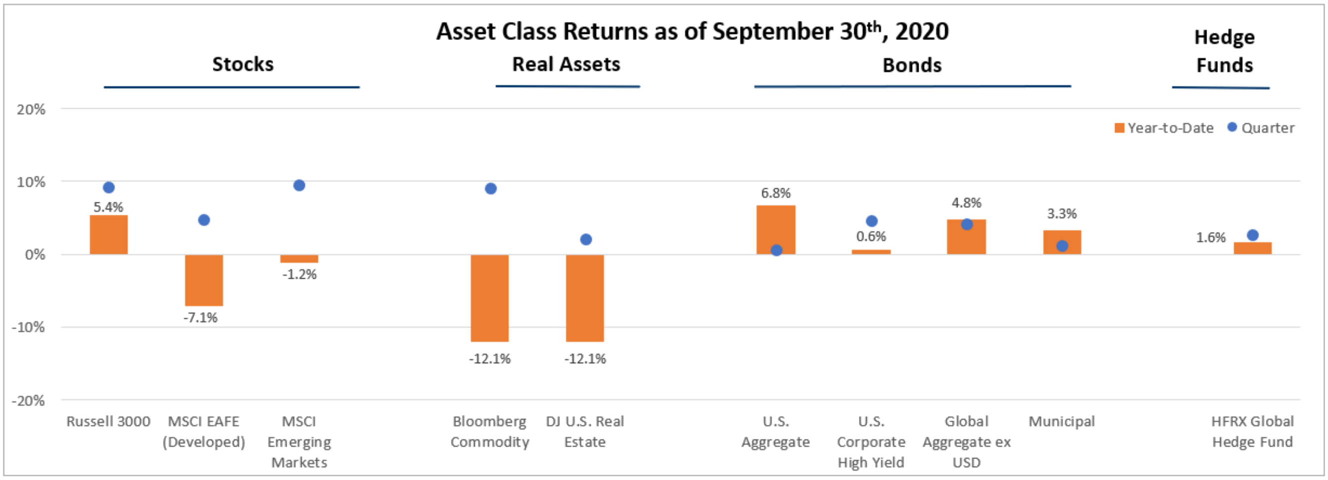
THIRD QUARTER 2020

Investment Newsletter

EXECUTIVE SUMMARY

Although the U.S. economy rebounded sharply in the third quarter, there are ominous signs of a slowdown. As the coronavirus crisis grinds on longer than most had feared, the adverse consequences for society, businesses and the financial markets become more acute and harder to reverse. COVID-19 is now being fought on multiple fronts. The prospects for one or more vaccines to be available for widespread distribution next year remains favorable, but the effectiveness will not be known for a long time. In the meantime, the expansion of rapid testing and therapeutics to alleviate symptoms and reduce the fatality rate will help to diminish the health impact and to bring back normal activities. The threat of a second surge will weigh on investors as well as consumers and more organizations will revamp their business plans to better confront the new circumstances.

The global economy has shown significant improvement and, in many cases, has beaten expectations. Manufacturing activity and other economic indicators continue to recover, although at a slower pace. However, consumer data such as retail sales and consumer confidence have weakened as the effects of the recent government stimulus abated and job market gains slowed.



Morningstar & Hedge Fund Research, Inc. (HFRI); Bond indices from Bloomberg Barclays

The strong rally in risk assets such as equity and credit-sensitive bonds over the past few months has been fueled by a confluence of factors, including upbeat investor sentiment, low interest rates and central bank liquidity. Asset prices in many markets appear stretched relative to fundamentals and the evident risks. Market movements have sometimes been driven by technical factors rather than fundamentals. Unusual activity in the derivatives markets has caused swift price reversals, particularly in sectors such as technology which had been powered higher by momentum.

While uncertainty and fear surrounding the coronavirus, political strife and natural disasters might call for a defensive outlook, there is some cause for hope. The healthcare response to coronavirus may surprise on the upside. Relations between countries and trading partnerships may improve. And the sudden and dramatic change forced upon us may drive innovation and create better approaches.

We recommend that investors not take material bets to any one market sector and stay well diversified with a mix of growth, defensive, and liquid assets that are in line with their target allocations. This should include exposure to asset classes that are cheap on a relative basis such as international developed and emerging market stocks and which may recover on a different path than the U.S. low volatility strategies that are less dependent on the direction of interest rates and stock markets may also enhance investment portfolios. And although low yields and limited price gains dampen return potential, fixed income can diversify equity market risk and provide stability whatever the future might bring.

SUMMIT FINANCIAL

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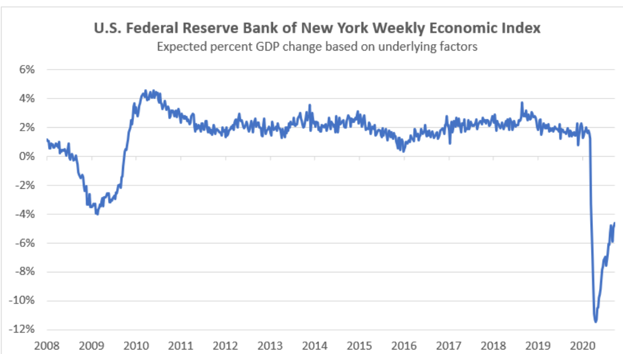
ECONOMIC GROWTH

