



# QUARTERLY NEWSLETTER **4Q 2020**

## Unchained

 **Chart 1. Index Performance as of 09.30.2020**



Source: Bloomberg as of 09.30.2020

### INDEX PERFORMANCE

#### Returns as of 09.30.2020

S&P 500 (SPX)	8.93%
Dow Jones Indus. Avg (INDU)	8.22%
MSCI U.S. Value	5.50%
MSCI U.S. Growth	13.32%
MSCI EAFE (Non-U.S.) (MXEA)	4.80%
MSCI ACWI (Non-U.S.)	8.13%
U.S. Corp High Yield	4.60%
Alerian MLP	-16.26%

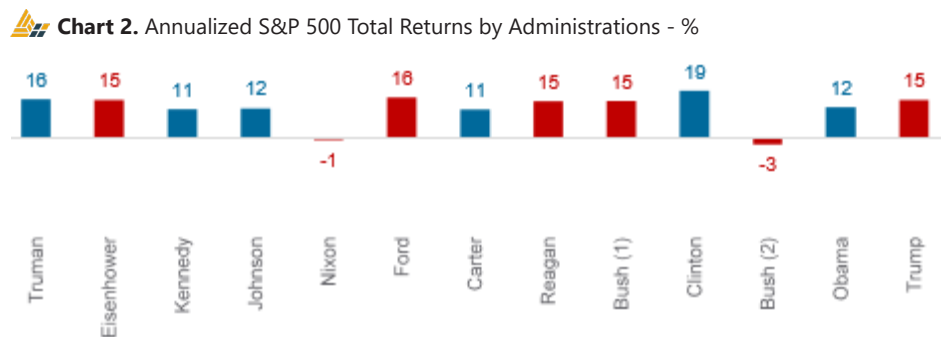
*"Change, nothing stays the same, Unchained, and ya hit the ground running..." - Van Halen*

## U.S. MARKET REVIEW

Over the years we have all likely caught ourselves saying that we are living in unprecedented times. The truth is, previous generations have experienced plenty of elections, wars, pandemics, recessions, and depressions which is perhaps proof that though history holds plenty of change, it at least rhymes. Our predecessors likely had the same thoughts and fears about the market that we currently do, but the markets have always found a bottom and didn't stay down. At the time of this writing, we are not dealing with a market bottom. The market is on a tear since bottoming in March which was partly due to a very easy Fed, including a substantial amount of stimulus (\$86 per day/per U.S. household) versus the daily \$4 during the 2008 financial crisis according to Blackrock's Rick Rieder. Though some of these programs have since fallen off, the number is still a multiple from what it once was. With that said, let's hit the ground running with the major themes impacting investors. These include:

The 2020 U.S. Presidential and Congress Elections | COVID-19 Pandemic | Recession | Fed Policy

Of course the factors on the previous page are all related, but for this quarterly newsletter, we will focus on the upcoming elections and the implications, or lack thereof, for investors. Indeed, whether you believe one party or candidate is “good” or “bad” for the economy or the market, it is the long-term fundamentals, in our opinion, that ultimately matter. This is why equities have historically always rebounded; if GDP is growing over the long-term, even slowly, then revenues are growing, therefore assets are growing and generating free cash flow. These assets do not just disappear due to a short-term shock or disruption to the market, including electing a new President. Keep in mind that most candidates are not able to check off all of the ‘to-dos’ on their platform list, even when given the keys. In fact, this larger candidate wish list is the primary source of fear and uncertainty, but rarely is it all implemented or as bad as anticipated. Historically, the winner of the presidency is only a small factor in the longer term performance of the market. Based upon the historical data, the political party and President do not appear to matter much to the market (See Chart 2 below).

