TFC FINANCIAL
The Financial Counselors

COMMENTARY | 3Q 2020
OCTOBER 2020

OUR VIEW

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Third Quarter Review

Global equities, as represented by the MSCI All Country World Index, rose by more than 8% in the third quarter and have gained more than 1% year-to-date through September 30. Pandemic relief provided by governments and central banks, efforts to relax economic shutdowns, and optimism about the prospects for Covid-19 vaccines contributed to the positive results for global equities.

The S&P 500 Index gained nearly 9% during the quarter, ending the period with a year-to-date gain of more than 5%. Growth stocks continued to outperform relative to value stocks. U.S. large company growth stocks gained more than 13% during the quarter. In contrast, large company value stocks gained more than 5% for the quarter, and now trail growth stocks by more than 35% year-to-date. U.S. small company stocks gained approximately 5% during the quarter, also with dramatic performance dispersion between value and growth. Developed international stocks, as measured by the MSCI EAFE Index, gained nearly 5% during the quarter. U.S. small company and developed international stocks still have significant negative year-to date returns. Emerging markets stocks gained nearly 10% for the quarter, nearly erasing year-to-date losses.

From a sector perspective within the U.S., technology and consumer discretionary stocks are leading the way. The outstanding performance of Amazon masks overall weakness within the consumer discretionary sector. Materials and industrial stocks benefited during the quarter from rising optimism about economic reopening. The Energy sector was the worst performer during the quarter with declines reaching 48% year-to-date.

Bonds turned in a less spectacular quarter, but provided safety and liquidity. Treasury holdings and short-term, high quality bonds provided positive returns during the quarter. High yield corporate bonds were strong performers during the quarter, benefiting from central bank intervention and optimism about economic growth. Municipal bonds had a less volatile quarter than the first quarter, but still have not fully recovered from pandemic-inspired selling.

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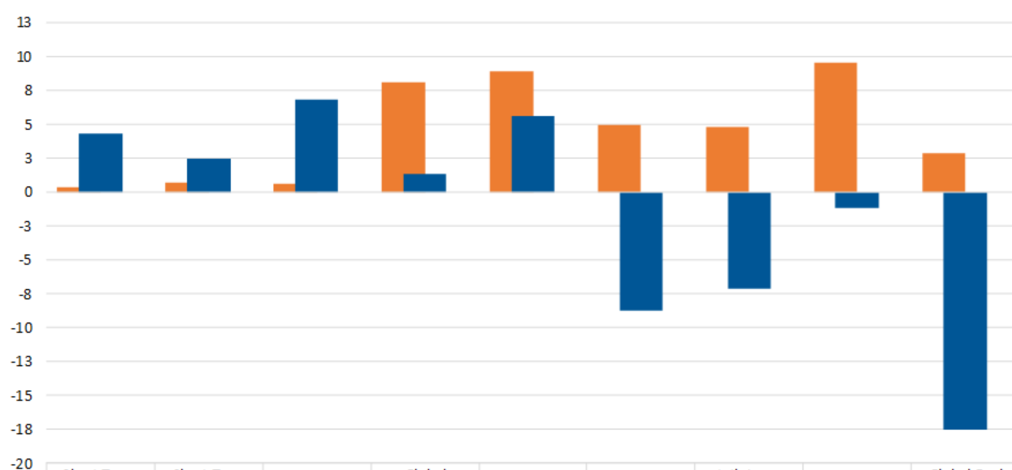
Quarter To Date Returns

9/30/2020



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	U.S. Small	Intl. Large Core	EM	Global Real Estate
QTD	0.4	0.7	0.6	8.1	8.9	4.9	4.8	9.6	2.9
YTD	4.4	2.5	6.8	1.4	5.6	-8.7	-7.1	-1.2	-17.5
Full Cycle*	2.9	2.5	4.4	4.4	8.6	6.3	0.9	0.8	1.9

* Full Cycle is the annualized return from October 2007 peak to present.

TFC client portfolios benefited from the market rebound during the quarter, gaining ground in absolute terms and performing in line with client benchmarks in relative terms. TFC's growth and innovation-oriented holdings continued to provide strong absolute and relative performance. TFC's value holdings provided positive absolute returns but trailed on a relative basis. TFC's small company growth holdings continued to excel in absolute and relative terms during the quarter and year-to-date period.

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In September, there were brief periods in which market leadership shifted from the growth-oriented "stay home" theme to more of a value-oriented "economic reopening" theme. Progress on testing, treatment, and prevention of Covid-19 should create a rotation to value stocks, but it may be next year before economically sensitive value stocks enjoy sustainable success.

