Insights: October 2020

Market Overview and Performance

For the most part, when people apply the term "unprecedented" to an event or situation, the moniker is generally not warranted. However, I think we can say with confidence that 2020 has thus far truly been a year like no other. Incredibly, despite the litany of uncertainty, broadly speaking we have experienced positive returns for equities, bonds and gold. As a result, for the average diversified investor, 2020 would be judged to be a pretty good year if one was oblivious to the environment around them. However, we all know that it is impossible to not feel the stress and angst of the previous 10 months, either from an investor standpoint or just as a human being. Consider the events compiled by Simply Wall Street as they assess 2020: a global health pandemic, government lockdown orders, a liquidity crisis, record unemployment rates in many nations, the price of oil went negative, the largest monetary stimulus package ever, the fastest asset price recovery post a recession, civil unrest, technology adoption skyrocketing, and global travel, hospitality and entertainment having ground to a halt. If we had been given that information ahead of time, the clear assumption would have been that markets would be down sharply across the board. However, the resiliency continues and there is even perhaps the chance that markets are poised to have an extraordinary recovery and rally higher in 2021. Before that can happen however, the US presidential election has to be completed and resolved in a definitive fashion and the heretofore uncontrolled spread of the COVID-19 virus needs to at a minimum be contained and perhaps even reduced as we make our way through the early part of 2021. As always, thank you for reading our latest Insights.

	Quarter to Date September 30	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**8.93**	**5.57**
Russell 2000 Index	4.93	**-8.69**
MSCI EAFE Index	4.80	**-7.09**
MSCI Emerging Markets Index	**9.56**	**-1.16**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.62	**6.79**
Barclay's U.S. Aggregate Credit Index	1.97	**8.00**
Barclay's U.S. Aggregate Corporate High Yield Index	**4.60**	0.62
Barclay's Municipal Bond Index	1.23	3.33
Macro Measures		
Gold	**5.28**	**24.45**
Crude Oil	2.42	-34.31
CBOE Volatility Index	-13.34	91.36
USD Dollar Index	-3.59	-2.59

Current Theme – Only Two Considerations Matter to Investors Right Now – The Uncertain US Presidential Election and the Trajectory of the COVID-19 Virus Spread

While Most Polls Suggest that There is a Clear Front-runner in the US Election, Many are Wary of a Contested Election as a Third Wave Of Virus Spread Impacts the Globe

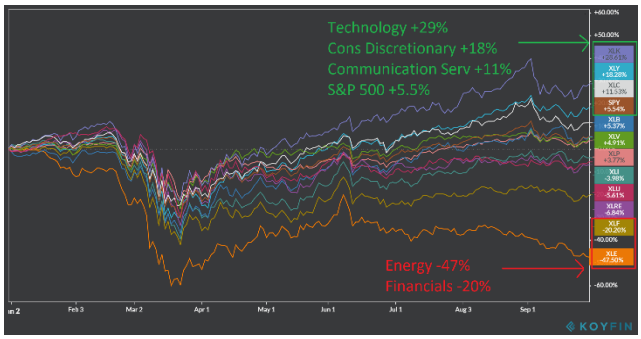
As the chart below highlights, US equity markets experienced a strong "risk-on" rally of +9% during July and August based largely off of the belief that the various re-opening plans across the country were generally proceeding with success. There was hope.

Risk-On Q3 Period Followed by Trading Range

Source: Refinitiv

However, with the onset of autumn, it became apparent that many of these policies were flawed with the presidential election quickly approaching. As a result, the market has settled into a trading range, yet market leadership remains firmly entrenched. As seen below, the Technology (+29%) and Consumer Discretionary (+18%) sectors have rallied while the Energy and Financials sectors have lagged far behind.

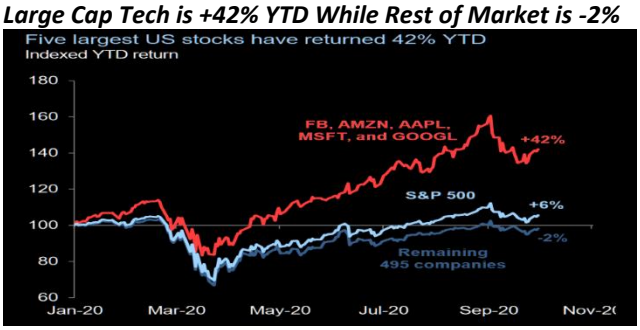
Clear Sector Bifurcation – Tech +29%, Energy -47%



Source: Koyfin

As we have discussed previously, it's not just sector allocation that has determined performance, it's really just a handful of names that absolutely must have been owned if one hoped to participate in the gains this year. The rest of the market is actually down.