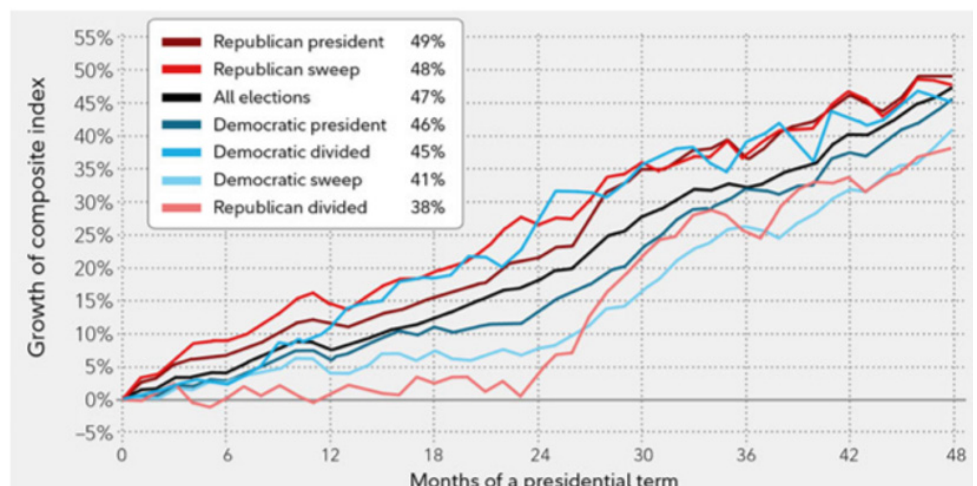


**Source:** Northern Trust Asset Management, S&P, Bloomberg. Returns are based on election dates. Republicans are colored red; Democrats are colored blue. Trump's return is calculated through 8/21/2020. Past performance does not guarantee future results.

Second-level thinking instead requires us to dig deeper into the underlying factors that may affect the valuation of the individual companies that make up the market. To name a few, this includes taxes, government spending, regulation, Fed policy, and long-term economic growth. And, what about Congress? In chart 3, which covers all political party scenarios and the associated market impact, we see that all are relatively equal after a few years.

Furthermore, recall that the market is forward-looking and many of the scenarios we read about are generally already reflected in current market prices. As we have covered before, the stock market is ahead of most of today's headlines. Instead, in our opinion, diversification and valuation are what we should be focused on and even though elections and recessions are large sources of short-term volatility, we are always looking to take advantage of these opportunities as they present themselves.

**Chart 3. Political party scenarios and associated market impact**

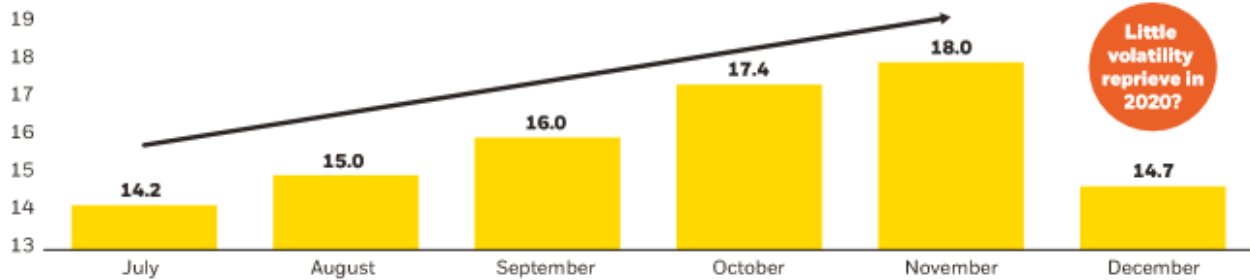


**Source:** FMRCo.

Monthly data since 1789 (mix of S&P 500, Dow Jones Industrial Average, & Cowles Commission).

Chart 4 below shows historically how volatility has increased each month during election season. We can't forget that we are also in a recession which is another source of volatility. Keeping this backdrop in mind, we expect plenty of volatility through the end of the year and the possibility that it will surely increase with a contested election.