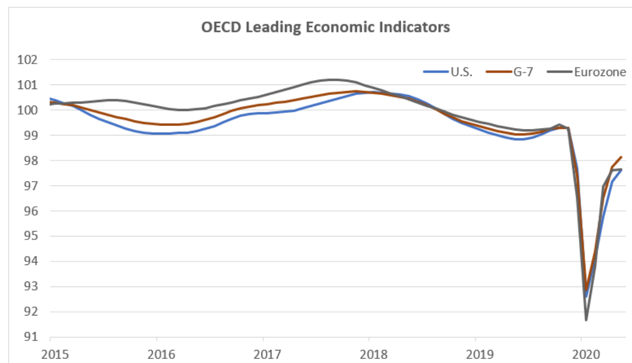
Earlier hopes for a V-shaped recovery appear to be waning despite what the stock market indicates. Domestic economic activity and employment remain well below pre-pandemic levels although some progress has been made as parts of the economy reopened over the summer. Heading into the winter months, uncertainty is elevated – especially with a contentious U.S. Presidential election quickly approaching. As this year plays out its final quarter, we will continue to get more tangible data points on the path of both the public health and economic recovery.

Much of the economic data over the third quarter indicated strong improvements relative to prior historic lows. This was partially attributable to pent-up demand in addition to many returning to work for businesses that can function with social-distancing protocols in place. While things have improved somewhat, there is a large portion of the economy that remains completely shutdown or that is operating under heavily reduced capacity. This would include industries such as airlines, retail, and hotels & hospitality. Extended restrictions on these industries are starting to translate into more permanent layoffs. This included Disney recently cutting 28,000 resort jobs and American and United Airlines moving forward with over 32,000 job cuts. Prolonged layoffs are likely to add volatility to the recovery ahead and it might take a vaccine for things to fully resume a form of normalcy.



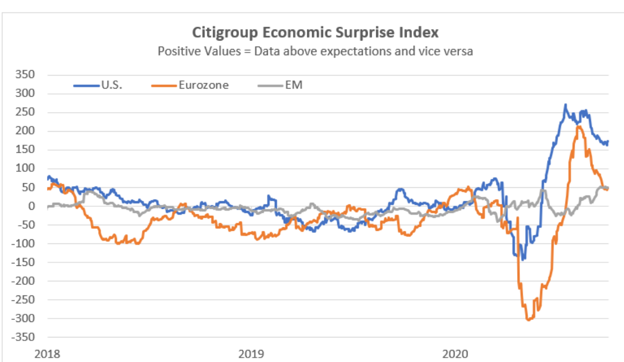
Federal Reserve Bank of New York

The Weekly Economic Index measures the expected change in GDP factors such as unemployment claims and gasoline sales. It continued to recover from unprecedented lows. The recovery has been fueled by the resumption of select business activity although there is still a long way to go until prior levels are reached.



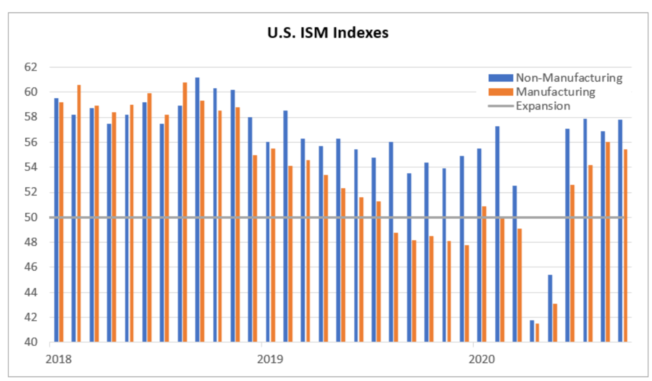
Organization for Economic Cooperation and Development

Leading economic indicators (LEIs) designed to show inflection points in economic growth, continue to recover although the rate of change has leveled off. This suggests that the summer recovery could be slowing somewhat as we enter the final months of 2020.



Citigroup

Economic surprise indices have realized unseen volatility – even surpassing prior highs and lows from the 2008 financial crisis. All three major regions starkly rose off lows from earlier this year. Readings for the U.S. and the Eurozone recovered more quickly but have come down in recent months, while EM readings steadily have improved.



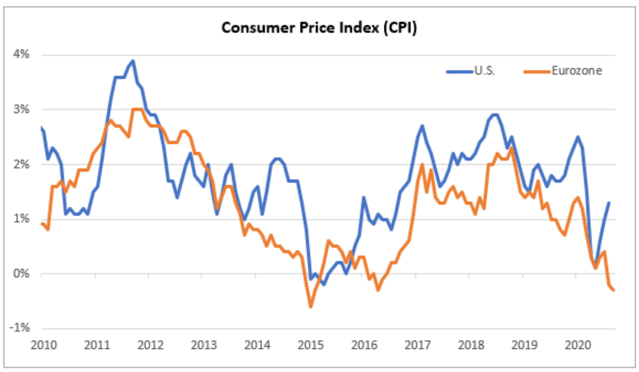
Institute for Supply Management

Both the manufacturing and services (non-manufacturing) indicators remained well above 50 – the inflection point between expansion and contraction. Strong readings indicate that these portions of the economy continue to rebound although both September readings were modestly below post-recovery highs.

