QUALIFIED PLAN ADVISORS

Quarterly Client Update

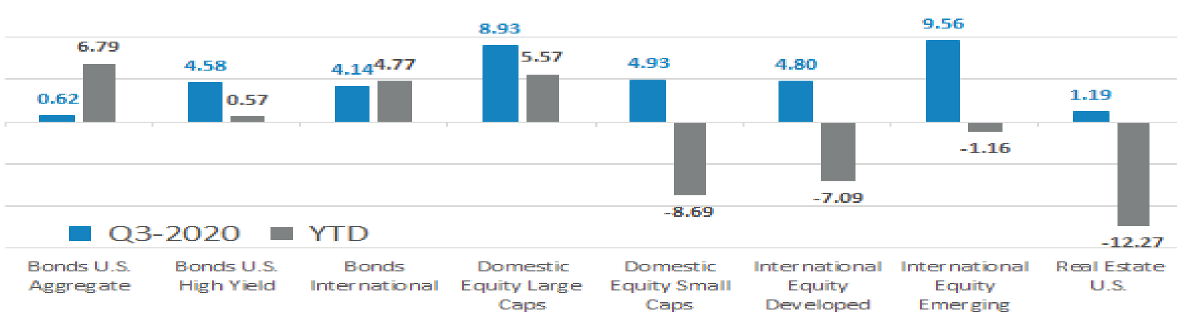
September brought some hiccups, yet the recovery continues…

While the impact of COVID-19 continues to leave its mark on 2020, this year's third quarter witnessed a resilient, albeit moderating, recovery in the capital markets and the economy. Though the markets hit a snag in the month of September with volatility spiking and the S&P 500 nearly hitting correction territory (pullback of 10% or more), they were still able to parlay the momentum from the second quarter, with the S&P 500 delivering the best consecutive quarterly results since 2009.

Looking back over the course of the year, I often comment that 2020 is the longest decade of my career. Never have I witnessed so many remarkable (both bad and good) events occur in such a short period of time. We have experienced a pandemic that shut down the global economy, witnessed the S&P 500 endure its worst quarter since 2008, only to watch it snap back with its best quarter since 1998. COVID-19 has delivered the worst economic crisis since World War II, a bear market, a bull market, negative oil futures, and record amounts of both fiscal and monetary stimulus. Yet, as of September 2, 2020 the S&P 500 again reached record highs. And with election uncertainty, US-China tensions increasing, and the hopes of another massive fiscal stimulus package waning, volatility returned with September delivering the first negative month of performance since March, at-3.80%. This snapped the index's longest monthly winning streak since 2018, and largest five-month percentage gain since 1938. For the quarter, the large cap index produced a solid total return (including dividends) of 8.93%, leaving the S&P 500 up a positive 5.57% for the year. While big tech continued to the steal show, September saw the NASDAQ correct, retracing more than 14% at one point during the month. However, the technology-heavy index still produced a return of 11.02% for quarter ending September 30, bringing the 2020 total return to more than 25%. Both small and mid-sized companies, as measured by the Russell 2000 and S&P MidCap 400, rebounded 4.93% and 4.77%, respectively; both continue to lag their larger capitalized brethren, delivering negative returns for the year of -8.69% and -8.62%, respectively.

As first to shut down, China and South Korea were more effective in their efforts to contain the virus, leading the global reopening charge with solid bounces in production. Led by a recovery in manufacturing, China has already turned in positive second quarter GDP. The coupling of a stronger economic recovery and weakening dollar lead to solid returns for emerging markets in the third quarter of 9.70%, and -0.91% for the year, as measured by the MSCI Emerging Market index. Conversely, already on fragile ground entering 2020 with the Eurozone barely squeezing out positive growth and Japan contracting in the fourth quarter of 2019, the developed nations outside of the US have lagged in the recovery. While foreign developed markets index, the MSCI EAFE Index, delivered a positive third quarter return of 4.88%, the benchmark is still down -6.73% for the year.

