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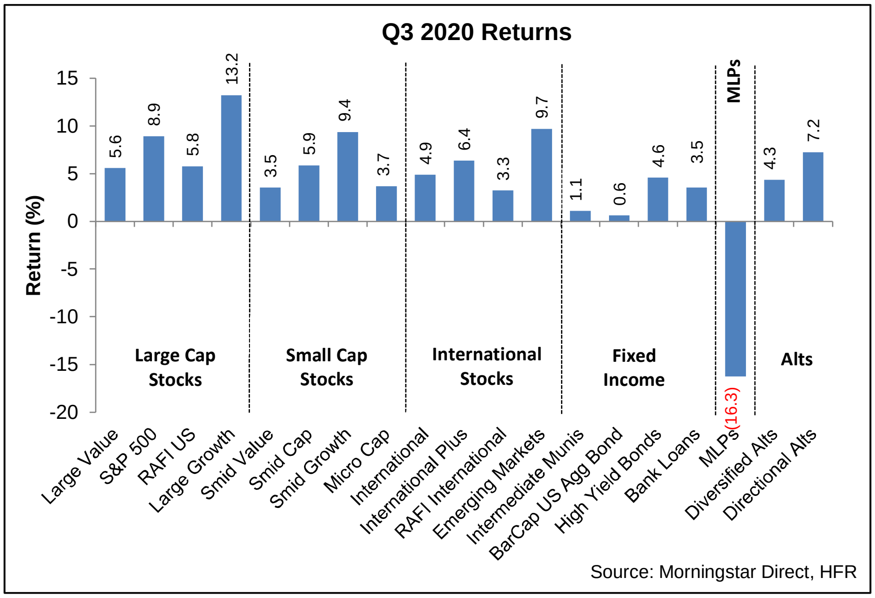
Third Quarter 2020 Investment Review & Outlook



EXECUTIVE SUMMARY

Q3 2020 Recap:

- Asset class performance continued to broadly rebound in the third quarter, with large-cap domestic and emerging market equities leading the way. The S&P 500 made new all-time highs despite a slowing global economic recovery and resurgences of the Covid-19 virus to end the quarter up 9%.
- The market recovery appears to remain on track but lost steam towards the end of the third quarter as uncertainty increased around the prospects of additional fiscal stimulus and the 2020 U.S. Election.

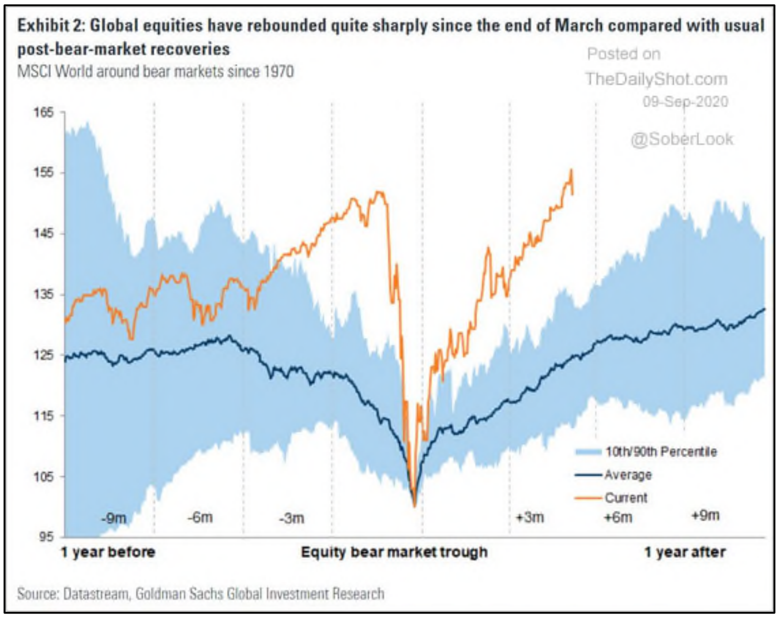
NEXT Outlook:

