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Quarterly Market Insights

The Quarter That Was

Despite some difficulties in September, equity investors were treated to solid gains during the third quarter. The large company S&P 500 had a total return in excess of 8.9% in the quarter and has recovered all its losses for the year (an astonishing feat in such a short period of time). Other equity indices returned slightly less for the quarter but still had very respectable results, although they are still negative for the year. Finally, growth stocks still outperformed value stocks for the quarter and year-to-date causing one of the largest differentials in returns on record.

Digging under the surface, we find the numbers a bit misleading. The mega-cap growth names continue to lead the market. The often-referenced FANMAG group of stocks (Facebook, Amazon, Netflix, Microsoft, Apple and Google-parent Alphabet) are up an amazing **+42.50%** year-to-date through the end of September on a price basis. The price return for the overall S&P 500 (of which they are all included) is up 4.1%. Excluding the FANMAG stocks, the other 494 names in the index have a price **loss** of **-3.6%** for the year so far.

The outperformance of these names at the top of the S&P 500 index means that concentration within the index has soared to record highs. The top 10 stocks in the S&P 500 make up a record 28% of the total value of the index.

Historically, the top names in the index have constantly changed throughout history. Back in the 1980s, oil and gas companies dominated the top 10 in the index. In the 1990s, it was technology companies that held the top position (Microsoft is the only remaining company in that basket). Today, the FANMAG stocks are in the pole position. Which companies will be the largest in the future?

It is not unusual for a handful of companies to make up a significant percentage of the index. Keep in mind, however, that these companies' outsized past returns have come from their ascension up the market cap spectrum, not when they got there. In fact, according to an analysis done by Ned Davis Research, from 1972 until the end of September of 2020, the return of the S&P 500 was 12,640% versus a return of 1,562% for the largest companies in the S&P 500 for the same period. Biggest is not necessarily best for performance over the long term.

As mentioned earlier, there has been a wide variation of returns between growth stocks (with technology making up a big part of that) versus more cheaply priced and often more economically sensitive value stocks. In addition, within a popular large company growth index (the Russell 1000 Growth Index), the **6** FANMAG names combined are nearly a 40% weight in the index whereas the Value index (the Russell 1000 Value index) has **40** names that make up 40% of that index.

In the bond market, things were fairly calm throughout the summer thanks in large part to an extremely accommodative Federal Reserve which has openly stated that they will keep rates down for an extended period of time (through the end of 2023 unless there is a material change in the economy). What this means is the likelihood that interest rates will stay lower for longer, which may help the economy in the short to intermediate term but could have long-term implications.

Low rates also have major consequences for investments because interest rates are used as a discounting mechanism. If rates stay low, this means that many investments that might not otherwise appear attractive at higher rates now look much more enticing. An example of this is mortgage rates and their effect on the housing market; as rates stay low or decrease, many more people can afford a home (and the mortgage payment) thus bidding up the price that buyers are willing to pay.

Below are various numbers for the quarter and year-to-date.

Stock Indices	Q3 2020 Return*	YTD Return %**
S&P 500 (large)	+8.93%	+5.57%
S&P 400 (midsize)	+4.77%	-8.62%
Russell 2000 (small)	+4.93%	-8.69%
MSCI EAFE (intl.)	+4.80%	-7.09%
Bond Yields	**Sept. 30 Yield & Qtr. Change**	**Dec. 31, 2019 Yield**
3-month T-bill	0.10% (-0.06%)	1.55%
2-year Treasury	0.13% (-0.10%)	1.58%
10-year Treasury	0.69% (+0.03%)	1.92%
30-year Treasury	1.46% (+0.05%)	2.39%
Commodities	**Sept. 30 Price & Qtr. Change**	**Year end 2019**
Oil per barrel	$40.22 (+$0.95)	$61.06
Gold per ounce	$1,895.50 (+$95.00)	$1,523.10

*Stock indices include reinvested dividends and are for the period 7/1/2020-9/30/2020
** Stock indices include reinvested dividends and are for the period 1/1/2020-9/30/2020

Pessimistic or Optimistic? It Depends

There are reasons to be both pessimistic and optimistic depending on your circumstances and time horizon.

A few of the reasons to be pessimistic

- **Election risk**: whether it is the uncertainty of the winner or the timing of knowing the results, we need to be mindful that this could have an affect on the markets. Be careful though on chasing the conventional wisdom; it is oftentimes wrong.
- **The economic risk due to a resurgence of COVID-19, along with the potential lack of additional fiscal suppor**t: the shut down has had a major affect on the U.S. economy and most economies around the world. Going through a longer shutdown especially without additional financial support could have very grave consequences.
- **U.S. equity market valuation risk**: many stocks are outright expensive although there are still pockets of opportunity in both the U.S. and abroad.

- **Geopolitical risks and other unknowns**: whether it be something that we might be able to anticipate like relations flaring up between the U.S. and China or something that comes out of left field, we need to be vigilant and have a contingency plan in case something unexpected happens.
- **Sizable and growing debt levels:** while it may be best to tackle more immediate issues in the short term, this is something that must be confronted before it is too late.

A few reasons to be optimistic

- **The economic recovery underway**: we do not wish to diminish the problems that many Americans are feeling both financially and otherwise. The economy improved in the second quarter and although we do not have numbers yet on the quarter (Q3) just ended, they will probably come out very strong (probably the strongest on record which goes back over 70 years). As an aside, this economic number comes out at the end of October, right before the election.
- **The likelihood of an effective and widely distributed coronavirus vaccine**: we don't know exactly when this might be widely available, but it is likely in either the first or second quarter of 2021. Depending on the timing and the effectiveness, this would help immensely in getting people more comfortable with getting back to some semblance of normal.
- **Extremely accommodative monetary policy**: the Federal Reserve has made it very clear that they will do whatever they can to help in keeping the economy from falling into the great abyss. Whether they will be effective, and legislators can get their acts together to do what is necessary (which is open to debate) is the question.
- **Relative valuations are still somewhat attractive**: with interest rates this low, stocks do have some appeal compared to other asset classes as mentioned earlier. For example, there are several big blue-chip companies whose stocks have dividend yields approaching 3% while their 30-year bonds have a fixed interest rate of around 2%. To make things even more interesting, the dividend will likely go up on many of these companies every year for each of the next 30 years while the bond will pay the same 2% each year for the next 30 years. We would contend that given the proper time frame and a reasonable valuation, many of these stocks will be better than their bonds as an investment.

What to Do Going Forward

We don't mean to sound like a broken record but ALWAYS develop your investment plan around your financial plan. What rate of return do you need to meet your goals? How much do you need to save? How much should you build into your spending projections? These are just a few of the things that must be answered as you develop and implement your investment plan.

Having said this, we would suggest that you be careful that you don't become overly optimistic or pessimistic. In addition, don't let the emotions of the moment (including the election) sway you from your long-term goals and potentially disrupt your future.

We are always here to discuss all matters that are important to you. Please let us help you talk through your various financial issues and develop a more cohesive financial plan.

Final Thoughts

As we all adapt to the current situation as best we can, we want to let you know that we continue to function at full capacity. We have all learned how to adapt but we truly believe that our business will be better off for the experience. A few examples are conducting Zoom calls, transacting business electronically, and assisting clients to better utilize our portal. Please let us know if there is anything we can do to make things easier or better for you.

As we have said before, **we are all in this together** and **we are here to serve you**.

Thank you for your business and trust.

Hopwood Financial Services, Inc.