Investment Newsletter

Third Quarter 2020

The U.S. and international stock markets performed strongly during the quarter, maintaining the recovery of the markets from the late March lows from concerns over the global COVID-19 pandemic. The S&P 500 gained +8.79%, the MSCI All-Country World ex-U.S. Index +6.25%, and the MSCI Emerging Markets Index +9.56%. Investors continued to react positively to the improving global economy as severe lockdown provisions in many countries were lifted and unprecedented levels of fiscal and monetary stimulus were provided around the world. Year to date, the S&P 500 is up +5.13%, the MSCI All-Country World ex-U.S. Index is down -5.44%, and the MSCI Emerging Markets Index is down -1.16%.

The stock market's recovery has been astonishing. In addition to massive monetary and fiscal support and the reopening of country economies, there was continued progress on COVID-19 medical innovation, vastly improved pandemic metrics in the U.S. and Europe, and increased retail investor participation, all of which combined to power the S&P 500 to an all-time high in early September that eclipsed the old all–time high reached in February 2020 by +5.7%. The Information Technology sector (+28.7% YTD) was largely responsible for this new high, as the pandemic spawned the work-from-home and virtual learning environments, which significantly increased demand for tech devices (e.g., laptops, tablets, routers) and services (e.g., e-commerce and cloud) from corporations, schools and consumers.

Fixed Income performance during the quarter was basically flat, with the Bloomberg-Barclays US Intermediate Government/Credit Index up +0.05% (+4.05% year to date) and the Bloomberg-Barclays (1-5 Year) Municipal Bond Index down -0.21% (-0.47% year to date).

This performance reflected the ongoing monetary support from the Federal Reserve, and strong inflows into fixed income funds during a time of great uncertainty. Yields on short and intermediate maturities generally declined in response to the Federal Reserve's commitment to keep interest rates low for the next two to three years. At the same time, yields on longer maturities rose as expectations of future higher inflation began to take hold among investors.

Despite some rising credit concerns and expensive valuations, we expect the investment-grade bond market to remain relatively stable, as the Federal Reserve continues to provide support through direct purchases of U.S. Treasuries and corporate bonds. These purchases should help keep interest rates low for an extended period. The Treasury Department has announced plans for increased Treasury issuance in order to fund the federal budget deficit, which should eventually cause longer rates to rise.

We also expect high-quality municipal bonds to remain stable, although this is likely dependent on whether or not states and municipalities receive additional stimulus funds from the federal government. We are beginning to see credit rating agency downgrades in response to the negative economic impact from COVID-19 shutdowns, but the municipal market has thus far taken these downgrades in stride.

For these reasons, our strategy remains cautious in this low-yield environment. We continue to structure bond portfolios with an emphasis on high-quality, short- and intermediate-maturity bonds.

The stock market's incredible ascent reflects high expectations of future developments – a recovery in corporate earnings and GDP growth in 2021, continued fiscal and monetary support from Congress and the Federal Reserve, and positive COVID-19 antibody drug and vaccine data into year-end.

After an estimated -19% decline in S&P 500 earnings growth this year, earnings growth is forecasted to rebound sharply by +26% in 2021 (FactSet) based on easy comparisons, continued government stimulus, and getting closer to ending the COVID-19 pandemic. GDP growth will likely follow a similar trajectory, with forecasted growth of +4.0% in 2021 after an estimated -4.6% decline this year (FactSet).

Monetary support from Congress and the Federal Reserve has been extraordinary, and investors are expecting that to continue for the duration of the COVID-19 pandemic. Administrative and legislative actions have committed an unprecedented $4.7 trillion, of which $2.7 trillion has been spent thus far. Additionally, the Federal Reserve's actions have committed $7.1 trillion, of which $2.3 trillion has been utilized (as of October 5; Committee for a Responsible Federal Budget). Consequently, the federal budget deficit is projected to be -$3.3 trillion this year - more than triple what it was in 2019 - before improving to -$1.8 trillion in 2021 (CBO). Moreover, U.S. federal debt has ballooned to $27 trillion and the U.S. federal debt to GDP ratio is now 137.7%, up from 56.1% in 2000 (Federal Reserve).

Investors also have confidence that positive COVID-19 antibody drug and vaccine data will be released by year-end. Regeneron (REGN), Eli Lilly (LLY) and GlaxoSmithKline (GSK)/Vir Biotechnology (VIR) are all in late-stage clinical trials of their antibody drugs, and Regeneron and Eli Lilly have recently filed for FDA authorization. For vaccines, there are currently 42 candidates in human clinical trials, 10 of which are in late-stage Phase 3 testing (WHO). Of those ten, four are American, four are Chinese, one is Russian and one is British. Two of the American-made vaccines – from Pfizer (PFE) and Moderna (MRNA) – are expected to be first to release their clinical trial data beginning in late November.

Despite these expected positive future developments, a number of risks lie ahead that could produce more uncertainty and volatility - a reacceleration of the pandemic this fall and winter, an elevated valuation for the S&P 500 (21.4x forward price-to-earnings ratio vs. its 10-year average of 15.5x), the outcome of the U.S. Presidential election, continued strife over racial, wealth and income inequality, and any lingering effects from the pandemic such as structurally higher unemployment.

In terms of the Presidential election, it is interesting to note that from 1933-2019 the average annual performance of the S&P 500 has been nearly identical under either a Republican or a Democrat President with a split-party Congress (+13.4% vs. +13.6%). Within that time line, the worst performance was under a Republican President with a Democrat-controlled Congress (+4.9%), with the 2nd-worst a Democrat President with a Democrat-controlled Congress (+9.3%; Strategas).

No matter who wins the Presidential election, or how long the pandemic lasts, our investment strategy will remain constant. Our strategy is centered on investing in well-established, reasonably valued companies in growing markets that are aligned with positive long-term secular trends that are growing their free cash flow and dividends; have sustainable and ethical business practices; and that can be owned for a period of 5-10 years - all attributes that can help mitigate short-term volatility while maximizing performance and success over the long term.

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