- With split government appearing to be the outcome of the 2020 elections, tax hikes appear to be off the table, which should be supportive of corporate earnings moving forward. It also suggests, however, that a smaller (or no) covid stimulus bill is forthcoming, which is a risk for a weak economy.
- The Federal Reserve continues to provide a base of support under this market. This should keep yields low and risk appetites high in financial markets.
- The increasing likelihood of a vaccine should bring an end to the pandemic and cause a sharp rally in cyclical segments of the stock market that have been left behind this year.
- These positive forces must be balanced against stock market valuations, which stand at multi-decade highs and leave markets vulnerable to any negative surprises.

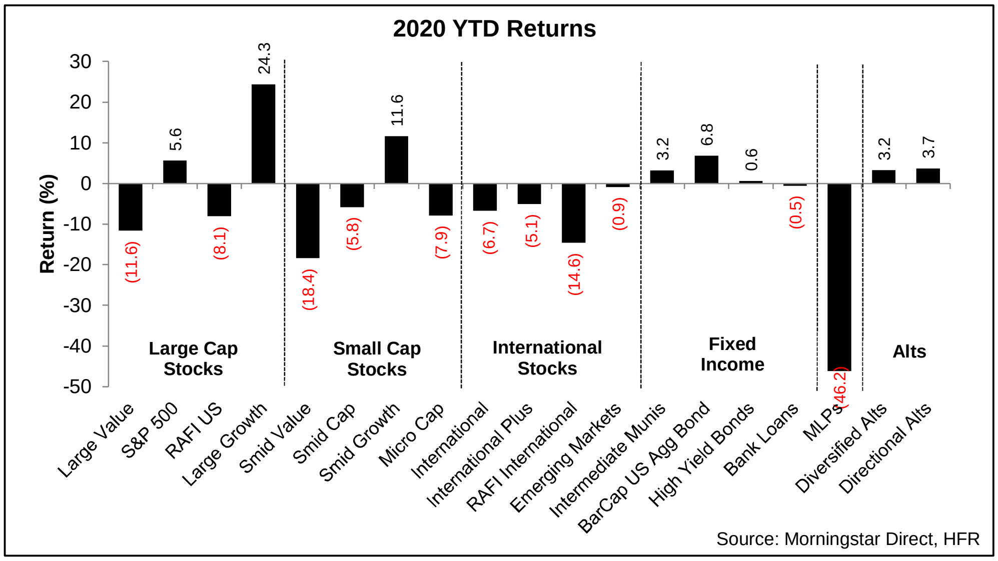
To Our Clients and Friends,

Financial markets rose in the third quarter, continuing the rebound that started in late March. The S&P 500 rose 8.9%, adding to the 20% return realized in the second quarter. This left the market up 5.6% for the year through September 30th – back near all-time highs and sharply above the 34% decline that occurred earlier this year.

For those who may be less familiar with market history, we must observe that the speed with which the market has declined and rebounded in 2020 has been extremely unusual. Deep bear markets typically unfold over a period of quarters, or even years, while recoveries are almost always a multi-year process. In 2000, the market declined for three years before bottoming in 2003 and regaining its highs three years later. In the global financial crisis, the decline took nearly 18 months and the subsequent recovery took three years. That this year's recovery occurred in just five months is clearly an outlier.

