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INVESTMENT REVIEW AND OUTLOOK

Expect the Unexpected

In an eventful year, the third quarter provided additional unexpected developments from the economy, the stock market and COVID-19. To the surprise of many observers, the U.S. and global economies grew at a higher-than-expected rate. Consumer spending, home sales, industrial production and employment all surprised to the upside during the quarter. Following a steep decline in economic growth during the second quarter, real U.S. GDP is forecast to rebound at an annualized rate of 24% during the third quarter according to a survey of economists by the *Wall Street Journal.* The economic rebound was underpinned by pent up demand from consumers and businesses, as well as record levels of fiscal and monetary stimulus.

The stock market, as measured by the S&P 500, posted a total return of 8.9% during the quarter. Combined with the second quarter return of 20.5%, the market staged its best 6-month performance since 2009. Reflecting the improving tone of the economy, the stock market was led by the consumer discretionary and industrial sectors. Growth stocks continued to outpace value stocks and the S&P growth index returned 11.8% vs. a gain of 4.8% for the S&P value index. Although the overall currently depressed level of earnings does not justify stock market valuations, much of the stock market performance is being driven by sectors, such as consumer discretionary, that are enjoying a strong earnings recovery. In addition, the broad technology sector, including social media companies such as Alphabet, reported a fairly shallow earnings decline and is projecting renewed earnings growth for the second half of the year.

COVID-19 provided a further surprise over the summer and early fall as many regions of the world experienced a substantial increase in new COVID cases. This development was amplified by the news in early October that President Trump and several members of his administration had contracted the virus. The rise in cases, although serious, was mitigated by several factors. While hospitalizations rose over the summer months, cases were generally less severe; and, according to the Center for Disease Control, by the end of September total COVID-related hospitalizations were 50% below the peak reached in April. The economic impact of the rise in cases was also muted because, in most geographies, "lockdown" measures were not re-imposed. Indeed, mobility data gathered by Apple and other vendors, indicated a steady increase in activity throughout the quarter.

Only Slightly Disconnected

We have recently received questions from clients and friends about whether the stock market has become disconnected from the real economy. How can it be that the stock market is reaching new highs while the economy is experiencing the steepest contraction in decades? The answer to the question contains several parts:

- While the economic contraction during the first and second quarters was severe, it was short-lived. Many companies that we follow reported a stabilization and sequential improvement in their businesses in mid-April. In addition, as we have written about previously, the economy and capital markets have been supported by record levels of monetary and fiscal stimulus since mid-March of this year.

- Interest rates remain at historically low levels. The current level of interest rates reflects the aggressive monetary easing by global central banks; it is also a reflection of the reduced demand for credit in developed economies, especially in Europe. The level of interest rates impacts the valuation of the stock market as a discounting mechanism. Interest rates also determine the "risk free" rate an investor can earn, therefore impacting allocation decisions. As of early October, the 10-year U.S. Treasury bond had a yield of 0.78% compared to a dividend yield of 1.85% for the S&P 500.

- Inflation remains well anchored in part due to a decline in energy prices as well as improved housing affordability. For the 12 months ended August 2020, the Consumer Price Index gained 1.3%.

- The composition of the stock market has changed considerably over the last decade. Today, "growth" sectors of the economy, such as health care, technology and communication services, constitute over 50% of the market's capitalization. The higher earnings growth rate for these sectors has made an important contribution to the stock market's recovery since March.

Given the low interest rate environment, ongoing rebound in economic activity and the changing composition of the stock market, the recent strength in equities begins to make more sense. Nevertheless, there are reasons for caution. Over the summer and early fall there were several signs of increased stock market speculation and these included: a large increase in retail investor participation via Robinhood and other low-cost online trading platforms. Similarly, there has been an increase in call option purchase activity (a leveraged wager on higher stock prices) by individual investors. This activity has been accompanied by a record resurgence in initial public offerings in the U.S. and this development is yet another signal that we are pretty far along in the stock market "cycle."

Straw Hats

An old Wall Street adage counsels, "buy straw hats in winter." Over the course of history, buying high quality businesses when they are out of favor has often produced attractive financial returns. One well known example of this practice is Warren Buffet's purchase of American Express stock in the early 1960s amidst an accounting fraud at the company known as "the salad oil scandal," whereby the company incurred losses due to misstated collateral. The losses to American Express were significant, but they were one-time in nature and not recurring. Over the next five decades the company's business grew manifold and today Berkshire Hathaway is the largest shareholder of American Express having earned a total return of over 1,500%.

In today's environment, the practice of buying "straw hats" itself has fallen out of favor with investors. To illustrate the point, since the start of 2019 the S&P Index of value stocks has *declined* 11.5% while the S&P Index of growth stocks has gained over 20%. The spread of over 30% between these two indices is at its widest level in decades. To be sure, there are numerous reasons for the value sector of the market to be out of favor. In the current economic setting, the growth segment of the market has superior earnings growth relative to the more mature and cyclical/value sector. Many of the companies that populate the value index are in industries of declining importance such as energy or brick and mortar retailing. The financial sector, which comprises over 18% of the broad value indices, has been challenged by the low level of interest rates. However, there are signs that the shift in favor of growth stocks may be running its course. From a fundamental perspective, the earnings of economically sensitive sectors, such as industrials and materials, are poised to rebound with the strengthening economy. Similarly, the financial sector should benefit from improved economic activity both in the form of new loan growth and lower loan losses. The valuation argument for the value sector of the stock market is a strong one. Many stocks of high-quality companies in these sectors are trading at reasonable multiples of earnings and have dividend yields of 2-3%. In the case of the financial sector, some of the highest quality names are trading at a discount to book value with dividend yields of over 3%.

We have been gradually adding some of these less favored "straw hats" to client portfolios in sectors such as industrials, materials and, in certain instances, financials during the third quarter. As always, we emphasize financial strength and above-average profitability in making our selections. While the innovation sectors of the economy (technology, health care and communications) continue to form an important foundation for client portfolios, we feel the time is right to seek opportunity outside of the "favored few" stocks that have driven much of the stock market performance this year.

The coming months will be eventful and also filled with uncertainty. The course of the global pandemic, the outcome of U.S. elections and durability of the economic recovery are just some of the questions facing investors. Although it is impossible to predict the outcome of these events, we have positioned client portfolios to take advantage of a further strengthening of the economy while also maintaining exposure to defensive sectors which should prove resilient in uncertain times.

As always, we welcome your comments and questions.