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Quarterly Playbook
4th Quarter 2020

Current Financial Planning and Investment Themes

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"Head down, Stay focused"

As we race toward the finish of 2020, there have been plenty of caution flags and even a restart, but it appears we are now racing again under green flag conditions. Sparks will surely continue to fly but we can't afford to be distracted coming down the home stretch.

"It's easy to keep focused when you are in a comfortable environment, but when things aren't going as planned, it's important to keep in control of your emotions"
- Lewis Hamilton, World Champion Formula One Driver

US Economics

The US economy has certainly gone through a re-start. As the lockdown and brutal -31.9% GDP crash in the 2nd quarter caused the economy to have to head to the pit lanes, it looks like the track has been cleared and we are getting back to an aggressive pace with the 3rd quarter GDPNow estimate of a stunning +35.3% as of October 6th. The chassis of unemployment shows continuing improvement with the latest U-3 (official) unemployment reading at 7.9%, falling from 10.2% back in July. Additionally, the U-6 (broader definition including part-time) unemployment rate also fell to 12.8% from the July read of 16.5%. Good news to be sure, but we think the next phase will be a tougher road, likely taking until the end of 2021 to get back under a 5% U-3 (official) unemployment rate. Not to mention the historic low of 3.5% at the start of this year. Other interesting facts according to the Bureau of Economic Analysis are that as of the beginning of this quarter, household net worth has reached another all-time high, the household debt service ratio (debt payments as a % of disposable personal income) is at an all-time low, and the Personal Savings Rate remains at an elevated 14.1%. These figures are a great testament to the strength of the US consumer! Furthermore, the US Consumer Sentiment Index is at its highest level since March and the ISM manufacturing index held roughly flat at 55.4.

continued…

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…That said, we have been saying that even though the economy as a whole seems to be recovering nicely, instead of the real estate saying of location, location, location the economic effects are based on sector, sector, sector. While technology, online retail, and professional service industries are having a very good year, businesses in the entertainment, restaurant, and travel industries continue to struggle. So even while it is likely that the National Bureau of Economic Research (NBER) is likely to officially declare the recession over within the coming months, there is certainly some work to be done within certain sectors that were severely impacted.

US Equity Markets

Well Growth started the year in the pole position and has widened the gap vs. Value ever since. Honestly, the continued dispersion is staggering. As of the start of this quarter, there was a 35.9% gap between Large Cap Growth and Large Cap Value, with Growth surging up 24.3% year-to-date and Value still down 11.6% year-to-date. Even more so, the gap between Small Cap Value and Large Cap Growth is an unbelievable 45.8%! Small Cap Value is still getting lapped by the rest of the pack. From a relative valuation perspective, Small Caps and Value are the least expensive and should close the gap once we return back to a normal environment in our view. The circumstances we are in lead many market participants to bid up prices for stocks that are showing any signs of good news, whether that is financial or otherwise. However, we believe that by the second quarter of 2021 we will be back to a more normal environment when valuation, cash flows, and earnings will once again matter. In the meantime, nearly all stock categories are trading at expensive levels based on relative Price-to-Earnings (P/E) ratios. But we think that is somewhat justified based on the extremely low current interest rate environment. Most likely we will see earnings back-fill in these valuations rather than prices coming down. We are also reiterating our call for a mild stock market rally here in the 4th quarter. There are four contributors to this thesis. First, things should kick off in late October when we get the official first read of the 3rd quarter GDP which is likely to be massively positive. Then once the election is over (and results are known), we should see a typical post-election rally based on clarity regardless of results. Studies show that the magnitude of the rally is higher if the incumbent is re-elected but there is still a rally even if the challenger wins. Third, there is a high probability of a vaccine announcement in the late November/early December time frame, and maybe multiple vaccines. This isn't to say that there will be complete distribution at that time. But simply the announcement of a vaccine will lead the market to believe there is a lower probability of another lockdown. Lastly, we believe the typical "Santa Clause" rally has a bit more fuel this year as consumers have record high net worth and significantly higher disposable income versus this time last year. You might be thinking that all these combined sound like more than a "mild" rally, but we see already high valuations restricting the move up.

