Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

SEPTEMBER 30, 2020

Equity Market Summary

U.S. Equity Markets	3Q	YTD	Top/Bottom Sectors	3Q	YTD
S&P 500	8.9%	5.6%	Technology	12.0%	28.7%
Russell 1000 Growth	13.2%	24.3%	Consumer Discretionary	15.1%	23.4%
Russell 1000 Value	5.6%	-11.6%	Communica-tion Services	8.9%	8.6%
Russell 2000	4.9%	-8.7%	Real Estate	1.9%	-6.8%
Russell 2000 Growth	7.2%	3.9%	Financials	4.5%	-20.2%
Russell 2000 Value	2.5%	-21.6%	Energy	-19.7%	-48.1%

Non-US Equity Markets (in USD)	3Q	YTD	Non-US Regions (in USD)	3Q	YTD
MSCI AC World Ex U.S.	6.3%	-5.4%	Developed Americas	6.6%	-5.7%
MSCI EAFE (Developed)	4.8%	-7.1%	Developed Asia	5.1%	-4.2%
MSCI Emerging Markets	9.6%	-1.2%	Developed Europe	4.7%	-8.1%
MSCI China	10.9%	15.0%	Emerging Americas	-2.5%	-36.5%
MSCI France	3.4%	-12.6%	Emerging Asia	11.2%	7.5%
MSCI Brazil	-4.3%	-41.3%	Emerging EMEA	1.0%	-19.6%

What's changed since our last report (on Aug. 31, 2020):

Coronavirus (CV-19) continues to spread and the global rate of infection is doubling every nine weeks. Total cases grew by 30% in September, down from 43% in August and 70% in July and June. Total deaths crossed 1 million on Sep. 27, but the rate of doubling continues to slow to once every 13 weeks down from 11.6 weeks at the end of August. In the U.S., total cases are 7.4 million and doubling once every ten weeks down from eight weeks a month ago. In 30 states Reproduction Rates (R_0) are over 1, up slightly from a month ago. The odds of an early 2021 vaccine option continue to rise. There are currently 11 vaccines in Phase 3 Clinical Trials and a total of 43 vaccines in some stage of clinical trials on humans.

Where are we now:

CV-19: Most case and death metrics have improved globally and in the U.S. over the past month. There are now more than 33 million cases and 1 million deaths (18% M/M rise) worldwide. Daily new cases are averaging 285,000 over the past week, up by approximately 35,000 from a month ago. Daily new deaths are averaging 5,300 over the past week, down slightly over the past month but well below the peak of 7,000 in mid-April. Daily new cases (7-day moving average) in the U.S. has not fallen below 40,000 for ten consecutive days since the third week of June. While daily new cases in the U.S. are holding relatively steady, hospitalizations decreased by approximately 16% from 35,400 to 29,500 over the past month. Daily testing in the U.S. increased by 30% over the past month to 1 million tests per day.

Market Review:

The quarter included a steady climb of 15% to new highs for the S&P 500 index, followed by a near -10% correction in September. Of the July-August rise, 41% was attributable to six stocks - Apple, Amazon, Microsoft, Facebook, Alphabet, and NVidia. Those same stocks accounted for 42% of the decline in September. At a sector level, just three sectors (Information Technology, Consumer Discretionary and Communication Services) accounted for 66% of the rise and 63% of the decline. Growth stocks were the clear winner in the July/August rally, while Value stocks held up better in the September swoon. While a few beaten-down industries like transports and utilities did catch a bit of a bid, the growth to value performance shift was more about a reversal to the downside in the big growth names than strength in the value names.

Many fundamental investors wondered how the market could continue to rise in July and August as valuations looked increasingly stretched. The easy answer is to blame it on momentum traders that do not care about the fundamentals of a company. But looking at the data may also provide some insight. It may seem counterintuitive to point to data when unemployment is still in the range of previous recession peaks, company earnings are still falling on a year-over-year basis, and many companies are still bleeding red ink. But a key nuance is how the data are changing. One example of a change that was a likely driver of the market upswing is the change in earnings outlook. A way of measuring that change is a diffusion index, which is the ratio of positive to negative earnings revisions. In April, at the beginning of the rally, this ratio had reached trough levels only exceeded by the deepest reading in the 2008 during the Global Financial Crisis. But by mid-August it had swung to an extreme positive reading, only exceeded twice in data going back 25 years. A flood of negative earnings outlook changes had been replaced by a gusher of positive ones. That led to a bottoming of expectations in July and they have been on the rise since. Consensus for S&P 500 earnings in 2020 is now 5% higher than in July, and 2021 earnings are currently expected to recover all the way back to 2019 levels. Investors are now looking through what may turn out to be a shallower earnings recession than originally feared to a quicker recovery than imagined. The improvement of that trajectory was a key driver during the quarter.