ECONOMIC GROWTH

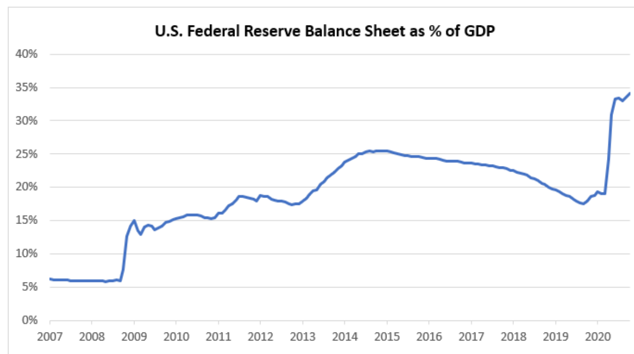
The U.S. Federal Reserve continued to increase its role in the economy. After taking drastic action earlier in the year by cutting the federal funds rate to nearly 0%, the third quarter brought new policy changes and forward guidance. Perhaps most notably, the Fed adopted a new approach to inflation targeting whereby it looks to achieve inflation of above 2% for an extended period to make up for years of undershooting this target. In response to this revised mandate, the Fed has agreed to hold the federal funds rate at near 0% until inflation is set to exceed 2% for some time. In addition to vast monetary policy, fiscal stimulus has (and will likely continue) to be a core component of government intervention to catalyze the recovery. Both efforts will push government debt levels to new highs – even above levels following World War II. Massive levels of government debt will require discipline in subsequent years following a hopeful re-acceleration of the economy or could lead to high levels of inflation and/or higher taxes in the future.

After falling to nearly 0% earlier this year, core inflation (as measured by CPI) has recovered somewhat. Despite low headline readings, inflation for many commonly purchased consumer goods has realized much higher increases. Some of the increase has come from elevated costs surrounding necessary adaptations to comply with the new COVID-world, while others stem from constrained supply and elevated demand. Some of the largest price increases can be seen at the grocery store and for home improvement projects.



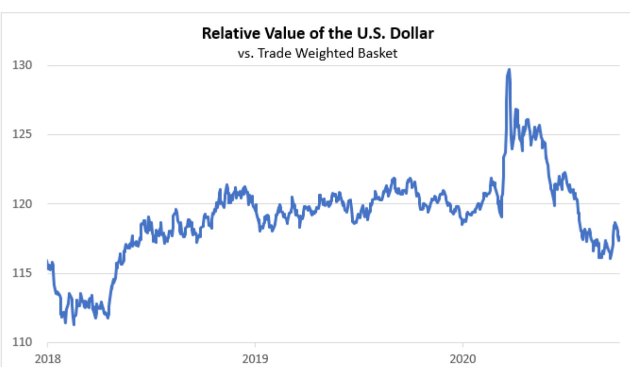
U.S. Bureau of Labor Statistics

U.S. CPI has bounced off recent lows while the European number continued to fall into negative territory. Select consumer-oriented goods and services are seeing increases well ahead of these figures offset by falling energy prices.



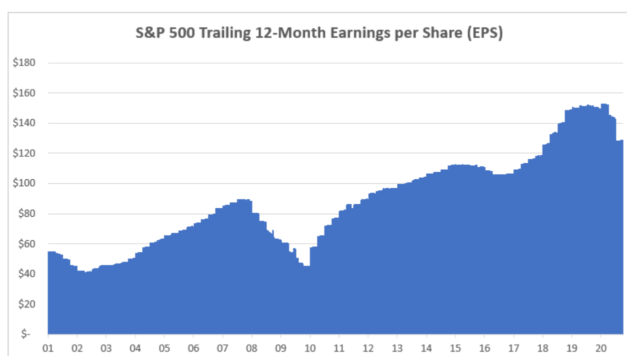
Bloomberg

A stated intent of keeping the federal funds rates near 0% for the near-term suggests that the Federal Reserve's balance sheet will show no signs of shrinking. The Fed's balance sheet has already grown by approximately $3 trillion this year including a $2 trillion increase in Treasury bond holdings.



U.S. Federal Reserve and Bloomberg

Following a flight to quality during the peak of the pandemic, the U.S. Dollar has steadily fallen in-line with rapidly expanding debt levels. The outcome of the election is likely to contribute to volatility as each party differs in its stated spending approach.



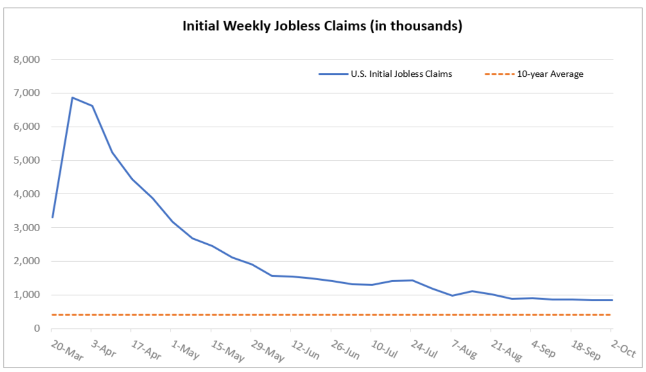
Bloomberg

The fall in corporate earnings reflected the extent of the recession in the first half of the year. Many analysts expect earnings to continue recovering throughout the rest of 2020 and into 2021. That said, it might not be until 2022 that new highs are reached for the S&P 500 Index in terms of earnings.

