LongView
ASSET MANAGEMENT

2020 Third Quarter Review and Outlook

Despite 2020's volatile mix of ingredients, the third quarter was a period of relative calm for investors. Stocks continued to recover from March's lows, and bonds held steady, with interest rates anchored near record lows. Markets are reacting positively to the shifting US electoral outlook and advances in virus treatments and vaccine trials, but the economic recovery is still vulnerable.

Led once again by large tech companies that have benefited from remote work and online commerce, the S&P 500 Index erased the year's earlier losses and finished up +5.6% through September. Asian markets have also moved back into positive territory and emerging markets ended down by only -1.2%. Declines of almost 9% in European markets and smaller companies helped to limit the MSCI All-Country World Index to a gain of +1.37%.

Markets were supported by central banks that have kept interest rates near or below zero and by the pickup in activity. US economic news was mixed, consistent with the expiration of emergency unemployment benefits on July 31 and the failure to extend stimulus since then. Despite severe stress in many service and leisure-related sectors, other areas such as manufacturing, homebuilding and auto sales are on an upswing. Outside the US, most notably China, economies have also rebounded from the lows of this spring.

Investors appear heartened by the strengthening lead of the Biden campaign, no doubt calculating that a Democratic sweep will usher in increased economic stimulus, while dissipating the risk of a contested election. It's worth noting that, in previous periods when one party held both houses of Congress *and* the White House, the market has always risen.

Wall Street optimism notwithstanding, near-term risks to such a rosy prognosis include a serious second wave of infection, delays in an effective vaccine, turmoil around the US election, and geopolitical tensions. After their six-month rebound, moreover, asset prices are elevated in many markets, particularly bonds and large US tech and internet stocks.

The safety net provided by the Federal Reserve is expected to remain in place for the indefinite future. The Fed Funds Rate is currently at 0% and recent guidance suggests it will not be raised until 2024. In addition, the Fed announced a change to its inflation targeting regime, saying it would target an average 2% inflation rate, allowing periods of overshoot. Longer-term, investors will be dealing with the consequences of the biggest runup in US budget deficits since WWII and stunning levels of debt worldwide.

While short term interest rates will remain anchored by the Fed Funds Rate, longer term rates are likely to rise along with investors' heightened inflation expectations, resulting in a "steeper" yield curve. This steepening could present challenges to current bond-holders, as rising interest rates tend to push bond prices lower. The shorter average duration of our bond holdings reduces their sensitivity to rising rates, which should benefit us in such a scenario.

After an unusually long stretch of underperformance relative to the US, international and emerging market stocks look cheap by comparison. Asia and Europe have combatted the Coronavirus more effectively than the US, and should recover faster. In addition, a coordinated international monetary policy response is supportive to non-US markets. With US interest rates more in line with those of other developed economies than they have been in many years, and a domestic recovery that is lagging that of other developed nations, the dollar may weaken, further boosting the performance of international stocks for US investors. Our current international equity allocation is 35%, giving us meaningful exposure if foreign markets gain.

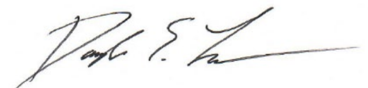
Finally, if the Wall Street predictions of an accelerating economy benefiting from a vaccine in 2021 are correct, smaller companies and "value" stocks, which are more sensitive to cyclical bounces in the economy, should outperform. Our portfolios are tilted towards these sectors and should benefit accordingly.

Through the course of this pandemic, maintaining a well-diversified portfolio and sticking to long term investment plans, while taking advantage of selloffs to rebalance portfolios and harvest tax losses, has proved a more expedient approach than attempting to time the market's ups and downs. We believe your portfolio is well positioned to weather the uncertainties of the months ahead, and we will as always look to capitalize on shifting trends as they occur.

We send you our best wishes during this fall and holiday season and we thank you as always for your trust.

David

Harlan


Doug