(Continued on page 2)

For additional information on **Smith Group** and our investment strategies and capabilities, please visit www.smithasset.com. The website contains information you may find useful regarding Smith Group including research articles, our economic and financial market outlook and detailed information on our team and investment capabilities.

(Continued from page 1)

The first half of 2020 saw the steepest global recession in recorded economic history, including the two world wars and the depression of the 1930s. The good news is that the third quarter looks positive. Virus cases have picked up again in the U.S. and Europe, but have remained mostly controlled in Asia. The difference in the ratio of deaths-to-population between Asian countries versus the U.S. and Europe is striking. But the economy appears to be moving on a recovery path despite second and third waves. Daily headlines stress how important a vaccine is for a recovery. For some segments of the economy, like air travel or restaurants, that is paramount. Yet many businesses are learning to live with the virus and getting back to work. The Citi Economic Surprise index reversed itself and swung to an all-time high in August as economic reports showed that businesses were far more resilient than expected. Residential real estate is discovering a renaissance as sales have rocketed to 2006 levels. Despite their lockdown challenges, small business sentiment is back up to long-term norms and corporate CEOs have a much-improved outlook relative to last quarter. Orders for new capital equipment have risen to levels close to the best seen since the 2008 recession. The point is not that the economy is great. There are still lots of things that can go wrong, but some segments are getting better, and that improvement tends to support stock prices.

The September stock market correction has been alternately blamed on the lack of a new stimulus bill, anxiety about a contested election result, investigations into the big tech platforms, over-valuations, momentum investors, etc. All of these factors probably played a role. Of equal importance was that the upside catalysts previously mentioned began to wane. Earnings season trailed off and there was no longer the wealth of positive surprises hitting the tape. Economists adjusted their outlooks, so data releases were not quite as big of a positive surprise. In other words, the market just ran out of fuel to feed the rally. That vacuum of information was filled with the worries of the day, prompting stock prices to take a rest from an exhausting climb.

Market Outlook:

Earnings are expected to rebound sharply in 2021 with S&P 500 index consensus expecting about 30% growth and a full recovery past 2019 levels. However, uncertainty about those projections remains high. The dispersion of analyst estimates is smaller than the April peak, but is still about 70% higher than normal. An examination of the earnings decline may add some perspective to the recovery. About 75% of the decline in earnings was directly related to the pandemic shutdown (energy, travel, and bank loan losses). A pandemic solution is critical to recovery for some of these businesses. That could take the form of a vaccine, herd immunity, or enhanced ways of living with the virus. But some of the 2021 earnings recovery is simply a removal of the red ink weighing on 2020 earnings. Banks have reserved considerable amounts for loan losses. Unless the recession deepens, that is unlikely to repeat. It is even possible that some of those reserves may be reversed. Energy earnings were firmly in the red for a couple of quarters, but prices have recovered to the point where the majors are profitable. It is unlikely they will regain peak levels anytime soon, but the sector has only been a nominal contributor to the aggregate earnings story for some time anyway. If they can at least not be a detractor that will be a boost. Travel related companies are probably the most dependent on a virus solution. In 2020 their losses are going to be a drag on earnings, but assuming they can stem the losses their impact on earnings expectations is a small fraction. For instance, in 2021 expected pre-tax profits for the four largest U.S. airlines are a mere $2.3 billion compared to $223 billion for the four largest Information Technology and Communication Services growth companies (Apple, Microsoft, Alphabet, and Facebook). Those growth companies are expected to contribute 100 times more to the aggregate than the airlines. Even in good times, airline profits were less than 1/10th the size of these powerhouses. Given the ongoing issues, we still think consensus growth of 30% next year looks optimistic. Nevertheless, we can also see how, if the negatives weighing on earnings in 2020 can be minimized, that will unmask the power of the stronger industries into the aggregate earnings stream.

No forward-looking discussion is complete without an examination of the valuation part of the equation. But that is at least two separate conversations. One being those companies that have growth and the other those that need a cyclical rebound to regain growth. Those of us that remember the fallout of the dot.com and the nifty fifty eras are reminded of discussions about how the old valuation metrics do not work anymore. It makes us a bit nervous with some of the current conversation. Those were periods where valuations did not matter until they did matter. But those periods extended over several years and valuations for some of the largest growth stocks of the day peaked at higher levels than today's darlings. Today, valuation models also are having to incorporate interest rates below 1% and negative real rates, which look poised to stay there for years to come. The only other time that was the case was in the Great Depression. When you discount the future stream of growing earnings at these low levels, you can come up with some crazy looking target prices. While many ratios currently look inflated, we admit there is at least a justifiable argument from traditional discount models at these discount rates. Turning to the cyclical side, it is useful to remember that valuations for this type of company always look the dearest at the bottom of the trough. That is because investors are anticipating the recovery. If we are indeed close to the lowest level of earnings for these recovery stocks, then it is more appropriate to begin looking through the fog toward clearer skies with the trick being accuracy about the speed, character, and scope of the recovery. Because of the unusual nature of the recession, the winners and losers in a recovery may look a bit different this time so extra care is needed in stock selection. Justifying current multiples seems like a lot of work right now and that is generally not a good sign. But the unpredictability of recession drivers and the extreme measures applied make the range of outcomes quite wide. We cannot wholeheartedly get behind these high valuations, nor would we be naysayers predicting a washout. There is just too much of the chapter yet to be written, and we may be in a period where valuations are distorted by low interest rates and uneven growth prospects.