EMPLOYMENT AND CONSUMER

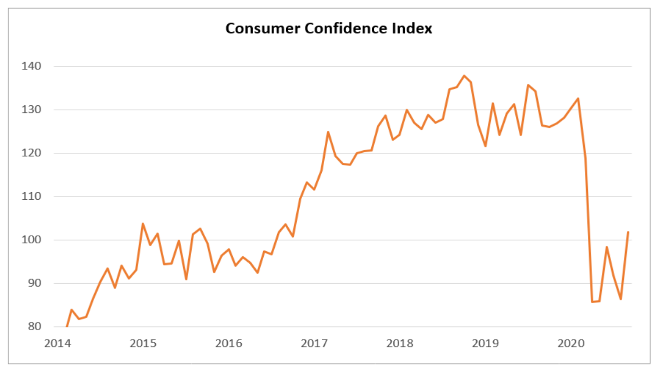
The third quarter continued the gradual recovery that's underway within the employment market. To quite simply break this down into three categories based on companies' ability to function during the pandemic, some companies can operate fine, some cannot, and some companies could likely operate with safety measures put in place. During the third quarter, many companies in the last category returned to work in the industries of home-building, manufacturing, and auto sales, which resulted in additional hiring that took place. Likewise, there are still many industries negatively impacted by the pandemic including airlines, hospitality, food services, and entertainment events like sports or concerts suffering from a lack of fans' attendance. All of these industries' effects have translated into the national unemployment rate declining modestly to 7.9% through September, after initially spiking to almost 15% in April. The pandemic resulted in a nationwide total of 22.2 million jobs lost offset after 10.6 million jobs were regained. This sedated return to full employment may continue as some challenges persist going forward. Forecasting the slow employment recovery, initial weekly jobless claims have trended downwards to above 800k, but are still well above the long-term weekly average of about 400k. The risk remains that people who previously dropped out of the labor market in the pandemic could soon be forced to look for a job out of financial necessity.

After the initial consumer confidence sharp drop in the second quarter, this benchmark gauge of investor sentiment has moderated over the past few months. Given the index is a leading indicator of economic data, readings above 100 imply the average domestic consumer is anticipating growth opportunities in the months ahead, while readings below 100 indicate the opposite. The future consumer's behavior is largely unknown given the upcoming election and conflicting policies that may follow. Similarly, the recent decrease in the personal savings rate indicates the average consumer is gradually considering more and potentially new ways to spend or invest their capital. As businesses continue to reopen (when it's safe to do so), the public takes notice and consumer spending ensues. The unknowns at this point are when this will happen and to what degree this will effectuate a meaningful economic rebound.



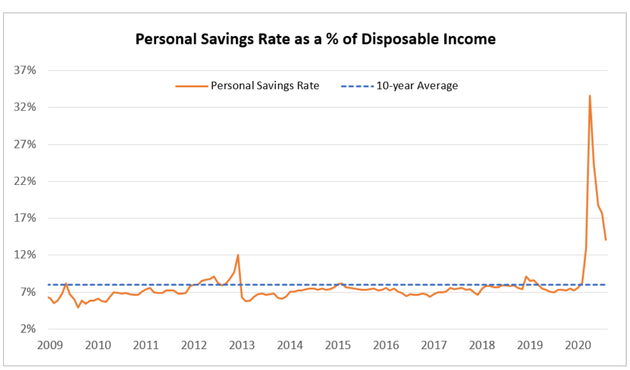
Labor Department

Initial jobless claims have moderated to below one million per week, but remain higher than previously forecasted and the long-term 10-year weekly average.



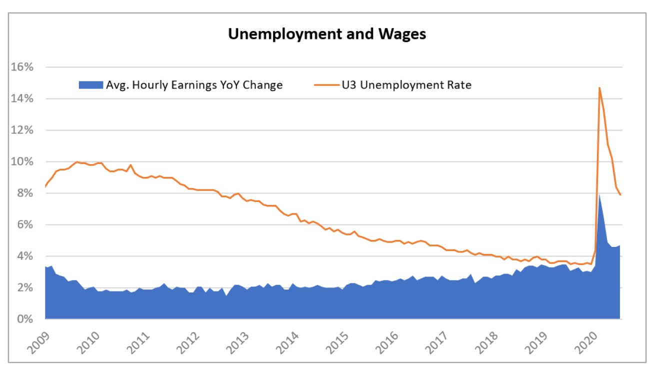
Conference Board

This index stopped its sudden plunge in April. For the first time since March, September's reading came in just above 100, hinting of future growth opportunities.



U.S. Bureau of Economic Analysis

The U.S. personal savings rate subsided from 34% in April but remains higher than the long-term 10-year monthly average rate of 8%. Americans continue to explore areas in which to spend their disposable income.



U.S. Bureau of Labor Statistics

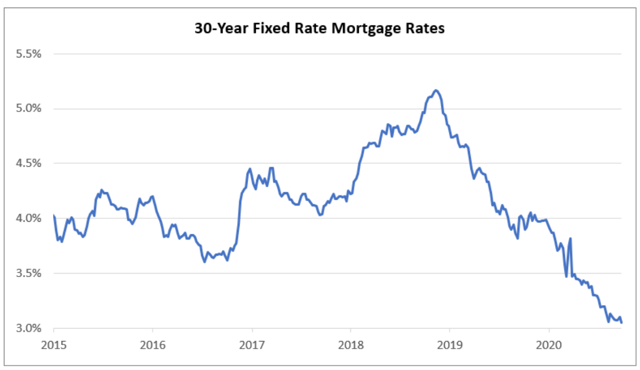
Unemployment in the U.S. initially spiked to almost 15% in April but has since fallen to below 8% through September. Progress towards returning to full employment remains an optimistic goal for the nation.

