Third Quarter Market Review and Comment

October 2020

Updated Market Performance

Returns	3rd Quarter 2020	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**8.93%**	**15.15%**	**12.28%**	**14.15%**	**13.74%**
DJIA	**8.22%**	**5.7%**	**9.98%**	**14.02%**	**12.69%**

Performance: July continued the rally/recovery from the end of June notching a return of 5.64%. August added to July's gains continuing a nice summer advance returning 7.19%. September took away some of our gains from August posting a return of -3.80%, but still leaving us with a robust quarter of returns.

After the 2nd quarter posted a gain of 20.54% the largest quarterly gain since 4th Quarter 1998's gain of 21.3% the 3rd quarter continued the advance rising 8.93%. The Dow Jones Industrial Average (DJIA) trailed the SP500, posting 8.22% gain over the same period. For the previous twelve months the SP500 has returned 15.15%, handily outpacing the DJIA which returned 5.7% over the same period. The annualized three-year returns are mixed with the SP500 being less than the near-term returns posting 12.28% and the DJIA being more than the near-term returns increasing 9.98%. Over the last five years the annualized returns are running well above historical norms (around 10%), with the SP500 returning 14.15% and the DJIA posting 14.02%. The ten-year annualized numbers are still running above long-term averages (around 10.00%); the S&P500 posted 13.74% vs the DJIA which turned in 12.69%.

Breaking down the returns for the Q3 2020, we note that there were six outperforming sectors and five underperformers. **The best sectors were Consumer Discretionary (15.06%), Materials (13.31%) and Industrials (12.48%)**. **The losers during the quarter were Energy (-19.72%), Real Estate (1.92%) and Financials (4.45%).** The clear winners the last twelve months were Technology (45.37%), Consumer Discretionary (27.49%) and Health Care (17.98%). Bringing up the rear were Energy (-59.44%), Financials (-14.02%) and Real Estate (-10.12%).

Economy: Continued growth in the economy will continue to return once the economy is fully operational and threats from the virus have subsided either due to a successful treatment, increased immunity, or a vaccine. The economic recovery is going to be path dependent on how long the economy is restricted, how well the virus is contained, and if the transmission can be minimized. The longer the economy remains restricted the more economic damage we will experience extending the length of the recovery. The economy will also receive a little relief once a phase 4 fiscal stimulus package is passed. As mentioned in my last letter I would have assumed we would have had the stimulus by now because the economy needs it, but I underestimated politics.

The third estimate of 2nd quarter Gross Domestic Product (GDP) is -31.4% according to the report released at the end of September by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 2nd quarter decreased -31.4% from 2nd quarter 2020 and was revised upward .03% from the second estimate. GDP for 2019 came in at 2.3% compared to 2.9% in 2018 and 2.2% in 2017. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted 2020 Q3 GDP growth at 14.1%

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and 2020 Q4 GDP growth at positive 4.82%. By comparison, China says their GDP increased at 3.2% in the 2nd quarter of 2020. Rebounding from 1st quarter 2020 contraction of -6.8%. China became the first major economy to report growth following the coronavirus pandemic. China's 2019 GDP was 6.1%, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were -14.4% and -11.8% respectively in the 2nd quarter 2020. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2017. GDP Growth forecasts for the end of the 3rd QTR 2020 are -7.8% for the EU and 7.5% for the Euro Area.

Unemployment is decreasing but is still well above historical norms (~5.76%). Once all the restrictions on the economy subside the unemployment rate will decrease back to historical averages. According to the Bureau of Labor Statistics, September unemployment declined to 7.9% a decrease of 0.5% from August's 8.4%. Unemployment for 2019 came in at 3.67%. The number of unemployed fell by 1.0 million to 12.6 million in September. Both measures have declined for 5 consecutive months but are higher than in February (pre-Covid), by 4.4% and 6.8 million. The labor force participation rate was 61.4% for September a decrease of 0.3% from August and is 2% lower than in February.

Inflation increased in September but is still well below historical averages. After averaging ~0.37% in the 2nd quarter 2020, inflation as measured by the Consumer Price Index (CPI) increased to an average of 1.22% in the 3rd quarter 2020. The average rate of inflation for 2019 was 1.82% and continues to be subdued by historical standards (~2.50% over last 30 years). Despite a September decline, the food at home index increased 4.1% over the last 12 months.

Consumption is an important driver of the economy as it represented 67.1% of 2nd quarter 2020 nominal GDP. The U.S. Census Bureau announced in September that retail sales for August 2020 were up 0.6% from July and were up 2.6% above August 2019. Non-store retailers were up 22.4% from August 2020, while clothing and accessory stores were down 20.4% from last year.

