Q3 2020 Commentary

October 15, 2020

"The ultimate rulers of our democracy are not a President and senators and congressmen and government officials, but the voters of this country."
– Franklin Roosevelt

The third quarter of 2020 delivered solid returns across the board for broad-based global asset classes. On a YTD basis, U.S. stock returns have been positive and foreign stocks remain negative. Unprecedented U.S. monetary and fiscal stimulus, a strong dollar, and significant technology weightings within U.S. indices have driven U.S. outperformance. Bonds remain ahead of most risk-based assets for the YTD period due to the freefall in rates that occurred with the onset of the pandemic. There continues to be a large performance gap between many leaders and laggards, with growth and value stocks providing among the best examples. YTD returns for U.S. growth stocks (+23%) have outperformed returns for U.S. value stocks (-12%) by 35 percentage points, representing near extreme levels in that relationship.

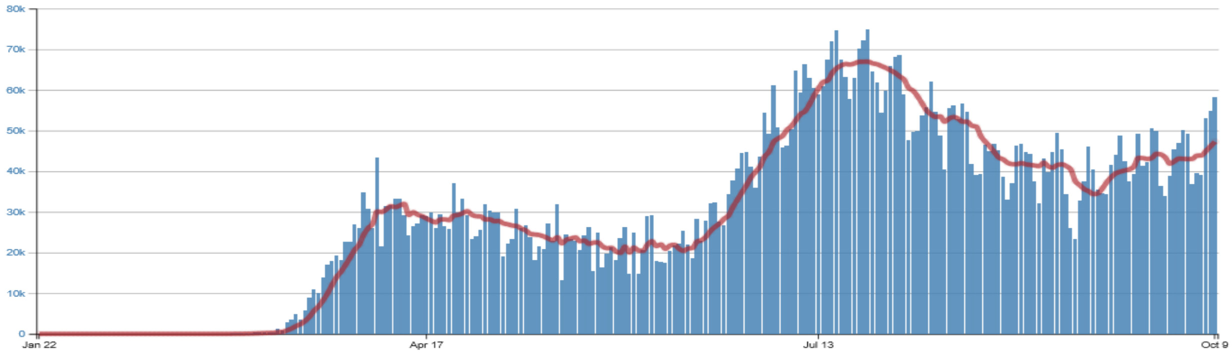
Global Asset Class Returns, 3rd Quarter and YTD 2020

	STOCKS				BONDS	
	U.S.	Developed ex-US	Emerging Market	Global Real Estate	U.S. Bonds	Global Bonds
Q3	9.21%	5.64%	9.79%	2.37%	0.62%	0.73%
YTD	5.41%	-6.70%	-1.29%	-19.23%	6.79%	4.65%

Source: Dimensional Fund Advisors as of 9/30/20. US Stock Market (Russell 3000 Index), Developed ex US Stocks (MSCI World ex-USA IMI [net div.]), Emerging Markets (MSCI Emerging Markets IMI [net div.]), Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

COVID-19 case trends remain a key driver of markets and the economy. In the U.S., the number of daily new cases peaked at almost 75K in mid-July. The trend improved significantly through August, but began to increase in early September, coinciding with the back-to-school season. Recent new cases are approaching 60K per day, approximately twice the level experienced earlier in the year. The silver lining— higher recent case counts have not been associated with significantly higher mortality rates. This positive trend is attributed to better treatment protocols and a higher concentration of cases in younger individuals. We continue to watch COVID-19 data closely given its impact on investor sentiment, consumer mobility, and the broader economic recovery.

COVID-19: U.S. Daily New Cases (Blue Bars) and 7-DayMoving Average (Red Line)

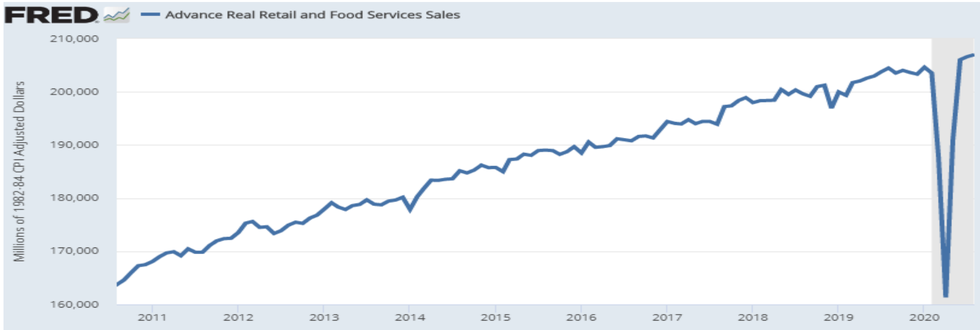


Source: U.S. Centers for Disease Control; October 11, 2020.

The U.S. economy continued to recover during the third quarter, helping drive the rally in stocks. Monetary and fiscal policy support combined with the gradual reopening of the service sector led to a rebound in consumption and labor. Retail sales, which represent approximately half of consumer spending and one-third of U.S. GDP, fully recovered to pre-COVID dollar levels by June. Much of this rebound was supported by the CARES Act, with government payments largely offsetting declines in income due to job loss.

