Market Review and Outlook—October 7, 2020

Merely a Good Quarter—With the shortest and fiercest bear market in memory, the 1st quarter results were horrid. While we remained mired in a pandemic and were suffering the worst unemployment in decades, the 2nd quarter results were incredibly strong. The stock markets truly had a snap-back recovery in the 2nd quarter. This recent quarter, on the other hand was, well, normal.

US Stocks—The table, below, shows that larger US stocks did very well, with good, but lower, gains from smaller US stocks. You see moderate gains for health stock funds during the quarter, but exceptional results in the past year. Technology, however, has been a rocket, gaining about 12% during the quarter and 32% in the past year. I am getting altitude sickness. With technology's ascent, it isn't surprising that growth stocks sharply outperformed value stocks during the quarter and year (and, frankly, during all five periods).

Foreign Stocks—With some weakness in the US dollar this year, foreign stocks are keeping up with some US stocks. You see that they outperformed small-cap US stocks in the past quarter, year, and three-year periods. Emerging market stocks have done even better recently, partially due to the early-onset of COVID in Asia, followed by an earlier recovery from it, for their markets. Smaller foreign stocks have outperformed larger foreign stocks in the past year, opposite to the behavior in the US.

Bonds—The two bond rows in the table fail to tell what's going on behind the scenes. The rows show normal bond behavior—moderate, fairly stable results. It fails to show the dramatic differences between types of bonds, wild feast/famine swings. Most importantly, like all data in the table, it shows trailing returns. Bond returns are fundamentally driven by interest rates, and for the near future, this is a curse for bond investors because bond interest rates are EXTREMELY low. This also means that trailing returns benefited from a very strong tailwind.

The two bond rows are for taxable and municipal quality bonds. Trailing returns for opportunity bonds (including high yield) tell a different story, as they have taken a different path. Their results are less driven by interest rates and more by economic growth, which has provided a headwind in recent years.

In the next page we will look forward. The last two quarterly rebalancing involved dramatic changes, to react to dramatic market moves. The past quarter had modest results, and so this quarter's rebalancing should be much less dramatic. It has been a very challenging year, and it is comforting that, after all is said and done, disciplined investors have fared well. 2020 has reinforced the importance of protecting portfolios from emotional decisions.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.64%	+1.29%	+0.87%	+0.44%
Intermediate Term Bond	+0.94%	+6.66%	+4.88%	+3.94%	+3.49%
Intermediate Muni Bond	+1.30%	+3.08%	+3.45%	+3.12%	+3.28%
Large-Cap Stock	+8.06%	+10.70%	+9.55%	+11.77%	+11.96%
Mid-Cap Stock	+6.34%	-0.46%	+3.43%	+7.34%	+9.51%
Small-Cap Stock	+4.17%	-6.56%	-0.86%	+5.68%	+8.66%
Foreign Large-Cap Stock	+5.80%	+2.19%	+0.41%	+5.19%	+4.34%
Diversified Emerging Markets	+8.87%	+9.11%	+1.73%	+8.08%	+2.46%
Health	+4.95%	+31.92%	+11.33%	+10.93%	+15.44%
Technology	+11.96%	+42.66%	+21.32%	+22.77%	+16.97%
Moderate Allocation (60% stocks)	+4.97%	+6.28%	+5.71%	+7.45%	+7.53%

The data in this table comes from Morningstar and is as of September 30, 2020.

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So Many Factors, So Many Unknowns—Investors are weighing three major factors at this time: the COVID-19 global pandemic, the economic abyss (both US and global) we fell into in March - with the inconsistent climb out of the depth, and the US national elections next month. Each factor has its own timeline and each factor has its own investment market ramifications.

COVID-19 in the US had its initial very steep climb in cases in March and April. The uncertainty during that time was nearly unlimited. Since then, we have adopted practices which slow spread, drastically boosted PPE supplies and testing capabilities, developed diagnosis and treatment protocols, and are well on our way to develop vaccines, including planning the global distribution. The two major challenges for investors are 1) the practices to slow spread directly diminish economic activity and thus profitability of public companies, and 2) the timeline for broad global vaccine delivery is uncertain, and perhaps will occur during the last nine months of 2021. Only after this is fully accomplished can we end the restrictions which both slow the spread and slow the economy.

The pandemic brought an economic collapse and the early stages of a recovery swifter and sharper than we have seen in decades. The alarm bells began in late February, and many states were 'shutting down' by the end of March. While reopening began in some states in April, most waited until May and June to begin meaningful reopening steps. This led to only modest economic decline in 1Q20, and a very sharp decline in 2Q20, with a strong 'snapback' expected for 3Q20. Until a vaccine is broadly distributed, subsequent quarters are likely to see anemic, and possibly small negative economic growth. Some of these results are driven by the fiscal relief provided by Congress, primarily under the CARES Act, helping both consumers and businesses. The majority of the benefit was delivered in the 3rd quarter, with some coming in the 2nd and 4th quarters. At this point, we are not expecting further relief from Congress until at least after the election results.

With less than four weeks until November 3rd, at this moment it appears that Joe Biden will be elected as our next President. It appears likely that there will be 50-51 Democratic Senators, and with a Democratic Vice-President, and with a continued Democratic-controlled US House, this would give the Democrats both chambers and the White House. Certainly much can occur in the next four weeks, however, with the pandemic, we have millions of ballots already voted and submitted, and so the likelihood of an 'October surprise' is quite small. The October surprises thus far (income tax revelation, poor behavior at the first debate, and COVID-19 diagnosis for the President and the First Lady all have widened, rather than narrowed the gap that Biden has over Trump. No guarantees, but the likelihood of a Biden victory continues to rise, and time is running short.

So investors see a pandemic much better understood, with many vaccines under development. They see a more stable economy, largely in a holding pattern until we get vaccines distributed worldwide, and then better days ahead. Regardless of their preferred candidate, investors see a likely Democratic White House, and at least an even chance of a Blue Congress. A blue wave will likely bring further economic relief until we get past vaccines, a rollback of the tax-rate cut for high-income individuals and of corporations, and also a broad, national infrastructure program. Given that literally 50% of the 2020 federal budget is paid for by borrowing, boosting federal revenues a bit through restoring some higher tax rates should have a mixed effect, slowing stock earning growth while also building needed confidence in the US government bond market. Further COVID relief should provide some short-term economic boost, while a big infrastructure package can provide more ongoing economic fuel. This analysis is behind this week's conclusion by Goldman Sachs that a blue wave next month could be beneficial to the US economy.

Stocks—We don't think that you can 'bullet-proof' a portfolio against the range of election outcomes. We are merely minimizing strong leans. We are leaning a bit into large US companies, and a little into healthcare. We are remaining committed to foreign stocks, which have been looking better and better.

Bonds—Due to miniscule interest rates, we are reducing usage of quality bonds, boosting opportunity bonds in lower-tax bracket/retirement portfolios to 35%, and in municipal bond portfolios to 30%. For quality bonds we are spreading maturities pretty evenly across short-, intermediate-, and long-term bonds. In opportunity bonds, we like high-yield and bank-loan bond funds, along with multi-sector bonds.

2020 has been a year of great uncertainty. We are pleased to be preparing portfolios for falling uncertainty.