2.90
S&P Small Cap 600	3.17	-15.25	-8.27	-0.33
MSCI EAFE	1.30	-9.08	-4.32	1.04
MSCI Emerging Mkts	8.79	2.93	12.80	5.20

Source: FactSet

Emerging market stocks continued to outpace international developed market stocks during the quarter. Much like the large cap domestic market, emerging market performance was largely driven by a narrow group of technology related stocks including Alibaba and Taiwan Semiconductor.

A number of domestic large cap sectors performed well in the third quarter. Consumer Discretionary, Materials, Industrials, Information Technology and Consumer Staples all exceeded 10% total return. Energy continued to struggle – down 19.7%.

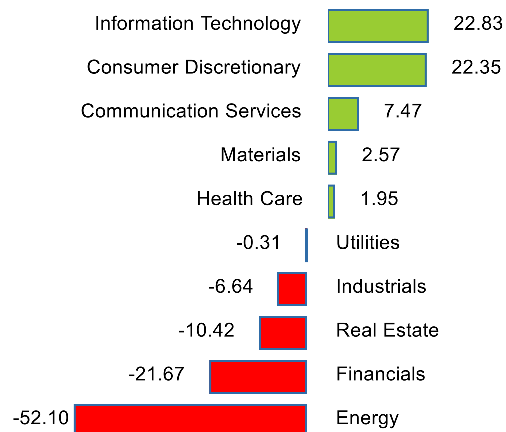
3 Months Total Return Change - Top/Bottom 5



Source: FactSet

The sell-off in October has left only two sectors with year-to-date total returns greater than 10%. Information Technology and Consumer Discretionary both exceed 22%. Financial and Energy sectors have taken some serious lumps during the period.

YTD Total Return Change - Top/Bottom 5



Source: FactSet

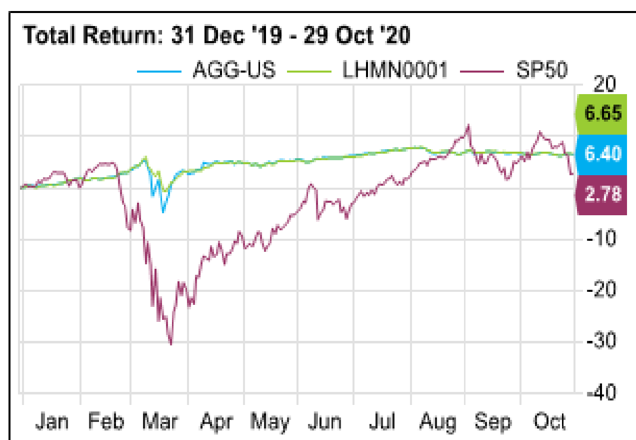
Financials suffer from a double whammy of economic distress and low interest rates. Energy

primarily suffers from its own success of providing more supply than is currently being demanded in a COVID impacted economy.

It will likely continue to prove fruitful to focus on stocks that have strong balance sheets, good margins, and can perform well during and after the pandemic. However, there is no doubt that pent up demand will benefit more cyclical stocks when we emerge from the pandemic.

Fixed Income Markets

Fixed income investments have historically been used for income generation and as a tool to manage overall portfolio volatility. Low interest rates have pushed investors to look for higher income through taking more credit risk in high yield debt markets and more dividend income in the equity markets. The idea of using it as a tool to help manage volatility is being pushed aside by some investors. Periodic equity sell-offs typically help to re-establish the principle. The following chart graphically compares the equity market (SP50) and the investment grade fixed income market (AGG) over



Source: FactSet

the past year. It is very apparent that fixed income investment helps to smooth out the ride.

Taxable bonds, as represented by the Bloomberg Barclays U.S. Aggregate index, were up 6.79% YTD through September 30. Municipal bonds as represented by the S&P Municipal Index were up 3.03% during the period.

2020 Q3 Returns				
FIXED INCOME	Q3 2020	YTD 9.30.20	1 Year 9.30.20	3 Years Annualized
B B US Agg Bond	0.62	6.79	6.98	5.32
S&P National Muni	1.01	3.03	3.67	4.07
B B High Yield	4.54	-0.08	2.65	3.07

Source: FactSet

Municipal bonds have historically been an important component in investment portfolios held by individuals in mid-to-high tax brackets. The virus continues to have a negative impact on state and local economies. Related tax and user revenues have been under pressure in many instances. Because of this, it is more important than ever to know what you own. It also makes good sense to take a step up in credit quality in an asset that is generally looked upon as “safe” money.

High Yield bonds have been negatively impacted by the COVID recession but rebounded considerably in Q3. High Yield bonds, as represented by the Bloomberg Barclays High Yield Index, remain in negative territory year-to-date through September 30 but reversed course in Q3 – rising 4.54. Spreads decreased in Q3 as concern for defaults declined. However, it is still a risky game to pick individual bonds without rigorous credit analysis and appropriate diversification.

Disclosures

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