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RDM Financial Group

Market Update

September 17, 2020

Key Takeaways

- Following the fastest decline into a bear market, equity markets have staged an impressive rebound this summer.
- In August, a majority of economic data came in better than market expectations.
- Labor markets continue to rebound but have only re-captured 47% of the jobs lost so far.
- While corporate profits are forecast to decline 24% in 2020, the outlook for 2021 is for an increase of 26%.
- Multiple companies are working on a potential COVID-19 vaccine, but the timing of a breakthrough remains uncertain.
- We continue to monitor for signs that the economic recovery remains on track and so far, the answer remains yes.
- Potential risks include uncertainty in Washington D.C., rising debt levels, trade tensions with China, an increase in new virus cases this Fall and failure to develop a vaccine.

The recession that started at the end of February likely ended over the summer months and an economic expansion now appears to be underway. The speed of the recovery may certainly be different than prior recoveries, but if a vaccine can be developed within a reasonable period of time, it

appears that the economic recovery should remain on track and that trends in key economic variables including GDP, employment and corporate profits should continue to trend higher in the years ahead.

Over the past several months, equity markets have largely been led higher by a number of technology and growth stocks. The "FAANG" names, which have been discussed here before, have largely been responsible for a significant portion of the market's gains in recent months. However, in a positive development, we have recently started to see somewhat better participation by a number of stocks in other parts of the market including the consumer discretionary, industrial and basic material sectors. If this trend were to continue, it would be an encouraging sign.

Looking ahead, we are focused on the big picture and trying to assess whether the current economic expansion which likely started this past summer remains on track. A rebound in copper prices, healthy credit spreads, a better performance by industrial and consumer discretionary stocks, rising inflation break-even spreads and a decline in the dollar are all positive signals that the U.S. and global economy have started to rebound. Trillions of dollars in government and monetary stimulus have played an important role.

Recent economic data over the past several weeks has largely been encouraging with most economic reports coming in better than expected. Third quarter GDP will likely be in the range of +20-30% (on an annualized basis) but keep in mind this comes after a massive decline during the second quarter of this year. To highlight a few of the most recent economic data points, the ISM Manufacturing Index recently rose to an almost 2 year high this past month (with new orders rising to the highest level since 2004), housing related data has continued to improve, auto sales are rising and monthly retail sales recently rose to a new all-time high. The September monthly jobs report showed further improvement with the unemployment rate falling to 8.4%. However, it's important to point out that we have only recaptured 47% of all the jobs lost during the economic downturn.

Among other economic data points, one report that did not improve last month was the Conference Board's Confidence Index, which fell to a fresh 6 year low. This is something that needs to be monitored since the consumer represents about two thirds of the overall economy. The July 31 expiration of enhanced unemployment benefits ($600 per week for almost 30 million people) could be a risk to economic activity this Fall but at least so far, does not appear to have had a major impact on the recovery.

Turning to monetary policy, the Federal Reserve Bank has signaled that it plans to keep short term rates on hold for an extended period of time. The Fed stated on September 16 that it will continue to be supportive in various ways through a number of

programs announced earlier this year. For reference, the year over year increase in the M2 money supply this year has been the largest on record since the Federal Reserve started tracking this data back in the 1950's. Following its latest meeting, the central bank forecast now forecasts that GDP is likely to decline 3.7% this year (compared with its prior forecast of a decline of -6.5%) before increasing 4% and 3% in 2021 and 2022. They believe that the unemployment rate, which is currently at 8.4% will fall to 5.5% next year, 4.6% in 2022 and 4% in 2023.

The central bank's main goals over the past several years has been to achieve full employment along with a stable inflation rate of 2%. More recently (at the Fed's annual Jackson Hole FOMC meeting last month), the central bank made an important shift and indicated that going forward, the Fed will be targeting an average inflation rate of 2%. This means that inflation will be allowed to moderately exceed the Fed's prior 2% target at least for a period of time. To achieve their goals, the central bank has indicated that monetary policy is likely to remain very accommodative until its longer-term objectives are met. We believe that these statements by the Fed are positive for risk assets over time. Their guidance reflects their strong commitment to do what they can to help various parts of the economy that were hard hit by the economic shut down earlier this year (for example the restaurant, travel & leisure and hospitality industries along with small businesses) recover and get back on their feet.

