Market Review

Third Quarter 2020

The third quarter of 2020 came to a close with US equity indices continuing to deliver positive returns. While returns were generally favorable for the quarter, the market's positive momentum reversed course in September, as the majority of US equity indices saw modest declines. For the quarter, large-cap stocks outperformed small-cap stocks and growth outperformed value. The S&P 500® Index returned 8.9% for the quarter, while Russell 2000® Index returned 4.9%. The outperformance of growth over value was greatest among large-cap stocks as the Russell 1000® Growth Index returned 13.2% compared to 5.6% for the Russell 1000® Value Index. Among small-cap stocks, the Russell 2000® Growth Index was up 7.2%, while the Russell 2000® Value Index rose 2.6% in comparison.

During the third quarter, many of the macro indicators inflected higher. The manufacturing PMIs continued to sit above critical thresholds and unemployment levels migrated lower from the peak numbers hit this spring (Chart 1). These trends are not only supportive of an economic recovery, but also indicate that a corporate profit rebound should be underway as well. While growth will remain challenged in 2020, the sequential improvements in earnings will likely translate into a more constructive backdrop in 2021 (Chart 2).

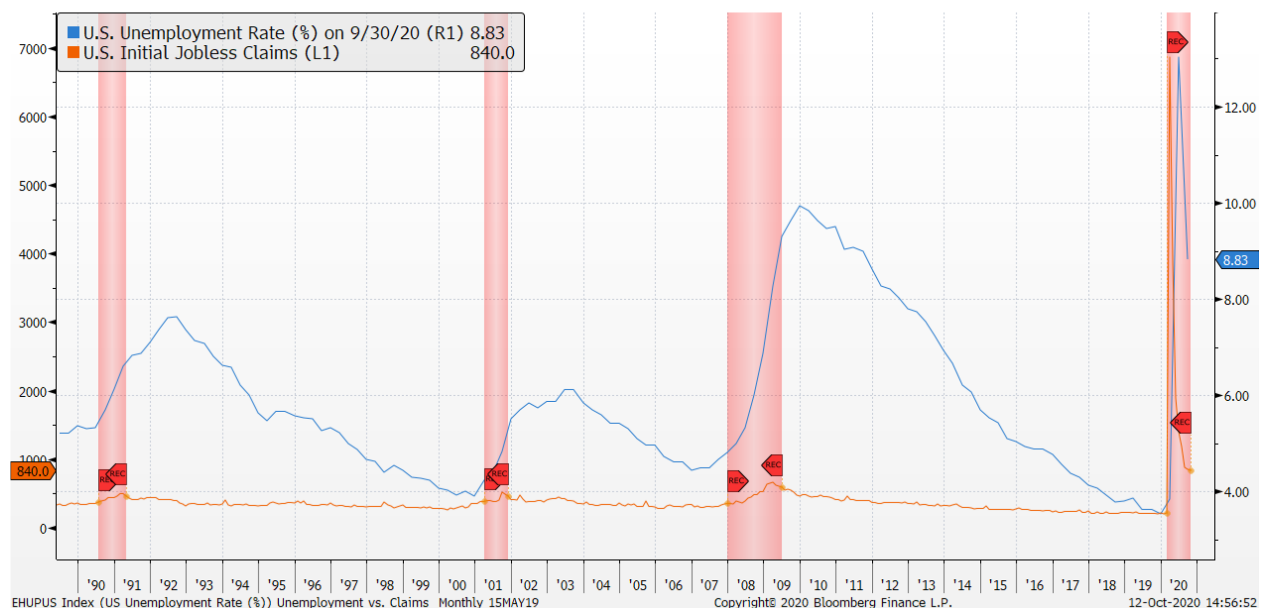

Chart 1: U.S. Unemployment Rate and Initial Jobless Claims

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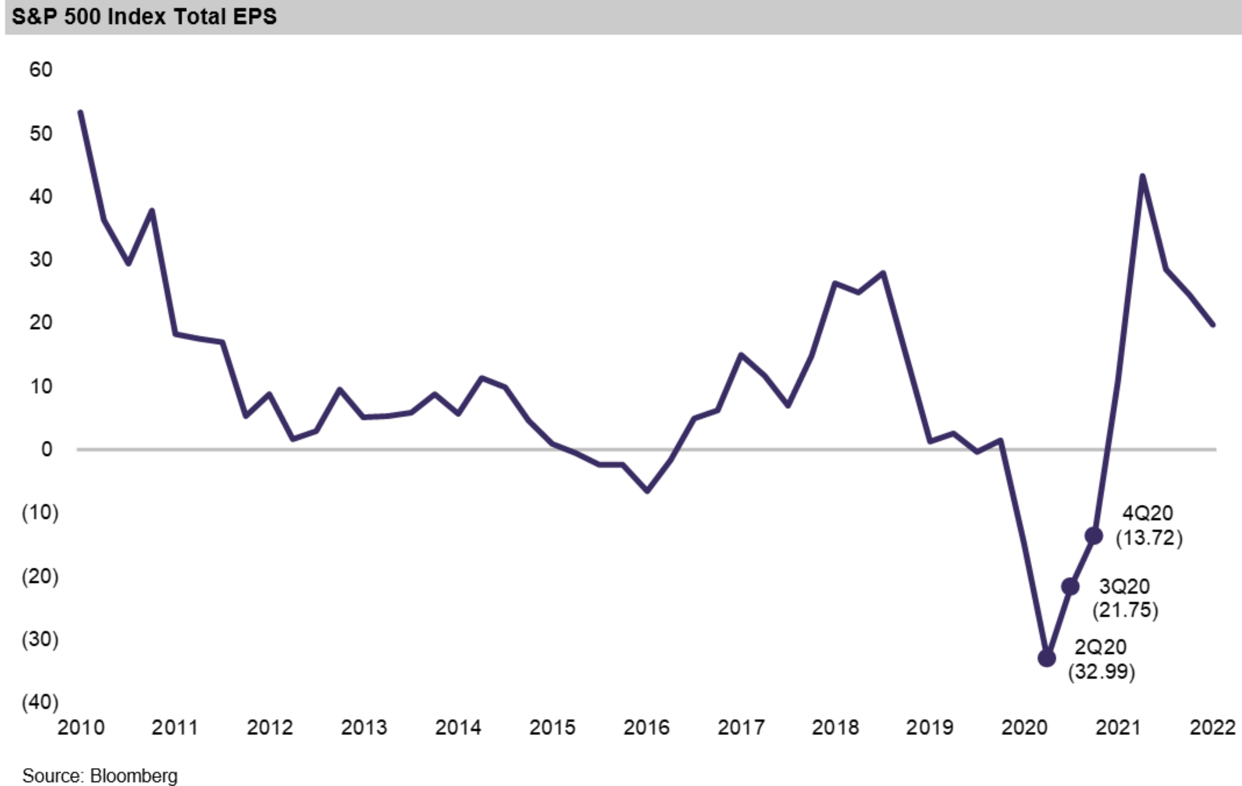

Chart 2: S&P 500 Earnings

While it is still early days in the economy's recovery from the Pandemic, there are many reasons to remain optimistic as we head into 2021. Though volatile, COVID cases are generally trending down, especially in geographies requiring mask wearing and social distancing precautions. Importantly, hospitals are now better equipped to manage the virus, which is reducing both hospitalization and death rates around the world. No doubt, controlling the virus is an important part of sustaining the economic recovery. Additionally, our Central Bank and Federal government have pushed large amounts of capital and liquidity into our economy and financial systems. This liquidity is assisting individuals and businesses during COVID and supporting asset prices. There are also massive stimulus moves, both fiscal and monetary, happening around the globe, which are a positive for growth. The Fed and ECB balance sheets were up 64% year-over-year in the beginning of October to illustrate just how significant the stimulus continues to be.

While the pieces appear to be in place to support the rebound in economic growth and corporate earnings, risks remain. COVID trends can be unpredictable, and we have seen selective increases in cases globally as economies try to reopen. The timing of a vaccine is still not certain even though our Healthcare industry set expectations for Spring 2021. Many of our major cities are still seeing the negative effects from mass dislocations in light of the pandemic. The residual effects on municipalities and local businesses are still largely unknown. The unprecedented level of stimulus means that our national debt is hitting new highs and will at some point need to be