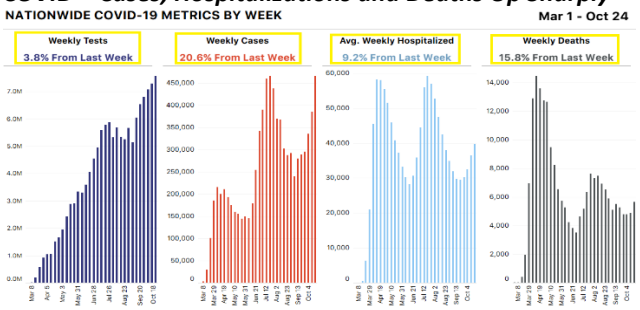
Large Cap Tech is +42% YTD While Rest of Market is -2%



Source: Goldman Sachs Global Investment Research

This dynamic has occurred because these companies are perfectly constructed for the deteriorating virus environment illustrated below. They are asset light, are essentially free to use for the consumer and provide services that only increase in demand during a "work from home" or quarantine scenario.

COVID – Cases, Hospitalizations and Deaths Up Sharply

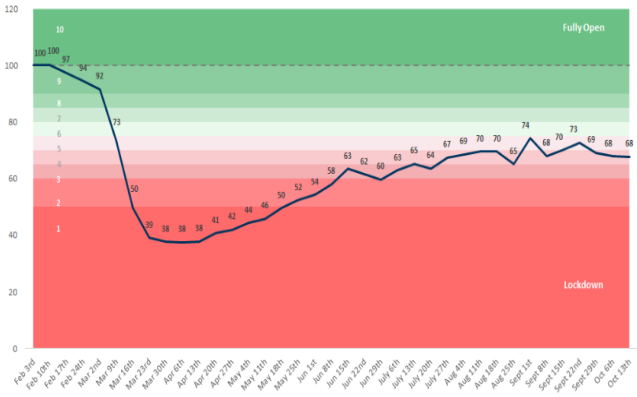


Source: The Covid Tracking Project

And this trend in leadership shows no signs of slowing. The US is now eight months into its COVID-19 experience and the decisions and policies that have been utilized have had zero success in stemming the spread. The virus in the US is no longer concentrated in the coastal metro areas like New York and California. Rather, it is rapidly infecting people within rural communities, especially in the Midwest, who perhaps originally thought they might escape the contagion unscathed. As the chart above highlights, while testing has increased modestly (+3%), cases, hospitalizations, and deaths have increased sustainably. As of this week, US cases are averaging over 70,000 per day – an increase of +41% in just two weeks.

The tragedy here is obviously the fact that the US is averaging over 800 deaths per day. For reference, US daily deaths averaged 514 during the Civil War and 297 during WWII. Beyond the dire health impact, the economic consequences have been quite severe.

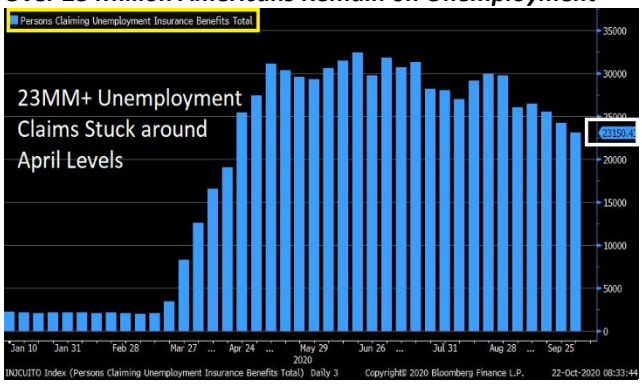
Goldman Sachs Activity Index Shows Recovery Stalled



Source: Goldman Sachs Global Investment Research

In the chart above, Goldman Sachs has illustrated their index of 68 factors they use to assess economic activity. These are not government economic report data, but rather things like airline travel, restaurant capacity, traffic flows, office building usage, etc. which generally provide a more concise picture of consumer behavior. The Index itself suggests that activity is still down -32% from pre-pandemic levels, however, probably more importantly, it's clear that there has not been a "V" shaped recovery off of the March lows. While things have certainly improved, the data has basically stalled and moved sideways since July.