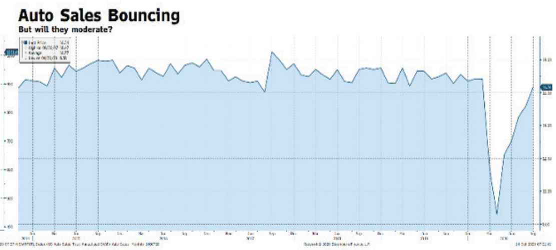
With the Federal Reserve's newly minted policy framework, the Fed communicated that low interest rates and bond purchase programs will likely last for years, pushing the Bloomberg Barclays U.S. Aggregate Bond Index another 0.62% higher in the quarter, bringing the index's 2020 return to 6.79%.

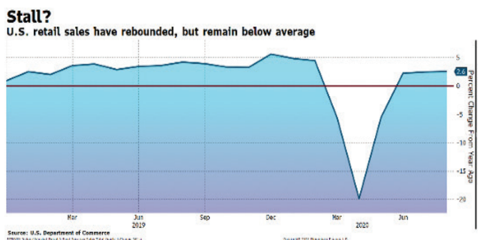


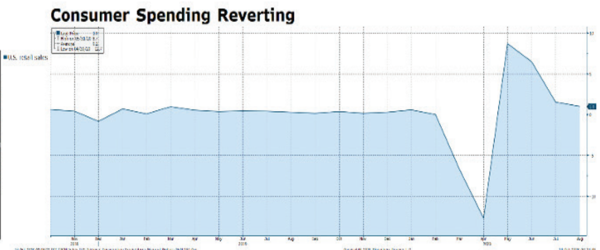
Source: Bloomberg

Policy has put the V in recovery, but momentum is fading

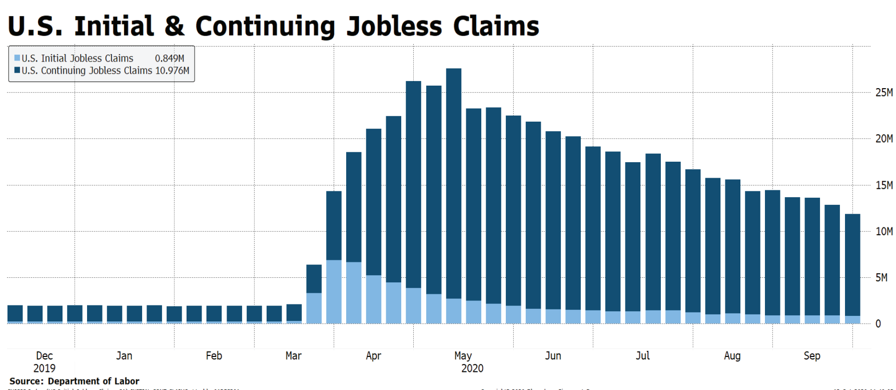
The US economy continues to deal with the fallout from COVID-19, with many service-oriented businesses (restaurants, hospitality, and travel) still struggling drastically from mandated social distancing and occupancy limits. Despite this, significant progress has been made in the third quarter to recover from the second quarter's annualized historic collapse of -31.7%; with the Atlanta's Fed model indicating the third quarter could produce annualized GDP growth rate of +34.6%. A prominent indicator measuring economic activity, the composite Purchasing Managers Index (PMI) has moderated recently, though continued the 'V' shaped recovery since bouncing from its sub-30 April reading, to levels last seen pre-COVID at +54.3. For perspective, a reading above 50 indicates expansion, while a number below 50 indicates contraction. As a result of our nation's largest fiscal and monetary stimulus programs implemented to combat the economic fallout from the coronavirus, consumers took to the street, purchasing homes, cars and other discretionary items to drive spending back towards pre-pandemic levels. Though like the PMI, retail sales and consumer spending has stalled of late, and in fact, on a month over month basis, retail sales actually declined, supporting the Federal Reserve's plea for an additional fiscal stimulus package in order to avoid an economic stall or even another contraction.