YTD

	Value	Blend	Growth
Large	-11.6%	5.6%	24.3%
Mid	-12.8%	-2.3%	13.9%
Small	-21.5%	-8.7%	3.9%

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US Fixed Income

The bond market is remaining status quo for the time being. The fall in interest rates to unprecedented levels is keeping government bonds and investment grade corporates at relatively high levels. Meanwhile, fixed income sectors such as High Yield, Floating Rate and Preferred Stocks have recouped much of their sell-off stemming from credit worries. However, there has been a tick up in High Yield defaults. The interest rate environment is likely to remain low for several years which will push investors toward riskier parts of the credit market in coming quarters. Up until now, fixed income has been ahead of stocks, but that is likely to change this quarter…

International Markets

We are still waiting for most of the international equity markets to catch up with the pack. So far this year, London’s FTSE “footsie” is still down more than 20%, Brazil’s Bovespa down more than 15%, France’s CAC40 down more than 17%, Hong Kong’s Hang Seng index down more than 14%. Both the German DAX and the Japanese Nikkei are roughly flat on the year. The only real positive international stock markets are both in China, with the Shanghai index up roughly 7%, and the Shenzhen composite up roughly 28%. So from an investable market perspective, there is much more room for recovery remaining internationally.

Real Estate

The commercial real estate sector has been under a lot of pressure this year because of the COVID-19 outbreak. Many tenants didn't pay their rent on time, which impacted the cash flows of most landlords. However, collection rates have been improving in recent months, which has significantly enhanced most real estate companies' cash flows. In addition, improving demand and low financing costs benefit both listed and private property owners. Keep in mind, recessions have historically preceded strong and sustainable gains in listed REITs. Even though fundamentals have bounced back, many real estate company stock prices haven't fully recovered. Because of that, investors can pick up some great bargains.

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Interest Rates & the Fed

The Federal Reserve has reiterated their commitment to adding racing fuel to the economy and markets for an "extended period". The forecasted "dot plot" projections show that the majority of the Federal Reserve Governors expect Fed Funds rates to be between 0-0.25% through 2023! I'm not so sure that will be the case, but at the very least, rates are likely to remain there through 2021. The most recent median projections for this year's GDP improved significantly from a -6.5% in June to a -3.7% in September. Likewise, the median 2020 unemployment estimate improved from 9.3% in June to 7.6% in September. And importantly, the current PCE inflation index (Personal Consumer Expenditures) forecast moved up from 0.8% to 1.2%, signaling a move away from deflationary worries associated with recessions. Rather than worrying about appropriate interest rate policy, the Fed will likely have its hands full dealing with the unwinding of the emergency liquidity measures it assisted with earlier this year. I expect the Fed to hold its position through 2021.

Legislative Affairs

Now that the elections are only weeks away, we will soon find out the direction of many policy questions, such as PPP loan taxation, the possibility and magnitude of a second stimulus package, the likelihood of adding additional Supreme Court justices or "court-packing", tax policy changes, healthcare reform, COVID-19 response and possible Federal economic lockdowns, just to name a few. Polls have been shown to not necessarily be reliable so we keep ourselves apprised of relevant data so that we can position portfolios appropriately. We are reiterating our long-standing view that President Trump will win re-election. This is led by data compiled by LPL showing that as long as the S&P 500 gains ground in the three months leading up to an election, the incumbent party wins 85% of the time. As of this writing, the S&P 500 is up over 9% in the last three months, so there would have to be a major sell-off in the coming weeks to change those odds. Moreover, according to Scott Martin of the "Wealth Advisor" publication, the weight of capital of the S&P 500 November 2nd futures contract says that the S&P 500 will at worst drop to 3,330 before that contract comes due. The index closed below that point on August 3, so that's a three-month win for investors and statistically a four-year win for Trump. Furthermore, the odds favor the Republicans based on fundraising support. As of September 22nd, 2020, the three Republican committees have raised $891.4 Million vs the three Democratic committees' $695.0 Million. However, the Democrats have raised more than the Republicans in the most recent months. We also believe that the House and Senate control will remain status quo as well, with the Democrats retaining the House and the Republicans retaining the Senate. This would likely be the most favorable scenario for markets as it is the least disruptive situation. In addition, markets tend to do well with divided government. That said, we once again want to remind clients that, while elections do affect the strength and trajectory of the economy and markets, the resiliency of businesses and the consumer remains, despite who controls Washington.