 **Chart 4.** Volatility in U.S. election years, 1928 - 2016



**Source:** Bloomberg, FactSet, BofA U.S. Equity & Quant Strategy, August 2020.

Chart shows the monthly average of daily S&P 500 return volatility from 1928-1989, and the average monthly volatility as measured by the VIX from 1990-present.

## HOW TO TAKE ADVANTAGE OF ELECTION RESULTS

There are many opinions on which sectors, stocks, or markets to invest in to take advantage of the election results. The truth is, most of it is probably much too late which is why we focus on individual company valuation as the market can seem disjointed during periods like these.

According to Denise Chisholm, Fidelity's sector strategist, "when market behavior is counterintuitive, however marginal, it often means there are other factors that are more critical drivers of the market. Case in point: Take health care reform in the 1990s. Ironically, just as the rhetoric was heating up on health care reform in late 1992 and early 1993, health care stocks were bottoming relative to the market. This shows a second potential issue with using one variable—the market often discounts that variable in advance. Peaks in uncertainty are often correlated with positive future relative returns."

This thinking could apply to energy stocks today. The market is currently discounting a Biden win and a possible blue wave and we have seen energy stocks severely underperforming, and alternative energy stocks and ETFs at their highs. The market has already moved on this variable and since our goal is to buy low and sell high, the election sector timing strategy might not work. Pundits and talking heads will have you believe that this a large reason why it is much harder to time the market.

## UNDERLYING FACTORS DRIVING VALUATIONS

Finally, let's go back to the idea of the underlying factors that drive valuation of equity in individual companies, and therefore the market.

In Chart 5, we see the "levers" that affect the valuation of an individual company and how Level Four Capital Management (LFCM) calculates the company value. ***Outside of any short term volatility around election time, which should be expected, the ongoing value of the company is what we focus on within our disciplined investment process.***

We believe the **value of a company** is the present value of the future free cash flows that the assets of the business generates. With this in-mind, below we touch on how the election and a possible blue wave could impact our calculations, while also drawing attention to some of the potential off-setting impacts.

### HIGHER TAXES

**Impact:** Under the blue wave scenario, **individual and corporate taxes** will likely increase, with corporate taxes potentially increasing from 21% to 28%. Higher taxes will impact a company's free cash flow negatively, but that is assuming we do not get some creative accounting to lower the effect.

**Offset:** The largest offset to higher taxes will be the positive effect on economic growth, and therefore **revenue** from increased government spending and stimulus. We think the multiplier effect from government spending is probably the most underappreciated factor and will be a large offset.

John Hatzius at Goldman Sachs agrees, "All else equal, such a blue wave would likely prompt us to upgrade our forecasts. The reason is that it would sharply raise the probability of a fiscal stimulus package of at least \$2 trillion shortly after the presidential inauguration on January 20<sup>th</sup>, followed by longer-term spending increases on infrastructure, climate, health care and education that would at least match the likely longer-term tax increases on corporations and upper-income earners."

### NON-OPERATING ASSETS AND LIABILITIES

**Impact:** Once the Value of Firm has been established, we subtract the market value of a company's debt, and add **excess cash** or any other non-operating assets or investments in order to arrive at the Value of Equity.