HOUSING AND COMMERCIAL REAL ESTATE

The residential portion of the real estate market has so far brushed off many of the implications of the pandemic. Historically low mortgage rates paired with evolving limitations on where people need to be for work has caused a flurry of activity. U.S. existing home sales posted their largest seasonally adjusted growth rate since 2005. Supply is quickly trying to catch up with demand as home building activity has risen near a decade long peak reached earlier in 2020. The pandemic has also accelerated some trends that were already occurring (rise of secondary markets, work from anywhere) in addition to igniting others (the move from cities to suburbs) at least in the near- to medium-term.

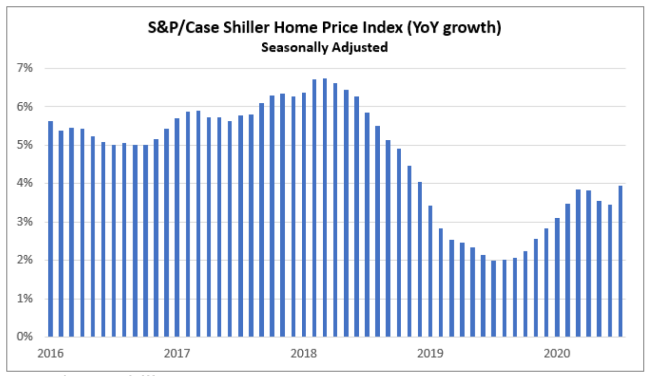
The commercial sector is more of a mixed bag. Like the residential sector, several pre-pandemic trends (retail moving online) have accelerated, although they often have less favorable implications. The pandemic has also introduced new trends where the longer-term implications are less clear. Companies across the country are rethinking where and what their physical footprints needs to be, travel and leisure destinations are coping with a fraction of prior demand, and social distancing requirements have turned open floor plans from an asset to a liability. The result of these factors can be seen through public market real estate equity performance. Within the FTSE Nareit Sector Indexes, the Residential sector is down less than half as much as the hardest hit Lodging and Resort Index with Office and Retail falling in the middle.

The rate of change within the real estate market stemming from the pandemic has been astonishing. As time progresses and the impacts of COVID-19 are less directly felt, it's possible that many of the aforementioned trends will subside to some extent. That said, volatility in this area of the market is likely to remain elevated until a new equilibrium is reached.



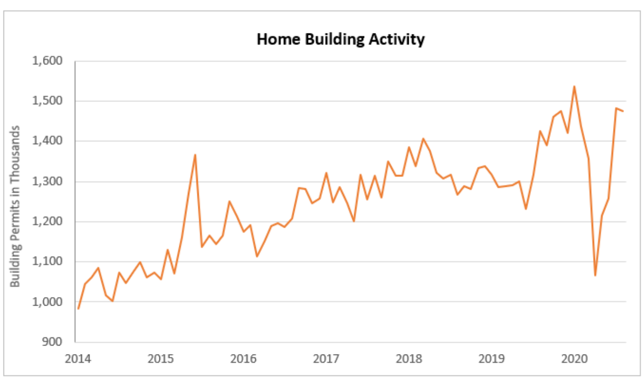
Mortgage Bankers Association

Mortgage rates have ticked down even relative to historical lows reached at the end of the second quarter. At the end of September, the effective 30-year mortgage interest rate stood at approximately 3%.



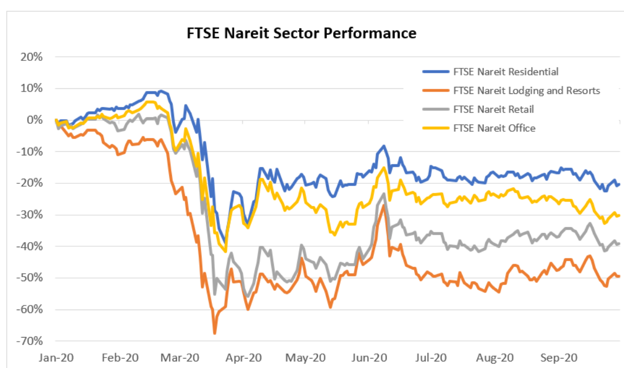
S&P/Case Shiller

Home prices saw sizeable gains over the quarter boosted by strong demand and record low mortgage rates. Secondary metro-areas often have realized the largest gains.



U.S. Bureau of the Census, U.S. Department of Housing and Urban Development

The third quarter continued the comeback in building activity as confidence among single-family homebuilders remained high. Continued demand should keep activity high in the coming months.