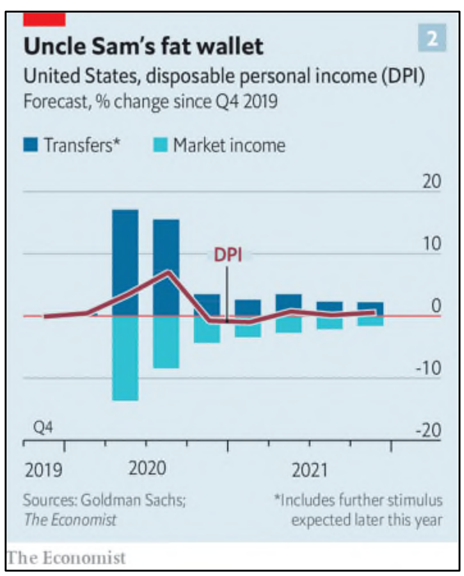


Of course, much of the world's financial markets are, in fact, performing as you might expect amid a devastating global recession. Foreign stocks, small cap stocks, and dividend paying stocks all remain in deeply negative territory in 2020. The S&P 500 has been a performance outlier due to its high weighting in technology and communication sectors, one of the few areas of the market performing well in this environment. Meanwhile, "old line" businesses like banks, industrials, and energy companies have all been more impacted by the shift to living and working from home.



The economy has shown signs of life since a historically poor second quarter. After declining by approximately 10% (the worst contraction since the 1940s and far greater than the 4.0% decline in 2008), US GDP posted a record quarterly gain in Q3. Similarly, labor markets improved as the unemployment rate dropped to 6.9% and millions of jobs were re-gained. Ultimately, though, US GDP is still 3.5% lower than its 2019 highs and 10 million jobs have still been lost as a result of the pandemic.

The remarkable economic recovery witnessed up to this point is largely attributable to fiscal and monetary programs that have bolstered the resilience of the US consumer. Between Congress' original $2 trillion stimulus package and the Trump Administration's extensions of additional unemployment benefits, US consumers' disposable personal income had remained relatively flat since the start of the pandemic. These stimulus measures were so meaningful that the personal savings rate more than quadrupled to 33% in April. This provided a significant buffer to individuals to pay their bills, despite the historic drop in wage income. However, that number has been coming down sharply as government transfer payments diminish.



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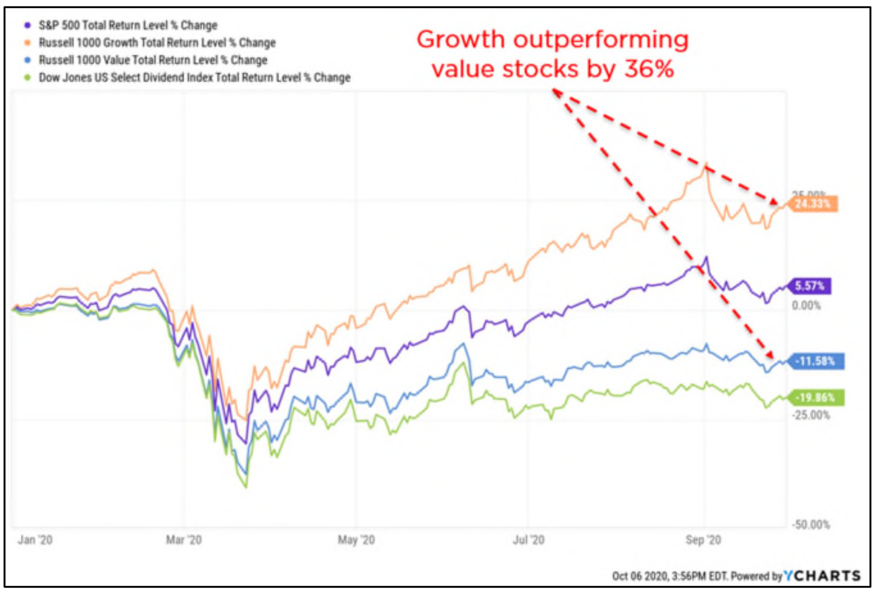
We point this out because, as encouraging as this economic recovery has been, its sustainability is still in question. Absent a vaccine or more government aid, a so-called "double dip" recession is still very possible – regardless of the stock market's exuberance.