The "B word" – bubble - is frequently mentioned in conversations about technology stocks. We worry about technology stocks that have reached what seem to be extremely high valuations but think a correction within the technology sector is more likely than a "dot-com" type of collapse. We are not recommending any of the stocks mentioned below, but would like to share comparisons that Blackrock's Rick Rieder recently made between the business models of Home Depot and Shopify (an ecommerce platform for merchants) and the business models of traditional casinos relative to on-line betting companies:

- ***Home Depot and Shopify.*** Shopify's growth in revenues during its first decade in business resembles Home Depot's growth at a similar point in time. Shopify, however, has grown profits and free cash flow at a rate far faster than Home Depot in its first decade. Shopify's business model required considerable upfront spending on research and development, but ongoing operations require minimal incremental investment. In contrast, when Home Depot was expanding rapidly it still had to spend a lot to open new stores, staff them and acquire inventory.
- ***Traditional casinos and online gaming companies.*** MGM and Las Vegas Sands are two of the largest casino companies in Las Vegas, with a combined 125,000 employees. The Las Vegas market in total has approximately 140,000 rooms and a pre-pandemic average of approximately 40 million annual visitors. In contrast on-line gaming leaders FanDuel and DraftKings have less than 2,000 employees and have grown their user base from 0 to 14 million users in less than a decade.

There are considerable unknowns entering the final quarter of the year, with the 2020 election, uncertainty about containment of Covid-19 and partisan frictions over pandemic relief creating the near-certainty of a bumpy ride into year-end.

For successful technology platforms that demonstrate rapidly rising revenues and profits, particularly in a low interest rate environment, there may be justification for valuation multiples that are higher than the typical multiples earned by capital intensive, "brick and mortar" companies. It is important, however, to be aware of how easy it is for a speculative frenzy about future growth to get ahead of itself.

Outlook

There are considerable unknowns entering the final quarter of the year, with the 2020 election, uncertainty about containment of Covid-19 and partisan frictions over pandemic relief creating the near-certainty of a bumpy ride into year-end. The hospitalization of President Donald Trump and Covid-19 infections among key White House and campaign staff added another dimension of uncertainty at the start of the quarter. We continue to closely watch Covid-19 related factors that are likely to influence either a breakout to the upside or a market correction:

<u>Percentage of positive test results and hospitalizations for Covid-19:</u> Case counts are rising in much of the world, though to date hospitalizations and deaths are rising at a slower pace. The coming weeks will help determine whether there is sufficient health care capacity to handle the inevitable rise in Covid-19 infections as the country relaxes social distancing measures and cooler weather causes social gatherings to move to riskier indoor settings.

<u>Activity and mobility measures:</u> There may be big differences between what people are "allowed" to do and what they are willing to do as social distancing restrictions are relaxed. Activity and mobility measures provide early indications of changes in behavior, measuring activities such as trips to work, use of public transportation, shopping in retail stores, dining out at restaurants and hotel stays. We have seen significant improvement in activity measures but signs of flattening of progress as Covid-19 case counts rise.

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Alpine Macro's Chen Zhao has sage advice: "Investors should never take a simplistic approach when dealing with politics because the economic and political reality is always more complex than easy presidential election narratives."

State government response to the virus: One factor contributing to the market rally is the expectation that state leaders have little appetite to resume the extreme lockdown measures that decimated economic growth in April and May. Investors expect states to respond to rising infections by slowing the pace of reopening and tightening social distancing protocols. State governments could rethink their plans if hospitalizations, strains in the health care system and death rates surge in more of the country. Public statements from governors and mayors may provide advance warning of shifts in sentiment toward a resumption of lockdowns.

Portfolio Positioning

The 2020 election will be in the headlines in the coming weeks, potentially influencing the direction of the market and undoubtedly contributing to market volatility. Alpine Macro's Chen Zhao has sage advice: "Investors should never take a simplistic approach when dealing with politics because the economic and political reality is always more complex than easy presidential election narratives." TFC's time horizon is a long one, and that time horizon cautions us not to overreact to near-term volatility. We are tactically neutral on equities. Longer-term, we are expecting economic growth to revive next year with progress on Covid-19 and fiscal expansion regardless of the election results.

Within equity portfolios, we have emphasized quality – strong balance sheets, cash flow and liquidity – while reducing investments in more cyclical segments of the market. Within the value-oriented segment of TFC portfolios, we have invested with fund managers that assess the ability of companies to withstand the extreme economic volatility caused by the Covid-19 pandemic. TFC continues to favor shorter-term/investment grade credits, but also invest in intermediate-term bonds that provide desirable diversification in the event that economic growth falls short of expectations.

As always, we welcome your comments and questions.

Sincerely,

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