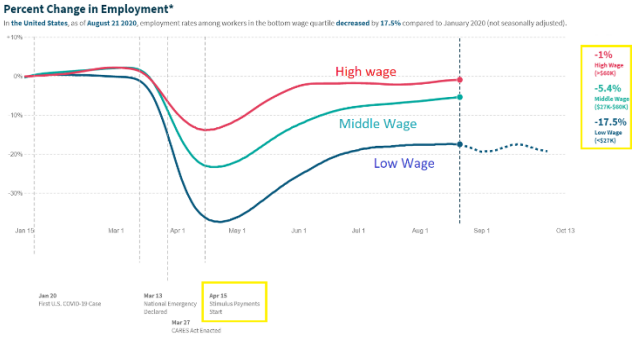
Over 23 Million Americans Remain on Unemployment



Source: Bloomberg

We see this in other measures of the health of the economy as well. Consider the chart above which underscores the unfortunate fact that a large number of Americans remain on employment assistance. Over 23 million people in fact. While that is undoubtedly better than the 31 million people on unemployment this summer, today's level remains stubbornly high.

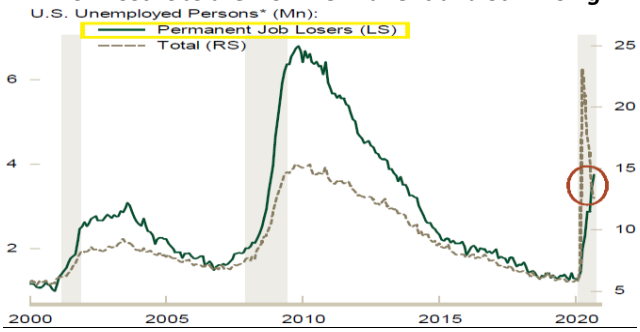
Employment: High Wage = -1%; Low Wage = -17.5%



Source: TracktheRecovery.org

The real challenge however, becomes clear when we look at segments of joblessness. As seen above, only 1% of High Wage earnings are unemployed while almost 18% of Low Wage workers are out of work.

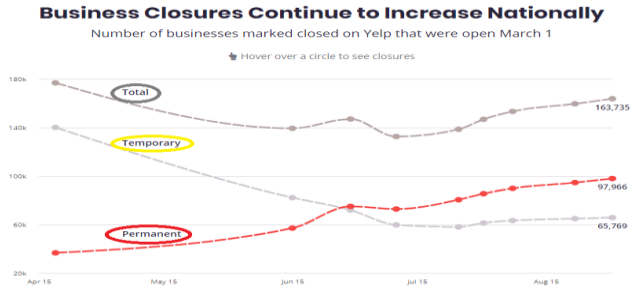
4 Million Lost Jobs are Now Permanent and Still Rising



Source: MRB Partners; US Bureau of Labor Statistics

Sadly, these job losses increasingly look to be permanent as the recovery stalls and perhaps may even deteriorate during the winter. As the chart below shows, many small business have also closed for good.

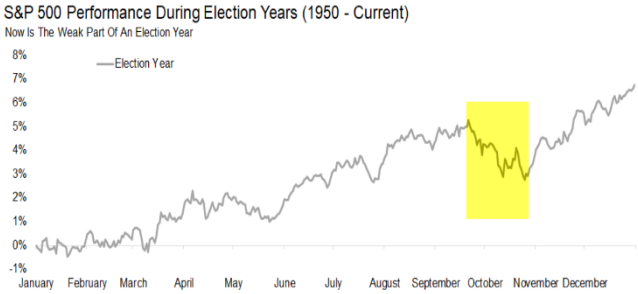
Permanent Business Closures Have Surpassed Temporary



Source: Yelp Local Economic Impact Report September 2020

The picture that emerges from these data points is that there truly is two different economies running concurrently within the US. For the high wage earners, things are generally ok. They typically work in fields that translate well to a work from home environment, job losses have been minor, and since most people aren't really going anywhere, they even have a bit more discretionary income in their pocket to spend on consumer items. Additionally, high wage earners historically have a portion of their wealth invested and have thus benefitted from the rally across markets. Conversely, mid and lower wage workers are facing exactly the opposite scenario. As opposed to a "V" this dynamic has been termed the "K" shaped recovery - some stand to benefit while others continue to decline economically.