Market Recap…

US large cap stocks maintained their market leadership during the third quarter, in a continued show of resilience amidst the pandemic. Over this time frame, the S&P 500 rose by 8.9%, bringing its year-to-date gains to 5.6%. As noted above, however, this resilience was not broad in scope. Mega cap tech stocks, whose business models are somewhat insulated from the economic impacts of the pandemic, have been the primary drivers of the broader market's recovery.

Consequently, growth equity remains the allocation of choice for most investors as large growth outpaced large value by 13.2% to 5.6%, respectively. On a year-to-date basis, large growth has posted gains of 24.3% while large value declined by 11.6% – the largest spread between those segments in 50 years. While fundamentally growth stocks are faring much better, we do point out their valuations are significantly elevated and are something to watch in the quarters ahead.



Similarly, US small cap stocks underperformed the broader market, posting a gain of 6% versus that of 9% for the S&P 500. As the recovery continues to drag out, and fiscal stimulus dries up, the risk profile of smaller and mid-sized firms has become more precarious as compared to their high quality large cap peers.

From a global perspective, emerging markets ("EM") stood out amongst all regions in gaining a 9.7% return for the quarter. This compares to a more muted gain of 5% for developed international stocks. Performance in EM was largely propelled by the relatively strong economic recovery taking place in China and other East Asian markets. In particular, the Chinese economic rebound has surpassed expectations as improvements in external demand have brought China's export industries back to life. China experienced positive GDP growth of 4.9% during the third quarter, bringing its year-over-year gain to 0.7%.

Bond markets also continued their upward climb to recovery in the third quarter, with riskier segments such as high yield debt and bank loans outperforming other subsectors. High yield bonds and bank loans saw gains of 4.6% and 3.5%, respectively.

High quality bonds, on the other hand, produced limited returns in the quarter. Amid historically low yields and a lack of significant movement in interest rates, the Barclays US Aggregate Bond Index gained only 0.9%. Given their high level of interest rate sensitivity, and the potential for rates to increase in an economic recovery, we remain wary of the poor risk-reward trade off of this segment of the bond market.

Municipal bonds outperformed their taxable counterparts in the quarter, as the Barclays US Municipal Bond Index rose 1.2%. We note, however, that although municipal yields appear cheap relative to Treasuries, they remain historically low on an absolute basis. We are cautious around the sector – especially the lower quality segment of this universe – as there is little cushion to make up for the risks created by the pandemic-induced fiscal deficits of state and local governments.

On a final note, alternative investments exhibited healthy returns, with diversified and directional hedge fund strategies ending the quarter up 4.3% and 7.2%, respectively. Overall, it has been a good year for many hedge funds (with the notable exception of some credit funds), as they were able to successfully navigate the volatility of this year. Given the diminishing attractiveness of many fixed income instruments, we are increasingly attracted to this space as an appealing diversifier and risk mitigator within client portfolios.

A Note on the Election…

As we finish this commentary just days after the election, news outlets are projecting that Joe Biden will become the 46th President of the United States. Despite a broad media narrative entering the election that Joe Biden had a significant polling edge (and that flawed polling from the 2016 election had been fixed), the final outcome was unexpectedly close – razor thin margins in states such as Arizona, Nevada, Pennsylvania, and Georgia foreshadow potential recounts and litigation in the weeks ahead.

Since election day, the stock market has surged, defying expectations that a protracted election would cause significant volatility. This is likely due to the surprise performance of Republican Senators, who appear to have the inside track to maintaining control of Congress' upper chamber. Prior concerns that tax rates would be going higher under a Biden administration have now shifted, improving the expectations for corporate earnings. This was a stunning reversal of fortunes, given that the implied odds of Democrats seizing control of the Senate were 70% before the election.

We note, however, that while the premise of Republican Senate control appears likely, it is not a foregone conclusion. Both Senate races in Georgia will go to a special run-off in early January, which ultimately will determine the balance of power in the Senate. With such dramatic differences in policy hinging on these elections, Georgia will take center stage for much of the country's attention over the next two months. The outcome of those races will have enormous implications for financial markets, as personal and corporate tax hikes and more significant fiscal spending packages could be back on the table.

