



Market Moves Higher, and So Do Virus Numbers

October 2020

My Dear Client:

I hope you continue to be in good health and spirits.



The third quarter of 2020 began strong, continuing the pace of the market's rebound from its Q1 lows. All equity markets remained in positive territory for the quarter, with emerging markets leading the way. U.S. markets had a September swoon in the final month of the quarter, as concerns over rising Covid-19 cases impacted reopening the economy and anxiety over U.S. elections moved into focus.

An impressive 6-month run for the U.S. equity markets – which were up 31.3%, the best since 2009 – saw year-to-date Standard & Poor's 500 returns turn positive at 5.6%. The U.S. stock market's historic peak to trough to current rebound continues to be driven by FANGMA stocks (Facebook, Apple, Netflix, two share classes of Alphabet – aka Google, Microsoft and Amazon). These companies' earnings are either insulated or benefit from the impact of social distancing prompted by the pandemic. Their low debt ratios also make these companies less risky during a recession.

Investors are often cautioned to remember that the economy is not the market, though the two are related. The U.S. economy has regained many of the jobs it shed in the first and second quarter of this year, yet the pace of rehiring and new job creation is slowing even as job losses continue.

The gross domestic product (GDP) is expected to have grown by more than 30% in 3Q20. Investors be mindful that even after reports of such growth, the GDP will not be even close to where it was at the beginning of 2020, and GDP growth in Q4 is likely to be positive but substantially slower.

The U.S. unemployment rate is currently 7.9% – yet the true number is closer to 11% once consideration for “furloughed” employees who hope to reclaim their job. Although this reflects considerable progress from the record number of jobs lost in March and April this year, it is still more than double the level of pre-pandemic unemployment. Even if the economy were to add 800,000 jobs a month (the consensus September estimate that the economy failed to achieve), getting unemployment back to pre-pandemic levels is still likely to take *several years*. Most importantly, the job losses resulting from the pandemic are probably not over, with airlines and



hotels recently announcing new layoffs and furloughs, declines in state and municipal government payrolls and the loss of the temporary jobs that were created in connection with the 2020 Census.

While the news to-date on vaccine research has been promising, new updates on the vaccines and the course of the pandemic will likely continue to influence markets until there is a clear line-of-sight to the broad availability and adoption of a vaccine, which will likely be in the second half of 2021.

Finally, it is typical in any U.S presidential election year if the markets continue to see elevated volatility with the potential for pull-backs. Whether Democrats or Republicans win the White House does not usually have any long-term impact on the stock market, which has been able to do well under both parties.

The fiscal policy implications of a sweep of both the White House and the Senate this election by one party or the other might have a significant impact on markets and the real economy. The market, inclusive of FANGMA is very vulnerable to volatility given our weak economy – with more bad news to come and unprecedented political and public health uncertainty.

Domestic equity market

The old story continued, as Growth stocks again bested Value this quarter; the Russell 1000 Growth was up 13%, versus a 5.6% gain for the Russell 1000 Value. Large-cap growth outperformed large-cap value 7% for the quarter and by more than 32% for the year-to-date period. Growth has expanded its lead over Value so far this year to a 36% spread, the second-largest gap on record for the first nine months of a year. Last year was the second largest gap between the two styles of investing.

Small-cap stocks reversed course from last quarter and went back to trailing Large-caps. Mid-caps and small-caps trailed the S&P 500 4.2% and 5.8%, respectively, for the quarter.



Six sectors saw double-digit returns for the quarter, with three seeing returns of more than 40% for a six-month period. Leading this quarter was Consumer Discretionary, returning 15.3%. We also started to see some broadening of leadership, with Materials (13.5%) and Industrials (12.5%) rounding out the top three sectors. Information Technology (12%), Communication Services (10%) and Consumer Staples (10%) were also in double digits this period, while Utilities (6.1%),

Health Care (5.9%), and Financials (4.5%) were also positive. Energy was the only sector with negative returns, at (-19.6%), as the collapse of global oil demand continued.

The Fed reduction of interest rates as well as the purchasing of Treasuries, some corporate bonds and the threat of buying below investment grade bonds has successfully added liquidity and gas to capital markets. It also has propelled two stocks – Apple and Amazon – to 12% of the S&P 500 index and drive 25% of the S&P 500 return for last quarter.

Outside of these two stocks, the S&P 500 saw some broadening of contribution to returns, as staple companies like Berkshire Hathaway, Procter & Gamble, UPS and Mastercard made it into the top 10 contributors. Year-to-date, the dominance of remained, contributing 8.9% to the S&P 500 return while the other 494 stocks detracted (-3.3%). The top five of these companies enjoyed a YTD return of 43.3% while the stocks of the 495 other companies in the S&P 500 combined returned a paltry 0.8% for the same period.

While it can be argued their low debt ratios make these companies less risky during a recession, their massive distortion of the performance of the “market” should not be ignored, nor should their monopolistic business models.

International markets



International markets had a good quarter.

Emerging Markets were the global performance leader during the third quarter. Developed international equities as measured by the MSCI EAFE Index (net of taxes) were up a solid 4.8%. While historically volatile, emerging-market equities (as measured by the MSCI Emerging Markets Index) rose strongly, up 9.6%. The COVID-19 outlook is particularly pessimistic for Latin America, especially Brazil, as well as for Europe and India, all of which have increasing positive cases. Still, the emerging market countries of like China, South Korea, and Singapore among others continue a recovery to new normal functionality and a muting of virus

spreading which bolstered those markets.

