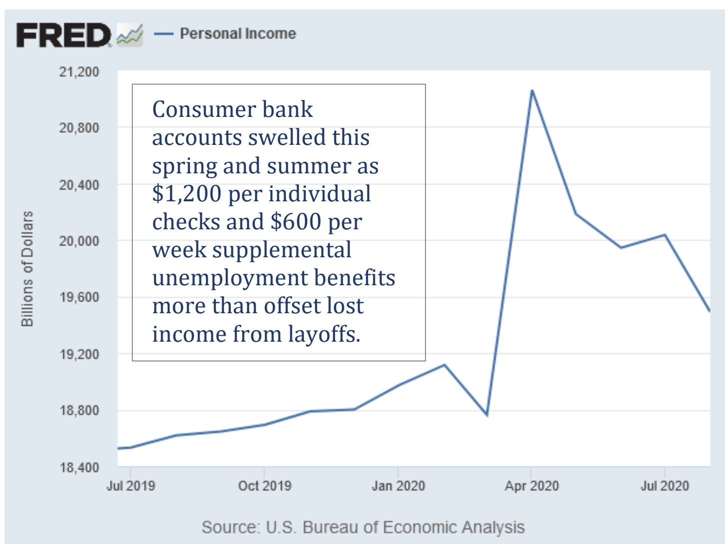
Fourth Quarter 2020 Outlook and Commentary

Over the course of the summer the economy and stock market continued to recover from pandemic-induced declines. The trajectory from here will depend a great deal on the course of the pandemic and the timing and scope of additional fiscal stimulus, but the worst-case scenarios imagined in the spring seem unlikely. The restaurant, aviation, hospitality, and entertainment industries are in the doldrums, but other parts of the economy, especially anything related to housing, have bounced back sharply.

The vigor of the recovery owes a lot to the speed and scope of actions taken by the Federal Reserve and Congress in late March. The Fed's actions stabilized the financial system and ensured that credit continued to flow. The CARES Act--including loans to small businesses, direct payments to 150 million individuals and families, and increased unemployment benefits—put hundreds of billions of dollars into consumer's pockets.

The chart below from the Federal Reserve Bank of St. Louis illustrates the impact of the CARES Act. Personal income during the first six months of the pandemic was four percent ***higher*** than



pre-pandemic levels! Much of that massive stimulus has ended up in new home purchases and home improvement. Revenues at Home Depot and Lowe's are now expected to increase by a stunning 10% and 15% respectively for their current fiscal year.

Further economic gains get a lot harder from here. Each month more of the job losses from the spring and summer become permanent. Bankruptcies in moribund sectors of the economy like restaurants, aviation, hospitality, and entertainment are rising. However, the negative impact of bankruptcies and job losses could be partially offset by additional fiscal stimulus. House Speaker Pelosi and Treasury Secretary Mnuchin have been negotiating a new package with a price tag in the vicinity of $2 trillion. President Trump broke off those discussions only to reverse course two days later. If sanity prevails, and a deal is reached, the economy should continue to recover, with overall levels of economic activity potentially reaching pre-COVID levels by the end of 2021. To some degree that will depend on the course of the pandemic, but even in the event of a major second wave, a national lockdown seems unlikely. And the fact that much of the labor force is already operating remotely is helpful.

As if uncertainty around further fiscal stimulus and the course of the pandemic aren't enough, you may have heard that there is an election around the corner. A few weeks ago, we received calls from some clients worried about a disputed election and civil unrest. Since then the Biden campaign has gained in the polls and there is less talk of a contested election. A Biden victory would thrill some readers and fill others with despair. For now, capital markets appear very comfortable with the prospect of a Biden win. It is helpful for all of us to remember that over longer periods of time the stock market tends to do well whether a Democrat or a Republican is in the White House, as illustrated in one of the two charts accompanying this commentary.
In the near term, investors need to be prepared for a wide range of scenarios. In an optimistic (but still quite plausible) scenario, Congress and the President agree on a meaningful stimulus package, the pandemic grinds on but doesn't derail the recovery, and the election and its aftermath are not as chaotic as feared. And then, sometime in 2021 a vaccine is widely available, the economy is on solid footing, and stocks, bolstered by rock-bottom interest rates and recovering corporate profits, deliver positive returns.