Comments on Covid-19…

When the pandemic initially took hold in February and March, much was unknown about the coronavirus. Financial market declines reflected this uncertainty, as did the lock-downs which caused severe economic damage and job loss in this country.

Since that time, our scientific and health communities have learned how to better treat the virus and our society has adapted to living in a way that has limited its spread. Mortality rates have come down, while our economic and market recovery have been able to advance despite periodic spikes in the virus. More recently, it appears that one of the major vaccines created by Pfizer has proven over 90% effective in trials, bringing prospects of the pandemic's conclusion closer to reality.

This is certainly exciting news, and we are optimistic that the vaccine will work as advertised. However, we also observe that it is very difficult to prognosticate the forward path of the virus – including whether the major vaccine candidates will achieve widespread use before the second wave worsens. In recent weeks, the virus has been spreading in a more meaningful way. Hospitalizations and case counts have been increasing significantly in the US, while new lockdown measures enacted throughout Europe mirror those that we saw back in the early Spring. Until the vaccines are officially approved and distributed, Covid remains a significant risk factor for our public health, our economy, and for our financial markets.

Final Thoughts…

After an extremely challenging and uncertain year, we appear to be on the precipice of much greater clarity. The elections have seemingly given us much better insight into expected policy in the coming years, while recent vaccine news suggests that there is an end in sight to the pandemic. The latter, especially, should prove positive for the more cyclical elements of the stock market that have been left behind. If and when we begin to see a major vaccine distribution effort begin, we expect to see a significant rally in those assets as they "catch up" with their growthier technology peers.

However, we must also take note that the economy will not suddenly be robust post-pandemic. Behaviors have changed, risk appetites have been reduced, and it will still likely take years for labor markets to regain their previous highs. Both the US and the developed world settled into a new and lower growth trajectory following the global financial crisis of 2008, and it is hard to see that meaningfully change now aside from a temporary rebound. Demographically, our country's population is aging and expanding at a slower rate than past decades, which will naturally constrain growth.

With the Federal Reserve committing to extended extraordinary measures – such as keeping short-term rates at zero through at least 2023 – we very much expect to fall back into the low growth, low interest rate environment that we faced for much of the past decade. This environment would suggest a continuation of prior trends: preference for secular growers that can drive revenue growth regardless of the country's GDP. Once we move beyond the catch up trade in value stocks, we have every expectation that growth sectors within healthcare and technology will regain their leadership positions.

This backdrop also means that, absent runaway inflation (which would be a big negative for most financial assets), bond yields are also likely to remain low for years to come. This makes a large swath of fixed income instruments much less palatable. Alternative means of income and portfolio stability will be increasingly necessary in the years ahead. Our focus on real estate, private investments, and certain hedge fund strategies will likely require more prominence in our client portfolios.

We must caution, however, that as much as we welcome greater certainty about the economic and political environment, stock market valuations are very elevated. The market has anticipated an eventual recovery in corporate earnings in a way that has pushed price-to-earnings multiples to multi-decade highs. As long as we continue to see that recovery unfold as expected, market prices will be justified. Any sharp deviations from the expected – say a significant lockdown, failure of the vaccines to deliver, or a change in approach by the Federal Reserve – would all be negative catalysts for a market that may already be ahead of itself.

We point this out not to suggest that investors should run and hide from this market. To the contrary, we expect some momentum now that many of these outstanding questions have been put to bed. But the market is vulnerable, and staying diversified and not overextended in terms of risk will be important as we navigate the next few quarters.

As always, we welcome your calls and emails and look forward to speaking to you soon. We hope that you and your family remain safe through these difficult times. If anything has changed in your life or circumstances that would affect your ability to take portfolio risk, please contact us as soon as possible.

Kindest regards,
Your Investment Team
11/11/2020

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