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QUARTERLY MARKET UPDATE

WEALTH MANAGEMENT by BerganKDV

OCTOBER 2020

MARKET LANDSCAPE

Name	YTD 2020 Return (%)
Barclays US Aggregate Bond	6.8
Barclays US Credit	6.4
S&P 500 TR USD	5.6
Barclays US Corporate High Yield	0.6
MSCI Emerging Markets	-1.2
MSCI EAFE	-7.1
Russell 2000 TR USD	-8.7

Data Source: Morningstar Direct

The Standard and Poor's (S&P) 500 has registered a year-to-date return of 5.6% ending September 30th. So far, this result compares unfavorably to an S&P 500 average annual return over the last 50 years of 10.9%. However, it is fair to characterize this year as anything but average.

We have experienced the most widespread pandemic in a century, weathered the largest ever second quarter decline in real Gross Domestic Product (GDP) growth, seen the highest unemployment rate since the Great Depression and of course are keeping an eye towards an impending and contentious election.

The economic data over the last month has continued to improve but the breadth of improvement has narrowed. Additionally, the marginal rate of improvement has diminished, though that is to be expected as the initial phase of the recovery comes to an end. The second quarter saw a massive decrease across the data spectrum, while the third quarter can be characterized as an almost commensurate rebound in those figures. This dynamic seen in the macro environment is also present in corporate earnings results and estimates.

Of course, even after an initial acceleration out of a deep recession, from an absolute level, we remain in aggregate below where we began. And with all the monetary (and fiscal) stimulus by the Federal Reserve (Fed) related to Covid-19, there is no question that the Fed balance sheet and overall deficit profile have been impacted.

However, we feel that in some ways we are back to where we started before all the chaos began. Equity valuations are once again in our view, fully valued in relation to earnings expectations. That is not to say that long-term return expectations are pessimistic; it is simply that it has once again become more difficult to find substantial pockets of value paired with quality.

Interest rates remain at extremely low levels. We recognize that the Fed had been on a tightening program over the last four years, but given the still historically low rate stance in addition to the compressed and comparatively flat yield curve, we remain in a yield scarce environment as we have for some time. As such, fixed income currently offers the occasion to provide an equity hedge more than a total return opportunity in line with historical results.

Overall, it appears that investors have weathered the storm with one caveat; concern related to weakening growth prospects, particularly surrounding the uncertainty related to a coronavirus vaccine, has increased downside volatility lately. Additional influences might include the concentration risk in mega-cap stocks, increased diplomatic tension between the U.S. and China, and concern regarding the ongoing effectiveness of the Fed's ultra-accommodative monetary policy.

Sector Returns

S&P 500 Sectors	YTD 2020 Return (%)
Information Technology	28.7
Consumer Discretionary	23.4
Communication Services	8.6
Health Care	5.6
S&P 500	5.5
Consumer Staples	5.0
Materials	4.1
Real Estate	-4.0
Utilities	-5.7
Industrials	-6.8
Financials	-20.2
Energy	-48.1

Data Source: Morningstar Direct

Concentrated Returns

This recession has been the result of global governments making calculated judgements to purposely dampen economic activity. The goal being to diminish the magnitude of the health impacts of coronavirus, hoping to minimize the overall duration and impact of the outbreak.

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Unsurprisingly, this disruption has been detrimental to some sectors and industries, while beneficial to others and therefore catalyzed a wide dispersion of outcomes across the economic spectrum. This is somewhat reflected in the distribution of sector returns (Table 2).

Adding to this dynamic, we are witnessing the continuation and acceleration of outperformance by very few companies which greatly skew the overall results of the market. Over the past few years, the largest tech stocks have generated returns much greater than other constituents of broad equity indexes. As a result, the market can be separated into two categories; one comprised of the largest five companies in the S&P 500: Facebook, Apple, Amazon, Microsoft, and Google (FAAMG), and the rest of other 495 companies in the index. There is no question that FAAMG companies are driving the stock markets.