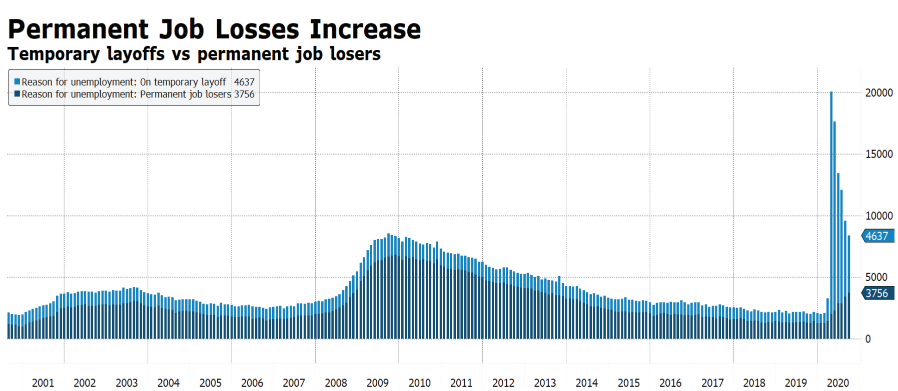






Many consumers continue to suffer from unemployment. April saw the unemployment rate peak at post Great Depression highs of 14.7%, and while the labor market has continued to recover with September's unemployment rate down to 7.9%, the bottom line is that like other areas of the economy, the labor market's recovery has been moderating. Weekly first-time unemployment claims and continuing claims have maintained their downward trend from their April highs, but both have also stalled of late. Unemployment claims, or those filing for unemployment for the first time, finally broke under one million, but remain elevated over the peak witnessed during the 2008 Great Financial Crisis. Perhaps a better guide to employment, continuing claims, or those that are





still filing for unemployment benefits, have retraced from close to 26 million in April to a four-week moving average of approximately 12 million in recent weeks. This trend will be important to monitor, as many of the first wave of job losses were mostly considered temporary, and came from the sectors most impacted by COVID-19, like hospitality, travel, and retail. However, we are continuing to witness the contagion to white collar jobs, where the job losses appear to be more permanent. Also impacting the consumer was the July 31 expiration of the additional $600/week granted to those unemployed through the CARES Act. While a new stimulus package is still being debated by Congress, many expect a continuation of those benefits in some fashion. Clearly, a failure to extend additional aid could also threaten the economic recovery, as approximately 12 million Americans will be faced with increased financial hardship through the loss of benefits, especially with savings for unemployed starting to dwindle. According to Evercore ISI Research, without another stimulus package, those displaced may only have enough savings to last until mid-December; further supporting the need for additional aid.

While fiscal policy may be lacking, the Federal Reserve continues to provide as much accommodative monetary stimulus as possible through the continuation of their new round of open-ended Quantitative Easing (QE4) and keeping rates historically low. As the Fed continues their 'anything it takes' mentality, 2020 has already seen the Fed's balance sheet balloon from approximately $4 trillion to $7 trillion in a matter of months, with no real signs of slowing. Fed Chair Jerome Powell continues to stress the Fed's concern for the nation's rebound, as they believe containing the pandemic will be crucial for recovery, creating "extraordinary" uncertainties and "considerable" risks. Furthermore, Chairman Powell, as well as many other Fed members, continue to clamor for additional fiscal stimulus. Monetary policy tends to have a diminishing return on growth, and the Fed is urging Congress to strike a deal for a new fiscal stimulus package to help the economy weather the storm until a vaccine is developed and the economy can begin to fully open up and forge a sustainable path towards recovery. Perhaps lost in the fray of the pandemic, but nevertheless monumental, is the Fed's September decision to change their policy framework. Rather than implementing policy to achieve 2% inflation, and subsequently tightening to prevent the economy from overheating (see 2018 monetary policy), the Fed has adopted a soft, or flexible, inflation averaging policy, whereby the Fed would hypothetically allow inflation to run above 2% for an undisclosed period of time, with the goal of averaging 2% inflation. Under this framework, should inflation remain suppressed below 2% for long periods of time, when/if inflation rises above 2%, the Fed would allow inflationary pressures for longer periods of time before tightening policy (reducing asset purchases, raising rates, or even engaging on bond sales). This new framework suggests that rates will remain low for longer, which should keep rates on the short end of the curve relatively low. However as the economy recovers and inflation begins to increase, we could witness continued yield curve steepening. A steepening yield curve typically indicates stronger economic expectations; with a steepening curve, also comes rising inflation expectations, and thus higher interest rates. This likely is not an immediate concern in 2020 or even perhaps in the first half of 2021, as the market is still fighting disinflation. As we look to the second half of 2021 and beyond, the massive amounts of stimulus could very well lead to inflationary pressures and higher interest rates, both of which could threaten a meaningful recovery.

