EQUITY MARKET UPDATE

As of 9/30/20 | Volume 9, Issue 9 | FFTAM.com

Stocks experienced their first negative month since March. The month was filled with news pertaining to the major issues influencing investors—COVID-19, the upcoming US election, stimulus talks, Brexit, and political tensions with China. Collectively, the headlines did little to assuage fears, so volatility remained high.

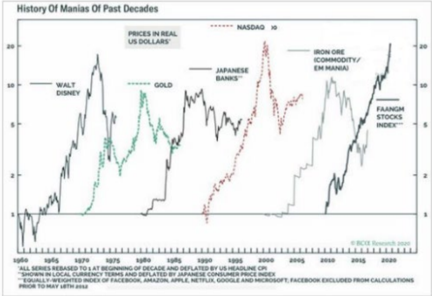
<u>American Stocks Pullback as Investors Take Profits in Growth Stocks</u>

The S&P 500 declined 3.80% in September. This occurred after the index hit an all-time high at the end of August. Year-to-date, the S&P 500 is still up 5.57%, but that return is deceptive due to the narrow leadership within the index.

The Dow Jones Industrial Average fell 2.18% last month. A lower allocation to technology finally benefited the index as investors took profits in growth stocks. Year-to-date, the Dow is still down 0.91%.

The NASDAQ was the worst performing American index in September dropping 5.11%. This is a rarity for the index since investors have gravitated to technology and biotech stocks given the dynamics of the pandemic. The index remains the best performer in 2020 with a total return of 25.40%.

Losses were also seen in mid and small-sized companies with the S&P 400 Mid-Cap Index and the S&P 600 Small-Cap Index declining 3.25% and 4.70%, respectively. With greater exposure to financials and industrials, along with less technology and healthcare, these indexes are more representative of the total US economy than their large cap peers. Small businesses, especially those owned by moms-and-pops, have taken the brunt of the economic pain caused by COVID-19; therefore, these indexes have underperformed year-to-date with returns of -8.62% and -15.26%, respectively.



The returns listed above indicate the American stock market continues to be heavily influenced by a handful of large technology companies. The year-to-date performance in six tech related companies—Apple, Amazon, Microsoft, Facebook, Alphabet, and NVIDIA—accounts for all the gains in the S&P 500 and most of the performance in the NASDAQ. If you exclude these six tech giants, the S&P 500 would be down 3.66% in 2020, while the NASDAQ's total return would drop by two-thirds to 7.99% from 25.40%. As we have written about many times in the past, this is not a new phenomenon. Over the last five years, these six stocks have accounted for almost half of all the gains in the market!

EAFE Dips on Brexit, 2nd Wave of COVID-19 in Europe, and Higher Unemployment

The MSCI EAFE Index fell 2.59% as the European Union launched legal action against the UK over aspects of the withdrawal agreement. Talks appear to be breaking down between the two sides. The UK Prime Minister continues to insist that a final agreement be struck prior to the European Council meeting on October 15th. Disagreements over Brexit are happening at a difficult time for Europe. A second wave of coronavirus could be under way. France and the UK have seen their highest infection rates since the spring. Most of the positive tests are occurring in younger aged people, and hospitalizations are far less than the initial outbreak. The UK tightened restrictions on bars, nightclubs, and restaurants to prevent further spread. Unemployment ticked higher in Europe despite heavy government stimulus. Eurozone Manufacturing PMI rose to 53.7, but most of the growth was seen in Germany because of higher Chinese demand for heavy machinery tools. Year-to-date, EAFE is down 6.69%.

Emerging Markets Outperform as Chinese Economy Recovers

The Chinese economy improved further last month. Manufacturing PMI rose to 51.5, while export orders entered expansionary territory for the first time this year. Service PMI jumped to 55.9, its highest reading since 2013 as Chinese consumers increased spending on hotels, restaurants, and travel due to low COVID-19 infection numbers. Retail sales grew for the first time in 2020, gaining 0.5% on a year-over-year basis.

Meanwhile, the political rivalry between the US and China intensified. Chinese internet company, ByteDance, said Oracle and Wal-Mart would be allowed to own a stake in the popular app, TikTok. Data from American users would be stored on Oracle equipment inside the US, but the Chinese government would not allow the algorithms or artificial intelligence code to be sold. The agreement fell far short of the demands from President Trump. The US government retaliated by imposing restrictions on China's largest semiconductor company SMIC. The Commerce Department said the chips capture American data and can be used for military purposes. Per the order, US companies must obtain individual licenses to do business with SMIC. Finally, the Chinese government issued the framework for its "Unreliable Entities List" that enables the government to deny or confiscate work from foreign companies, along with the ability to levy fines and revoke resident status for employees. They failed to identify any specific foreign companies, but investors took the framework as a warning against American businesses if political relations continue to deteriorate.

