Stembrook Asset Management

Stembrook Market Review — Third Quarter 2020

Following the steep selloff in February and March resulting from the global economic shutdowns, global equities continued to rebound from their March lows, up 6.7% in the third quarter.[1] Much of this recovery has been attributed to the massive amount of stimulus at the hand of central banks. As noted in last quarter's review, the stock market and the economy do not move in lockstep, especially over short periods of time. Consumer behavior, while improving, is far from normal. The economy in the U.S. has shown signs of improvement, GDP grew 33.1% in the third quarter[2] and unemployment fell to 8.8%.[3] That said, we are still a long way from 2019 levels and economists expect it will take over a year to rebound to the level of output seen before the recession.

With the election looming, it is reasonable to ask how certain outcomes might impact our portfolios. There have been many studies of how markets perform under different scenarios (see middle chart below for an interesting example). That said, we approach predicting elections with a fair dose of humility. Further, predictions of winning and losing sectors can disappoint. Consider that a win by the current administration was expected to provide a boost to oil and gas companies due their stance on deregulation, but this group of stocks is down –15.8% on an annualized basis since the previous election due to industry fundamentals unrelated to government policy.[4] Given their unreliable nature, we have not made changes to the portfolio based on election predictions. We will be looking for further opportunities as events unfold.

Our proprietary models forecast long-term, pre-tax returns ranging from 0% to 3% for fixed income-like asset classes and 8% to 10% for equity-like asset classes (see table to the right). We maintain target weight allocations for equities and fixed income. We removed REITs from our strategic allocation at the end of the third quarter in our continuing effort to shift our equity model closer to the MSCI All Country World Index benchmark, a benchmark of stock markets around the world. Our more detailed observations and current portfolio positioning are outlined in the following comments.

Expected Market Returns and Risks 7-10 Year Horizon

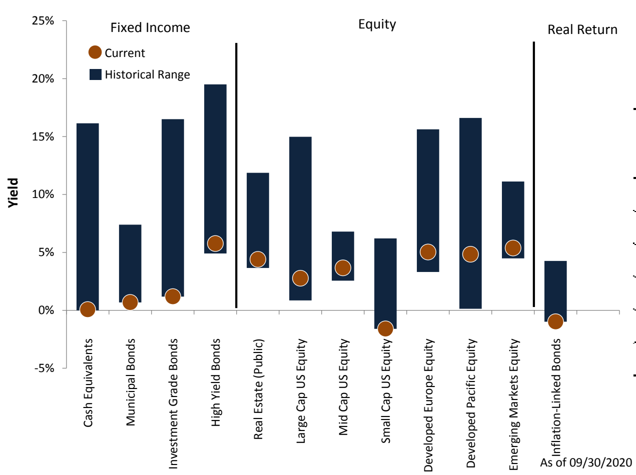
As of: 30-Sep-20

Expected Risk and Return - 7-10 Year Horizon

		Pre-Tax Annualized Return	After-Tax Annualized Return	Volatility[1]
	Inflation	1.6%	1.6%	3.1%
Fixed Income	Municipal Bonds	0.6%	0.6%	4.4%
Fixed Income	Inflation-Linked Bonds	0.5%	0.2%	5.6%
Fixed Income	Investment Grade Bonds	1.0%	0.5%	6.7%
Fixed Income	High Yield Bonds	2.6%	1.2%	13.2%
Equity	Broad Market US Equity	7.9%	6.1%	16.9%
Equity	Developed Non-US Equity	8.6%	6.6%	21.4%
Equity	Emerging Markets Equity	10.1%	6.6%	29.6%

A sampling of return expectations produced by our models. Expected returns are projections and are not guaranteed.

Yields Across Asset Classes



Yields are an indicator of future returns. Orange dots show current yields, blue bars show historical ranges. Bond yields are generally low versus historical range.