So much uncertainty in Washington...

Before the ink could dry on the passage of the CARES Act, many were already anticipating the size and timing of the next fiscal package. It was our belief that Congress would agree to the next round of fiscal stimulus prior to entering the heart of the election campaign and their government's budget expiration on September 30. However, the spending bill was delayed and extended to December 11, and as of the writing of this piece, no fiscal package has come to fruition. Both side of the aisle have made concessions with the Democrats bringing their initial $3 trillion dollar package down to $2.2 trillion, and the Republicans coming up from $1 trillion to $1.6 trillion. The parties are still far apart in terms of amount and directives. While Congress agrees additional stimulus checks should be sent, unemployment benefits should be extended, and state and local governments should receive more funding, the most significant gaps continue to be around the amounts paid for unemployment benefits and support directly given to state and local governments. The odds of a deal are certainly increasing, but the likelihood of a package before the election is diminishing as we approach November 3rd.

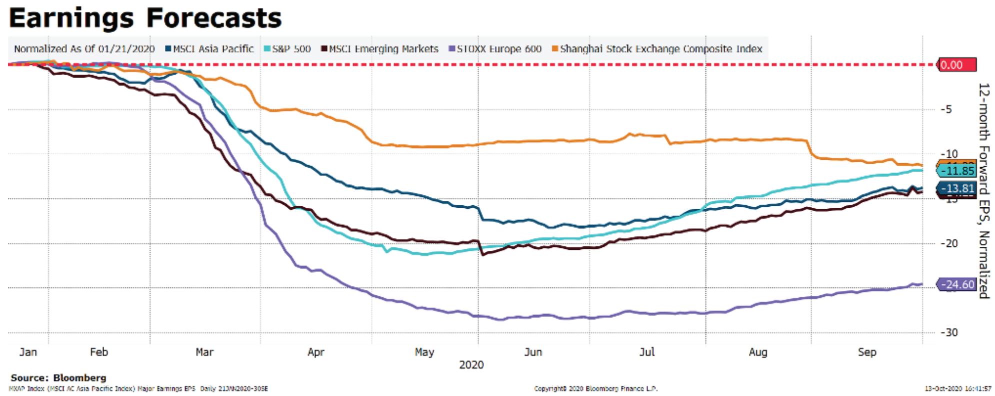
As previously mentioned, the uncertainty surrounding the upcoming election in November was a cause for some of the September volatility. Since COVID-19 and a national shut down took hold, President Trump has been continually criticized for his handling of the pandemic, and according to the current polls, this may have cost him the election. According to RealClearPolitics, as of October 2, 2020, public approval of Trump's handling of COVID-19 was at 42.5% and 56.2% disapproved. Biden's poll leads have widened since the summer and received another bump after the first presidential debate, where COVID-19 took center stage. If history is any indication, the chips are stacked against Trump, as no other incumbent president has ever won re-election when the country was in or on the heels of an economic downturn during the election. If we learned anything from 2016, it is never to count Trump out. Given this recession was caused by a natural disaster, rather than a financial disaster, there is no guarantee that history will repeat itself. Fitting for 2020, this voting cycle will truly be unprecedented. With social distancing mandates, we will witness a record number of votes being cast via mail-in ballot, almost ensuring delayed discovery of the president; we may not know who our nation's next president will be for days, or even weeks after the election. Not-to-mention, as Trump alluded during the first debate, the odds of him challenging the outcome are high. Markets dislike uncertainty, and the odds of a hung election are increasing, which could lead to market volatility in the short-term.

