Market Commentary

Market Recap

Despite some choppiness in September, equity investors were treated to solid gains during the third quarter. The S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year. Underneath the surface, mega-cap growth names continue to lead the U.S. market. Without the astonishing 42.5% year-to-date price return of the six so-called FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), the S&P 500 would still be down for the year.

The outperformance of these top names means they now dominate the index. Market concentration is not unusual, but with the top 10 stocks in the S&P 500 making up 28% of the index, it's extreme today. The important investment takeaway is to not be lured into chasing the returns of what has worked well in the recent past. These companies' outsized past returns have come from their ascension to the top, not from owning them once they were already there. Owning the largest stocks has badly lagged owning the diversified index over time.

Nevertheless, this U.S. mega-cap growth effect is driving the outperformance of U.S. stocks versus foreign stocks this year. Developed international stocks gained 6.0% this quarter, almost three percentage points behind U.S. stocks, though, emerging-market stocks outperformed U.S. stocks with a return of 10.2%. Both groups still trail U.S. stocks year to date.

Some of this relative performance is deserved. Unlike in the dot-com era, today's large U.S. growth firms have created real economic value. This has come at a time when growth has been scarce and interest rates low, so investors have been willing to pay up for their growth. That said, a durable economic recovery taking hold could be the catalyst for investors to turn away from these highflyers and favor undervalued stocks in out-of-favor industries and overseas markets.

Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. Treasury yields were unchanged, and core investment-grade bonds gained 0.6% in the third quarter. Fed officials say they are now targeting "average inflation" of 2% and have signaled that they do not expect to raise rates at least through the end of 2023. Since inflation has not topped the Fed's target in a decade, many market participants expect low rates and supportive policy to continue for a long time. In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% but remain slightly negative for the year.

A Look Ahead

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks, over the near term and medium to longer term. A unique U.S. election approaches in November. The market does not like uncertainty, so the weeks leading up to the election and afterward may be volatile. However, history shows any election-year declines are usually short-lived and the political party in power is not a significant driver of investment returns. Political views have no place in our investment process, and we don't attempt to predict the short-term market reaction to elections (or any short-term event). There are simply too many other factors that impact markets over time. Instead, we stick to our longer-term analytical framework in which we consider and weigh multiple macro scenarios and assess the potential risks and returns for numerous asset classes and investments in each scenario. The fundamentals are what really drive long-term market performance.

Below, we highlight some key reasons for optimism and other reasons for caution going forward. We conclude with a discussion of our portfolio positioning and the need for balance given this backdrop.

Reasons for Optimism

An economic recovery is underway. Economic data and forecasts are improving (see the growth projections from the Organization for Economic Co-operation and Development, or OECD, in the next page). All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets.

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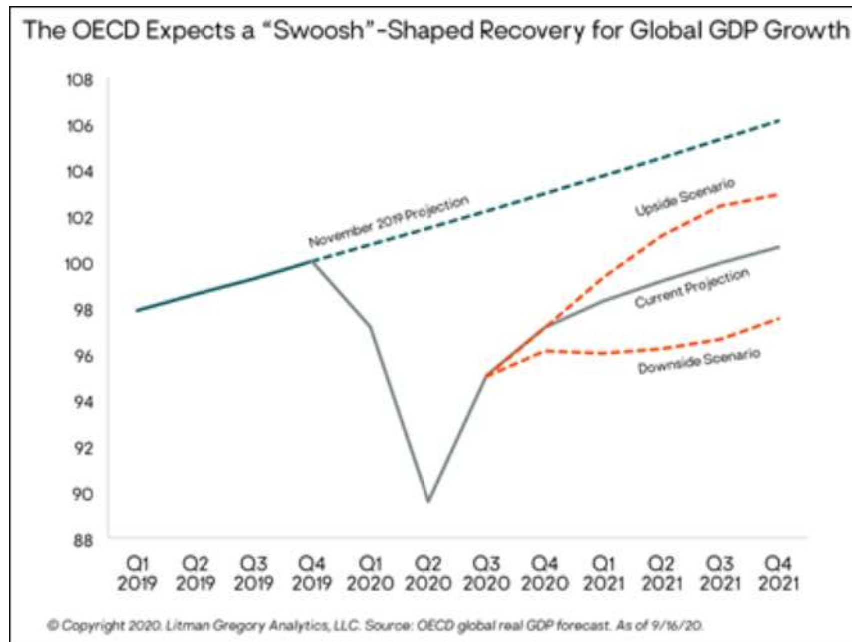

On the virus front, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.

And this year's extraordinarily supportive monetary policy (asset purchases and lower interest rates) and huge fiscal stimulus, both here and abroad, were key drivers of the speedy recovery in markets and the global economy. Central bank actions and government spending don't *guarantee* the absence of volatility, another bear market, or recession. But there are programs now in place, especially in the United States, that could step in to help the functioning of markets and the economy in case volatility returns or setbacks occur.

Reasons for Caution

It remains to be seen how strong the actual economic recovery is and how much of it is already discounted in current prices. In our view, there is as much room for disappointments as there is for positive surprises.

While vaccine development steams ahead, the potential remains for a large resurgence of COVID-19 in the fall and winter months. We are seeing this already in Europe, and the infection rate has popped up slightly here in the United States recently. This raises the risk of renewed shutdowns and another economic downturn.

