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Q3 Review and Q4 Outlook

It is hard to believe that three quarters of 2020 are in the books. COVID-19 continues to dominate the headlines and impact our lives like nothing we've seen in a very long time, and the fourth quarter promises to keep the suspense level high. With the presidential election around the corner, and a COVID-19 vaccine hopefully not too far away, let's recap the events of the third quarter that impacted client portfolios and look forward to what the rest of the year is likely to bring.

After advancing 15.9% in the third quarter through September 2nd, the S&P 500 abruptly fell 9.3% in the first three weeks of the month, only to recover 4.0% through the end of September to end the quarter up 8.9%. The decline was seen primarily as profit taking, with the technology sector bearing the brunt of the drop. As we look across the major asset classes, US Large Cap, which returned 8.9% for the quarter, is the only area of the equity market with positive returns year-to-date. Bonds have outperformed equities in 2020, with the aggregate bond market up 6.8% year-to-date, and treasury inflation protected bonds up 3% in Q3 and 9.2% year-to-date.

CAPITAL MARKETS REVIEW:

Asset Class Returns

	Index	September 2020	Q3 2020	YTD 9/30/2020
Equity				
US Large Cap	S&P 500	-3.80	8.93	5.60
US Small Cap	Russell 2000	-3.34	4.93	-8.70
International Developed	MSCI EAFE	-2.60	4.80	-7.10
Emerging Markets	MSCI EM	-1.60	9.56	-1.20
US Investment Grade	Barclays US Agg	-0.05	0.62	6.80
US Inflation-Indexed	Barclays US Tips BBgBarc US Corp High Yield	-0.37	3.03	9.20
Fixed Income				
US High Yield	JPM EMBI Global	-1.03	4.60	0.60
EM US$ Debt	Credit Suisse Equity Mkt	-1.85	2.32	-0.50
Alternative				
Absolute Return	Neutral	-0.07	6.23	2.10

Source: FactSet

Technology leading the way

The technology sector, led by the five largest US companies (Facebook, Apple, Microsoft, Amazon, and Alphabet) continues to lead the way, up 12.6% in the third quarter and 28.7% year-to-date. These five stocks now account for roughly 1/5th of the entire US stock market, with a combined market cap of over $7.4 Trillion

Sector Review: Returns YTD and the September Correction

September and year-to-date percentage change for US sectors

Equities	Index	September % Chg	YTD % Chg
Information Technology	S&P 500 / Information Technology - SEC	-6.20%	28.7%
Consumer Discretionary	S&P 500 / Consumer Discretionary - SEC	-3.30%	24.3%
Communication Services	S&P 500 / Communication Services -SEC	-6.20%	9.10%
Health Care	S&P 500 / Health Care - SEC	-1.80%	3.10%
Consumer Staples	S&P 500 / Consumer Staples - SEC	-1.50%	2.40%
Materials	S&P 500 / Materials - SEC	-3.00%	2.20%
Industrials	S&P 500 / Industrials - SEC	-2.10%	-5.70%
Utilities	S&P 500 / Utilities - SEC	3.00%	-7.10%
Financials	S&P 500 / Financials - SEC	-3.70%	-21.6%
Energy	S&P 500 / Energy - SEC	-16.50%	-51.7%

Source: FactSet

Investment Themes Review

Overall, the investment themes we modified during the early stages of the pandemic have largely been on point, as we review below.

THEME 1: RECESSION THEN RECOVERY

After posting annualized declines of -5.0% and -31.4% in real GDP growth for Q1 and Q2, Q3 GDP is highly likely to show a strong rebound due to government interventions and the gradual reopening of the US economy. The Bureau of Economic Analysis won't release the first official estimate until October 29th, but FactSet's consensus estimate is for a 25% rebound in real GDP. The jobs picture continues to improve as well with unemployment numbers continuing to rebound. The latest reading showed September nonfarm payroll employment improving by another 661,000 jobs added back to the economy, bringing the unemployment rate down to 7.9%. At this point, roughly 55% of jobs lost in the early days of the pandemic have returned. After peaking at 28.9% in June, the leisure and hospitality unemployment rate decreased to 19%, as pandemic restrictions ease, restaurants and bars reopen, and society adapts to the "*new normal*".