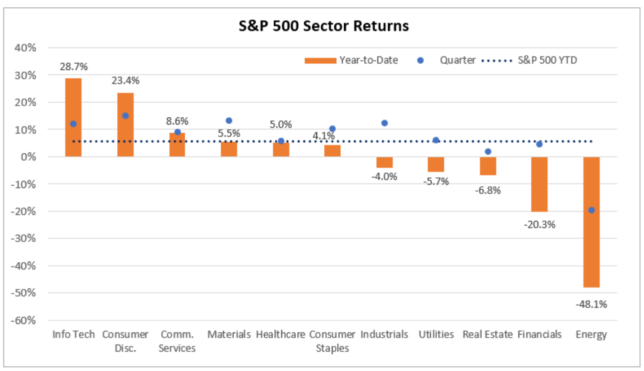
Nareit

The current pandemic continues to affect various areas of the real estate market very differently. Residential has marked the strongest recovery while areas such as Retail and Lodging & Resorts keep suffering.

EQUITY MARKETS

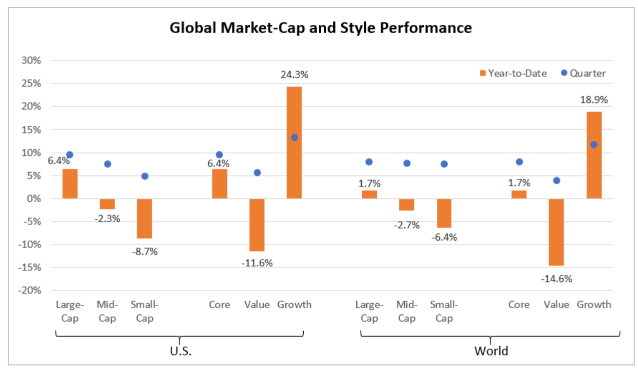
Strong equity market results persisted in the third quarter following some astounding second quarter indices' returns. The benchmark U.S. equity S&P 500 Index produced an 8.9% positive return which leaves it in positive territory for the year thus far. The level of volatility experienced during the quarter, as represented by the CBOE Volatility Index (VIX), remained slightly elevated compared to its long-term average, which presented brief bouts of peaks and valleys. Internationally, emerging markets sharply outperformed developed markets due to the dominance of technology firms in emerging market countries like China and Taiwan. Valuations, especially for certain areas of the market such as large-cap technology firms, are elevated relative to historical levels. Some of these metrics haven't reached similar levels since the dot-com bubble and are vulnerable to small disappointments in business fundamentals relative to expectations.

In the U.S., all sectors produced positive returns aside from energy which fell 20%. This sector still suffers from a drastic decline in the demand for oil as commuters have not returned as quickly as previously thought to their pre-pandemic traveling routines for either work or leisure. The leading sector was consumer discretionary, which rose 15%. It benefited from the prolonged work-from-home and online-shopping environment. Even though all market-caps and styles produced positive third quarter results within the U.S. and internationally, some regions did better than others. Around the world, growth beat value which extended the styles' year-to-date performance gap. Large-cap stocks once again trounced small-caps within the U.S. for the quarter, but the disparity was much more muted outside of the country.



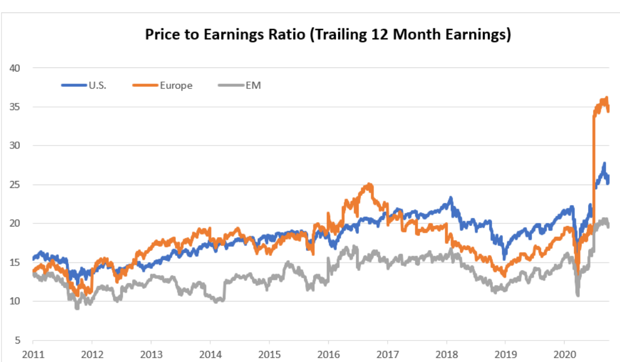
Bloomberg

All sectors rose during the quarter except for energy, which continues to struggle as levels of transportation lag. Contrary to this, the consumer discretionary sector led all others, which profited from several companies that capitalized on the prevailing social distancing measures.



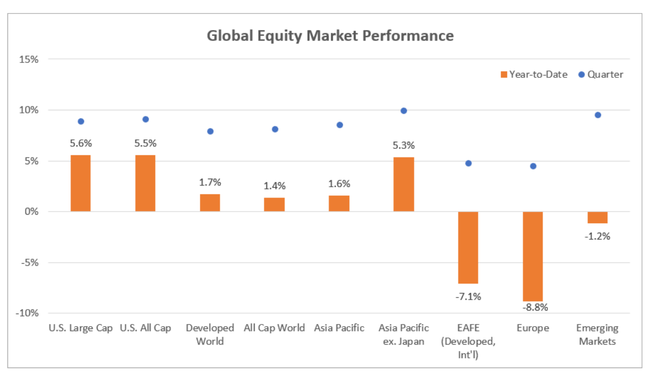
Bloomberg; U.S. indices from Russell and World indices from MSCI

Large-cap stocks outpaced small-caps in the U.S. while the dispersion between market caps was neutral throughout the world. The growth style once again beat value, which was a common theme that existed in the U.S. and the world during the quarter and for the year-to-date results.



Bloomberg

The current price to earnings ratio in Europe has not been reached since late 2009, while in the U.S. not since 2002. This creates a concern that stocks are overvalued today. Part of the rise in valuations is attributable to historically low interest rates.



S&P and MSCI

All regions around the world produced positive returns for the quarter between 5-10%. However, for the year results are mixed. The U.S. and Asia Pacific ex. Japan lead with returns over 5%, while developed international, Europe, and emerging markets lag with negative absolute returns.