Strength among underlying retail sectors has varied substantially. Spending increases for categories helped by the pandemic have offset spending decreases for categories hurt by social distancing, remote work, and reduced travel. The strongest sectors include internet-based retail, home improvement, sporting goods, and grocery. In contrast, the weakest areas have been restaurants, clothing, and gas stations. Labor market improvements and high personal savings rates have allowed consumers to continue to marginally increase spending in recent months despite the expiration of many CARES Act provisions.

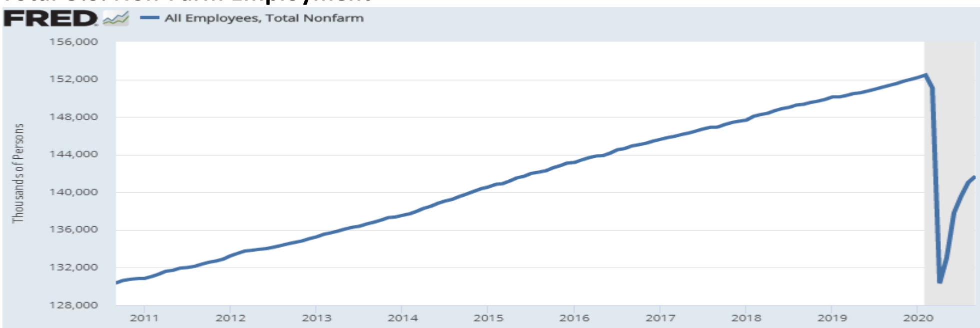
U.S. Retail Sales



Source: Federal Reserve Economic Data, October 2020; millions of CPI-adjusted dollars

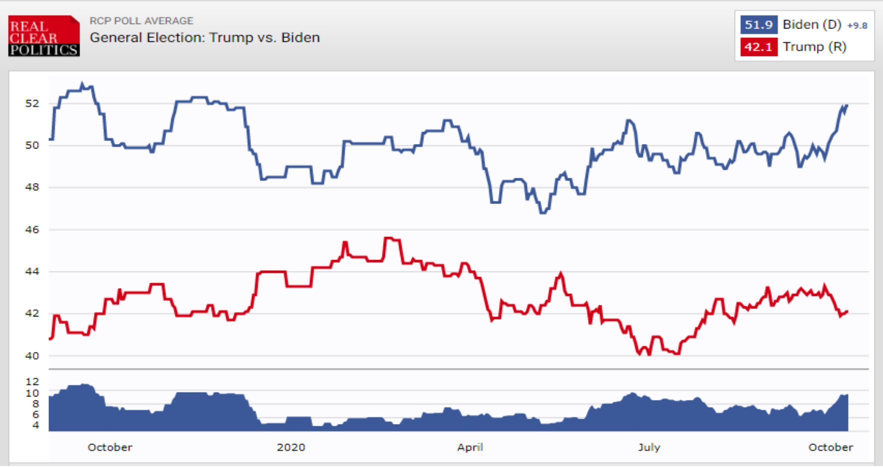
Employment remains key to the economic recovery given its close ties to consumer sentiment, consumer spending, and corporate earnings. There were approximately 152 million people on U.S. payrolls in February prior to the onset of the pandemic. By April, that number had fallen to 130 million, representing a loss of 22 million jobs. Fast forward to September and the jobs report showed almost 142 million persons employed. Roughly 10 million more jobs are needed to reach pre-COVID levels. During this same period the U-3 unemployment rate has gone from a low of 3.5% to a high of 14.7%, and now stands at 7.9%. Future jobs gains may be harder to come by without more fiscal support. However, Congress remains in a legislative stalemate over stimulus despite bipartisan support.

Total U.S. Non-Farm Employment



Source: Federal Reserve Economic Data, October 2020; thousands of persons

The U.S. Presidential election is less than three weeks away. Biden has consistently led Trump in national polls over the past year and that lead has widened to almost 10 points in recent weeks. In the Senate, the Democrats hold only a slight lead in the polls with no significant majority expected regardless of the outcome. The House of Representatives is expected to maintain its Democratic-party majority.

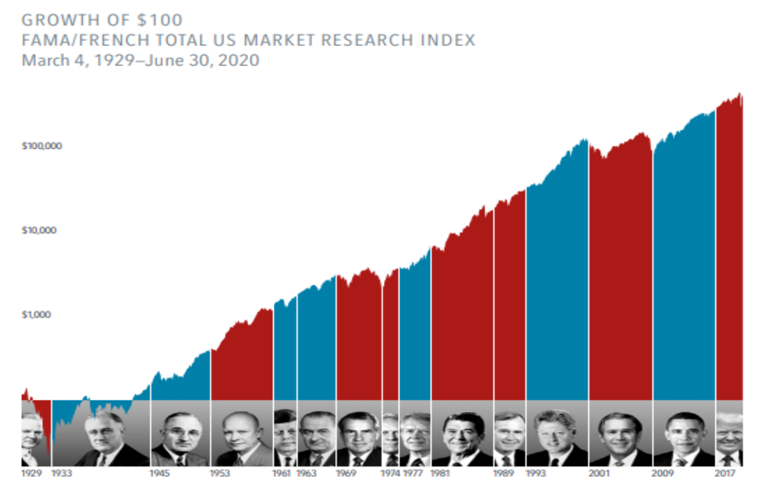


Source: Real Clear Politics, October 11 national poll aggregate

Investors continue to evaluate the policy implications for the Presidential and Senate races. Potential changes to the tax code are among the biggest issues on the ballot. Biden has proposed raising taxes on individuals making over $400K, increasing the corporate tax rate from 21% to 28%, cutting the estate tax exemption in half, and eliminating the step-up in basis for inherited assets.