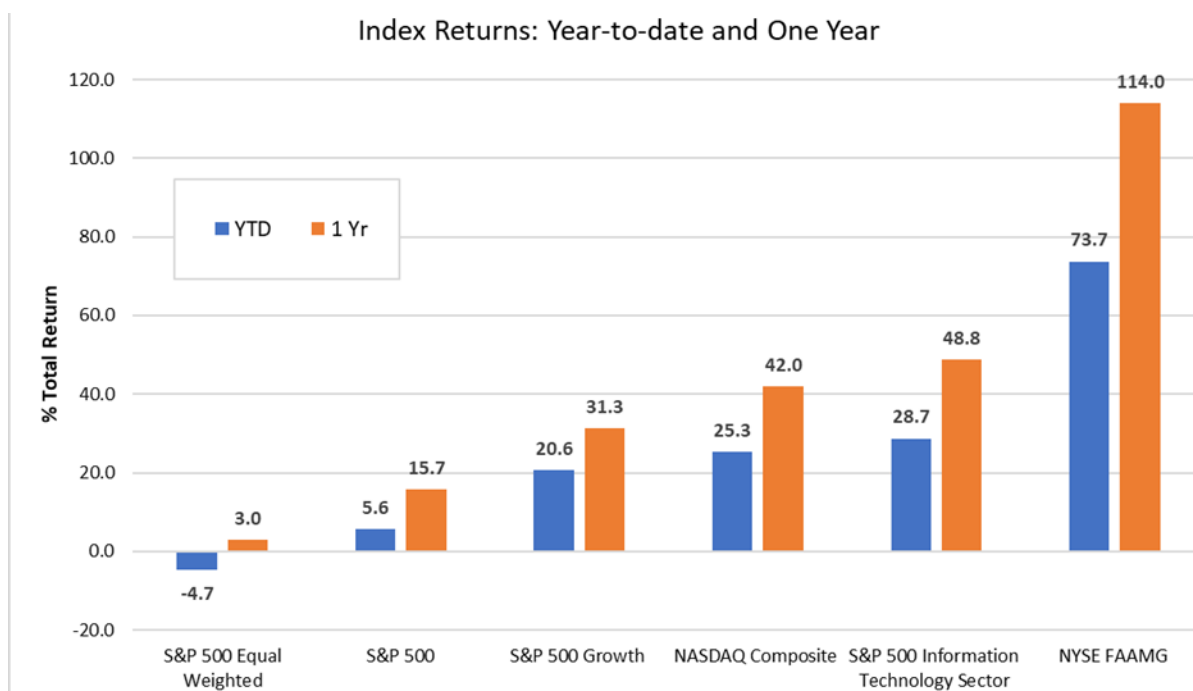
This is because the S&P 500 (and some other popular market indexes) are market-cap weighted. A capitalization-weighted index is a type of market index with individual components that are weighted according to their total market capitalization. The components with a higher market-cap carry a higher weighting percentage in the index. Conversely, the components with smaller market-caps have lower weightings in the index. As a result, the largest publicly traded companies exert the most influence over broad index returns.

Currently, given the size and performance of the FAAMG stocks, this overweight toward these larger companies results in the approximately 25% of the S&P 500 being comprised by just these five stocks. The annualized return of the S&P 500 since the beginning of 2018 through the end of the September is 10.8%. The FAAMG stocks account for an estimated 70% of that performance, meaning the 10.8% annualized return provides a distorted picture of overall market performance.

The S&P 500 equal-weighted index (where each company comprises a 0.2% weight of the index, regardless of market-cap {the weight of the FAAMG stocks is a combined 1%, not 25%}) shows a very different story than the market-cap weighted S&P 500.

Since January 1st, 2018, the S&P 500 equal-weighted index has posted and annualized return of 4.8% vs. the S&P 500 market-cap weighted index which has posted an annualized return of 10.8%. This 6% underperformance of the equal-weighted index pales in comparison to the 2020 year-to-date results, where the equal-weighted index lags the market-cap weighted index by 10.3% (equal-weighted and market-cap weighted posted -4.7% and 5.6%, respectively). See Chart 1.