The uncertainty and negative sentiment created by a contentious election season could be a headwind for both the market and the economy. This also has the knock-on effect of making it more difficult for Democrats, Republicans, and the President to agree on another stimulus bill, which they all agree is needed. Add to that a rushed

(Continued on page 3)

(Continued from page 2)

Supreme Court justice nomination process, and the next month is bound to have some significant shifts in sentiment. Of course, the potential for another wave of virus infections also could weigh on the outlook. Yet a second shutdown like the last is not likely. Doctors have learned more about treatment, capacity issues have lessened, and some research is now pointing to a full shutdown being too blunt of a reaction. After all, some of the Asian countries have demonstrated that an effective testing and tracking regime goes a long way toward controlling outbreaks. We still have concerns about the long-term effects of an economic cold war with China and the threat of regulation for some of today's growth engines, but we do not think they will derail the current recovery. No doubt about it, there is danger in this volatile environment.

There are also tailwinds, one of which is the sheer amount of cash that could be allocated to equities. Money growth has been exceptional as the Fed injected massive liquidity. Global monetary authorities have greatly inflated balance sheets. Money market fund assets currently hold $800 billion more than pre-pandemic levels, a 21% increase. Currently those liquid assets pay 0.1-0.2%, so some of it is bound to make its way into the market and/or business investment. Pension plans have return assumptions in the high single digits, but with interest rates poised to stay low indefinitely and cash flow issues in commercial real estate, opportunities for returns to meet those obligations are few and far between. Higher equity allocations are back in the conversation. Mergers & acquisitions are also beginning to gain some steam, and if companies deem the worst to be over, buybacks could resume. Economic policy uncertainty as measured by the National Bureau of Economic Research is easing, which tends to be a support for equity markets. Coming out of the 2009 recession it took two quarters for analysts to readjust 2009 earnings expectations higher and 2010 upward revisions lasted more than a year. If that pattern repeats, it could very well be a driver of stock prices.

But will the economy be strong enough to support earnings growth? Expectations for 3Q U.S. GDP growth have steadily risen during the quarter. The Atlanta Fed Tracker is now anticipating Q/Q annualized growth of 32%, up from about 12% at the beginning of the quarter. The average expectation from a WSJ survey of economists pegs that growth rate at around 24%, but the range of estimates is quite large. The main issue is not the exact percentage but rather what growth is sustainable in the following quarters and how long before economies will "normalize". Consensus expectations for 2021 GDP growth are currently around 4%, or a recovery almost back to year-end 2019 levels. Slack employment numbers continue to be a problem if the safety net is not continued. No income means reduced consumption. But the state of the jobs market is more complex than a simple unemployment rate. No question that metric is too high. But drilling down in the surprisingly positive consumer confidence survey, we found that more respondents said jobs were plentiful than those that said they were hard to find. Looking further, we find that the ratio of job openings reported by the Bureau of Labor Statistics to official unemployed workers of about 0.40 is not that far off the 0.55 long-term average. We are also reminded that in an expanding economy, idle labor is a resource that can be put to work with no net cost to the economic aggregate. Take that against a backdrop of rising business investment, which is historically correlated with hiring, and you can see how positive momentum can build on itself. It would be wrong to ignore the dangers to this recovery and the lasting economic scars in the way the world does business. But it is equally delinquent to dismiss the possibility of continued momentum. At Smith Group, we have been a "V" shaped recovery skeptic, but do have to acknowledge it is a possibility if another shutdown and/or a policy mistake can be avoided.

Economic and market drivers in the current environment are volatile and, at least on the surface, unpredictable. Seemingly full valuations would argue against much more upside to the market, and many risks abound to a nascent recovery. But bull markets are built from the depths of despair. If some of the momentum we have seen continues, and offsetting losses are eliminated, some of the optimistic earnings predictions could be realized. The recovery will not be even. Manufacturing and technology are recovering. Some industries are thriving. Service industries that involve physical interaction are not, and may struggle for quite some time. Stock selection is important at this juncture. In our experience, when discomfort is at its highest, it is usually a good time to be in the market and complacency is a sure warning sign. Investor discomfort currently is being driven by their focus on what can go wrong. We acknowledge all those risks but also recognize the potential for things to go right. For the foreseeable future the ride is likely to be hilly, yet one worth taking.

[1]: The COVID Tracking Project at The Atlantic