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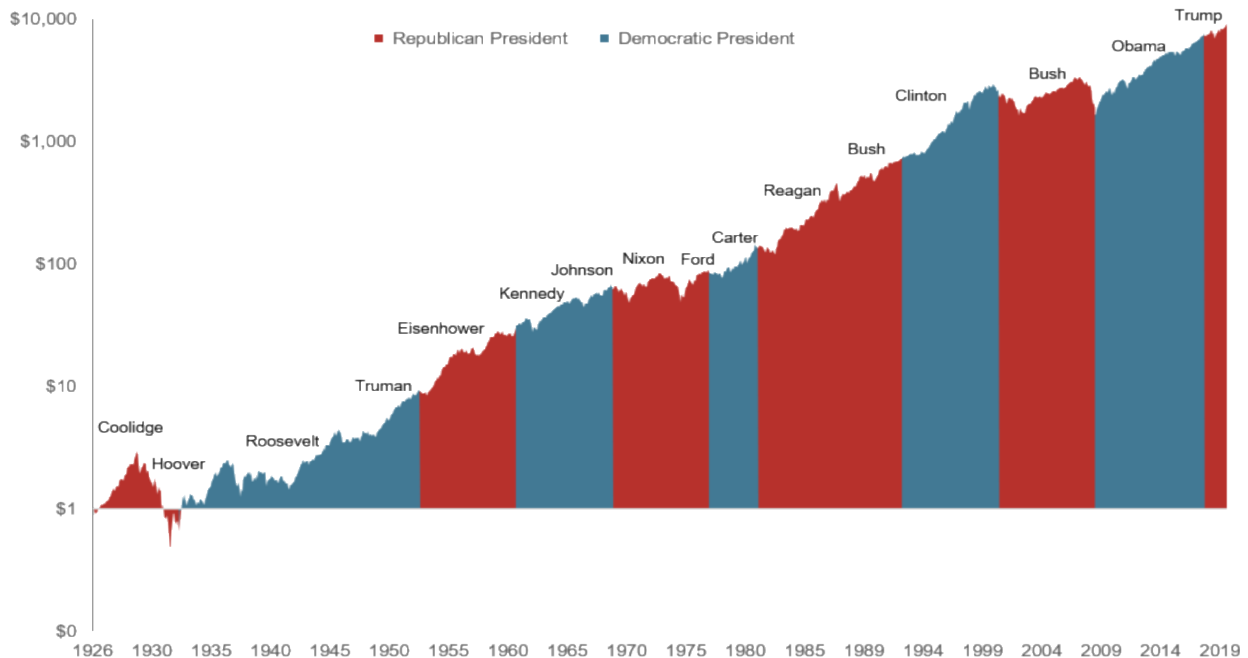
Financial Planning Corner

Keeping Elections in Perspective

Without a doubt, the most common question we're fielding right now is what can we expect to happen with our investments as a result of the presidential election? Considering the year we've had thus far and how this election in particular might feel as high stakes as ever, it's no wonder why many of us are worried about more market volatility in the coming weeks.

But making speculative investment moves surrounding the election and anticipated market volatility has yet to prove to be a wise decision. This is primarily because of one crucial investing concept – one that history has consistently rewarded investors who understand it, and it's this: It's the business cycle that drives markets in the long-run. Not anything else, and especially not who's in the White House or Congress.

An extremely popular chart that depicts historical proof of this concept is this one provided by Dimensional Fund Advisors, showing the growth of $1 in the S&P 500 since 1926:



What this chart shows us is that it has never really mattered which political party has been in office, controlled Congress, or controlled the Senate. Markets have always marched upward and onward over the long haul, and this is simply because it's the business cycle that determines market growth. Politics may have a mild effect for short periods of time, but politicians and policy change alone have never had a material impact on the persistence of capital market businesses to succeed.

If we think back to the last three elections results, after each one there were numerous claims of a looming market crash. President Obama's more liberal spending agenda in 2008, President Obama's continuation with implementing the ACA in 2012, and President Trump being an outsider with no political experience in 2016. Headlines told us the market would crash after all the three election results came in. As you can see in the chart above, the market has made very healthy gains throughout all three elections, and any short-term volatility did not stop the S&P500 from making a 12+% annualized return over the last 12 years.