Manufacturing economy grew in September. Economic activity in the **manufacturing sector** expanded for the month of September, with the overall economy notching a fifth consecutive month of growth after contracting for one month (April). The Purchasing Managers Index (PMI®) registered 55.4, a decrease of 0.6 from August's reading of 56. The PMI signaled a continued rebuilding of economic activity in September, with all subindices either remaining in moderate to strong growth territory or slowing their rate of contraction (Employment and Inventories). Five of the big six industry sectors continued to expand. New Orders and Production continued strong expansion levels. Supplier Deliveries continued to reflect supplier difficulties in maintaining delivery rates due to labor safety issues and transportation challenges. The overall economy grew for the 5th consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business®*. Based on historical relationships between PMI and GDP, a PMI of 55.4 corresponds to a 3.7% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices continue to increase at a moderate pace. According to the S&P Case-Shiller Home Price Indices home prices rose in July with the S&P CoreLogic Case-Shiller National Home Price Index rising 4.8% over the last 12 months. Phoenix, Seattle, and Charlotte had the largest year over year increases with 9.2% for Phoenix followed by 7.0% for Seattle and 6.0% for Charlotte. According to the National Association of Realtors, the year over year change in existing home sales was 14.2% in August for Single family homes between $250,000-$500,000 and housing supply continued to remain tight in August with 3.9 months of supply.

Markets: The markets are largely being driven by the Covid-19 virus and whether restrictions or shutdowns will be reimplemented. Right now, in European countries we are seeing large increases in cases and restrictions being reimposed. If the U.S. experiences an increase in cases that warrants tighter restrictions with potential shutdowns the economy will slow, and the stock market will react negatively. Currently we are making headway on therapeutics and vaccines which should help curtail restrictions as well as shutdowns. Also, more stimulus will buy the economy more time while we wait for therapeutics

and vaccines. At this time, the market is expecting more stimulus, so if we do not receive more fiscal stimulus the market will temporarily sell off.

- **Covid-19 Virus: The market reacted fast and furious as it priced in a worst-case scenario. We have since rebounded and created new all-time highs on the SP500.** The immediate impact was felt quick with the closing of most of the global economy. Once we get on the other side of the virus and the economy returns to normal capacity equity markets should benefit from ultra-low interest rates and the tail wind of all the economic stimulus we have and will receive. The old acronym TINA (There is no alternative) will come back to fashion.
- **Earnings growth for the SP500 is expected to decline -20.5% for the 3rd quarter 2020. If the actual decline for the quarter is -20.5%, it will mark the second largest year-over-year decline in earnings reported by the index since Q2 2009 when the decline was -26.9%.** According to FACTSET, of the SP500 companies that have reported earnings as of 9 October (Approximately 22), 91% reported earnings above the mean estimate and 86% have reported sales above the mean estimate. **Many companies (~36%) are having difficulty providing estimates for future earnings due to the uncertainty surrounding the negative impacts of COVID-19**. Looking at future quarters, analysts predict a decline in earnings for the fourth quarter of -12.4% and a return to growth in the first quarter 2021 of 12.8%.
- **After the continued rally from the low's stocks look a little rich.** ***It does not look like we will receive any meaningful earnings growth until early 2021.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 21.5. The long term (20 Year Average) PE for stocks is 15.4, so we do not see a lot of room for valuations to move higher without growth. Lower interest rates allow for higher multiples, so we could maintain these higher levels of P/E's until interest rates return to meaningful levels.
- **Interest Rates are still near Zero again and the Fed is still waiting in the shadows ready to do whatever it takes.** The Federal Reserve dropped short term rates 1.50% in March and launched multiple quantitative easing programs. Rates have since been left unchanged at a range between 0.0-.25%. The Fed continues to closely monitor developments and is prepared to adjust plans as appropriate.
- **More fiscal stimulus.** After the Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress and signed into law by President Trump on March 27th, 2020 plans of another round of stimulus began. The Phase 4 stimulus package might include more stimulus checks, an extension of the eviction moratorium, more unemployment aid as well as other stimulative measures. The actual details are still being debated between the house and senate. I am unsure as to when there will be an agreement and a stimulus package passed. It is looking more and more like it will not be until after the election.
- **An election that could drag on past election day.** There has been a widespread expansion of vote-by-mail this year in response to the pandemic. A tight race for the presidency could produce vote recounts in one of more swing states. In an environment of extreme polarization, President Trump or former Vice President Joe Biden would refuse to concede while recounts are underway and their vast army of lawyer's dispute to results in court. In general, our constitution is more effective than the consensus thinks. The market is likely to overact creating a short-term buying opportunity. The US possesses the world's oldest operating constitution. It is very robust. The Supreme Court and Congress will intervene, if necessary, to determine the succession of the presidency. The market has priced a lot of this uncertainty in, but a surprise could always cause a jolt of volatility.
- **Election Year.** Election years bring policy uncertainty, which usually translates into higher market volatility. Currently the Pandemic is still overshadowing most policy uncertainty. The last 23 election years since 1928 the S&P 500 was only negative 4 times. Historically if the S&P 500 rises between July 31st and October 31st in an election year, the incumbent candidate (current holder of office) wins 80% of the time. On the other hand, if stocks fall, the incumbent loses 88% of the time.

Forecast:

We continue to think the biggest threat to the stock market is the uncertainty presented by the Covid-19 virus and the uncertainty of how and when the economy will return to business as usual. We think the SP500 will end the year between 3,500 and 3,600. At this juncture, we venture a guess that stocks will end up somewhere between 7% and 10% for the year.

For the next six to twelve months, the Federal Funds rate should remain at its current range of 0%-0.25%. **The 10-year Treasury which is currently priced at ~.73% should remain in a range between .60%-.80% through the end of the 4th quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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