Post Oak Private Wealth Advisors

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Quarterly Market & Economic Commentary

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Many people are ready to put 2020 in the rearview mirror, but we're not out of the woods just yet. The remaining three months are poised to be critical from an investment standpoint. We're still battling the COVID-19 pandemic, with new cases sprouting from different hotspots around the country. We're waiting for the U.S. economy to regain its footing, with many people remaining out of work and many businesses on the brink of failure. We're watching a stock market ascend to record highs while many sectors seem to be running on fumes.

Did I mention the presidential election on the horizon? I am sure you're aware of it.

Turning the page on 2020 may not even resolve many of these uncertainties. In this quarter's letter, I'd like to discuss how these unknowns are playing out in the stock market and the economy. Then, because this is my last letter before Election Day, I share some words about the upcoming contest and how to prepare for the possible outcomes.

A Tale of Two Markets

The second half of 2020 started with a bang for stocks, with the benchmark S&P 500 Index gaining 5.5% in July and another 7% in August. But the real excitement was in the Nasdaq Composite Index, which gained over 18% for the two-month period. The Nasdaq's outperformance was due to the over-representation of technology stocks, which were among the market leaders this past quarter, and the underweighting of finance, real estate and energy sectors, which lagged in Q3.

S&P 500 sector performance as of 9/30/2020	Q3 2020 return	YTD return
Consumer Discretionary	15.1%	23.4%
Materials	13.3%	5.5%
Industrials	12.5%	-4.0%
Technology	12.0%	28.7%
Consumer Staples	10.4%	4.1%
Communication Svcs.	8.9%	8.6%
Utilities	6.1%	-5.7%
Health Care	5.9%	5.0%
Financials	4.5%	-20.2%
Real Estate	1.9%	-6.8%
Energy	-19.7%	-48.1%

September was a different story—some of the hot air came of out the market with the S&P 500 falling nearly 4% and the Nasdaq down 3% during the month. For the 3rd Quarter overall, the benchmark stock index gained nearly 9% and is up 5.5% for the year-to-date through September 30. The Nasdaq Composite was up 13.1% for Q3 and over 25% for the year-to-date.

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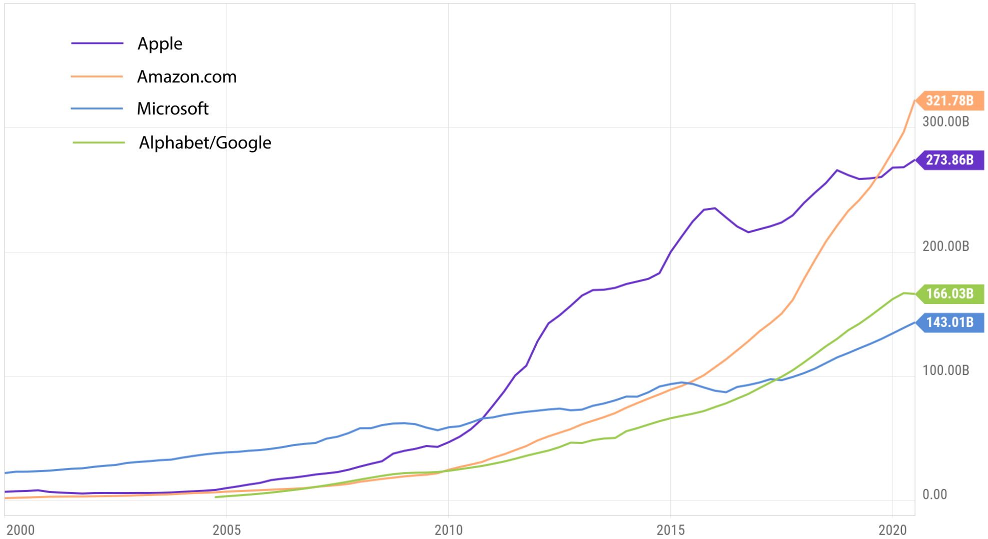
It wasn't just tech as a sector powering the index's summer gains (although technology was the best performing sector in the S&P 500 for Q3). The biggest of the big tech behemoths—Apple, Amazon, Alphabet/Google, Microsoft and Facebook—dominated market performance. Apple, in particular, gained over 41% in July and August and became the first firm to reach $2 trillion in market capitalization. A few standout companies performed even better than Apple during these two months, namely cloud computing, hardware and e-commerce firms that are benefitting from the uptick in remote working, learning and shopping during the continuing COVID-19 pandemic. Zoom Communications (ZM) gained over 80% in July and August, while Salesforce.com (CRM) climbed over 50%. (Also of note, Salesforce.com joined the Dow Jones Industrial Average in August, bumping energy-sector stalwart ExxonMobil after more than 90 years in the index.)

Those "fab five" firms I mentioned earlier are now the largest stocks in the S&P 500, comprising around one-quarter of the index's total market capitalization. That's important when looking at a cap-weighted index like the S&P 500, where the biggest stocks have an outsized influence on the large-cap benchmark's total return. While the headline S&P 500 return for 2020 year-to-date was positive, the YTD return for the equal-weighted S&P 500 Index (where all stocks from 1 to 500 are measured on a level playing field) was a negative -4.7%. The rising tide at the top clearly did not lift all boats. What we had instead is a tale of two markets—one where tech firms and other companies ideally suited for the pandemic are doing well, and another where companies struggle with the loss of revenue and face continuing uncertainty about the future.