Looking at corporate profits, second quarter profits (which came in better than lowered estimates) are now in the rearview mirror and investors are starting to look ahead to the second half of the year and 2021. Earnings for companies in the S & P 500 are currently forecast to decline 22.4% this quarter, 13.0% during the fourth quarter before turning positive again in the first quarter of 2021 and rising an estimated 26.3% next year. Looking ahead, all 11 sectors of the S & P 500 are currently forecast to generate positive earnings in 2021 and 7 out of 11 S & P 500 sectors are currently forecast to generate double digit EPS growth. While there is currently a very wide range of Wall Street estimates for corporate profits next year, the consensus forecast right now is for earnings to post a new all-time high in 2021.

On the fixed income side, credit spreads (i.e. the different between U.S. Treasury Bond Yields and the yield on corporate bonds) have continued to improve over the past few months. This reflects a number of factors including support from the Federal Reserve Bank, a rebound in the overall economy, a more risk-on appetite among investors along with continued investor demand for fixed income investments in a low interest rate environment. It will likely continue to be a challenging time for fixed income investors in search of yield.

Despite uncertainty surrounding COVID-19 and development of a vaccine, the S & P 500 established a new all-time high on August 18, 2020 marking the

fourth fastest recovery of a prior bull market high from a bear market low (source: Merrill Lynch). Other parts of the market including small cap stocks, mid cap stocks, U.S. non-tech companies and international markets remain below their prior highs. Only the recoveries following market lows in 1932-33, 1982 and 2009 occurred faster than the current market rebound and those recoveries all represented positive important turning points for equity markets. Each of those periods had their own unique set of major financial and economic issues but did not include COVID-19.

As the economy continues to gradually recover over the next year or two, we are likely to see stronger GDP, rising corporate profits, a pick-up in consumer and business spending along with a more broad-based economic expansion. However, we also see a number of potential headwinds that include a policy mistake out of Washington, growing trade tensions with China, rising debt levels and failure to develop a vaccine to truly generate a robust long-lasting economic recovery. The upcoming presidential election is currently too early to call but could also lead to a period of volatility this Fall especially if a winner is not announced quickly.

In summary, the recent market advance has been impressive and follows a major economic downturn which was the result of the government shutting down the economy to deal with the outbreak of COVID-19. A continuation of the global growth recovery now underway likely depends on at least two important factors, a vaccine and likely more stimulus. To date, financial markets and economies around the world have received a lot of stimulus but no vaccine, although progress is being made towards an FDA approved vaccine. We believe that the worst of the recession that started earlier this year is likely behind us and that a new economic recovery is probably in the early stages.

On the investment side, we currently favor a diversified barbell approach. Growth stocks (which we have been overweight across most of our equity models for the past several years) are likely to remain in demand due to the low interest rate and uncertain growth environment that we are currently in. Some of the themes that we think should do well over the next several quarters include the digital transformation taking place across various sectors of the economy, growth in e-commerce payments, increased use of artificial intelligence, workflow automation, the rollout of 5G and new discoveries in healthcare and biotechnology. We also have some exposure to cyclical parts of the economy that should start to generate increased sales and profits as the global economy continues to improve.

Looking ahead two big question marks are the speed of the recovery and how long it will take to make up all of the lost ground (in terms of jobs, profits and economic activity) from earlier this year. We would not be surprised to see some volatility in the months ahead as investors digest recent market gains, debate the upcoming election and adjust to living

with COVID-19 before a vaccine is (hopefully) developed and made available. Having the appropriate asset allocation can help ride out the inevitable pullbacks and corrections that occur in the markets over time and that are a normal part of the multi-year investment process.

As always, please do not hesitate to call us with any comments or questions you may have.

Respectfully,

Michael Sheldon

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RDM Financial Group

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