FIXED INCOME MARKETS

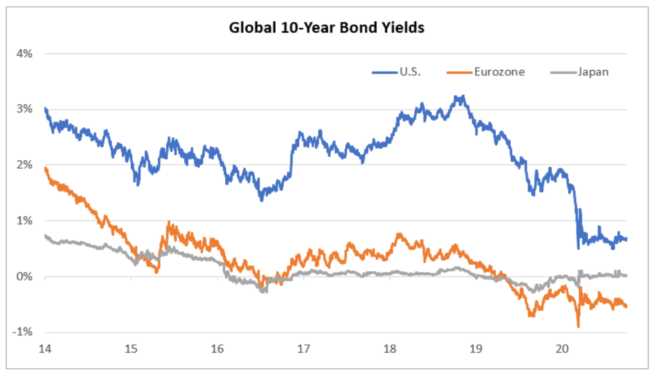
Fixed income markets had a strong third quarter. Non-traditional sectors such as Treasury Inflation- Protected Securities (TIPS), high yield and international bonds sharply outperformed core U.S. bonds. TIPS rose over 3% for the quarter and have gained almost 10% year to date. Lower quality high yield bonds, which often move in tandem with stocks, also outperformed in both the taxable and municipal bond segments. TIPs and municipal bonds have experienced strong buying demand. With the sharp decline in U.S. bond yields and a weaker dollar, international bonds have become more attractive.

Credit concerns remain elevated in the corporate and municipal bond markets. Corporate high yield default rates were 6% at quarter-end and are forecasted to eventually reach double-digits. Defaults have been concentrated in industries most heavily impacted by COVID-19, highlighting the importance of credit selection. Municipal default rates are historically very low, even during recessions. Although many states and local municipalities are facing budget gaps due to reduced revenue and higher costs, tax collections have been stronger than expected.

The Federal Reserve has announced a more flexible approach to setting rates by allowing inflation to exceed the current 2% target. This procedural change raised inflation and growth expectations, driving yields higher as the quarter came to an end. The continued expansion of the U.S. budget deficit could further lift long-term yields and inflation, while also boosting economic growth. However, Fed bond purchases and sustained low policy rates should balance the inflationary impact of additional government spending.

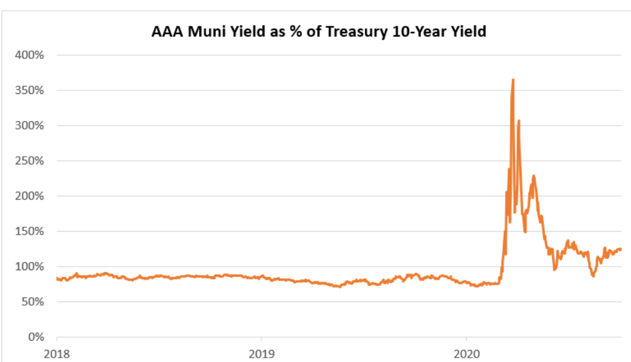
Barclays Capital

High yield spreads have been trending upward, but remain far below the recent peak at the height of the coronavirus crisis. Corporate default rates have reached 6% and are expected to go higher.



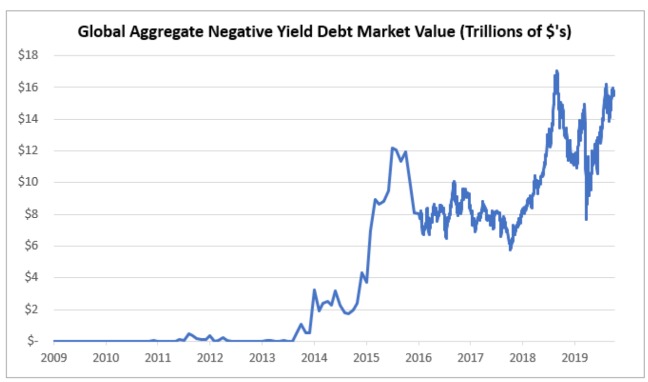
Bloomberg

Sovereign bond yields remained relatively stable during the quarter. Lower U.S. bond yields and a weaker dollar made international bonds, particularly in emerging markets, more attractive to investors.



Bloomberg

Strong investor demand supported municipal bond yields. The yield on intermediate-term municipal bonds was in line with Treasuries at quarter-end. Heavy new issue supply is expected prior to the election.



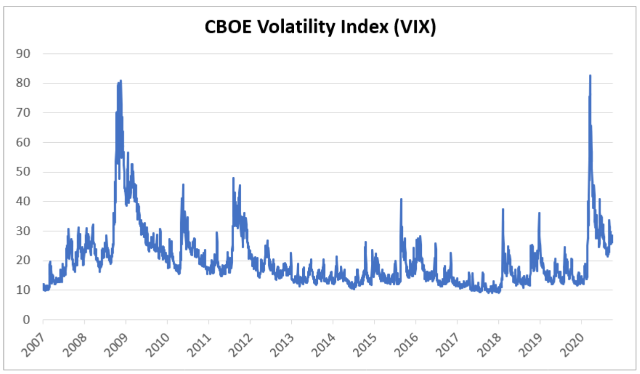
Bloomberg Barclays

The share of global bonds with negative yields stabilized during the quarter. Yields remain negative in several European countries including Germany and France. Yields in emerging countries are generally positive.