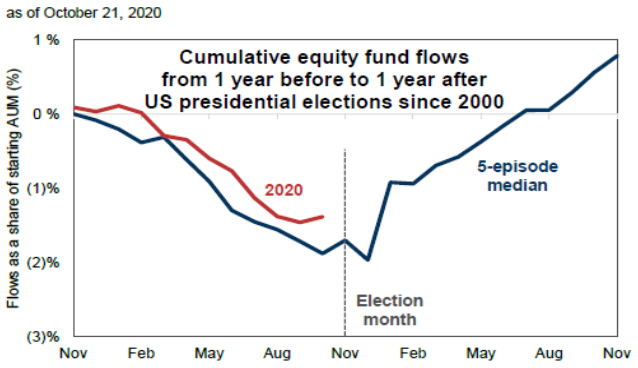
September/October Historically Weak In Election Years



Source: LPL Financial; Ryan Dietrich

Obviously, this presents a messaging challenge to anyone seeking to become president. A focus on either constituent group may alienate the other. While this has always been true to certain degree, it's worth looking at past years to see if 2020 is proving any different. As the charts above shows, the equity market typically declines heading into an election.

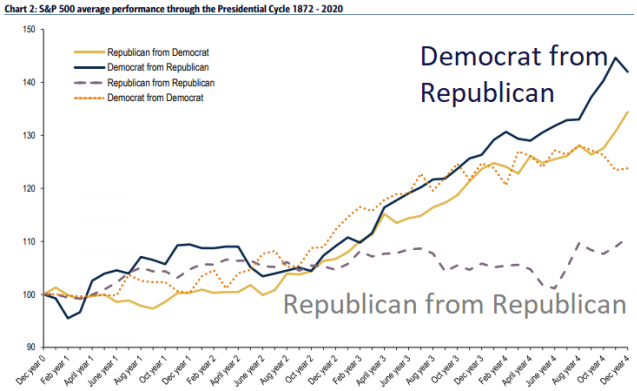
2020 Equity Flows Tracking Historical Election Pattern



Source: Goldman Sachs Global Investment Research

2020 has matched this pattern fairly well with a choppy downward path during September and October. Looking at the previous chart, Goldman Sachs finds that equity flows in the 12 month period leading up to this election have matched the prior five events. As they suggest, money historically flows back into the markets in the proceeding year after the election.

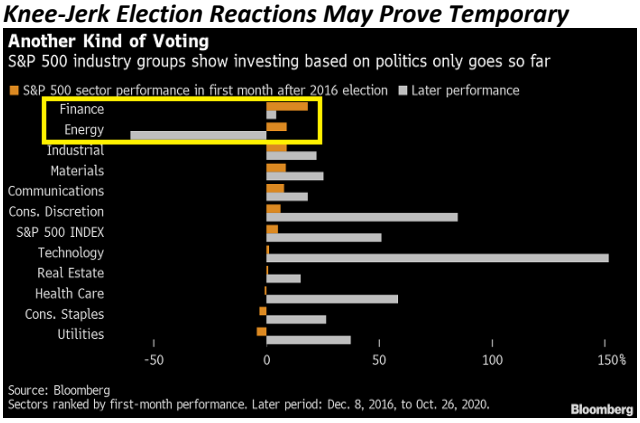
Presidential Cycles Have Done Best After Party Change



Source: BoA Global Research; Global Financial Data (GFD)

When looking more specifically at presidential cycles, Bank of America has found that four year returns have fared best when there is a change of party. A transition of office with a Democrat from Republican ranks highest followed by the reverse scenario. Keep in mind that their data goes back to 1872 - post WWII patterns will vary as will one term versus two term presidents, but it illustrates the fact that perceptions don't always match historical data.

