Market Commentary

Third Quarter 2020

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We begin by saying to each of you, we hope you and your families are healthy and have gotten through the past six months as best as could be expected with all the changes and upheaval in our daily lives and routines. As life in the United States slowly moves towards more normalization, we collectively face a large number of changes in our daily lives – some which may become permanent.

Following some market consolidation in September, the benchmark S&P 500 Index rose by 8.9% during the quarter, bringing the year-to-date return to 5.5%. Fixed income yields remained near all-time lows during the quarter with minimal fluctuations. Rates on the benchmark 10-year US Treasury note ranged between a high of 0.75% and a low of 0.51% during the three month period, before ending September at 0.68%, essentially unchanged from the 0.65% yield on June 30, but far below the 1.92% yield at the end of 2019. During its September meeting, the Federal Reserve vowed to keep the short-term Fed Funds rate near zero into 2023 to help boost economic growth.

Oil prices traded in an extremely tight range during the recent quarter, contrasting with sharp moves in the first two calendar quarters. Beginning the quarter at $39.27 for a barrel of the benchmark West Texas Intermediate, oil reached a peak of $43,39 in late August, before closing the quarter at $40.22, up slightly for the three-month period. This stability in oil prices removes one variable from our economic forecast mosaic. In a more normal global economy, we maintain a fair price range of $50-$70 per barrel for oil. Until the US and other economies reduce unused capacity and increase travel closer to pre-pandemic levels, oil prices should remain below that range.

Economic and Market Outlook

You may recall that the second quarter of 2020 showed a very sharp contraction in economic activity following the nearly complete lockdowns of April and May. As restrictions began to be lifted in June, we observed signs of hiring demand that has continued since. Following a spike to 14.7% in April, the US unemployment rate has been ratcheting lower each month, falling to 8.4% in August. Continued declines in the unemployment rate will be tied to continued easing of COVID restrictions along with fiscal and monetary policy that encourages companies to bring back furloughed workers. Real GDP declined at an annualized rate of -31.4% in the second quarter, reflecting the sharp slowdown in economic activity. Estimates for the third quarter, which will be released in late October are for a jump of 30-35%, after which GDP growth is expected to revert to more historic rates. Current estimates for GDP growth for the full year of 2020 approximate -5%, with preliminary estimates of 3-4% growth in 2021. Obviously, these estimates are tied to continued positive news on COVID and no more widespread lockdowns in the US. S&P 500 earnings are expected to decline approximately 25%-30% during 2020 before rebounding with a gain of 25% in 2021. This would result in full year 2021 earnings approximately 5% below 2019 levels.

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During the third quarter, we had some concern about the bifurcation of market returns between growth and value companies along with the seemingly irrational valuations given to some companies. As your risk manager, we are always watching for signs of excess in markets that could signal the need for portfolio adjustment. From the start of 2020 through the end of August, the five largest companies in the S&P 500 rose an average of 40%. The other 495 companies in the benchmark index declined by an average of 1% during the same period. This extremely narrow market is a sign of herd mentality along with some rampant speculation by investors.

The NASDAQ 100 index rose more rapidly than the Dow Jones or S&P 500, rising approximately 80% between late March and early September before giving up some of those gains through the end of the quarter. Five companies - Apple, Microsoft, Amazon, Facebook and Tesla -account for a combined 42% of the NASDAQ 100. While one could plausibly argue that the first four companies have benefited from changes in the economy and lifestyle modifications since the outbreak of COVID, the meteoric rise in Tesla perplexed us. While we have never owned Tesla for clients, we have gotten many calls on the company. Tesla rose 496% YTD and 690% from its March low through the end of August. At that point, the company – which has NEVER earned an operating profit – was valued at $460 billion. These dislocations in valuation always draw concern and tend to be signs of rampant speculation. Our clients are not subject to swings in Tesla's share price, but companies like Tesla can distort market indices and raise the obvious question, "Why don't we own Tesla?" We do not know what a "fair valuation" is for Tesla but we are quite confident it is well below the current stock price. There are some other companies that have reached extremely stretched valuations, but we wanted to use a well-known company as an example to help our clients understand our long-held thought process on valuations.

After watching technology stocks lead stock prices higher since March, there has been a bit of sector rotation over the past few weeks. Materials, Industrials, and Consumer Discretionary companies have perked up and are now the best performing sectors since the start of the quarter. These sectors are very economically sensitive, and their strength shows investor belief in a continued economic rebound. We continue to have limited visibility into corporate earnings for the next several quarters but hope to gain some clarity as companies provide 2021 guidance when they report third quarter earnings in October and November.

Portfolio Positioning

Client portfolios saw adjustments as we rebalanced asset allocation during the quarter. After a stunning rise of nearly 60% from the March lows, portfolios became over-weighted in equities versus target allocations, allowing us to trim equities with the proceeds going into fixed income holdings. Similar to moves we made in March and April - where we added to equities after the sharp market decline - this adherence to asset allocation is one of the disciplines we rely on to be sure market movements do not cause portfolios to deviate from desired risk tolerance levels.

With economic growth likely to remain choppy over the next few quarters, we continue to favor growth stocks over value stocks, although certain areas of value have gotten quite attractive for patient investors. We would put financial stocks in this category. They pay healthy dividends and should be able to maintain strong profitability despite the disruptions from COVID. We remain invested in companies with strong balance sheets, and diversified customer bases or differentiated product lines. The sharp market movements in both directions since February this year have worn on some investors' patience. We have

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been saying since early summer that stocks needed to consolidate some of the sharp gains following a nearly 60% rise in just over five months. Unfortunately, many investors that enjoyed the rapid rise upwards begin to panic when markets consolidate and decline. While nobody likes to see their investments decrease in value, we remind you that the past few weeks have seen a reduction in the prodigious gains since March. Major indices have merely declined to levels seen as recently as mid-August. To use an analogy, consider a person who enters a casino with a $10,000 bankroll. Due to some success at the card table, this person builds his stake to $50,000 before the cards turn against him, cutting into his gains. After seeing his stake decline to $40,000 he decides to cash in and leave the casino. We can all agree this investor won $30,000 at the casino. This person would not tell anybody that he lost $10,000 at the casino. Regrettably, many investors check their portfolio values far too often and would lament the $10,000 decline from the peak in this scenario. It is this short-term focus and emphasis on declines from market peaks that tend to cause investors to trade more than they should, to the detriment of their long-term returns.

Conclusion

The final three months of 2020 may see the continuation of elevated volatility. We are facing a number of events that could move markets meaningfully in either direction. While a Presidential election always bears watching, this year it is even more relevant due to the focus on mail in voting. There is a meaningful likelihood that we may not know the winner on Election Day or even for days or weeks afterward. A repeat of the 2000 election drama could cause a period of heightened unpredictability in stock and bond prices. Markets abhor uncertainty, so a rapid election decision would most likely lead to reduced volatility in the capital markets during November. Any widespread resurgence of the COVID virus could have negative effects on the economy and consumer behavior. Although we continue to monitor corporate earnings, investors have already written off 2020, deciding to focus on earnings prospects in 2021 and beyond.

As always, we welcome feedback from our clients. Please call or email us if you have any comments or questions about your investment portfolio.

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