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Monetary policy is supportive, but more fiscal support from Congress is likely needed to further protect citizens, help businesses survive, and shore up state finances. If it doesn't happen, it will be a hit to fourth quarter economic growth, which could in turn impact markets.

Finally, there is always the potential for a negative geopolitical shock. The U.S.-China conflict and Brexit come to mind, but a new development could emerge that no one is considering (like the pandemic did earlier this year).

Portfolio Positioning & Strategy*

Our portfolio model(s) are balanced across multiple dimensions: domestic versus international stock exposure, growth versus value strategies, interest rate risk versus credit risk, traditional versus alternative investments. We've designed our portfolios with the goal of generating potentially strong returns in our base-case and more optimistic economic scenarios, while maintaining resilience in a more challenging scenario.

On the equity side of our portfolios, as a reminder, we were *slight* underweight to U.S. stocks (versus global) going into the pandemic due to unattractive valuations. In March after an initial large decline (and increasing our margin of safety) we added thoughtfully back to U.S. and Global equities at more attractive prices. Since that time, U.S. stocks have appreciated strongly, outperforming most other investments. They have soared more than 50% from the March low and again look historically overvalued. Forward price-to-earnings (P/E) and median P/E ratios are approaching dot-com-bubble highs. Nothing prevents valuations from rising even further near term, but we know high starting point valuations have a strong *inverse* relationship with future long-term returns. Overvaluation tends to not matter … until it does.

But while U.S. stock valuations look expensive relative to history, they look cheap relative to bonds. Bond yields are extremely low, which forces investors to allocate more to stocks, pushing stock valuations even higher or keeping them higher for longer. Cheap relative valuations, in addition to a supportive Fed and plausible optimistic scenarios in which U.S. stocks *can* deliver decent returns, keep us from a larger underweight. We don't want to be too underweight to U.S. stocks as there could be a significant opportunity cost if they continue to perform well.

Our overweight to emerging-market stocks offsets some of our underweight to U.S. stocks. And we hold a full strategic weight to developed international stocks. We do not want to reduce our global diversification right now as stock valuations are cheaper in non-U.S. stock markets. We continue to see superior five-year expected returns there across most of our macroeconomic scenarios. Stocks being cheap compared to bonds is even more true in international markets. Plus, in a sustained global economic recovery with Fed-repressed U.S. interest rates, the odds are that foreign currencies will appreciate against the U.S. dollar. This would further enhance the returns of international assets for U.S. dollar–based investors.

On the fixed-income side, core bonds can serve as an important shock absorber in a negative economic or geopolitical shock. However, yields are historically low and even a modest increase in interest rates could lead to negative short-term returns.

To better diversify our fixed-income allocations, we have recently invested a portion of the allocation in investment- grade passive and actively managed flexible bond strategies with higher expected returns and lower interest rate risk. The tradeoff is they will not hold up as well as core bonds in a deflationary or "shock" events referenced above. We have taken this into account when setting the remaining part of the target allocation which includes short to medium-term government/treasuries (providing the needed "shock" event ballast).

The third broad component of our balanced portfolios comprises trend-following managed futures strategies. These investments further diversify equity and bond market risk and are intended to generate returns over time that are much better than we expect from core bonds and potentially competitive with equity returns. In a bull market, these alternative strategies will likely trail stocks. But in a sustained bear market, we expect them to provide protection and partially offset losses in risk assets. They have performed well this year and continue to add substantial value in their portfolio role.

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In sum, we have built our portfolios to diversify and balance the wide range of risks and return opportunities the financial markets are presenting us near term and longer term. Overall, we are very comfortable with how our portfolios are positioned and nothing in our assessment indicates a shift in positioning would improve the risk/return balance. Yet our actions in March show we will not hesitate to take advantage of compelling tactical opportunities (buy or sell) when they arise. We believe we are tilted in the direction markets are headed, not stuck following the trends of the last 10 years that are unlikely to sustain given the cyclical nature of investing.

History shows markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing. Having a high degree of conviction in any single outcome strikes us as imprudent. Instead of trying to continuously predict the future, we are focused on building resilient portfolios across multiple plausible scenarios, accounting for a range of shorter-term risks but keeping our primary focus on the medium- to longer-term fundamentals that ultimately drive investment returns.

Investing this way requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, put capital at risk when markets are plunging, or refrain from chasing overvalued markets higher when they are soaring. But in the end, this is the best approach we have found to achieve long-term investment goals.

**Positioning & Strategies do not apply to all portfolios*

Closing Thoughts

While we are constantly making decisions about what actions may be needed in portfolios, we are also working behind the scenes to grow your wealth and bolster your financial position in ways that do not necessarily show in performance reports.

Some steps we have taken with clients this year include working with their accounting professional identifying tax-loss harvesting opportunities in taxable accounts, especially earlier in the year. This can offset realized gains this year and possibly into the future. In addition to focusing on portfolio tax optimization, we can help strategize broader planning areas, such as education and retirement planning or arranging a plan for philanthropic goals. Financial planning has taken on additional complexities this year, as we work through the rules and opportunities presented by the SECURE and CARES Acts. These Acts created opportunities for waiving required minimum distributions, planning for IRA beneficiary changes, rolling over traditional IRA accounts to Roth accounts, and reviewing existing estate plans.

As always, we appreciate the trust you place in us and encourage you to contact us with any questions about your specific situation.

Take care and stay safe.

Rainey & Randall Investment Team

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