ALTERNATIVE MARKETS

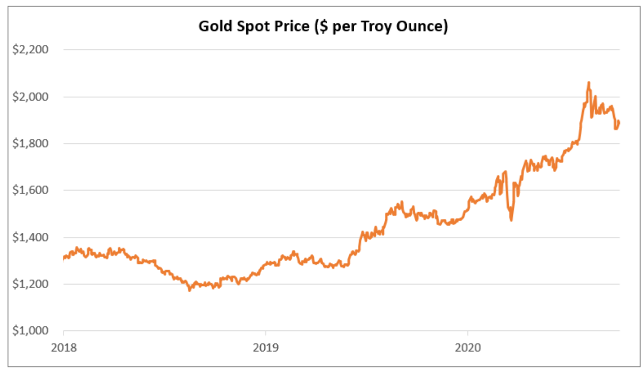
Hedging and tactical strategies had positive, but muted results during the third quarter. Most strategies provided downside protection during the bouts of stock market volatility that marked the start and end of the quarter. Options based equity and convertible strategies were notable standouts. Convertible arbitrage benefited from elevated stock market volatility and the upswing in new issuance with many bonds offered at attractive terms. Options based mutual funds designed to hedge stock market volatility have seen the largest inflows of any category this year. Commodities experienced a broad rally during the quarter, with rising prices in all major sectors. Energy commodities such as crude oil staged a modest recovery, but are down over 40% year to date.

Private capital markets have seen material dislocations during the coronavirus crisis. Traditional lenders pulled back as the liquidity needs of borrowers swelled, creating opportunities for private lenders. M&A activity slowed significantly as the health crisis unfolded and returns for many deals completed before the crisis will see write-downs and reduced return expectations. However, rising defaults and stressed situations may create a compelling opportunity set for private investments going forward.



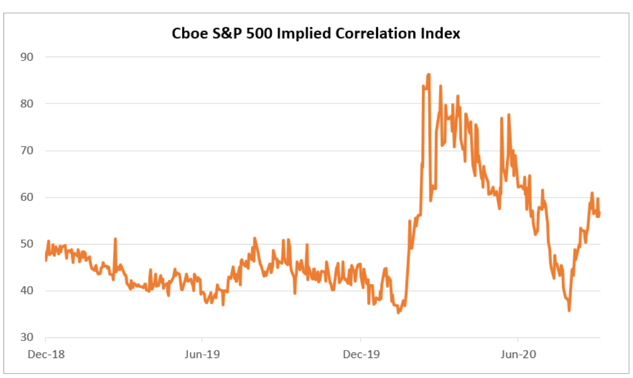
Cboe, Bloomberg

Stock market volatility expectations, as measured by the VIX Index, remained above average in the 20 to 25 range during the quarter. VIX prices at different maturity dates suggest investors expect volatility to remain elevated.



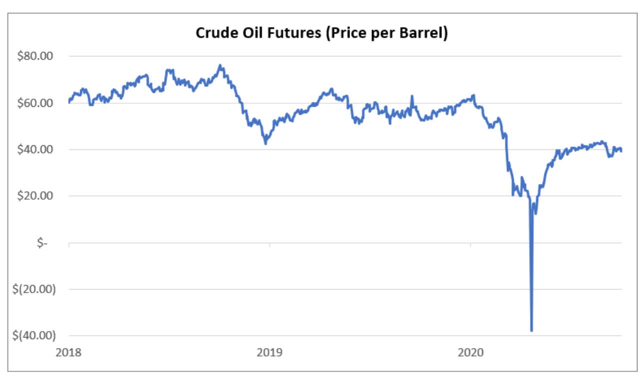
Bloomberg

The price of gold rose modestly for the quarter, despite a sizable drop in September. Gold prices can be unpredictable and typically move in the opposite direction of real interest rates which have increased in recent weeks.



Cboe, Bloomberg

S&P Correlation has recently been unstable, and by quarter end had once again risen sharply. The correlation between stocks tends to rise during market corrections and periods of heightened volatility.



U.S. Energy Information Administration

The price of crude oil was relatively stable during the quarter due to a supply reduction and favorable economic outlook. The oil price has a major influence on the inflation rate and is a bell-weather for global growth.

CAPITAL MARKET RETURNS

	Third Quarter	Year-to-Date
Cash and Fixed Income		
U.S. Treasury Bills	0.0%	0.6%
Barclays U.S. Aggregate Bond Index	0.6%	6.8%
Barclays Municipal Bond Index	1.2%	3.3%
Barclays Global Aggregate ex. USD	4.1%	4.8%
Hedge Funds and Alternatives		
Bloomberg Commodity	9.1%	-12.1%
DJ U.S. Real Estate	2.1%	-12.1%
HFRX Global Hedge Fund	2.7%	4.2%

	Third Quarter	Year-to-Date
U.S. Equity		
Russell 3000	9.2%	5.4%
S&P 500	8.9%	5.6%
Russell 2000	4.9%	-8.7%
International Equity		
MSCI ACWI ex. U.S.	6.8%	-5.2%
MSCI EAFE (Developed)	4.8%	-7.1%
MSCI Emerging Markets	9.6%	-1.2%

Morningstar & Hedge Fund Research, Inc. (HFRI)

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