paid back. Lastly, the country is approaching another controversial election, which adds a great deal of policy uncertainty. While it is still too early to call, however, it is largely believed that a potential democratic sweep could mean even larger fiscal stimulus.

In terms of equity markets, it has been a tricky environment for many active managers. Factor volatility has increased, and the market is experiencing intra-week swings between a preference for growth, value and deep cyclicals. With the green shoots of recovery in sight, an orientation towards companies that will experience the most positive year-over-year earnings going forward is potentially underway. This is one of the many reasons to believe that we could experience a shift in market leadership. Over the past few years, the market has been driven by narrow leadership dominated by technology (growth) stocks. Within the S&P 500, the big five tech stocks currently represent 23% of the index. Such dominance surpasses even the nifty fifty days. For small-cap stocks, there has also been extreme levels of outperformance coming from growth industries such as Software, leading to unprecedented valuation metrics (Chart 3).

Chart 3: *Software and Service Returns Versus Russell 2000 Index*

While we are not top-down investors, we believe there is an opportunity to see a rotation to companies that are levered to economic growth. Many will also look for signs of inflation or, in the case of Financials, a steepening yield curve, to become more constructive on these neglected segments of the market. Within sectors like Industrials and Consumer, there are opportunities to find attractively valued companies with sustainable business models and earnings upside in 2020.

That said, today's technological innovation is hard to ignore and supports the case for growth stocks. COVID has led to a transformation of the hypercloud. The on-line migration has accelerated as businesses adapt to a new reality. Digital payments are rapidly becoming

dominant at the expense of cash payments. This migration to the cloud and online payments has made cyber security more critical than ever. As such, these tailwinds are not going away, arguing for ownership of technology stocks. In these segments of the market, identifying companies with competitive advantages and large untapped addressable markets will be the keys to justifying rich valuation multiples.

The equity market has experienced what feels like unprecedented extremes. Value stocks are trading at decade-low valuation discounts to growth stocks. Small cap stocks have meaningfully underperformed large cap stocks. Interest rates sit at generational lows, skewing the equity risk premium. As investors, we remain steadfast in continuing to look for stocks that are attractively valued relative to their current and future cash flow generation. In addition, we are also staying especially mindful of long-term business-model sustainability and growth potential as companies adapt to a COVID and post-COVID world.

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