Chart 1 – Index Returns Supported by FAAMG



Source: Morningstar Direct

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The solid performance of these few companies is on balance supported by various fundamentals dealing with industry dominance, solid cash flows, very healthy balance sheets etc. However, investors should understand the impact these few companies are having on index returns when comparing them to equal-weighted or more broadly diversified portfolios across sector and style. This type of extremely narrow leadership in markets is never perpetual, especially when overly crowded trades and valuations become more conspicuous.

Election

Top of mind for many investors these days is the outcome of the 2020 elections. While of course politics exert some impact in shaping the business operating environment, on a standalone basis (at least as it relates to Presidential races) it has a small effect on the economic trajectory and the direction of capital markets.

As the election approaches and the possibility of a change in party leadership in the Presidential and Congressional races, it's important to note that a Democrat win of the executive and/or legislative branches doesn't presage a market decline or a continued rise for the stock market any more than a Republican win ensures market movements in any one direction.

Bespoke Investment Group has done much analysis on the topic of politics and markets and has concluded the impact of the party elected in the Presidential election is overrated. Their research shows that since World War II, the average return for The Dow Jones Industrial Average under Republican led administrations is around 6%, while under Democrats it is around 7.5%.

Our former colleague David Sparks analyzed research relating to this topic during the last presidential election. He found that when multiple factors are considered in tandem, the presidential party factor loses predictive significance. A study first published in 2012 looked at the effects of, in addition to the party of the President, the following potential influences on market returns:

- The year (1-4) of the Presidential term
- Political harmony or gridlock
- Federal Reserve policy

David's following conclusions from the October 2016 Quarterly Thoughts piece are still relevant in the current election cycle:

Fed Policy - Federal Reserve policy was shown to have exerted important influence on stock market returns. The large-company stock index in this study performed on average 11.7% per year better when Fed policy was Expansive compared to years when it was Restrictive. This result is independent of Presidential party.

[As the study's authors define these terms, Fed policy most recently entered an Expansive period when the Open Market Committee reduced its Fed Funds rate target this year.]

Harmony v Gridlock - The presence (or absence) of political harmony proved meaningful for small-cap stocks and corporate bonds. Harmony means that the same party controls both the Presidency and Congress. The opposite condition is gridlock. Small caps fared relatively better when political harmony prevailed compared to periods of gridlock. Corporate bonds, conversely, did their best during gridlock. These results appeared during both Democrat and Republican administrations. Gridlock has prevailed most recently.

Third Year - Stock market returns were found to have been stronger during the third year of presidential terms, out-performing by 17% on average compared to years 1, 2, and 4, regardless of which party held office. Recall that this study covered years through 2008.The political party of the President was left without much explaining power after taking these other influences into account. Politics and markets influence each other.

These findings are consistent with our view that fundamentals such as corporate earnings, interest rates, and economic growth are the main determinants of the behavior of capital markets. Macroeconomic conditions shape outcomes in both elections and investment returns, while monetary and fiscal policies and political harmony or gridlock resulting from elections in turn shape the economic backdrop. These are interdependent variables.

Investors are naturally interested in the outcome of the U.S. Presidential election because it will set the direction of economic, regulatory and tax policy for the next four years. Yet as the research indicates, which party occupies the White House may have little effect on stock market returns after taking other factors into account. Political harmony and a restrictive monetary policy on the part of the Federal Reserve would likely weigh more heavily on markets.

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There could well be some market volatility soon after the winner of the upcoming U.S. Presidential election becomes known. In that event it may prove useful to look beyond the party of the winner, to weigh the broader economic backdrop of Fed policy and the outlook for political harmony or gridlock in 2020. With earnings potentially on track toward resuming a trend of modest growth, stocks appear to offer long-term upside potential.

Invest Do Not Trade

Most investors are aware of the magnitude of not only the market downturn earlier this year, but also the rapid and drastic fashion the market recovered. Chart 2 offers a nice visual of this dynamic. As we have postulated before, because the nature of the economic disruption was neither cyclical or structural in nature, investors became comfortable overlooking the scale of the damage in favor of the eventual and hopefully rapid and sustainable recovery.

