Trumbower Financial Advisors, LLC
3rd Quarter 2020
Investment Market Commentary

Two Speed Recovery – Reverse and Overdrive

Analysts and advisors have been asked if US election uncertainty or COVID-19 presents a greater threat to financial markets in Q4. The future course of the Pandemic wins hands down in our survey of responses. Election results will spark reactions regardless of the outcome but barring a stalemate they are likely to be positive in some respects and negative in others. The longer the Virus continues to flourish, however, the greater the likelihood of a prolonged global recession where no-one comes out ahead. The expectation of strong economic recovery once the illness is contained is one of several reasons equity markets have continued to rally in spite of sobering statistics.

Blend US equity indices rose from 4.9% to 8.9% in Q3. Led by China, up over 12%, Emerging Markets posted a gain of 9.6% outpacing Developed Foreign equities - up 4.8%. The S&P 500 recorded its swiftest round trip from record high into bear market territory (down -20%) and back to a new high in 126 days.

As discussed further in our topical essay, Large Cap US Growth was up 11.8% while Value rose 4.8%. YTD the spread is startling. Growth has returned 20.6% but Value is still down -11.5%. Value has recouped losses over the last 12 months but is still in the red compared to an astounding 30% return on Large Cap Growth.

Much has been said about the 5 Tech leaders owning the S&P 500, but other swan songs took investors on wild rides. ~ 60 stocks in the NASDAQ index were up more than 400% in 2020 at their Q3 highs. Most have since receded from their peaks but some still eclipse the Big Five. Concentrated in Tech and Biotech they also include names catering to life-style changes induced by Coronavirus as well as a few of the many IPOs that hit the street this year. Undaunted by quarantines, July was the most active month for new public offerings since 2014. On the flip side, more than 1,000 of the 2,500 NASDAQ constituents were down 50%+.

Mid and Small-Cap US Equities trailed the S&P 500 and remain in the red YTD and over the past 12 months. Only 29% of stocks in both indices delivered positive returns YTD. A handful of supercharged growth companies are also driving smaller cap index returns.

Individual investors, many younger and new to the game, continued to fuel momentum sharing tips on Facebook and other social media platforms and piling into stocks that

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Selected Benchmark and Category Average Total Returns

Large Cap Equity		
Benchmark Indx & Category Average*	**3rd Q 2020**	**12 Mos.**
S&P 500 Index	8.93	15.15
Large Cap Blnd Avg	8.48	11.70
S&P 500 Growth	11.75	30.64
Large Cap Gr Avg	12.02	37.05
S&P 500 Value	4.79	-2.68
Large Cap Val Avg	4.74	-4.83

Mid Cap Equity		
Benchmark Indx & Category Average*	**3rd Q 2020**	**12 Mos.**
S & P 400 Index	4.77	-2.16
Mid Cap Blnd Avg	6.42	-0.14
S&P MC 400 Growth	7.00	8.25
Mid Cap Gr Avg	9.42	24.33
S&P MC 400 Value	2.01	-13.42
Mid Cap Val Avg	4.49	-10.10

Small Cap Equity		
Benchmark Indx & Category Average*	**3rd Q 2020**	**12 Mos.**
Russell 2000	4.93	0.39
Small Cap Blnd Avg	4.07	-7.38
Russell 2000 Growth	7.16	15.71
Small Cap Gr Avg	8.21	19.46
Russell 2000 Value	2.56	-14.88
Small Cap Val Avg	2.44	-15.62

International Equity		
Benchmark Indx & Category Average*	**3rd Q 2020**	**12 Mos.**
MSCI EAFE	4.80	0.49
Intl Equity Avg	5.83	3.63

* **Category average** calculated using *Morningstar Direct* . Fund universe screened to include funds that meet the following criteria:

A. M-Star Category consistent with designated asset class and management style.

B. M-Star Style Box consistent with designated management style.

C. Fund's Objective consistent with asset class.

D. Excludes Index Funds.

We have not independently verified *Morningstar* data.

Managing Portfolios With Style

Value-Style fund performance has notably lagged Growth in recent years. Financial headlines resound with accolades for Amazon, Google, Microsoft and other top Technology companies while Value stocks such as those in Energy and Financial sectors have been shrouded in negative news flashes. But Value is more than a sector play. It is an approach to stock selection with a long storied history beginning with Columbia Business School professor Benjamin Graham in the late 1920s and espoused by the likes of Warren Buffet. Value and Growth managers are buying the same things – earnings and earnings growth. The difference is what they are willing to pay for them. In theory Value investors are bargain hunters looking for essentially sound companies that have been mispriced by the market. They start with fundamental stock pricing models but the process is ultimately a subjective one. Value enterprises tend to exhibit certain attributes - low price to book value, low price to earnings ratio, higher dividend yield – but these features do not guarantee the stock will prove to be a hidden gem.