A run to record highs can create euphoria among stock investors, but it could be worrisome to see a rally dependent on a handful of companies. Some of that worry fueled September's pullback, which was more technical than structural in nature. This quarter's run-up in tech stocks drew some comparisons to the "dot-com" stock bubble of 1999-2000, but this year's tech leaders are different in that they have good fundamentals behind them. They're generating revenue and, most importantly, growing earnings. And investors are more than willing to pay a premium for the above-market earnings growth these firms are producing. Moreover, this isn't a phenomenon related to the coronavirus pandemic; these tech heavyweights have been delivering strong earnings growth since the days of the dot-com bust. (See chart below.)

Chart 1: Revenue Growth (trailing 12 months), 2000-Sept. 2020



Source for chart: YCharts

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Societal changes due to the COVID-19 pandemic and shutdowns have helped these firms get more entrenched in our modern, digital-driven economy, but in many ways they have been out in front of this cresting wave for several years. And I don't see this leadership changing any time soon.

A tale of two economies, too

There seems to be a split personality in the broad U.S. economy as well; stock markets and housing are booming, while at the same time unemployment remains high and many families struggle to cover basic spending needs. The early days of the pandemic seemed to hit all workers and households equally. After a few months and the appearance of the green shoots of an economic recovery, the differences are becoming more visible.

Many of the jobs that have been lost due to the coronavirus pandemic were in service industries; the economic shutdowns have decimated restaurants, airlines, hotels and entertainment companies, any business that depends on social proximity. These service jobs can't be done from a home office. And many of these workers didn't have much in the way of savings to help them through a spell of unemployment. While growth has returned to the labor market, we're still in the hole from the massive job losses seen in the early months of the pandemic. On the other end of the job market are white-collar office workers, many of whom have not faced layoffs or furloughs. In fact, work and business are largely the same for many of these employees, except for the challenge of juggling the job responsibilities while working from home. Their expenses may even be lower since the pandemic started thanks to the restrictions on travel and dining out, so many are able to save money. Their stock portfolios and retirement accounts have largely reclaimed the losses from earlier in the year.

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The CARES Act programs that directed financial support to households and small businesses offered relief in the early days of the pandemic. This fiscal stimulus, along with the monetary support provided by the Federal Reserve, contributed to the economic bounce-back in Q2 and formed what looked like a V-shaped recovery at the time. But these measures were always meant to be temporary, designed to shepherd the U.S. economy through the shock of the pandemic. Now that the effects of the initial stimulus efforts have waned and a second round of fiscal stimulus appears tenuous, the V-shaped recovery is looking iffy.

While Congress seemed too preoccupied with the upcoming election to hammer out another CARES Act this past quarter, the Federal Reserve continued to do its part to support economic recovery. In August, the Fed announced a significant shift in how it views inflation that would theoretically keep interest rates low until inflation was sustained at or above its 2% target. Ever since the Fed set this inflation target in 2012, price rises have barely come close to this 2% rate. On top of this announcement, the Fed pledged in September to maintain near-zero interest rates through at least 2023. That's over three years from now. This kind of central bank news would normally make markets smile, but it may not give much of a boost to the overall economy except to inflate asset prices, whether through stock buybacks funded by cheap corporate debt issuance or robust home sales supported by low mortgage rates.

The next Election Day looms

You're reading this quarterly report around one month out from the next presidential election. In recent election years, these weeks have typically been an anxious and stressful time for the

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country and the financial markets. COVID-19 has certainly made the 2020 White House campaign stranger than previous election years; the political conventions were subdued, and in-person candidate rallies aren't as frequent as they typically have been. Much of the anxiety around the upcoming election concerns what might happen the night of Election Day and even the days afterward. Many political observers anticipate a highly contentious ballot count, with the possibility of an uncertain outcome for several days or even weeks. Recent reports have raised the speculation of a sitting president not accepting the legitimacy of any result that doesn't show him winning.

There's a high enough likelihood for a contested election to warrant a cautious approach with your portfolio.

The possibility of a contested election, with the potential for further division of the electorate, is one outcome investors would dread. Volatility would certainly churn through the market until the parties come to resolution. We may see a return of street protests and unrest we witnessed over this summer. But the consequences of a disputed election result don't have to be as dire or long-lasting as some may fear. Strange as it may seem, our country has been through a contested election before, and survived; the 1876 presidential election involved dubious electoral votes and was eventually settled by Congress through negotiation. Of course, the U.S. was a different country back then; we didn't have the world's largest economy or any standing for global leadership in 1876. Nor did we have 24-hour cable news channels or Twitter flame wars.

There's a high enough likelihood for a contested election to warrant a cautious approach with your portfolio. But other outcomes are worth consideration as well. A Trump victory would be the most preferred result for investors. It would ensure the low tax rates passed by the Republican Congress in 2017 would remain in place for at least another four years, with the possibility of even lower taxes to come. The worry over a Biden victory would mostly center around a reversal of these tax cuts. But even if so, a Biden White House would likely not push taxes up much higher than they were previously, especially if the GOP manages to maintain control of the Senate.

Why protection matters

Many people are ready to say goodbye to 2020, but with the election on the horizon and the pandemic as of yet unresolved, the next three months could be volatile. The potential for significant market losses makes protection of your portfolio value as important now as ever.

We advocate for maintaining portfolio protection in all markets, utilizing hedging strategies that can help contain losses while offering participation in market growth. Keeping a protective hedge in place in all market environments may create a slight drag on performance, but with so much uncertainty out there I believe our hedging capability is essential for helping our clients avoid a catastrophic loss in portfolio value, which is inherent in the markets.

But a change of the calendar won't necessarily remove a lot of the uncertainty that's currently out there. Every day, it seems we are closer to a COVID-19 vaccine, but even the news of a preventative treatment won't settle questions about its effectiveness and deployment across the country. I believe investors can expect many of the trends in working and living that we're getting used to in the pandemic will remain in place in the post-COVID-19 world. At times like these, it is valuable to have professional management of your long-term assets and protection for your savings for the future.