With an accommodative Fed pledging to continue its unprecedented levels of monetary support and Congress eventually passing additional fiscal stimulus in the months to come we believe that the recovery should accelerate through the fourth quarter and into 2021.

THEME 2: GLOBAL PANDEMICS MAKE FOR VOLATILE MARKETS

Q3 year-over-year earnings are forecast to decline -21%, which represents an approximate 4% improvement since June 30th due to smaller earnings declines or higher earnings growth rates. As was the case in Q2, fewer companies have provided earnings guidance for the quarter.

The tech sector corrected -12.2% from September 2nd – 24th, due primarily to profit taking after delivering blistering 80% returns from the March lows. During periods of uncertainty, market movements tend to be exaggerated in both positive and negative directions, and this has clearly been the norm in 2020. In fact, 2020 has already seen 41 trading days with market moves exceeding up or down 2%, the most since the midst of the Global Financial Crisis in 2008. To put this in perspective, there were only 9 such days all of last year.

Volatility is highly likely to remain elevated as we move closer to the end of this most unpredictable presidential election race.

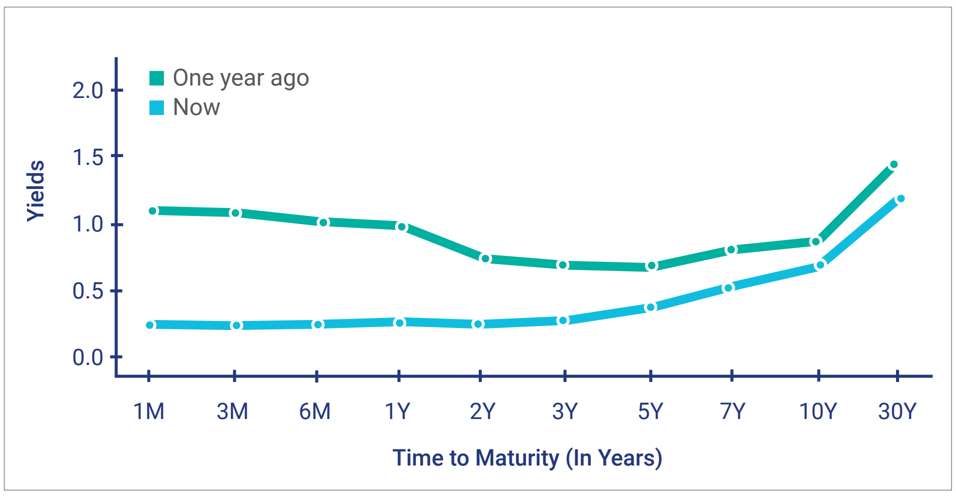
THEME 3: RANGE-BOUND RATES

With the Federal Reserve pledging continued monetary support and telegraphing their intention to keep interest rates low through at least 2021, interest rates will remain at or close to historic lows for the long term. The balancing act of spurring growth, fighting inflation and lowering unemployment will no doubt require a steady hand and frequent fine-tuning. With the Fed Funds rate pegged at 0.0 to .25%, monetary policy options are limited. The Fed clearly does not want to send rates into negative territory, as other countries have done, and still has plenty of ammunition available through additional bond purchases across virtually all bond sectors.

For investors focused on deriving an income stream from balanced portfolios, this presents a challenge. A low-rate environment helps the economy to recover as borrowing costs remain low for corporations. This is good news for investors in the equity (stock) market, but negatively impacts savers and fixed income (bond) investors, as real yields (after factoring in inflation) are now in negative territory.

U.S. Treasury Bonds Yield Curve

Interest Rates at or near historic lows



Source: FactSet, 9/30/2019 and 09/30/2020

Outlook for Q4 and beyond / Portfolio Positioning

It goes without saying that 2020 has been a year unlike any other in our lifetimes. As we move into the fourth quarter, we face two potentially large sources of volatility – the race to find the COVID-19 vaccine, and the presidential election.

Vaccine on the horizon?

Moderna and Pfizer reportedly have the two vaccines that are closest to FDA approval. However, both vaccines are extremely sensitive to temperature changes, and widespread distribution would present significant challenges. Other drugs are following, but it is nearly impossible at the moment to predict the timing of approval and subsequent distribution. Without a vaccine, economic growth will remain challenged.