Keep in mind that even if the Democrats sweep the elections, campaign proposals will be subject to debate and revision. There may also be a real hesitation for either party to raise taxes during a time when the economy is still recovering and the pandemic remains a threat.

Considering historic market trends, investors may be wise to refrain from making long term investment decisions based on who may be President. The U.S. stock market has performed well under both Democrat and Republican administrations for nearly 100 years. We anticipate the path forward from the 2020 election to likely be no different.



Source: Dimensional Fund Advisors

The S&P 500 ended the third quarter 50% above the March 2020 lows. How durable is the market recovery and what do we expect going forward? Looking past the election, many risks remain. While most economists don't expect the absolute level of GDP to reach pre-pandemic levels for a year or more, they do expect GDP growth to turn positive in Q3. Combined with recent improvements in employment and other indicators, it's possible that the recession that started in February 2020 may already be behind us. As a reminder, the National Bureau of Economic Research marks the start and end of recessions based on the following definition:

> ***A recession is a significant decline in economic activity that is spread across the economy, and normally visible in production, employment, and other indicators. A recession begins when the economy reaches a peak of economic activity, and ends when the economy reaches its trough. Between trough and peak, the economy is in an expansion.***

The Conference Board Base Case Economic Outlook

	2020				2021	
	I Q*	II Q*	III Q	IV Q	first half	second half
Real GDP	-5.0	-31.7	32.9	1.3	1.8	6.4

Source: The Conference Board October 2020, percentage change seasonally adjusted annual rates; *= actual data.

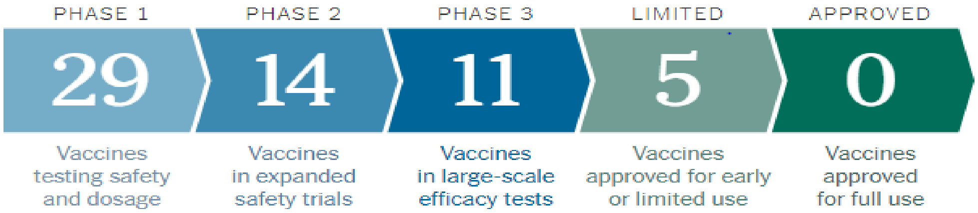
A return to economic growth should flow through to corporate earnings and generally be positive for markets going forward. After dramatic cuts to earnings estimates earlier this year, the earnings picture appears to be stabilizing. In Q2 2020, earnings results came in well ahead of lowered estimates, beating the consensus by a greater margin than any quarter coming out of the 2008 financial crisis. For Q3 2020, analysts increased earnings estimates during the quarter. This represents the first increase during a quarter in two years and only the fourth such increase in the past 10 years. On a dollar basis, earnings for the S&P 500 are estimated to recover to pre-COVID levels late next year.

The relationship between stock prices and earnings is something we continue to watch closely. The forward PE multiple of the S&P 500 at the end of the third quarter stood at 21.5. This compares to the 25-year average of 16.5 and the dot-com era peak of 27.2. Notably, interest rates today are at historically low levels, especially compared to early 2000 when the 10-year treasury yielded over 6%. Lower interest rates make cash flows more valuable and allow for higher asset prices, all else equal. Despite the benefit of low rates, stock prices will likely need greater support from earnings to move materially higher from here. Any significant increase in rates could also prove to be a headwind for stocks based on current valuations.

Key market drivers we will be looking for in the coming months include a second round of fiscal stimulus, continued jobs gains, consumer spending growth, an acceleration in corporate earnings, positive COVID-19 trends, and clinical progress on a vaccine.

Vaccine development progress heading into winter presents somewhat of a wildcard for markets. There are currently 11 candidates in late stage human trials, raising the probability of at least one successful drug eventually emerging from Phase 3 clinical trials. The FDA has committed to fast-tracking the approval timeline, but has said that a COVID-19 vaccine would have to protect at least 50% of those vaccinated to clear the efficay hurdle. In addition, questions remain as to when large-scale production and distribution for a vaccine would occur, what protocols may exist relative to who receives the vaccine, and how many people will ultimately volunteer for vaccination, all of which create potential for continued market volatility.

COVID-19 Development Progress



Source: New York Times as of October 12, 2020.

Although uncertainty remains high, there may be light at the end of the tunnel. We are grateful to the scientists, researchers, and public health officials who have worked tirelessly throughout the pandemic and are hopeful their efforts will ultimatley result in a safe and effective vaccine.

Sincerely,
The Private Capital Management Team