How then can the entire universe of stocks be relegated into Growth and Value indices? By definition, Value investing doesn't seem like a passive activity. In fact, many stocks find their way into both Style indexes. Movement from one to the other is not uncommon and entire industries have been known to migrate. The manner in which different indexes are constituted can influence perceived investor Style preferences. Since the end of the "Financial Crisis" in 2009 Growth has more or less persistently trounced Value and by increasingly wider margins. In 2019, however, the S&P Value and Growth indices were running neck to neck. Value then tipped the scales in its favor by a 5% premium during the last four months of the year. A sign that the Growth era was finally waning? Nope. S&P rebalances fairly frequently (the Russell annually). Apple's PE was so low at the beginning of 2019 that S&P sent it packing into the Value index where it ultimately garnered a 9.5% stake. The stock soared over 80% through November 30th while squatting in Value city giving superficial followers of the S&P version of the Large Cap index deceptive signals.

In spite of the vagaries of construction and Style characterization, we look to historical index statistics for some perspective. The Russell 1000 Growth index outpaced Value by 8.0%, annualized, over the 10-years ending in August. The disparity is more pronounced over the last 3 and 5 years at 19.7% and 13.1%, annualized. Since 1979 the Russell 1000 Growth has beaten Value in 52% of rolling 5-year periods but only 41% of rolling 10-yr windows. At present, Growth is walloping Value by the largest premium seen in any of our 1, 3, 5 or 10-yr data sets. Does Growth have the steam to sustain its position after racking up such awesome excess returns? Over trailing and forward 3 and 5-years periods, Growth continued to overtake Value 51% and 57% of the time, respectively. However, on a forward basis, Growth has never kept the lead after outperforming during a previous decade. That doesn't mean it can't happen- it just hasn't yet.

What has driven the enormous disparity between the two investment Styles? Rising revenues, earnings and cash flow all foster love for Growth attributes. A near record period of gradual economic expansion has prevailed following the Financial Crisis – until the Virus landed. Unlike the previous tech bubble driven Growth bonanza, free cash flows within Russell 1000 Growth stocks have increased 160% from June 2007 through August 2020, dwarfing Value companies up 33%. Similarly, sales per share escalated up a cumulative 51% for Growth and only 13% for Value. Interest rates have stayed persistently low throughout most of the past ten years. Low interest rates enhance the present value of high long-term growth rates in fundamental stock valuation models. Value stocks tend to shine during periods of strong underlying economic growth, higher inflation and its companion higher interest rates. Value stocks tend to outperform Growth following a market bottom – something we experienced only briefly this Spring. Value and Growth both rebounded robustly but unique circumstances surrounding the Pandemic coupled with dirt cheap capital spurred desire for Growth stocks.

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Portfolio Styling
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Further complicating an evaluation of Styles are market breadth and sector influences. Technology darlings are concentrated on the Growth side of the ledger. The year-to-date return of the S&P 500 is almost entirely attributable to the 5 largest index members. Apple, Amazon, Microsoft, Facebook and Alphabet (Google) contributed 9.4% of the supposed broad market index's 9.8% 2020 return through August. We are all aware that Energy and Financials have suffered, but Industrials, Real Estate and Utilities sectors are also down. The top five names in the S&P 500 comprise 23% of its total weight, a record high and roughly double the concentration in the top five names 5 years ago. These stocks have returned 244% since the end of 2015 compared to 41% for the other 495 Large Caps. The five tech giants reign the Russell 1000 Growth index even more tightly taking up 39% of its space.

Growth companies have in fact delivered superior fundamental growth. At the same time prices are undeniably rich. The ratio of S&P 500 market cap to revenues sits at a record high of nearly 2.5x well in excess of the 2.0x recorded during the Internet Bubble. Broken down between Value and Growth (data is only available from 2002) the S&P Value is a pedestrian 1.5 times revenues – within normal range. S&P Growth multiple tops the charts at nearly 5 times and has doubled in the last 5 years. Russell 1000 Value PE ratios average 17 times, unchanged over 5 years. In 2015 Russell 1000 Growth PE ratios averaged 22 times and are now 34X. Yet there are strong arguments against labeling this Technology trajectory a bubble. The sector likely enjoys prospects for continuing prosperity especially in the context of tame global economic recovery rates. In addition to sluggish GDP and low interest rates, Covid lockdowns have accelerated the development and adoption of advances in technology. Biotechs that successfully deliver better treatments, devices and vaccines will surely be rewarded.