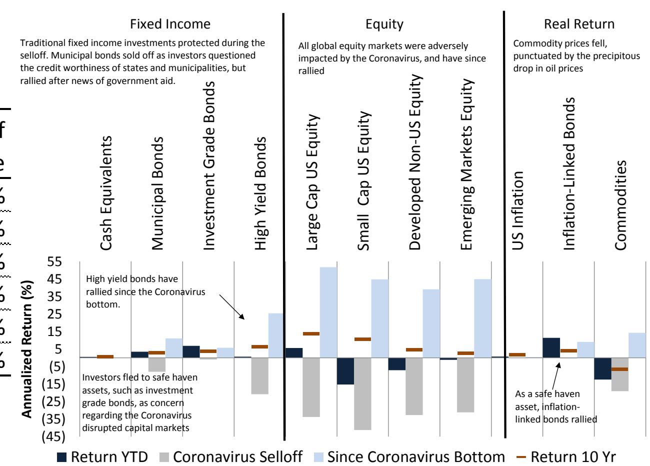
Party Leadership and Equity Returns

DJIA Performance Since 1901

When U.S. Government Has A:	% Gain/ Annum	% of Time
Democratic President, Republican Congress	5.21%	10.06%
Democratic President, Split Congress	7.99%	3.35%
Democratic President, Democratic Congress	2.96%	33.36%
Republican President, Republican Congress	7.09%	23.45%
Republican President, Split Congress	-4.69%	11.37%
Republican President, Democratic Congress	-2.05%	18.42%

Betting on an election outcome isn't a reliable source of return. Markets and the economy can flourish under all leadership combinations.

Historical Market Returns



Historical market returns as of September 30th, 2020. Note that looking backwards at recent returns is not a reliable method for predicting future returns.

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Global Asset Class Returns

Asset Class Name	Last 10 Years	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Small Cap US Equity	S&P 500 11.2%	Real Estate 28.6%	Infl-Indx Bnd 14.0%	EM Eq 18.2%	Small Cap 41.3%	Real Estate 31.8%	Real Estate 2.8%	Small Cap 26.5%	EM Eq 37.3%	CPI 2.0%	S&P 500 31.5%
Large Cap US Equity	Small Cap 11.0%	Small Cap 26.3%	Real Estate 9.2%	Real Estate 17.6%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	HY Bnd 17.5%	Intl Eq 25.0%	Inv Grd Bnd 0.0%	Real Estate 28.7%
Real Estate (Public)	Real Estate 10.5%	EM Eq 19.2%	Inv Grd Bnd 7.8%	Intl Eq 17.3%	Intl Eq 22.8%	Inv Grd Bnd 6.0%	CPI 0.8%	S&P 500 12.0%	S&P 500 21.8%	Infl-Indx Bnd -1.8%	Intl Eq 22.8%
High Yield Bonds	HY Bnd 6.2%	Commod 16.8%	HY Bnd 4.5%	Small Cap 16.3%	HY Bnd 7.4%	Small Cap 5.8%	Inv Grd Bnd 0.5%	Commod 11.4%	Small Cap 13.2%	HY Bnd -2.1%	Small Cap 22.7%
Emerging Markets Equity	Intl Eq 4.8%	HY Bnd 15.2%	CPI 3.0%	S&P 500 16.0%	Real Estate 1.9%	Infl-Indx Bnd 4.6%	Intl Eq -0.2%	EM Eq 11.3%	Real Estate 8.7%	Real Estate -4.0%	EM Eq 18.6%
Developed Non-US Equity	EM Eq 3.1%	S&P 500 15.1%	S&P 500 2.1%	HY Bnd 15.4%	CPI 1.5%	HY Bnd 2.5%	Infl-Indx Bnd -1.4%	Real Estate 8.6%	HY Bnd 7.5%	S&P 500 -4.4%	HY Bnd 14.3%
Investment Grade Bonds	Inv Grd Bnd 3.1%	Intl Eq 7.8%	Small Cap 1.0%	Infl-Indx Bnd 7.2%	Inv Grd Bnd -2.0%	CPI 1.3%	Small Cap -2.0%	Infl-Indx Bnd 3.6%	Inv Grd Bnd 3.5%	Small Cap -8.5%	Infl-Indx Bnd 10.6%
Inflation-Linked Bonds	Infl-Indx Bnd 2.9%	Infl-Indx Bnd 6.5%	Intl Eq -12.1%	Inv Grd Bnd 4.2%	EM Eq -2.6%	EM Eq -1.8%	HY Bnd -4.6%	Inv Grd Bnd 2.6%	Infl-Indx Bnd 3.0%	Commod -13.0%	Inv Grd Bnd 8.7%
Inflation	CPI 1.5%	Inv Grd Bnd 6.5%	Commod -13.3%	CPI 2.0%	Infl-Indx Bnd -9.4%	Intl Eq -4.5%	EM Eq -14.8%	CPI 1.8%	CPI 2.1%	Intl Eq -13.3%	Commod 5.4%
Commodities	Commod -4.4%	CPI 1.5%	EM Eq -18.4%	Commod -1.1%	Commod -9.5%	Commod -17.0%	Commod -24.7%	Intl Eq 1.6%	Commod 0.7%	EM Eq -14.5%	CPI 2.1%

Returns are arranged in columns, by year. Each color represents a different asset class. Each year, the leaders and laggards tend to shift. Diversification across a range of asset classes can smooth returns and enhance growth.

