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THIRD QUARTER 2020 ECONOMIC AND FINANCIAL MARKETS REVIEW

In July and August, the stock market continued the recovery that began during the second quarter this year, as investors took comfort in the further reopening of the economy and the Federal Reserve Board's extraordinary monetary stimulus. As part of this stimulus, the Fed lowered interest rates to near zero in March so that individuals and corporations could borrow money at ultra-low interest rates. However, this policy has also made it so investors cannot earn a reasonable return on fixed-income investments such as bonds, CDs, or money market funds. Therefore, they have been investing money in stocks, particularly those that are viewed as having the best future growth potential in the current stay-at-home and work-from-home economy. Then in September, a stock market pullback occurred as investors and traders realized that stocks had become overvalued and overbought while sentiment became overly optimistic. Despite the large market swings this year, the S&P 500 Index ended the third quarter up 4.09% year-to-date, while the Dow Jones Industrial Average lost only 2.65%. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index gained 5.92% year-to-date as of September 30, 2020.

During the mid-year stock market rally, not all stocks were rising in sync. A relatively small number of large technology companies have been thriving during the pandemic due to modern or adaptive business models, while other companies that have been harmed by the pandemic have underperformed. For example, companies like Zoom, Apple, Microsoft, Netflix, Facebook, and Amazon were soaring, while many other companies and entire industries like retail, energy, airlines, leisure, and financials are still struggling. Because popular market indexes like the S&P 500 Index and the Nasdaq Composite are market cap-weighted (as opposed to equal-weighted), their returns are more heavily influenced by the largest companies, which have also been the best performing. Smaller companies do not carry as much weight in the calculation of the returns of the major market indexes. For example, the five largest stocks in the S&P 500 Index account for nearly 25% of the entire index's return this year. An equal-weighted version of the S&P 500 Index has not been performing nearly as well as the S&P 500 Index itself.

Much of the optimism that led to the market rebound, particularly in large technology stocks, may subside as time goes on. The stock market rally was partially predicated on the hope that a vaccine or treatment for the coronavirus would be rolled out relatively soon, helping the global economy to recover more quickly. Although drug companies are moving at a historically rapid pace to produce meaningful vaccines, so far there has yet to be any such development. Similarly, although the economy has stabilized, there is an inherent risk that the pace of the recovery could slow or reverse as the winter arrives when people tend to spend more time indoors.

Another important factor that obviously bears watching is the upcoming U.S. elections that will take place on November 3rd. Partisan rhetoric and division have already created a contentious election environment. Investors' focus will be on several key policy issues that the two presidential candidates differ on. Perhaps most notably, Vice President Biden has vowed to increase the marginal tax rate on high-income earners and raise corporate tax rates from 21% up to 28%, after President Trump lowered them from 35% in 2017. President Trump's policy of deregulation has also come under fire from his opponents, and Vice President Biden has said he will issue more regulations, specifically on the energy industry. Differences between the candidates' policies on trade with other countries will also be noteworthy.

In tandem with the presidential election, Congressional elections are also worth watching. Although turnover in the control of the House of Representatives is less likely, the Republicans could struggle to hold on to their 53-47 majority in the Senate. Of the 35 Senate seats up for election, 23 are currently Republican-held. If one party holds a monopoly on both chambers of Congress and controls the White House, it will be much easier to pass policies without worrying about obstruction from the opposing party. Historically, the stock market has performed best when opposing parties control Congress and the White House, creating checks and balances.

Due to these remaining uncertainties, we continue to favor investing in large companies with strong balance sheets and strong growth potential. Many smaller companies have struggled to withstand the current economic environment, and it may become even more difficult if conditions worsen. We also continue to prefer short-term bonds over long-term bonds due to the low yield environment. Lastly, we still believe that gold will continue to perform well, as the U.S. dollar is generally declining, and political and economic uncertainty remains high.

We will continue to monitor the upcoming elections, along with the trajectory of the economic recovery during this pandemic. In the meantime, please contact us if you have any questions regarding your investment portfolio or the financial markets in general.

** Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on October 1, 2020.*