Improving economic data mixed with difficult to quantify political tensions caused the MSCI Emerging Market Index to decline 1.62% for the month. The index is slightly negative in 2020 with a total return of -0.96%.

COVID-19 Vaccine Update & Trump Tests Positive

There was a pause in Astra Zeneca's Phase III COVID-19 vaccine trial to review an unexplained illness that developed in one participant. Moderna's CEO said emergency authorization for its vaccine would not be requested until the Phase III data has been analyzed which is expected no earlier than November 25th. The company said widespread availability of its vaccine would not occur until the spring.

Globally, over one million people have died from COVID-19. New infection in the United States remains around 40,000 people per day. Finally, President Trump and First Lady Melania Trump tested positive for the virus. The President was hospitalized for observation.

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<u>Political Jockeying Ahead of Hotly Contested November Election</u>

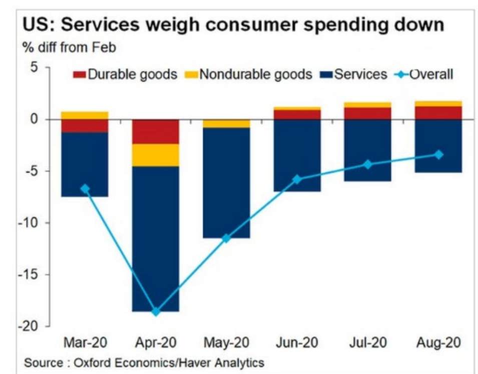
President Trump's positive COVID test adds uncertainty to the final weeks of the campaign since the President will have to miss several scheduled visits to battleground states. Mr. Biden continues to lead in the polls, and it appears most voters did not change their opinion after a contentious debate filled with insults by both candidates.

Supreme Court Justice Ruth Bader Ginsburg died at the age of 87. President Trump nominated Amy Coney Barrett as her replacement. Senate Majority Leader Mitch McConnell said confirmation hearings would begin on October 12th. Democrats don't have much leverage to stop the proceedings, but the market believes this further complicates additional stimulus talks since the election is only one month away.

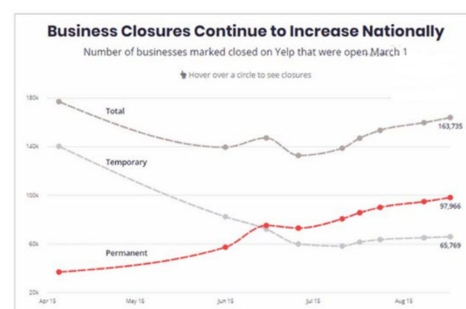
The House of Representatives approved a "slimmed down" $2.2 trillion stimulus package with no Republican votes. The two parties remain far apart on the details of enhanced unemployment and aid to state and local governments, so the bill has almost no chance of passing in the Senate. The vote was mainly done for campaign jockeying because it forces Senate Republicans to reject the House's plan the same week they begin Supreme Court confirmation hearings.

<u>US Economy Shows Signs of Cooling</u>

The labor market continued to cool in September with the US economy creating 661,000 jobs. This was the first time since April that job growth was less than 1 million. The unemployment rate dropped to 7.9%; however, the improvement came mainly from lower participation as many workers became frustrated with their job prospects and stopped looking for work. Thus far, the US economy has replaced 11.4 million of the 22 million jobs lost in March and April. Further improvement from here will be more difficult as state restrictions are being lifted at a slower pace due to COVID-19 infections. We are also seeing a wave of corporate layoffs from Disney, American Airlines, United Airlines, Allstate, Chevron, BP, and Royal Dutch Shell. Of the nearly 12 million people receiving unemployment benefits, 58% have been out of work for at least three months, while 19% have not had a job for 6 months. The longer the virus lingers, economists are worried we could be creating an employment picture that resembles the recession of 2008, which led to the slowest economic recovery since the Great Depression.



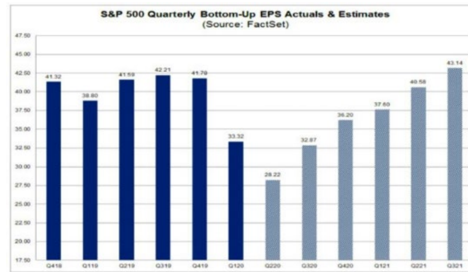
The economic pain from COVID-19 continues to be felt the most in small businesses and firms associated with leisure and hospitality. Yelp reported that nearly 100,000 small businesses have no plan to reopen. As lockdowns force consumers to focus on stuff over services, manufacturing data continues to improve. The ISM Manufacturing Index came in at 55.4, its fourth straight month of expansion. Despite the gains, manufacturing activity is still 7.3% below pre-virus levels, and factories in the US, Europe, and Asia continue to cut jobs as productivity among existing workers has been able to handle the demand. Within manufacturing, consumers are spending heavily on durable goods associated with housing and automobiles.