Economic Backdrop

- **After a massive drop in global economic activity in the second quarter from COVID-19 related shutdowns, global economies are expected to bounce back in the third quarter, growing by 7.1%.[2] While this recovery appears to be strong, economists expect it to take years before economic activity reaches its prior peak.**
- Despite the record amount of monetary support from central banks, global Inflation for G-20 countries is expected to hold steady, with prices continuing to increase modestly by 1.4%.[5]
- With many countries still struggling to control the Coronavirus, Emerging Markets GDP is expected to contract by -0.7% in the third quarter.[2] Notable weakness in India and Argentina, both of which are struggling to control the virus, has weighed down growth for the group of countries. In contrast, China continues to show relative strength and is expected to grow by 5% in the quarter.[2]
- Business confidence has rebounded after considerable weakness in the second quarter. Both services and manufacturing purchasing manager's indices are, once again, above 50. A level above 50 indicates expansion, while a level below 50 indicates contraction.[6]
- The United States labor market has seen a meaningful rebound from the initial 22.2 million jobs lost as a result of the pandemic, having regained 10.6 million jobs.[7] The lion's share of the jobs that have not been recovered are in the leisure and hospitality space, as many companies await an additional round of Coronavirus relief funding.

Equities

- **Equity markets continued to recover in the second quarter, led by technology stocks. The NASDAQ was up 10.6% in the quarter.[8]**
- Emerging markets stocks outperformed developed non-U.S. stocks up 6.4%[9] and 3.3%[10] respectively.
- Equity markets have rallied back since the lows of March, specifically in the U.S. This strong performance has been dominated by only a few large stocks. These stocks have reached 24% of the overall market share in the index. The last time that the top 5 names dominated the market share of the index was in 2000 when they accounted for 18% of the index. Through September 18th, the S&P 500 was up 2.7% year to date. The top 5 largest stocks in the index were up 28.8%, while the bottom 495 stocks were down –3.4%.[11]

Fixed Income

- **After a strong first half, most fixed income-like investments had returns closer to their yields. High yield bonds continued to outperform, up 3.8% in the quarter.** [12]
- With yields at record lows, it is difficult to find attractive opportunities in the fixed income market.

Current Positioning

- In late April, **we increased our allocation to high yield bonds** for both taxable and tax-deferred portfolios as yields became more attractive during the selloff. We maintain this neutral weighted position.
- We maintain our **overweight to developed non-U.S. and emerging market equities**, where valuations and long-term return potential remain attractive.
- We also maintain our **underweight to large cap U.S. equities.**
- We favor **lower priced, value-oriented equities, both in the U.S. and abroad,** which tend to outperform the broad market over time, with less volatility.
- We remain **overweight municipal bonds** for taxable investors.

As a reminder, all required minimum distributions (RMDs) have been waived for tax year 2020 as a result of the CARES Act. If you have any questions about year-end gifts or tax-planning strategies, please do not hesitate to contact us. The final estimated tax payment for tax year 2020 is due on January 15, 2021.

We continue to focus our efforts on helping you meet your financial objectives by following our disciplined investment approach. Our approach uses return and risk models, incorporating fundamental valuations and tax-efficient strategies. This investment discipline is tailored to your individual situation in our continuing effort to craft and implement your customized investment solution.

As always, we thank you for placing your trust in our investment management and advice and welcome your questions and comments at any time.

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Endnotes and Sources:

Text:

(1) Bloomberg: MSCI ACWI Total Return. 6/30/20-9/30/20.
(2) Bloomberg, Stembrook Research: GDP measures are based on the most recent annualized quarterly, seasonally-adjusted data. Statistics are stated in inflation-adjusted terms. Aggregate Statistics are weighted by each country's GDP translated into USD. Where available, official estimates are used. Where official estimates are not available, GDP data is based on Bloomberg Contributor Forecasted GDP. Emerging Markets measures are based solely on Bloomberg Contributor Forecasted GDP. As of 9/30/20.
(3) Bloomberg: US Unemployment Rate. As of 9/30/20.
(4) Bloomberg: S&P 500 Energy Sector GICS Level 1. 11/8/16-9/30/20.
(5) Bloomberg, Stembrook Research: Aggregate inflation statistics are weighted by each country's GDP translated in to USD. As of 9/30/20.
(6) Bloomberg: Markit Global Purchasing Managers Index for Manufacturing and Service. As of 9/30/20.
(7) Bureau of Labor Statics: Total Nonfarm Payrolls February—April 2020, April 2020—September 2020.
(8) Bloomberg: NASDAQ 100 Total Return. 6/30/20-9/30/20.
(9) Bloomberg: MSCI Emerging Markets Total Return. 6/30/20-9/30/20.
(10) Bloomberg: MSCI EAFE Total Return. 6/30/20-9/30/20.
(11) Charles Schwab Investment Research, S&P 500 12/31/19-9/18/20.
(12) Bloomberg: Bloomberg Barclays U.S. Corporate High Yield Index Total Return. 6/30/20-9/30/20.