History suggests that Style preferences are cyclical but often quite durable. We don't know when a sustainable rotation will kick in, but we are mindful of catalysts that may spark change. Most obvious is the impact a readily available safe Covid vaccine will have on overall economic activity and more specifically travel, transportation, hospitality and by association Energy. Fiscal stimulus in the form of infrastructure could boost profitability of less technologically oriented concerns. Extreme monetary easing should someday subside giving way to inflation and releasing interest rates – a boon for Financials. Regulation or anti-trust attacks could lay a chink in the armor of mega technology companies. Once they start to slide, their dominance in widely owned passive market cap weighted indexes could unleash a torrent of downward momentum and flight to more mundane names.

Returning to history, even long-standing Style predilections can shift very quickly. In February 2000, the trailing 10-yr returns for Growth and Value were 21.2% and 14.8%, a 6.5% annualized Growth premium. 18-months later those numbers were 11.6% and 14.6, respectively. Did Value stocks stage a massive rally? Not really. The reversal largely reflected Tech/Internet favorites coming back to earth. T. Rowe Price points out that being late to a Style rotation can wipe out much of the positive impact on longer term results. Missing out on the first 3 months of a Value-led cycle has been known to knock down 28% of the total outperformance.

We aren't going so far as to predict the end of a Growth era and there is no reason to underweight. On the other hand, Growth stocks are likely to be among the best performing in your portfolio and it won't hurt to take some froth off the top. Finally, without perfect clairvoyance, we don't want to make clients late for the Value revival. We are also hopeful that the inclusion of active managers who employ fundamental Value pricing models will prove themselves worthy in markets that are not overwhelmed by investors enamored with 5 big giants.

Two Speed Recovery
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have already climbed up fast and furiously.

The S&P 500 Energy index, down -20.9%, got the booby prize for worst performance last quarter. So called demand destruction is estimated at ~8 million barrels a day. Some forecast demand won't return to pre-Covid levels for 3 years and depends to a large extent on when travelers take to the skies. Current prices are bound to force more exploration/production and oil services companies into bankruptcy.

Another factor underpinning stock market advances is early and aggressive fiscal and monetary stimulus. The Federal Reserve has anchored rates near zero and is expected to leave them there for a few years. US companies issued record breaking amounts of cheap debt last quarter. Investors gobbled up higher risk lower yielding securities buoyed by the Fed's commitment to purchase bonds and bond ETFs. In fact, they didn't buy a single ETF share and corporate purchases were miniscule. The Fed successfully loosened up credit markets using communication skills.

Circumstances have affected the composition of the BloombergBarclays US Aggregate Bond Index markedly. Total return in 2020 through quarter-end was respectable at 6.7%, but strategies linked to it may not fare so well in the future. It is a cap weighted index so the flood of US Treasuries issued to stave off recession now dominate it. Average yield to maturity is barely over 1% while its average duration recently hit a record high of 6.17 years. Lower yields and longer durations are not an attractive bond market recipe.

The US dollar, down against a basket of currencies by -3.25% in Q3 and ~10% since it spiked in March, is another casualty of COVID repair. It is still trading above its 10-year average, however, and likely to retain its "reserve currency status." Those who predict its demise discount the improbability that another currency will take over supremacy. Real US yields are negative but the ECB imposes a penalty for holding euros in nominal terms. Foreign investors need USD to participate in our robust stock market and are enticed by the relative safety and liquidity of the US Treasury's printing press. These factors should help stave off total collapse. In the meantime, if the dollar downgrade proves to be more than a momentary blip it should bode well for International stock returns, multinational corporate earnings and US exporters.

The US has replaced half of the 22 million jobs lost in March and April, but the pace is slowing. The unemployment rate appears much improved at 7.9% from a 15% April peak, but labor participation is lower, and these figures do not reflect huge permanent layoffs recently announced. Also worrisome is decelerating consumer spending. After unleashing pent-up demand for bicycles, cars and home improvements this summer, households have backed off. Saving and paying off debt during Q2 with fiscal stimulus checks helped cushion the end of Cares Act support. The Fed and Treasury heads pled for more fiscal relief, but Congress and the President are mired in the Supreme Court appointment and upcoming elections.