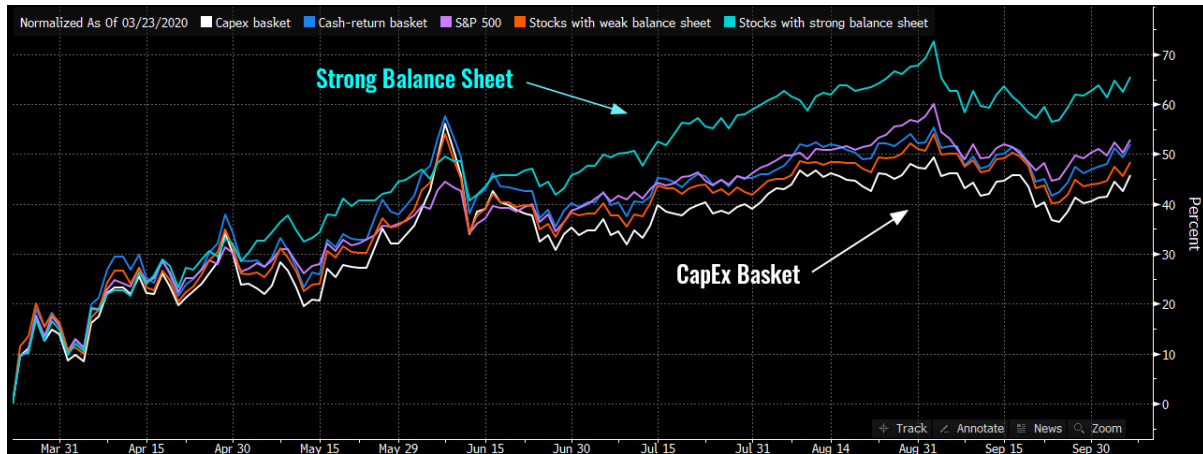
**Offset:** Company cash levels have seen a significant increase since March, in part from stimulus and company strategy, reduced spending on investment, and spending in general. Cash preservation has been a short term positive to valuation, however could be a negative offset on long term valuation if the cash is coming from the company's investment bucket. On the following page is an interesting chart (Chart 6) showing the performance of companies that have not slowed spending (CapEx Basket), versus companies that have built up cash (Stocks with strong balance sheet); we think the market is supporting our point here.

 **Chart 5.** Valuation Calculation



Source: Level Four Capital Management

**Chart 6.** Preferred Cash Use.



There are many other nuances and smaller factors affected in our company valuation chart with most being industry dependent, some shorter and longer-term, but in our deep dive process, we account for as much as we can. The Investment Committee is not quite as bullish as Mr. Hatzius at Goldman Sachs, and we put the net effect to be anywhere between a -2% to 2% change in cash flow. It's not a disaster, but more than likely a no-change from a valuation standpoint with some volatility to deal with first. If Trump wins the election, we could make a similar case on these levers. However, in our opinion, we think the Republican policies are very positive from a long-term investment and return-on-capital perspective. In other words, it is our belief that government spending can only last so long, and at some point we need organic growth from capital expenditures and other investment.

## INTERNATIONAL MARKET REVIEW

Overall, global equities advanced at a slower pace than in the previous quarter. It was no surprise, as the March dip provided a great buying opportunity for investors to acquire companies at a significant discount to intrinsic value. The rally that ensued in the second quarter was almost symmetrical to the drawdown, making it unsustainable. In the summer, service providers were hit by travel restrictions, a reduction in business hours, and weak demand. However, pent-up demand, government stimulus programs, and Central Bank accommodation limited margins contraction. In fact, the JP Morgan

Global Services PMI improved from 48.1 in June, to 51.6 in September. The Energy sector continued to struggle and was down 13.79% (Chart 7) as Brent crude oil consistently traded below \$45 per barrel. Conflicting market signals and economic data continue to add to investors' uncertainty as we enter the fourth quarter. More than ever, we embrace Henry David Thoreau's famous quote: "it's not what you look at that matters, it's what you see".

**Chart 7.** MSCI Sector Returns





## THE LEGACY OF ABENOMICS

Shinzo Abe, the longest-serving Prime Minister in Japanese history abruptly stepped down in late August due to health issues. He will be remembered for his ambitious plan to revive Japan known as “Abenomics”, which relied on three arrows: easy monetary policy, fiscal stimulus, and structural reforms. After a short tenure from 2006 to 2007, he regained his position as prime minister in 2012, appointing Haruhiko Kuroda as the Governor of Bank of Japan (BOJ) to implement easy monetary policy.