Investors who did nothing during this period were rewarded, providing a contrast between the concepts of investing and trading. The stock market has a history of beneficial "do not trade" periods for investors with a long-term mindset. Over the last 90 years, there have been 29 years that the price return for the S&P 500 has been negative, though there have been only five instances of consecutive down years. Most market downturns are swift and/or temporary.

We recognize periods like those we experienced earlier in the year are highly uncomfortable for investors and the inclination to get out of the way until the pain stops is natural. However, there is no disputing that statistically, investors with the fortitude to do nothing have been rewarded for their patience.

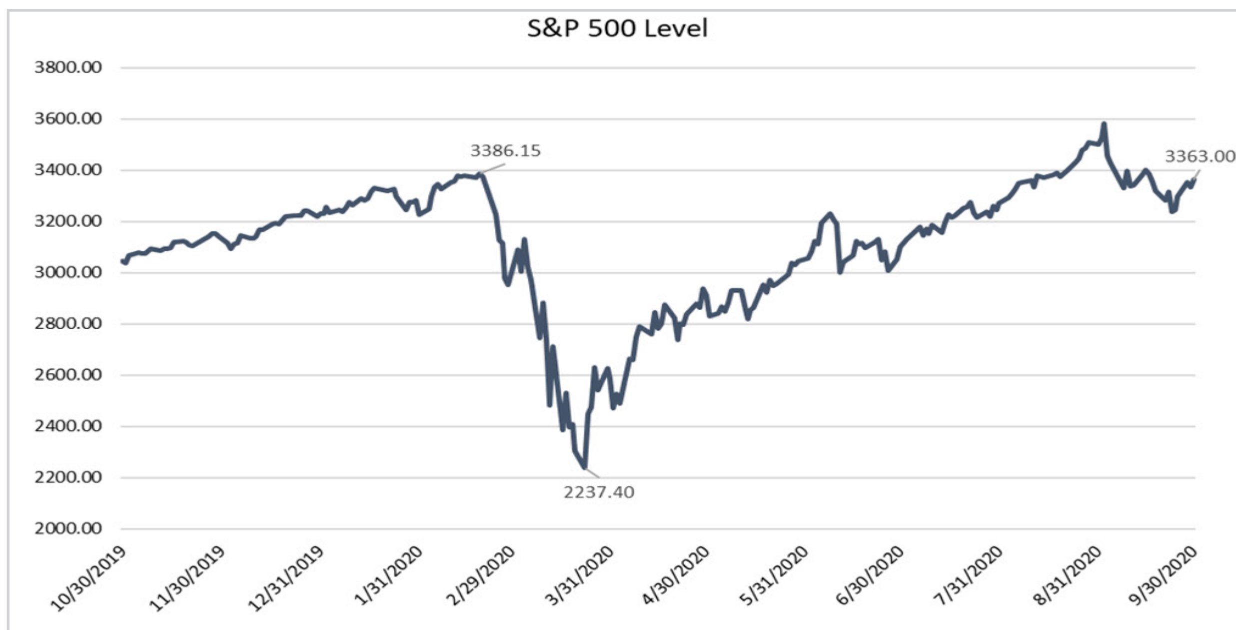
Of course, we appreciate that all investors have individual circumstances relating to time, comfort and ability to endure risk, etc. The ability to maintain purchasing power from accumulated asset base is important for many, especially retired individuals. We acknowledge the differences and importance of investment time horizons and sequence risk as it relates to investment planning.

History has shown that equity markets generate wealth over time, regardless of the nature of occasional shocks. This is logical as the market exists within the context of continual economic expansion over time (again, with occasional disruptions).

Patience is a trademark characteristic of the investor; and history has shown this element is rewarded over time by staying the course during periods of increased volatility - even large market declines.

The next several months could see increased volatility, tempting those with an inclination to attempt to time the peaks and troughs. The volatility could ultimately expose some good long-term investment opportunities, which only reinforces the dichotomy between the principles of long-term investing versus short-term trading and speculation regarding short-term price movements.

Chart 2 – S&P 500 Rebound



Data Source: : Y-Charts

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