Source: Yelp

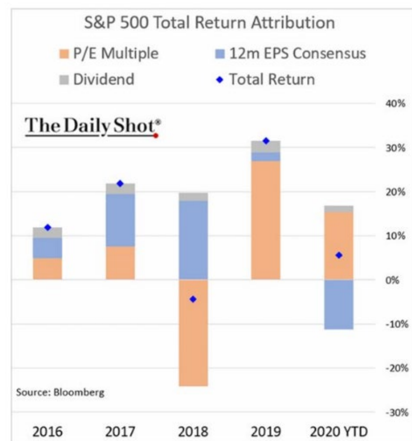
There are signs that consumer spending could be slowing. Personal income fell 2.7% as government stimulus checks and enhanced unemployment ran-out. Spending was still up 1% as consumers tapped savings and credit; however, the growth in consumer spending has decelerated every month since May. Spending on travel, hotels, and restaurants remain the weakest categories. Despite the ominous signs, the Conference Board said consumer confidence surged to its highest level since March.

In response to the economic uncertainty, the Fed voted to keep interest rates unchanged. This followed Fed Chairman Powell's comments in August that the central bank is unlikely to raise interest rates until the end of 2023 at the earliest. When looking at the dot plots, the median Fed governor believes rates will not rise until sometime early in 2025. This is part of the Fed's new strategy called "inflation targeting" which promises to keep rates low until inflation is above the Fed's 2% target for an extended period.



Valuation Remains Elevated as Earnings Season Begins

Companies are about to start reporting 3rd quarter results. According to FactSet, S&P 500 blended earnings per share is expected to fall 22.2% on a year-over-year basis. If this comes to fruition, it would be better than the 31.6% decline we saw last quarter. Over the last several weeks, 43 of 65 companies issuing earnings guidance have given profit ranges above the Wall Street consensus. This has caused analysts to raise numbers in anticipation of further profit beats.



The mixture of rising stock prices and declining profits has caused the valuation on stocks to balloon. Currently, the S&P 500 trades at 21.32x estimated earnings for the next 12 months. That is well ahead of the historical average of 15.73x, and it exceeds the 19.08x we saw at the highs in February. It is not unusual for the PE ratio to expand during a recession as price leads earnings; therefore, analysts are encouraging investors to look ahead to the 2021 estimated PE ratio of 19.87x. Given the uncertainties surrounding the virus and the timing for a vaccine, it is a stretch to rely on estimated earnings 15 months into the future, in our opinion. It is also important to remember that analysts are projecting record earnings by the end of 2021, which would be the fastest recovery in profits from a previous cycle peak in history.

Our Outlook and Strategy

With global supply chains suffering both a supply and demand shock from COVID-19, the economy is trying to emerge from a sharp recession. Opinions vary on the duration of time and the magnitude in which the economy can heal. This makes the market very sensitive to news about daily infections, hospitalizations, and clinical trials on a possible vaccine. We believe political polls will take on heightened importance as the Presidential election nears.

We believe the effects of COVID-19 will linger well beyond the time in which the virus is contained; therefore, the new "normal" will look much different than the world we saw prior to the virus. First, we have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, etc. We have also adapted to a non-centralized workforce. This will put pressure on commercial real estate values as office footprints and the number of retailers shrink. Next, companies across a wide range of industries have seen the risks associated with having too much manufacturing capacity centralized in China. There are likely to be serious conversations in board rooms across the US and Europe on whether several regional points of manufacturing are better for business and political relations than supplying the entire globe with products from a single country of origin. A shift from the current model will have significant ramifications for the future growth of the Chinese economy, along with the cost of goods and services sold. With the world fully dependent on scientists to create therapeutics and a vaccine for COVID-19, we believe future healthcare spending will increase as we replenish healthcare supplies used during the pandemic and boost R&D to solve other illnesses. Finally, these structural changes, along with the large stimulus responses from global central banks and governments will result in 0% interest rates for a very long period. The high levels of indebtedness also make future tax increases likely.

As we described above, the pandemic and the Fed's response to the crisis have greatly benefitted technology-related companies. This has resulted in wide differences in valuation between growth and value investment styles. If you assume a vaccine gets approved and the economy recovers in 2021 and 2022, the spread in PE valuation between technology and cyclical sectors, like industrials and financials, is the widest in history. This sets the stage for a massive rotation and heightened volatility. In some cases, the shift could be dramatic given the high levels of operating leverage in many businesses that have yet to participate in the rally.

Given these various scenarios, we remain highly selective about which stocks to own. We favor companies benefitting from the long-term secular trends mentioned previously, along with a mixture of financially strong cyclical and defensive stocks that can produce top-line revenue growth and sustainable cash flows.