The Governor quickly announced his intentions by saying that the BOJ could not only purchase government bonds, but also corporate bonds and stocks. For a short period of time, inflation went beyond the 2% target as the Yen depreciated against the U.S. Dollar. By June 2014, Japanese year-on-year CPI peaked at 3.6%, a 24-year high. However, March 2015 was the last time during Abe’s mandate that inflation was above 2%. Aging population and shrinking workforce put downward pressure on inflation that the BOJ struggled to battle with its policy tools. Abenomics taught us that Quantitative Easing (QE) helps create short-term inflation that will fade quickly without fiscal accommodation and structural reforms.

Was Japan more successful with Abenomics? There are many data points that indicate it has been more successful with Abenomics. The first indicator of its success was with the Foreign Direct Investment net inflows in Japan which grew from \$10.6B in 2013 to \$37.17B in 2019. In regards to trade, Japan reduced its trade deficit from \$117.8B in 2013 to \$15.4B in 2019. Japan's last success is that the real GDP was consistently below 2% between 2013 and 2019, except for in 2017 when it reached 2.15% in a global low inflation environment. If we look at the stock market, the NIKKEI 225 did better when Kuroda became Governor of the BOJ than in the previous two decades. In the third quarter, Japanese stocks grew 4.02%. The benefits of Abenomics did come at a cost. Government debt went from 232.5% of GDP in 2013 to 236.6% in 2019. In July 2020, Fitch Ratings downgraded its Japanese outlook from “stable” to “negative” all while maintaining its “A” rating.

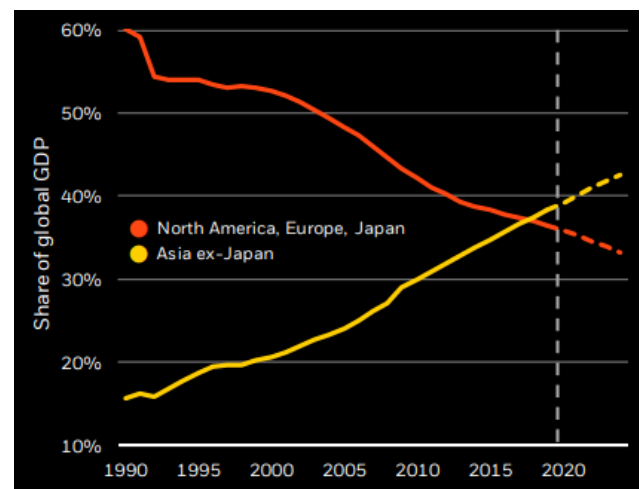
### So, why does it matter?

Central Banks around the world are looking at Japan as a model and using the same tools without robust empirical evidence that they have a net positive impact on the broad economy. The Japan case study is certainly being scrutinized in Europe, as they face similar challenges.

## EUROPE: HEADING TOWARDS JAPANIFICATION?

Demographers almost unanimously share the same forecast about Europe that the population is aging and declining, and that the fertility rate will continue to drop in the coming decades. According to the European Commission’s 2018 Ageing Report, the working age population will decrease from 333 million in 2016, to 292 million in 2070. The report also projects that the EU will only have two working age persons for every person aged over 65, versus 3.3 currently. In the last decade, the Eurozone real GDP peaked in 2017 at 2.6% while the world grew at 3.2% in the same year. Moreover, the IMF forecasts that Asia ex-Japan (the economic region of countries located in Asia, not including Japan) will continue to grow their share of global GDP while North America, Europe, and Japan will have a lower share by 2024 (Chart 8).

 **Chart 8.** Shifting center of gravity.



**Source:** BlackRock Investment Institute, with data from IMF, Refinitiv., June 2020.  
**Notes:** The lines show how each region's combined share of global GDP on a purchasing power parity basis. The dotted lines show the forecast period based on IMF projections to 2024.

In sum, it is a region with slow growth, low inflation, an aging population, and a highly educated declining workforce. Does it sound familiar? There is no shortage of articles talking about the Japanification of Europe. It is easy to make the connection at the surface level, but there are structural differences between Japan and the EU that are important to take into consideration.