While the presidential election is certainly important, perhaps more intriguing are the races in Congress. Democrats will likely keep the House of Representatives, but the Senate carries far more uncertainty. Republicans currently hold a small advantage, and only a few seats are needed to change the tides; resulting in a Congressional 'Blue Wave' whereby Democrats control the White House, Senate, and House of Representatives. With no party opposition, the White House will be able to push their policies through with relative ease. Biden's tax policies are less favorable to business and the wealthy, as he vows not to increase taxes on those earning less than $400,000 per year, overturning Trump's Tax Cuts and Jobs Act of 2017 by increasing the corporate tax rates to 28% and raising the marginal tax rate on the wealthy back to 39.6%. Meanwhile, capital gains and dividends tax rate could go from a maximum of 23.8% to a maximum of 43.4% for one million-dollar earners. Raising taxes for any president will be met with opposition, so even if a blue sweep occurs, we would expect to see changes over time rather than an overnight shift. Raising taxes while the economy is recovering could lead to derailment, as capital would cost more to raise and deploy, leading to reduction in productivity. But we would also look for a 'Blue Wave' to spend an enormous amount of money, resulting a large infrastructure package to help stimulate the economy further.

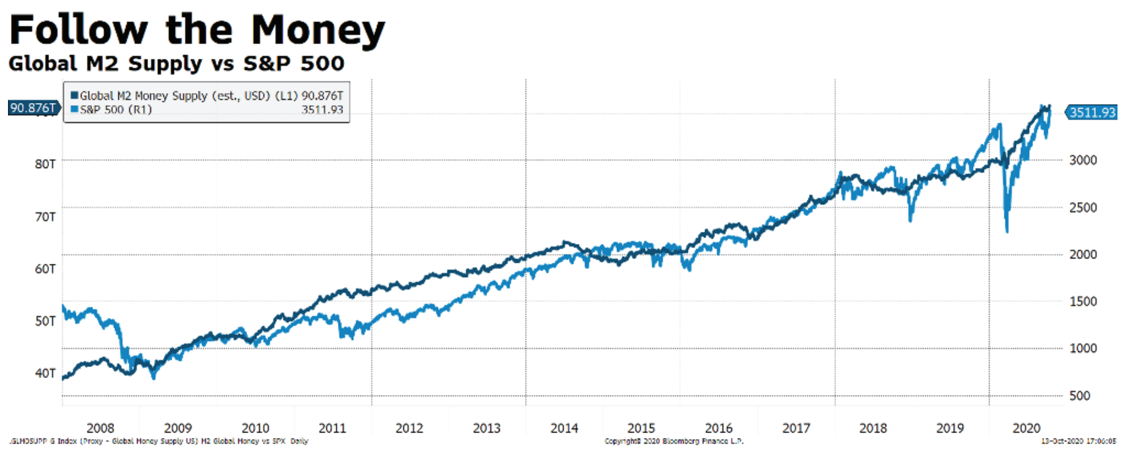
Implications looking forward

The markets and economy have certainly shown resilience in the wake of COVID-19, recovering stronger and quicker than most predicted. As we mentioned earlier, this recession was caused by a natural disaster, not a financial disaster. The economy, while slowing, was healthy entering 2020. Given this, and the unprecedented amount of both monetary and fiscal stimulus poured into the economy since March, we are long-term fundamentally bullish on equity markets. That is not to say we are out of the woods and no longer facing a 'wall of worry' in the short-term. In addition to the ongoing saga and increasing US-China tensions and the resurfacing of Brexit, we are also faced with event risk surrounding the upcoming elections, and the inability of Congress to pass a stimulus package. Perhaps top of mind is the seasonality – we are about to enter our nation's flu season, which is perceived to be highly correlated to COVID-19, potentially leading to Fall COVID-19 resurgence. Significant spikes in new cases, and more importantly fatality numbers, could pose a threat to continued re-opening and even lead to a 'second wave', forcing the economy to shutdown again. Containment of the virus is imperative to a sustainable recovery. As we shared in our second quarter update, we believe this recession is a bookend recession; it was caused by a virus, and as such, should end with a vaccine.

We are entering third quarter earnings season. While second quarter results faired far better than expectations, third quarter forecasts are still expected to decline significantly. Europe is expected to slump by about 25%, a mere 3% better than the region's second quarter forecast. While the forecasts for the United States have rebounded from their June levels of -20%, earnings for our nation's largest companies are still expected to contract at a rate of almost 12%. Many companies have already pulled guidance for 2020 and beyond, so it will be important to monitor how companies are performing as the country continues to come back online, and equally important to key in on management's messaging as