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Q320 Strategy Commentary

IMPORTANT INFORMATION

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Third Quarter Global Market Review and Outlook

Four ongoing themes have dominated the third-quarter investment landscape: 1) the virus; 2) the pace of the economic recovery and the potential for further fiscal and monetary stimulus; 3) the behavior of the stock market—specifically the large-cap tech sector; and 4) the U.S. elections.

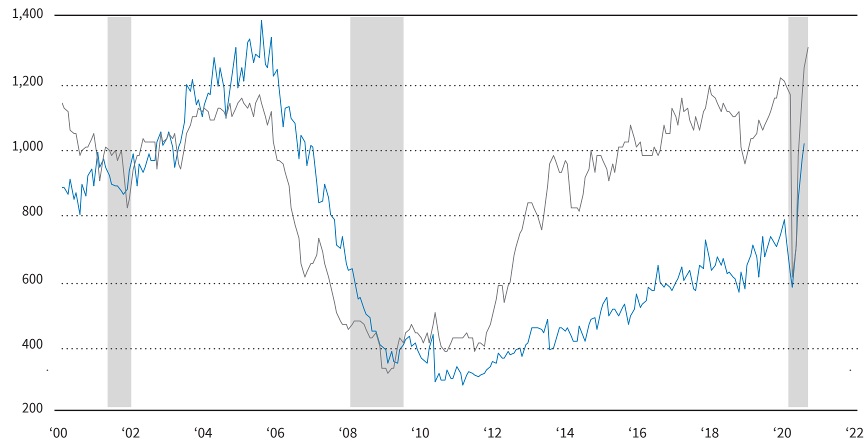
Index		YTD	3Q	1Y
S&P 500	US Large Cap	5.57	8.93	15.15
DJIA	US Large Cap	-0.91	8.22	5.70
Russell 3000	US All Cap	5.41	9.21	15.00
Russell 2000	US Small Cap	-8.69	4.93	0.39
MSCI EAFE	Developed Int'l	-7.09	4.80	0.49
MSCI EM	Emerging Markets	-1.16	9.56	10.54
Bloomberg Barclays US HY	US High Yield	0.19	4.24	2.81
Bloomberg Barclays US Agg	US Core Bond	6.79	0.62	6.98
Bloomberg Barclays Muni	US Muni Bond	3.33	1.23	4.09
MSCI US REIT	US Real Estate	-17.12	1.63	-17.76

Source: Bloomberg

During the quarter, the number of new virus cases surged in July (to a level that was far higher than that experienced during the height of the lockdown measures through March and April), followed by a steady improvement through August and early September. Importantly, the number of deaths has remained low, as have the number of hospitalizations. However, the worry about another wave erupting during the fourth quarter, as we move into the autumn/winter flu season, continues to be a risk facing investors at this time.

Despite this resurgence of the virus, macroeconomic growth indicators managed to handily beat economists' expectations during the quarter, with the Citigroup Economic Surprises Index for the United States reaching its highest-ever reading in July. Furthermore, a number of economic variables, such as retail sales and the residential housing market, have experienced full V-shaped recoveries, with activity in each of these now higher than it was at the peak of the last cycle in February (see chart, Figure 1).

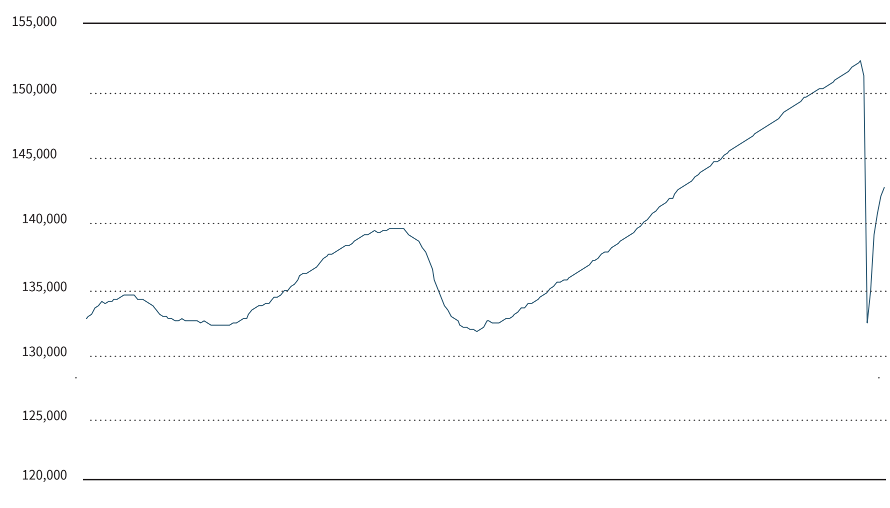
Figure 1
U.S.: New Single Family Home Sales
(SAAR, Thous, LHS)
U.S.: NAHB Home Builders Index
(SA, All Good = 100, RHS)



Source: Strategas

Even with these positive dynamics, we are not out of the woods just yet. Scratching a little under the surface reveals that the rising tide has not lifted all boats. Lower-income households, racial minorities, and women have not fared nearly as well during the recovery so far. Unfortunately, we have also yet to see a full V-shaped recovery in employment. From February to April, the labor market shed 22 million workers. At the time, the vast majority of those workers (78%) were deemed on temporary leave; there has since been some transition, with a rising number of permanent layoffs. Companies are discovering that in a new normal post-COVID environment, they may not need as many workers as they had previously. The majority of these layoffs have been due to a collapse in their businesses, e.g., airlines, theme parks, and restaurants; however, some have been the result of productivity improvements (companies have been forced to upgrade systems). Through September, a little more than half of those lost jobs have now been recovered, which is extremely encouraging; however, more work needs to be done, and the easy gains have largely been made (see chart, Figure 2).