First, the European Central Bank (ECB) does not have a mandate to do “QE infinity” like the BOJ. The lawsuit from the German Supreme Court that we mentioned in the last quarterly newsletter is a reminder that there are boundaries. Second, the gap between decision and action is not the same in Japan and in the EU. For instance, in July, EU members reached an agreement regarding the COVID-19 stimulus package that conveniently left out the details of the execution. Recent meetings in Brussels showed that there is no consensus regarding what to do if a country receiving the funds does not respect the covenants. If getting 27 countries to agree on a vital stimulus package requires Olympic gymnastics skills, the EU looks less nimble than Japan, China, and the United States.

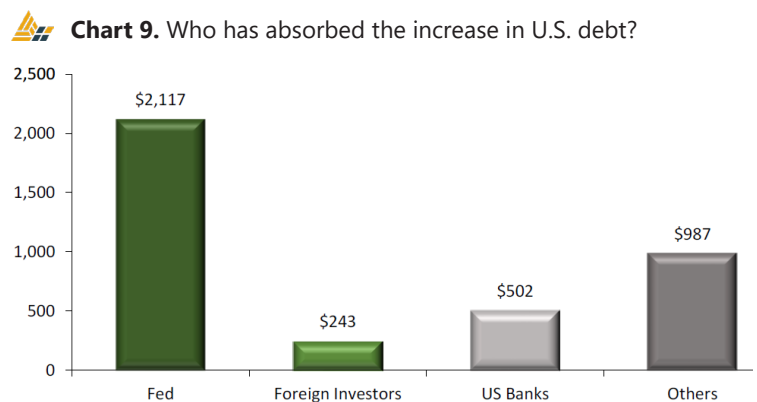
Regarding European equity performance, the Euro STOXX index only grew 0.28% last quarter, led by the rally in Auto & Parts, up 9.44%, and Travel & Leisure, up 8.47%. European banks lagged the index, down 13.24%.

### What else is on our radar?

- Brexit talks between the EU and the UK will be important to watch with direct consequences for the British Pound in the event of a hard Brexit. The FTSE 100 was down 4.92% in the third quarter.
- The People’s Bank of China will issue \$1.5 million worth of digital currency to 50,000 consumers to run a pilot test of the digital Yuan payment system. There is a lot of speculation surrounding China’s master plan to decrease global trade’s reliance on the U.S. Dollar. We will see how it is received by trading partners. The Shanghai Composite Index was up 7.82% last quarter.
- The emerging market response to the crisis will be crucial for their growth outlook. We will watch how countries like Brazil and India boost consumer and business confidence by using monetary and fiscal stimulus. India’s service PMI is still in contraction territory, although it improved from 33.7 in June to 49.8 in September. Brazilian stocks were down 0.48%% in the third quarter.
- We will continue to monitor the U.S. Dollar, as its relative weakness is a tailwind for global companies and commodity exporters. The Demand for U.S. Dollar Swap lines by foreign central banks decreased in the last quarter, which could be perceived as a sign of stabilization in these markets or demand weakness.

