Quarterly Market Review & Outlook

October 2020

QUARTER IN REVIEW

The third quarter of 2020 was mostly a positive one for investors, with global equity markets rising and bond markets largely stable. Economic data released in July and August surprised to the upside and spurred hopes for a swift rebound in global economic activity. Equity markets responded accordingly, with the S&P 500 reaching an all-time high on September 2nd. In the last month of the quarter, however, fresh data indicated a slowdown in the pace of recovery, causing global equity markets to give back some of their gains. Despite this end-of-quarter sell-off, stocks still ended the quarter broadly up, and major U.S. indices have fully rebounded from their March lows.

It is important to observe that, although stocks have largely recovered from their March swoon, economic activity still remains well below pre-COVID levels. While there has been marked improvement since the spring's nadir, many key measures still point to a struggling economy, with unemployment elevated and many small businesses closing or on the brink of doing so. How do investors reconcile the apparent disconnect of strong stock market gains alongside an economy still struggling to recover from the COVID 19-induced shock? Part of the answer is that equity markets are forward looking and are anticipating a likely eventual full recovery in economic activity. Widespread monetary easing from global central banks in the form of low interest rates and asset purchases has also served as accelerant for markets. However, there are also other critical factors to consider in understanding this apparent disconnect:

The Stock Market is Not the Economy

As alluded to above, the stock market is not the economy. The service sector, which makes up about 70% of the U.S. economy as measured by GDP, has been hardest hit by COVID-related lockdowns but represents a much smaller percentage of U.S. stock market indices. In fact, most of the small businesses that represent the U.S. service economy are not publicly traded and thus not represented in stock market indices at all. As a result, a recovery in the S&P 500, for instance, does not necessarily represent the still struggling service sector and provides an incomplete picture of the health of the economy as a whole.

Source: AMG Funds

A Narrow Stock Market Recovery

The stock market recovery has also been narrow, with U.S. large cap growth stocks, and particularly technology stocks, leading the charge. In fact, a handful of these tech stocks have been responsible for much of the recent gains in the S&P 500. The so-called FAAANM stocks (Facebook, Apple, Amazon, Alphabet, Netflix, and Microsoft) gained about 50% year-to-date through the end of August. Without these stocks, the S&P 500 would have been flat over the same time frame. The combined market cap of the FAAANM stocks is so great that they are able to push the entire index higher. The extreme narrowness of the recovery has masked weakness in other parts of the market. In fact, while major U.S. indices are up for the year, U.S. small cap value stocks, as measured by the Russell 2000 Value index, are still down 19% through September.

Authored by the Freedom Capital Management Strategies® Investment Team | October 2020

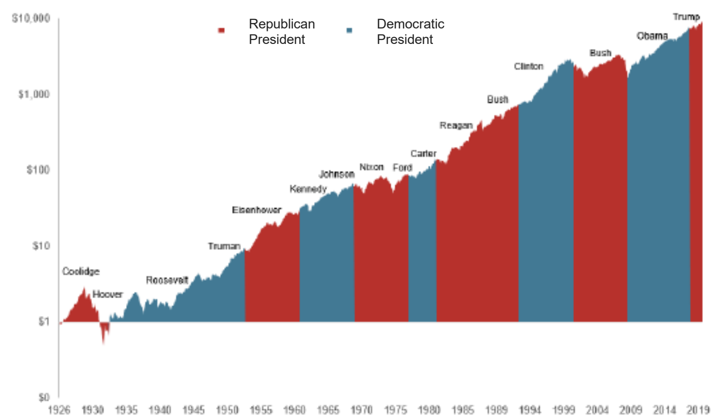
INVESTMENT OUTLOOK

As mentioned above, stock markets were rocky at the end of the third quarter; the S&P 500 declined four weeks in a row, as even technology stocks showed weakness. As we enter the final quarter of 2020, investors will be watching to see if this weakness continues or if markets stabilize and resume their ascent. A few critical factors will likely influence the trajectory of markets in the fourth quarter and beyond:

U.S. Election

On the immediate horizon, the U.S. election may make market participants skittish. Expect some volatility around headlines leading up to the vote. While markets have historically tended to favor incumbents, it has also historically been a challenge for an incumbent to win when there has been a recession in an election year. A “blue sweep” in November may cause investors to worry about the effects of proposed tax hikes, but it is also important to remember that markets are forward-looking and may already have that eventuality priced in. Overall, while geopolitical events such as elections can influence markets, their effects tend to be short-lived, and it has historically proved most prudent to stick to a long-term investment plan and to avoid trading around these types of events.

Growth of a Dollar Invested in the S&P 500:
January 1926-December 2019



Source: Dimensional Fund Advisors; S&P Dow Jones Indices, LLC

The Economic Recovery

The most influential factor for markets going forward will likely be the ultimate trajectory and strength of any economic recovery. A sustained and robust recovery in economic activity would likely stimulate a broader recovery in global equity markets and potentially benefit market segments that have been largely left behind in the stock market rebound thus far, including U.S. small cap, U.S. value, and international equities. A continued drop in unemployment, an increase in wage growth, and recovery in the service sector are some of the most critical factors to watch here. On the other hand, if the recovery begins to falter due to the ongoing pandemic or geopolitical events, the recent weakness in equity markets may be extended.

Central Banks, Again

As mentioned above, monetary easing from central banks has aided stock and bond markets in their recovery thus far. The Fed has made clear its intention to keep interest rates historically low and to provide continued support to markets through continued large-scale asset purchases for the foreseeable future, both of which should remain supportive of stock and bond prices. In the past, as the economy has recovered from recession, the Fed has raised interest rates to combat inflation. Notably, in August, the Fed implied that it would be willing to let inflation run higher for a period of time before raising interest rates, which is a change from historical precedent and suggests monetary policy will likely remain accommodative for longer. However, if the economy does rebound quickly, potential inflation and the Fed’s uncertain response could become a hot button issue for markets.

CLOSING THOUGHTS

While the global economy and capital markets have improved markedly since the depths of the pandemic-induced recession in the first half of the year, the outlook remains uncertain as concerns about COVID-19 remain and many consumers and businesses are still struggling to recover. Given this uncertainty, it seems prudent for investors to position for what may lie ahead by maintaining discipline around a long-term financial plan, staying diversified in their investment portfolios, and avoiding short-term, emotionally-driven investment decision.

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