On the other hand, failure to enact more stimulus before January or a major second wave of the pandemic could cause the recovery to stall and send the economy back into a recession. We're less concerned about the risk that divisiveness over the election results will have a significant negative impact on the economy or the stock market, but 2020 has certainly been a strange year, so we can't rule it out entirely.

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Investing with a crystal ball would be easy. Anyone lucky enough to have one on New Year's Day 2020 might have loaded up on a handful of technology stocks such as Amazon, Apple, Facebook and Microsoft. The second chart accompanying this commentary illustrates what a winning strategy that would have been. The chart is composed of rectangles representing each stock in the S&P 500. The size of the rectangle is determined by the size of the company (share price times the number of shares outstanding), with the stock ticker symbol included for the larger companies. The color of the rectangle and the number inside indicates year-to-date price change as of September 30th. You can see two things at a glance: (1) a handful of tech stocks have been going through the roof and (2) the huge gains in these stocks mask a lot of weakness in the broader stock market.

As of this writing the combined price-to-earnings (p/e) ratio[1] of Amazon, Apple, Facebook and Microsoft is 45. As a point of reference, we checked to see what the p/e ratio of these four

[1] All p/e ratios discussed in this paragraph are trailing twelve-month reported earnings.

stocks has been in recent years. Somewhat arbitrarily we looked at the last trading day of 2016, 2017, 2018 and 2019. The p/e ratios were 24, 29, 25 and 32, respectively. To get back to these p/e ratios the combined value of the four companies would have to decline between 29% (to get back to 32) and 47% (to get back to 24). "Reversion to the mean" is a powerful force in the stock market. It reminds us that when fundamentals like p/e ratios get way out of whack, they tend to come back to historical averages. Reversion to the mean can happen quickly or it can happen slowly, but it always happens.

Speaking of reversion to the mean, the incredibly wide dispersion in returns this year--i.e. the contrast between the bright green boxes and bright red boxes on the chart--has created near-record discrepancies in valuations on value stocks as compared to growth stocks. There are a lot of ways to identify less expensive stocks (value stocks) and more expensive stocks (growth stocks). That accounts for the seven different rows in the chart below. The details of the different methods don't matter. What does matter is that almost no matter how you look, or where in the world you look, the valuation differentials are extreme, with more than half the numbers in the chart at the 100th percentile, meaning that value stocks have never been as relatively inexpensive.

Value Stocks Trading Near Lowest Relative Valuations to Growth in History

Percentile Rank (100th is Least Expensive)

	Global	International	US	Emerging Markets	Europe	Japan	International Small Cap
Price to Book	100%	100%	99%	97%	100%	99%	100%
Price to Earnings (P/E)	100%	100%	97%	100%	100%	94%	86%
Dividend Yield	100%	100%	100%	100%	99%	99%	67%
Price to Cash Flow	100%	100%	95%	99%	100%	98%	96%
Forward P/E	100%	100%	100%	100%	98%	100%	89%
EV/Sales	96%	97%	95%	100%	100%	97%	98%
EV/EBITDA	98%	100%	95%	99%	100%	100%	

Relative value is based on various fundamental ratios applied to the relevant MSCI indices between 12/31/74 and 6/30/20.

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Though not quite as extreme, an analysis of relative valuations would show a similar story for foreign stocks as compared to US stocks (foreign stocks being less expensive) and for smaller company stocks relative to large company stocks (smaller company stocks being less expensive). Reversion to the mean would imply significant outperformance for value stocks, foreign stocks, and smaller company stocks over the next five to ten years. With client portfolios weighted toward value stocks and having significant allocations to both foreign stocks and smaller company stocks, that would be very welcome news!

October 14, 2020
Boston, MA

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We will seek to minimize your investment expenses.

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