Impact of presidential election

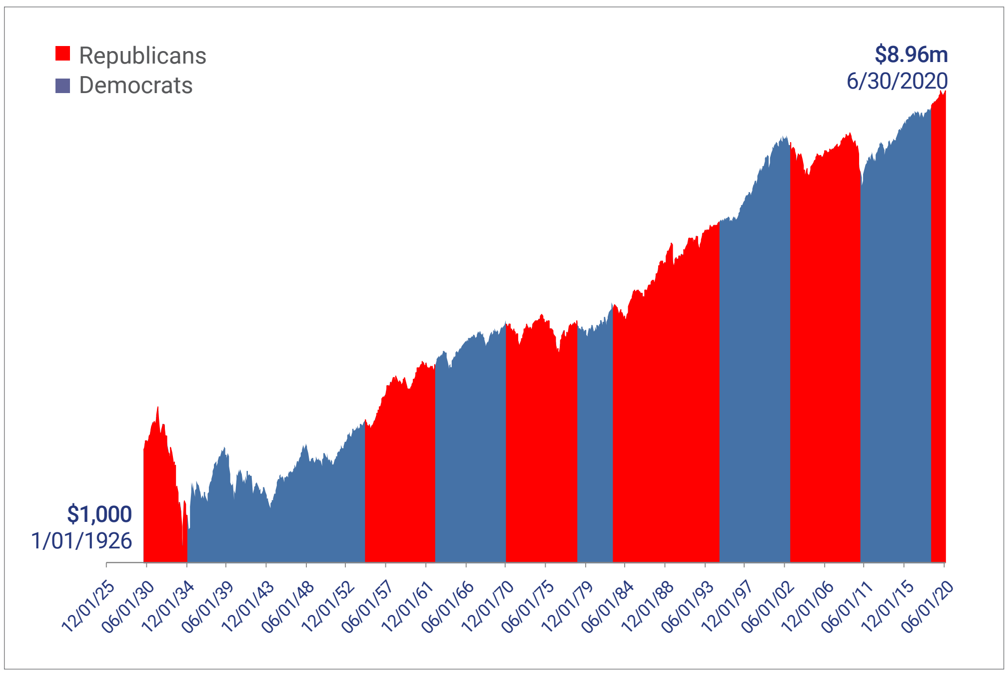
The presidential election is coming down to the final weeks, with its never-ending stream of surprises. The October 2nd news of President Trump's COVID-19 diagnosis spooked the futures markets, but markets quickly calmed in response to benign employment data once markets opened.

Clients frequently ask about the impact of an election on the market. In 2000, the "hanging chad" controversy in Florida left the election contested until December 12, 2000. The impact on the market was negligible, and barely stands out on the chart below.

In 2016, Hillary Clinton was favored in the polls to win the election. As election night played out, it became clearer by the hour that Trump was going to win. Futures markets, caught by surprise, nosedived by over 800 points. On November 4th, the Dow Jones Industrial average opened lower, but finished up 256 points. In the short term, markets are fickle, and can be driven by uncertainty. Over the longer term, fundamentals matter. The chart below illustrates this very clearly. We've had Republican presidents and Democrat presidents. The market has advanced through both parties' leadership, along with wars, economic recessions / depressions, and many other challenging world events. As such, we would certainly not recommend any strong bets or portfolio actions based on election predictions.

Market Performance & Elections

Equities have advanced regardless of presidential party



Source: FactSet

Short-term adjustments for a long term view

As long-term investors, we strive to take advantage of short-term events through our "tactical" positioning, making adjustments to our positions based on perceived dislocations between current and future market pricing. We are bullish on global equities over the next 3-5 years. However, in the near-term the level of uncertainty is extremely high. Disappointments in the development and distribution of the COVID-19 vaccine would likely result in substantial declines across global equity markets.

Portfolio positioning considerations

As is typically the case, the appropriate portfolio action is heavily dependent on each investor's time horizon. For an investor who needs access to cash within the next 6 months, the equity markets are probably not the wisest investment at the moment. However, once we move beyond this surreal pandemic, a slow and steady economic recovery should support a renewed bull market phase for an extended period. With this in mind, our portfolio positioning strategy includes the following considerations:

- We are modestly overweight equities relative to fixed income, given the challenging interest rate landscape.
- We've added to alternative income sources, such as convertible and preferred securities recently, and slightly higher cash levels.
- Finally, with a bullish view in the longer-term, we would lean towards buying equities on market weakness.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.

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