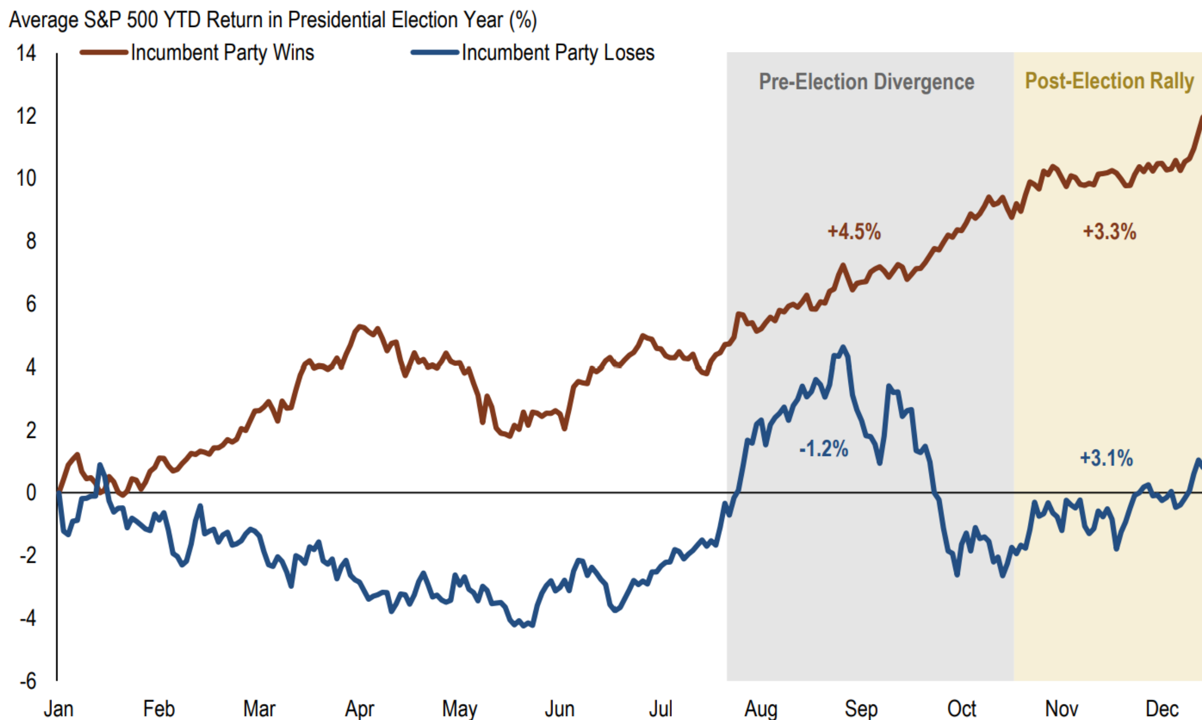
A great example of how business resilience that drives markets is more powerful than policy change in Washington is how health insurance carriers adapted to one of the most monumental industry changes they've ever seen with the ACA. They were forced to change so many fundamental elements of their business model that headlines told us it would be the end of private health insurance carriers, yet they found a way to adapt and succeed. And that's one of the most important takeaway lessons right now as the election approaches – that businesses in capital markets have always found ways to adapt and succeed regardless of their political environments, and that's ultimately what drives markets.

Another important lesson to takeaway is that there is a substantial disconnect between what we might think drives the markets and what actually does. A big reason why that might be is because news and media headlines need to grab your attention, and that's much easier to do with a headline about a looming recession if your least favorite politician gets elected. It's one more reminder to always be leery of the motivations of news and media headlines when it comes to the markets.

But the positive news in all of this is that if you want to use history as a guide, and if you're investing for the long-term future and not tomorrow, we see no reason to make any drastic portfolio moves in anticipation of the election, regardless of the results.

In fact, one final compelling piece of evidence to support that markets are not historically heavily driven even in the short-term by certain election results is this chart from Goldman Sachs:

When we look at historical election results and how the markets have reacted immediately after, we see that if the incumbent president is re-elected, the average stock market rally is 3.3% from post-election to year-end according to research done by Goldman Sachs. But even when the opposing party candidate is elected instead, the average stock market rally is 3.1% through the end of the year! This is even more proof that markets care much more about certainty and knowing the rules they'll be playing by going forward rather than the details of the rules themselves.



To summarize the historical evidence when it comes to investing and presidential elections: there has never been an election result or policy change that drove markets down over the long-run, and regardless of who is elected president, the average stock market result is a 3+% rally over the remaining weeks of the year. It's the business cycle that drives markets, and we believe you'll have a much greater chance of reaching your investment goals if you stay the course for the rest of 2020.

We're here to help. If you have questions about these or any other topics, don't hesitate to call us at (855) AFS-4545.

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