## ASSET ALLOCATION REVIEW

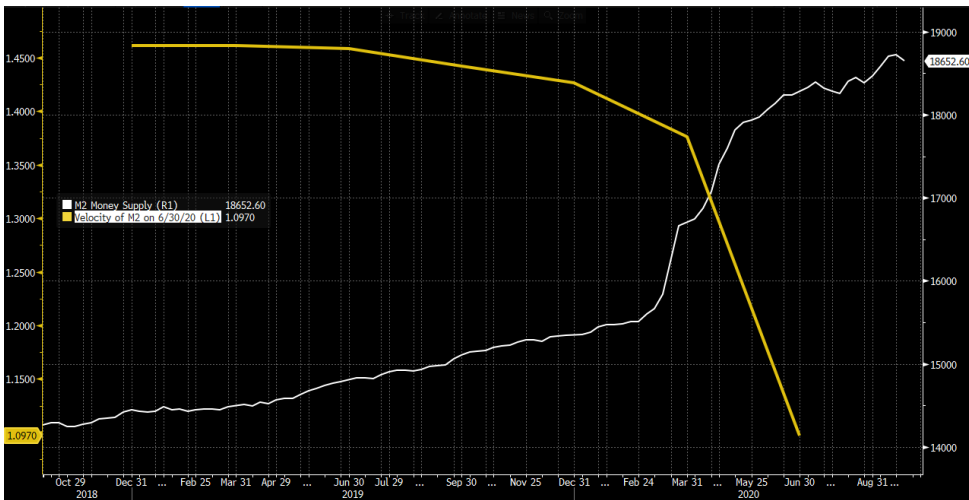
As the impacts from COVID-19 became apparent, the U.S. Government responded by passing several stimulus bills, the largest being the Cares Act. This legislation sought to stimulate the economy by a variety of measures including direct payments, unemployment enhancements, payroll support, and other financial support to a number of industries including hospitals, airlines and local and state governments. Further fiscal support may be upcoming in the months and years ahead. As a result of these expenditures, FY 2020 (ended 9/10/20) generated a budget deficit in excess of \$3 trillion. Chart 9 illustrates the purchasers of that debt. Note that the largest purchaser of this new debt by far is the Federal Reserve.



Source: Cornerstone Macro as of 09.30.2020

“ Fed, you really got me now , I only wanna be by your side. Please, don't ever let me be, I only wanna be by your side. ”

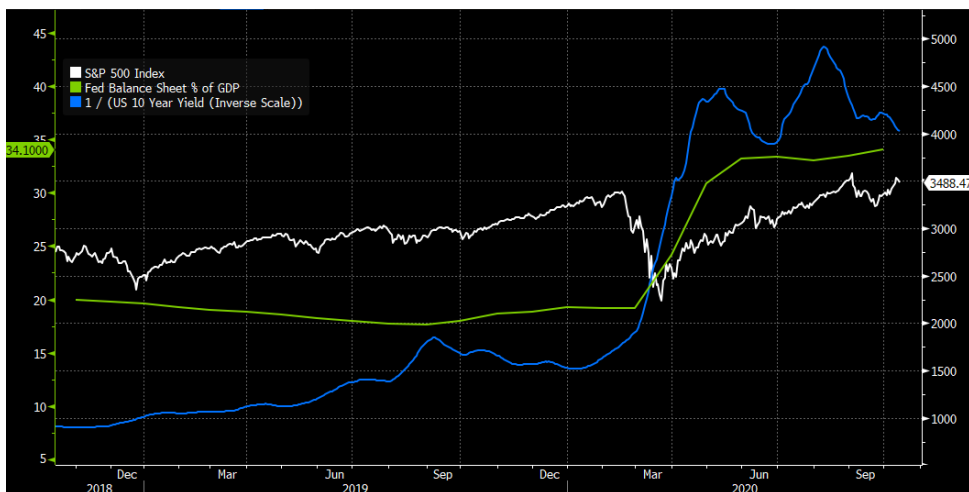
**Chart 10.** M2 vs. Velocity



Source: Bloomberg as of 09.30.2020

In order to purchase U.S. debt securities (or any other securities), the Fed creates or “prints” money. Chart 10 shows an increase in the U.S. money supply as measured by M2 of approximately \$3 trillion as a result of the Fed’s activity. Per the current Fed policy statement, it intends to continue this activity at a minimum level of approximately \$80 billion per month, or approximately \$1 trillion annually, and will spend more as needed. In addition, the Fed has announced additional bond buying programs that could spend as much as needed to support various parts of the fixed income market and enhance market liquidity. One might expect so much new money to generate inflation. So far that hasn’t happened, or has it? Also in Chart 10, it shows that as the Fed has increased the money supply, the velocity of money (how often those dollars turn over per quarter) has decreased. If money is not being spent, it doesn’t create inflation in the classic sense and it just “sits there”.