Knee-Jerk Election Reactions May Prove Temporary

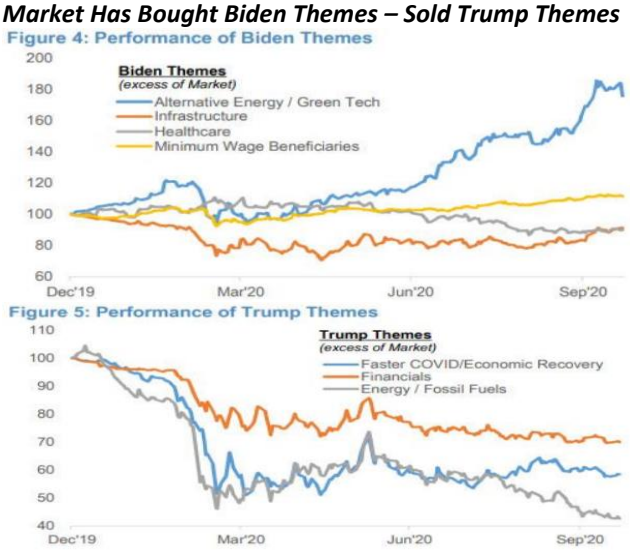


Source: Bloomberg

Along those lines, attempts to allocate toward areas that may seem poised to benefit from either one candidate or the other is not well advised. Consider what happened in 2016. As the Bloomberg chart

above highlights, during the first month after the election, the Financial and Energy sectors substantially outperformed the market as investors viewed those industries as beneficiaries of a Trump administration. In the subsequent period since December 2016, those sectors have actually underperformed every other sector in the Index.

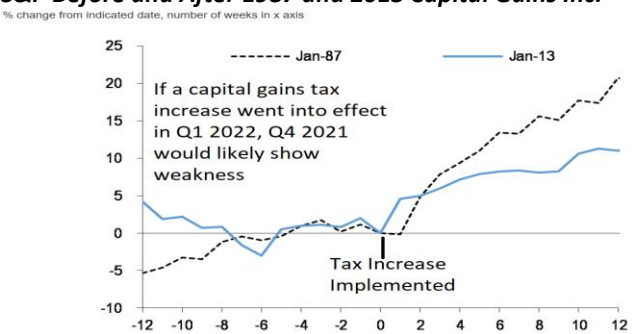
Market Has Bought Biden Themes – Sold Trump Themes



Source: J.P. Morgan US Equity Strategy

Interestingly, market participants have somewhat played election themes for the bulk of 2020. As J.P. Morgan highlights above, the "Biden Themes" of alternative energy, infrastructure, healthcare, and minimum wage beneficiaries have either been flat or up in 2020. Conversely, the "Trump Themes" of COVID recovery beneficiaries, financials, and energy have continued to struggle and are down significantly. As 2016 demonstrated, these trends could quickly reverse themselves once the election is resolved. As history has taught us time and again, money will follow profitability, not some perceived plan of a politician.

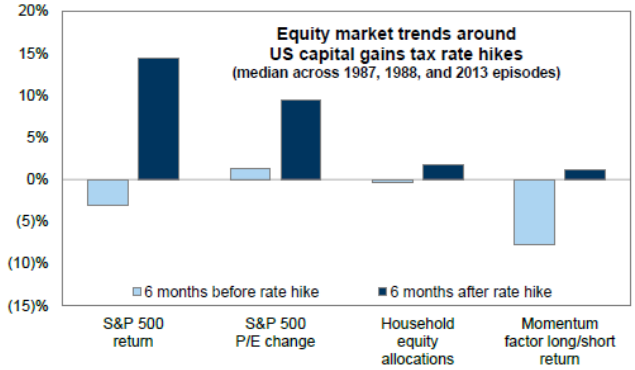
S&P Before and After 1987 and 2013 Capital Gains Inc.



Source: J.P Morgan

It is difficult to discuss this year's election however, without giving some consideration to an increase in the capital gains rate. For the time being, the market seems content with the belief that significant fiscal stimulus and expansionary policies would be more than enough to offset the tax implications. As the previous chart illustrates, during the past capital gains increases in 1987 and 2013, the S&P 500 was subdued leading up to the change, but increased immediately thereafter. As similar analysis by Goldman Sachs suggests the same results would be expected in the lead up and subsequent 6 months after the change. Looking at 1987, 1988 and 2013, they found a +15% return for stocks and flows into the asset class.