Despite more than half the countries in the global equity index seeing positive returns, only two countries – the U.S. and China – made up more than 90% of the index local-currency return for the quarter. A second solid quarter for emerging markets led to an impressive 29.7% return for the past six months, but not quite enough to turn the year-to-date return positive. In the U.K., continuing fallout from the pandemic and Brexit resulted in the weakest returns across the developed regions.

The pattern of a weakening U.S. dollar continued to serve as a tailwind for non-U.S. stocks this quarter, despite the dollar and U.S. Treasuries still being seen as a global safe haven. A multi-year trend based on the massive debt levels in the U.S. may be starting to take hold, which would have significant positive benefits especially for Emerging Market stocks.

As in the U.S., Growth stocks held up better than Value across international markets.

Bond markets

As measured by the Bloomberg Barclays Aggregate, the U.S. bond market delivered positive 0.6% returns during the third quarter, bringing its nine-month gain to 6.8%. The U.S. Treasury yield curve was basically unchanged throughout the third quarter. The yield on the 2-year U.S. Treasury note fell 3 basis points to yield 0.13% at quarter's end. At the longer end of the yield curve, the 10-year note and the 30-year U.S. Treasury bond rose 3 and 5 basis points respectively to yield 0.69% and 1.46% at quarter's end.



Credit spreads in both high-yield and investment-grade corporate debt narrowed during the quarter. Credit was the area of highest relative strength, with high-yield bonds up 4.6% and investment grade credit up 1.5%. While this looks promising, one cannot be oblivious to the volume of companies that are able to obtain financing via the issuance of debt through the capital markets. That a company like Carnival that could not operate cruises before September was able to issue new debt is astounding; many major airlines were also able to borrow from the government and the broader corporate debt market.

Municipal bonds also did well during the quarter, outperforming Treasuries as well as the broader Bloomberg Barclays US Aggregate Bond Index. High-yield municipals, with exposure to revenue bonds, fared best as the economic recovery continued. While another stimulus package remained elusive, investors expect additional stimulus will include some funding for state and local governments, perhaps raising the attractiveness of municipal bonds.

In September, the Fed released its updated statement of economic projections and guidance, keeping its target for the Federal Funds rate at the zero bound through the end of 2023. Fed will be on hold for the foreseeable future, so expect interest rates to remain subdued.

Consumer confidence exceeded expectations (+15.5 in September, to 101.8) and employment continued to improve. Stable interest rates and tighter credit spreads kept mortgage rates low,



helping the robust housing market stay strong for both purchases and refinancing. Housing has been especially strong, proving to be one of the strongest segments of the economy to recover from virus-induced shutdowns (pending home sales up 9% month-over-month and 21% year-over-year).

Even so, transmission of the virus has recently reaccelerated, particularly in the Midwest. The pandemic continues to impact nearly all aspects of the economy, as ongoing efforts to contain the virus will persist until an effective vaccine can be broadly distributed. Recent indications are that a vaccine may be available in limited quantities under an FDA Emergency Use Authorization (EUA) in November.

A Look Ahead



This year can best be described as unpredictable. We continue to learn more as each quarter passes and still we are left with more questions. Although the stock market has bounced back quickly, the damage to the U.S. economy – and how long it takes to recover – should not be underestimated.

The pandemic has changed the economy, business, work, school and our lives in ways we never envisioned just nine months ago. The financial markets are starting the fourth quarter on a relative high note, providing investors a golden opportunity to reevaluate their portfolios and risk exposures.

We need to understand that we may be entering a fundamentally different investment environment where the old frameworks and rules-of-thumb will no longer apply. Investors need to be cognizant of this and still not fall for the “this time is different” mantra as many did in 1999 or 2006.

Right now, US stock market is at best slightly pricey and can stay so for a bit longer. Or at worst it can align with true economy and its value will shift dramatically downward. The cheapest markets by far are still value stocks and non-U.S. stocks. When does this change? Why is the market doing almost as well today as it did back in February – before the lockdowns and the pandemic’s deep impact?

Lastly, individuals, small business, corporations, state and local government need cash, grants, and low interest loans to stay afloat to meet basic necessities until a vaccine is found. Then...is that money “really” stimulus or rather support to simulate the economy hoping the recipients stay solvent?



My portfolio considerations remain consistent with those of the past few quarters. Maintain a focus on a risk-balanced, multi-asset class approach and evaluate opportunities when larger short-term declines occur. Consider:

- Maintaining overall U.S. equity allocation to portfolio targets and below maximum range;
- Using cash raised from Large-cap growth stocks and other U.S. equity sales for new investments in Emerging and International stocks and some Mid/Small-cap;
- Directing fixed-income portfolio allocations to high-quality bonds and proven opportunistic credit strategies;
- Seeking niche, opportunistic, and secondary illiquid private investments, avoiding Real Estate (for now) as opportunities will be plentiful next year; and
- Reviewing prior asset allocation adjustments in public equities, preparing for further rebalancing.

Looking to the fourth quarter, maintain discipline, pragmatic approaches, and patience to strategically deploy capital, riding the Fed's wave without creating undue risk to your portfolio. Take a long-term balanced approach to your portfolio as I will continue to discuss any concerns or changes of plan to assure that your current strategy is on target to achieve your objectives.

As always, it is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,

A handwritten signature in black ink that reads 'Walid L. Petiri'. The signature is written in a cursive, flowing style.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, [JP Morgan].