Figure 2
Nonfarm Payrolls Total
(EOP; SA; Thous.)



Source: Strategas

A continuation of the recovery will also depend on whether Congress is able to pass an extension to the CARES Act. The consensus among economists is that a failure to pass new legislation here would raise the unemployment rate by 0.8% and subtract 1 percentage point from the fourth-quarter GDP growth (currently anticipated to be 4.9%). There is no question that the CARES Act has played a significant role in supporting the economy during this pandemic, and failure to pass new legislation increases the risk of a much less favorable outcome, with more longer-term scarring on the economy.

Financial markets have nevertheless continued to react positively to the crisis. The S&P 500 increased by 7.0% in August, which was its best August performance in 34 years, and leading the charge yet again were the large-cap technology stocks. The pandemic has only accelerated many trends that were bourgeoning prior to 2020 and have been a tailwind to growth for these technology company sales and earnings. Trends toward the rise of e-commerce, cloud computing, telehealth, digital payments, and other were underway before COVID-19, and this pandemic has accelerated their adoption. With this, we have seen a dramatic performance gap between traditional "value" sectors in the market, such as industrials, financials, energy, and materials, and traditional "growth" sectors in the market, such as healthcare and technology. As the chart (Figure 3) below illustrates, growth has significantly outperformed value in the quarter and the year.

Figure 3

	QTD			YTD		
	Value	Blend	Growth	Value	Blend	Growth
Large	5.6%	8.9%	13.2%	-11.6%	5.6%	24.3%
Mid	6.4%	7.5%	9.4%	-12.8%	-2.3%	13.9%
Small	2.6%	4.9%	7.2%	-21.5%	-8.7%	3.9%

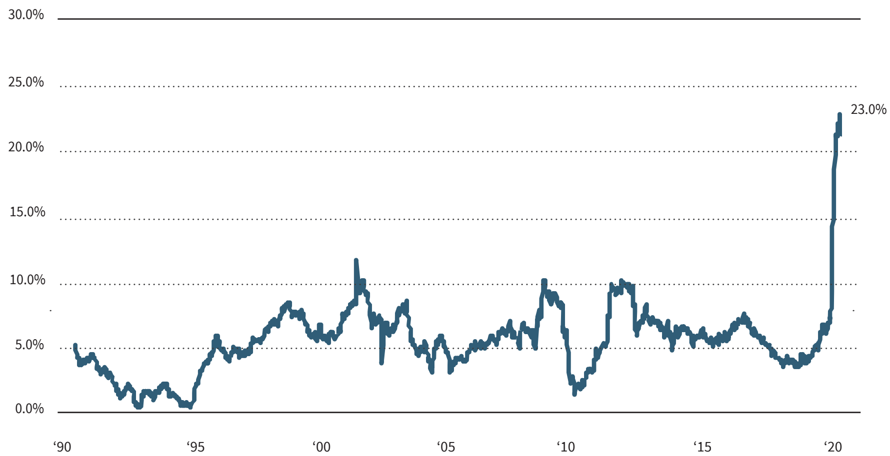
Source: JP Morgan Asset Management

As we closed out the third quarter, the tech rally took a pause in September, enabling some of the more-cyclical sectors, such as materials, utilities, and industrials, time to catch up and thus helping broaden the stock market recovery. This still did not extend to energy stocks, nor did it do anything to prevent the iconic large-cap oil giant Exxon from being ejected off the Dow Jones Industrial Average, a coveted membership it had held since 1928 (then under the banner of Standard Oil)—this must surely be classified as an important marker in our economy's growth history. Only a few years ago, Exxon was the largest company by market capitalization in the world; today, it has dropped to No. 42 in the S&P 500.

High-yield markets also continued to improve during the quarter with spreads tightening, as investors have felt increasingly comfortable taking on risk. The Federal Reserve's actions have helped encourage these investors with the increase of the money supply in our economy (see chart, Figure 4), both through the Fed's purchases of corporate debt and by its guidance toward an extended period of low rates.

This rhetoric was solidified by the shift to an average inflation targeting regime, one where the Fed will tolerate moderate—but sustained—inflation overshoots to better achieve its 2% target rate over time. This more dovish stance from the Fed and the steadfast nature of the ECB's policy stance, in addition to some further unwinding of the flight-to-quality trades that took place at the height of the pandemic, resulted in a sharp depreciation of the dollar (-3.6%) and an appreciation of gold (+5.9%) during the quarter. While we do not believe this to be the start of any kind of challenge to the dollar's reserve currency status, further weakness is a highly desirable outcome for the Fed in helping it maintain easier financial conditions and achieve its mandated targets of 2% inflation and maximum employment.

Figure 4
U.S. Federal Reserve M2 Money Supply
(SA,Y/Y Pct. Chg.)



Source: Strategas

As Election Day nears, investors have increasingly started to price in higher expected volatility. These expectations have been driven by the tightness of the polls, the diametrically opposed nature of the two candidates, and the probability of a contested election. While presidential elections do not tend to be overly meaningful for the stock market over the longer term, in the very near term they cause volatility. And while neither candidate is being viewed as a disaster for the markets, a clean sweep for the Democrats is being seen as the least favorable outcome by market participants, given their platform of higher taxes and increased spending.

As we look forward to the remainder of the year, two crucial questions the market will be looking to answer is 1) the possibility of a "second wave" or acceleration of COVID-19 cases and deaths and 2) the results of the November 3 election, both the presidential and Senate races. We are certainly monitoring these closely for their impact on the economy and markets.

As always, we look forward to our reviews and conversations with you as we move into the end of a historic year. Thank you again for your trust and confidence.

Warm regards,

The William Blair Custom High-Net-Worth Team

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