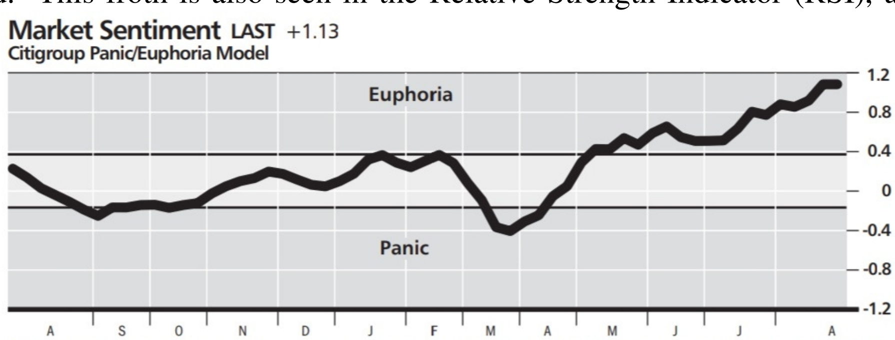
COMMENTARY

September 2020

The performance of equity markets has been extraordinary this summer, but we have started to see some cracks in the foundation as we enter the fall. While the broad indices, most notably the NASDAQ, have continued to power higher in recent months, underneath the surface you see that it has been a tale of two markets. Technology stocks have led the way in 2020, as their businesses have remained immune, or in some cases strengthened, from the economic impact of COVID-19. On the other side of the coin, many cyclical stocks such as industrials and financials, that are dependent on economic growth and an open economy, have only partially recovered from their March panic lows as the lingering pandemic continues to weigh on them. Some market observers have described this phenomenon as a “K-shaped” recovery, with a wide disparity between the winners and the losers. This can be seen most sharply by comparing the market cap weighted S&P 500 (where larger companies are a larger component of the index) versus the equal weighted S&P 500 (where each company is weighted the same). The market cap weighted index is up almost 9% year to date as of the end of August, while the equal weighted index is down nearly 4%, a spread of nearly 13% and the highest relative gap since 1999. Trees do not grow to the sky, and the rally may need to broaden out to more sectors to continue higher. We have started to see a sharp rotation in early September from the recent winners into the recent losers, but it remains too early to conclude that it is a “sea change.”

Driven by “new economy” technology outperformance, market sentiment has become extremely bullish in recent months. Citigroup, the global investment bank, publishes a widely followed “Panic/Euphoria Model” which has shown over the decades to have a strong negative correlation to the 12 month forward return of the stock market. After reaching “Panic” territory in March, the model is now fully into “Euphoria”, a remarkable 5 month turnaround. This froth is also seen in the Relative Strength Indicator (RSI), a widely followed indicator of short term trading conditions. In late August, the RSI rose to its highest level in 2 years, right before the selloff we have experienced in recent days. Bullish sentiment has been seen in certain corners of the stock market. Recently, both Tesla and Apple announced stock splits, which means that a company increases the number of shares outstanding by lowering its price. The economic impact is zero, as the company theoretically should have the same market capitalization, with changes in the price per



The panic/euphoria model is a gauge of investor sentiment. It identifies "Panic" and "Euphoria" levels which are statistically driven buy and sell signals for the broader market. Historically, a reading below panic supports a better than 95% likelihood that stock prices will be higher one year later, while euphoria levels generate a better than 80% probability of stock prices being lower one year later.

Source: Citigroup Investment Research - US Equity Strategy share and the number of shares outstanding. The common justification for stock splits is to reduce the per share price, thus allowing more small investors the opportunity to buy a stock that has run up in price. Both Apple and Tesla's stock prices have climbed considerably on the news, which again should have no economic impact to the company, but leaving many market observers to conclude that short term speculation of retail investor flows explains the dramatic short term gains. As of this writing, some of the air has come out of the Apple and Tesla balloons, a healthy development to remove some of the excess froth from markets.

As we enter the fall, markets appear to be headed for a period of elevated volatility. The recent market euphoria previously discussed is set against a deep recession and the continued fight against COVID-19, increasing the risk of sharp reversals. While there has been a steady drip of good news in the fight against COVID, any setback in the development of promising vaccines that are due to announce Phase 3 results in the coming months may be a "rude awakening" for levitating stock markets. Finally, we are within 2 months of what could be a contentious election, with dramatic headlines certain to move markets.

Despite all of the risks that may increase near term volatility, including areas of excess exuberance in markets, closely contested national elections, and the continued fight against COVID-19, we remain constructive on markets longer term. The Federal Reserve remains extraordinarily accommodative, which was once again confirmed in August. Chair Powell announced a new policy of average inflation targeting, in which the central bank will aim for inflation above its long term target of 2% for an extended period of time. The 2% inflation goal is not new, but the language around how long they will be willing to overshoot the target is. No specifics were defined in how long or how high inflation may need to be before the Fed will step in, giving it flexibility in implementation of policy. In recent years official inflation measures have mostly been below the 2% target, so the new messaging appears to be an effort to convince financial markets that it will allow inflation to run hot for longer than previously expected. While this has stoked fears of inflation in some circles, deflation is currently a bigger worry for the Fed given the massive recessionary shock caused by COVID-19. The "lower for longer" easy policy should result in ample credit remaining available to businesses and individuals alike, helping the economy bounce back from the COVID-19 recession. While a second round of stimulus has been delayed by disagreements in Congress, ultimately we believe additional help will be passed at some point. The healing economy, helped along by both Fiscal and Monetary authorities, should drive a bounce back in corporate earnings in 2021.