Charts:

Expected Market Returns and Risks, 7-10 Year Horizon: As of 9/30/20.
Source: Stembrook Research.
(1) Volatility is measured in terms of Standard Deviation. Standard deviation is the statistical measurement of dispersion about an average, which depicts how widely a stock or portfolio's returns varied over a certain period of time. Investors use the standard deviation of historical performance to try to predict the range of returns that is most likely for a given investment. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility. If an investment's returns follow a normal distribution, then approximately 68 percent of the time they will fall within one standard deviation of the mean return of the investment, and 95 percent of the time within two standard deviations. For example, for a portfolio with a mean annual return of 10 percent and a standard deviation of two percent, you would expect the return to be between 8 and 12 percent about 68 percent of the time, and between 6 and 14 percent about 95 percent of the time. Source: Morningstar.

Yields Across Asset Classes: As of 9/30/20.
Sources: *Cash Equivalents Yields* since March 1976. Ibbotson, Federal Reserve Bank, Thomson Reuters, *Municipal Bond Yields* since March 1988. Barclays Capital, Charles Schwab, BofA Merrill Lynch, Standard & Poor's/Investortools Municipal Bond Indices, *Investment Grade Bond Yields* since March 1976. Barclays Capital, *High Yield* since December 1984. BofA Merrill Lynch, Barclays Capital, *Real Estate (Public) Earnings Yield* since March 1976. NAREIT all Equity, *Large Cap U.S. Equity Earnings Yield* since March 1976. Standard & Poor's, BARRA, *Mid Cap U.S. Equity Earnings Yield* since June 1991. Standard & Poor's, BARRA, *Small Cap U.S. Equity Earnings Yield* since December 1993. Standard & Poor's, BARRA, *Developed Europe Equity Earnings Yield* since March 1976. MSCI Europe, Standard & Poor's Europe 350, *Developed Pacific Equity Earnings Yield* since March 1976. MSCI Pacific, S&P/Citi PMI Asia Pacific, S&P Asia 50, *Emerging Market Equity Earnings Yield* since December 1998, *Inflation-Linked Bond Real Yield to Maturity* since March 1997. Citi Yield Book, Federal Reserve Bank. Note: Yields are not perfect predictors of future returns and should not be used in isolation.

Government Leadership and Equities
Source: Ned Davis Research, S&P Dow Jones Indices. Monthly Data 3/30/1901-8/31/2020.

Historical Market Returns: As 9/30/20.
Coronavirus selloff: 2/19/20-3/23/20 Since Coronavirus Bottom: 3/23/20-6/30/20.
Source: Bloomberg, Stembrook Research.
Indices: Bloomberg Barclays U.S Treasury Bills 1-3 Month Total Return, Bloomberg Barclays Municipal Bond 5 Year (4-6) Total Return, Bloomberg Barclays U.S. Aggregate Bond Total Return, Bloomberg Barclays U.S. Corporate High Yield Total Return, FTSE All Equity REIT Total Return, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Total Return, MSCI EM (Emerging Markets) Total Return, Consumer Price Index – U.S., S&P 10 Year U.S. TIPS Total Return, Bloomberg Commodity (Total Return) Index.

Global Asset Class Returns: As of 12/31/19.
Source: Thomson Reuters, Bloomberg, Stembrook Research.
Indices: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Bloomberg Barclays U.S. Treasury Bills: 1-3 Month Index, Citigroup Inflation-Linked Index, S&P 10 Year US TIPS Index, Bloomberg Barclays U.S. Aggregate Bond Index, BofA Merrill Lynch U.S. High Yield Cash Pay, Bloomberg Barclays U.S. Corporate High Yield Index, Dow Jones Wilshire REIT Index, FTSE All Equity REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones AIG Commodity (Totl Ret) Index, Bloomberg Commodity Index.

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The capital market expectations developed by Stembrook Asset Management are estimates of both a central tendency of asset class behavior and a probable range of asset class behavior over a long-term horizon. These estimates are one of many inputs used in the portfolio construction process, and should not be used independently. These expectations should not be construed as the returns that will be achieved, but merely those that may be achieved if certain assumptions hold true. Also note that each client's portfolio may differ given specific goals and constraints applied to the portfolio construction process.

Additional information is available upon request.