they adjust to navigating in this 'new normal'. Banks and financial institutions get us kick-started, and we are extremely interested in their messaging. Given banks are in a unique position of understanding the financial strength and positioning of both consumers and companies, their messaging is often insightful. In the second quarter, many talked about building their loss provisions in anticipation of large future write down, warning that through stimulus and forbearance, the CARES Act only delayed the inevitable, with the worst yet to come. We will be keying in on any changes in tone given the passage of time and recovery.



From a positive perspective, we are entering a historically market-friendly period. As we noted in our September Month in Review, the fourth quarter has also been the best performing calendar quarter, up +3.9% on average, for data going back to 1950. The fourth quarter has also had the highest probability of being a positive quarter, with a 79% historical success rate. Additionally, the low level of interest rates, little inflationary pressure, and the massive amounts of federal stimulus all provide a positive backdrop in support of risk assets like equities. There is a common saying in the investing world, 'Don't fight the Fed'. Looking at the 'Follow the Money' chart, strong correlation can be observed between the change in money supply and the path of equity markets. In an attempt to jumpstart the economy, the Fed grew the M2 money supply by approximately 19% from February 2020 to August 2020, and thus far the market has held up its strong correlation.



With interest rates expected to remain low for longer, we anticipate a relatively neutral or perhaps even negative net real return in coming years on investment grade bonds. Often in low interest rate environments, we witness investors subscribe to the well-known acronym – 'TINA' – There Is No Alternative. In other words, there is no alternative to equities. We've already discussed the favorable long-term backdrop supporting equities, yet given nearly 70% of equities in the S&P 500 have dividend yields greater than the current 10-year US Treasury bond, many investors find themselves weighting equities higher to boost their income production; a decision we caution against. Turning to equities to make up for lost income, or even incorporating more esoteric credit vehicles like bank loans, structured credit (MBS, CMBS, CLOs, etc...), or high yield bonds in an attempt to boost yield often increases the underlying level of risk, leading to unintended consequences. Our focus remains on quality with a commitment to each portfolio's respective risk target. We have found that COVID-19 has magnified balance sheet weaknesses within companies, and believe it will also magnify and reward quality and strength during the recovery.

So, while the longer-term backdrop for equities is rather supportive, in the short-term, we remain cautious. I think I speak for everyone when I say that 2020 has been a unique and trying year thus far. After enduring such conflict, it can be easy to become complacent, but we will continue to stay nimble, maintaining a disciplined and diversified approach in our portfolios with a continued emphasis on quality. Most importantly, we look for opportunities to ensure the portfolios that we manage match the objectives and risk tolerance of the clients we have the privilege to serve. We appreciate your business and ongoing trust, and invite you to reach out to your advisor should you have any questions, or to schedule your next review.

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