We have been asked to recommend actions in response to possible election outcomes. As you might expect, we do not favor dramatic shifts in allocations that have been designed to meet long-term objectives. Neither do we recommend market timing driven by speculation. Vanguard found no difference in the performance of a 60%/40% portfolio during election and non-election years. Nor was there a difference based on political affiliation of the winner.

Undoubtedly, some market segments will be affected differently by their respective agendas. Both candidates promise to lower drug prices – bad for Pharmaceuticals – and spend on infrastructure – good for Industrials and Materials. Democrats have more vocally espoused anti-trust warfare against mega tech – but that process takes years and may lose steam as reliance on technology persists. A recent study estimates that the candidates' spending and tax policies will impact the deficit similarly. Equity investors are learning to live with the burgeoning deficit given minimal near-term inflationary risk and the Fed's commitment to keep the lid on interest rates. The longer-term problem with the exploding deficit is that debt has been incurred to replace revenues eradicated by Virus containment maneuvers. Spending on badly needed infrastructure, however, makes jobs and boosts productivity.

The market didn't sell off in anticipation of 1986 and 2012 increases in capital gains rates. JP Morgan research suggests stock prices could take a 5% hit if tax optimization opportunities arise – possibly in the 4th quarter of 2021, but that capital is likely to land back in equities given the TINA (there is no alternative) mood. We think investors should take some profits on their turbo charged positions regardless of whether the rate might be higher or lower next year.

Higher corporate tax rates will take a bite out of US corporate earnings disproportionately harming Tech, Consumer Staples and Healthcare companies - currently paying at the lowest effective rates. Then again, Biden proposes substantial Federal aid to state and local governments who will otherwise be forced to raise taxes to deal with squeezed budgets. As to the immediate fall out from a Biden win - keep in mind that major tax reform will require a majority in the Senate and may not be the government's highest priority while the Pandemic rages on.

The fact is that the US will have to address its mountain of debt and vast deficit someday. Raising taxes is just one of the options – none of which foster economic growth or positively affect stock market returns. Taxes will go up – it is just a question of when and who will pay them.

Backed by polls showing 66% of Americans view China negatively, tensions are likely to continue one way or another. Biden, however, may expend more effort on improving trade relationships with Europe and elsewhere in Asia including rolling back tariffs. Perhaps this approach will revive global trade activity that will favor Emerging market exporters. In summary, it feels like neither party nor candidate exclusively holds the keys to healthy financial markets. So far, the Coronavirus remains in charge.

In late July the European Commission authorized the establishment of a €750 billion Next Generation fund to battle the cost of the Pandemic throughout the region with centralized borrowing to be disbursed to members as grants and loans. Weaker recipients are to be held accountable for reforms and reinvestment plans – conditions sparking debate that may delay releasing aid. The EU leadership, like some of our own, is concerned that governments will pull back on stimulus too quickly. So far, Germany leads the World in Covid-19 spending as a percent of its GDP at 40% - compared to the UK 23%, France 19% and 15% for the US.

Now the Virus has reared its ugly head again within the zone, and in a time where cooperation should be a priority, the UK is poised to exit the EU January 1 without a formal trade deal. Britain's already tepid revival will be further challenged by uncertainty.

It is quite ironic that one of the best hedges against US stock market volatility has been exposure to China. XTrackers Harvest CSI 300 China A-Shares is up 21% through mid-October. Alibaba's shares are up 73%. China has purportedly squashed the Virus and targeted its stimulus effectively. According to the IMF, forecasted retraction in global GDP has been diminished by the only economy expected to expand in 2020. Fears that China would severely disrupt the global supply chain have been curbed as factories opened ahead of the rest of the world. At least they have helped the world recover from the disaster they unleashed with medical equipment, protective supplies and work-from-home electronics.

It might seem odd that EU governments haven't joined the crusade against Huawei and TikTok as implements of Chinese government influence. Come to find out, according to a Dutch research study, Beijing has a high to moderate level of influence on 260 of the 650 European enterprises acquired by Chinese companies over the last decade. State governance has been hidden by layers of complex ownership structures and until recently the EU did not have a system for flagging and blocking deals that give the Communist Party access to technology and information it can use toward nefarious ends. EU officials hope members won't unload companies on China in Covid fire sales like they did during a previous crisis.

In closing, we continue to don our masks, sit alone at our desks, avoid congregating at the water cooler and mail in our ballots doing our best to shepherd clients' resources during this baffling and worrisome time. We hope for the best and prepare for the worst. Please do not hesitate to contact us with your concerns, comments or ideas.