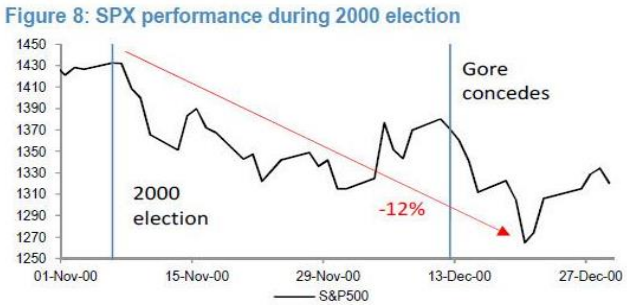
6 Month Period Positive After Past Tax Increase Episodes



Source: Goldman Sachs Global Investment Research

While endless polling data can be found to support either candidate, the most logical assumption is that each party has an equal chance of winning. Unfortunately, the current climate has bred an environment of distrust in the process which may result in a contested conclusion. The only parallel we have is the 2000 election which saw a -12% decline as the episode unfolded. It should be noted however, that roughly 8% of that decline occurred after Gore conceded the election to Bush in mid-December.

2000 Contested Election Path was Protracted & Volatile



Source: J.P. Morgan US Equity Strategy; Bloomberg

Going Forward

As we discussed with many of our clients earlier in the year, if this was a typical election year, we would be aggressively positioning for what has historically been a very strong period for risk assets after a US presidential election. However, 2020 has been anything but typical. Regardless of who wins the election, the priorities highlighted during their campaigns will quite simply have to take a back seat to the immediate needs created by the pandemic. First, a large fiscal stimulus plan will have to quickly be assembled as many of the temporary benefits established under the CARES Act and similar measures will expire on December 31, 2020 creating a cliff without a safety net for many Americans. Second, if vaccine timelines continue to progress as predicted, a comprehensive plan and procedures for how the medicines will be distributed is absolutely necessary to return the economy back toward a more normal state.

When we think about positioning for the balance of 2020, it is simply very difficult to make any allocation changes before knowing the result of the presidential election. As we have discussed, trying to position ahead of a binary event is not a wise idea. Under Biden, investor emphasis will clearly be biased toward stimulus beneficiaries, infrastructure, and healthcare segments. Under Trump, we may see a catch-up in the laggards of the financial and energy sectors as a de-regulatory environment would likely prevail.

While we are still ardent believers in long-term investment commitments and broad diversification to achieve superior risk adjusted returns over time, we were active sellers of overbought names after the strong run-up from June until the start of September at which point we began raising cash allocations. Conversely, we continue to be buyers of names which we view as trading at discounts to their long-term value, namely in the financial, industrial and consumer sectors. With that said, we have not seen any concrete reason to move away from the large capitalized technology and communication names which have clearly led the market this year. As we discussed earlier, these names appear poised to continue their leadership role as the virus spreads unabated and winter approaches. We have trimmed these names to lock in gains when merited by portfolio risk controls.

While investor behavior does not as of yet suggest that a meaningful recovery is likely near-term, we are strong believers in purchasing consistent cash-flows at discounted prices as we look toward what we believe may be a very strong 2021 on the back of continued fiscal stimulus and a waning of the COVID-19 pandemic. This also holds true for small and mid-cap stocks which have fared worse than their large-cap counterparts during most 2020 but have recently begun outperforming. These companies are more levered to the US economy and will benefit from the stimulus likely implemented in early 2021.

Equity markets outside of the US have generally declined in line with, and in some cases, worse than US markets. While we continue to believe that compelling opportunities exist within non-US exposure, we would not be adding to our allocations until we get more clarity on the impact of the virus on economies abroad. As of writing, the situation looks to be worsening with new lock-down measures enforced in major economies like Germany, France, Spain and Italy.

As a testament to diversification, our fixed income exposure has provided both positive returns and volatility reduction this year. We continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. The “flight to quality” sentiment in the market has produced very good returns in the 10-Year Treasury range. While we do not favor the risk/reward in long duration bonds, we continue to hold some exposure in that segment given the very opaque environment going forward.

Our measured allocation to gold has continued to serve us well as a non-correlated asset during times of market stress. It is our belief that this exposure will add value given continued uncertainty as well as the seemingly endless liquidity injected by central banks.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.