**Chart 11.** Fed vs. S&P and Treasury



Source: Bloomberg as of 09.30.2020

But where does the money sit? Often times, it finds its way into financial instruments of some type and can end up in high quality bonds, such as government issues while also affecting other financial markets as well. Chart 11 demonstrates the size of the Fed’s balance sheet as a percentage of GDP, the S&P 500 index, and the inverted 10-year U.S. Treasury Index (20 Smoothing). As the Fed’s balance sheet increased, the values of U.S. Government bonds increased and equities quickly recovered from their March 2020 lows.

In a risk-on financial market, we want the Fed to be by our side. The Fed has announced it will buy bonds “as needed” (in other words, unlimited), so it looks like they will be by our side until economic conditions indicate they must act differently.



## IN ACCORDANCE WITH THIS VIEW, WE CURRENTLY SEE THE FOLLOWING INDICATIONS FOR ASSET ALLOCATION:

**General Allocation** – In the third quarter, equity markets continued to rally with the MSCI ACWI up 8.13%, while fixed income markets saw a slight increase of 0.62%. In the fixed income markets, the interest rate spreads have tightened significantly, though not quite back to pre-COVID levels. We recommend a quality core of equity, focusing on companies with strong balance sheets and strong cash flows. For fixed income, we recommend a mix of core and multisector allocations, though we believe fixed income will be challenged from both a return and risk reduction perspective. Accordingly, we believe the equity markets continue to have greater potential for return than the fixed income markets. We believe that the Fed will continue to remain active, directly affecting the fixed income markets and indirectly affecting all other markets. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and market environment dictates.

**Equity Allocation** - We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks, we are currently overweight with equities relative to fixed income due to limited potential for returns for fixed income going forward. We remain slightly overweight with U.S. equities, and are constructive regarding select small/mid-cap equities. We continue to emphasize high quality and high cash flow equities as those type of companies should emerge from the current crisis in the most favorable condition to take advantage of the recovering economy. We continue to monitor international markets, and may move toward a more neutral weighting in the future. We see opportunity in emerging markets, especially those in East Asia that have handled the COVID-19 pandemic well.

**Fixed Income Allocation** – We believe fixed income going forward will be challenging. In response to the current crisis, the Federal Reserve has cut the Fed Funds Rate to 0% and has expanded their balance sheet (4QE) by approximately \$3 trillion to support fiscal stimulus and have announced “as needed” support for the bond market. The effects of these actions will likely be lower rates for longer. The Fed has basically begun managing the U.S. Treasury market as the large amount of current and future issuance will likely require the Fed to continue to increase the size of their balance sheet to ensure stability in these markets. Due to the lower rates seen in 2020, higher quality and higher duration fixed income have limited upside and provide lower yields. There is an unlikely tail-risk of much higher rates in the event of a Fed miscalculation. Longer term rates may simply rise with the improving economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. All of this indicates a more tactical approach of fixed income management as we expect limited opportunities and significant risks in this area. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

**Liquid Alternatives** – Liquid alternatives were helpful in reducing portfolio volatility and improving risk-adjusted returns during the recent market volatility. We recommend considering alternatives as an option to reduce portfolio volatility. Given the limited return potential of fixed income, we also recommend a consideration of liquid alternatives as an alternative to a portion of a traditional fixed income allocation.

## OUTLOOK

*As we move into the final quarter of 2020, it is a great time to make sure your investment policy or plan is updated and your current asset allocation is aligned with your long-term goals. In our view, the best plan is to stick to the plan and invest with managers and strategies that can take advantage of opportunities that present themselves over time, while backed by the process to do so. Asset allocation with high-level investment strategies is a powerful way to reach your goals and sleep at night.*

Thank You,  
**Level Capital Management Team**

## IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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