Independence | Asset Advisors

MarketMatters

INDEPENDENCE ASSET ADVISORS' QUARTERLY GLOBAL MARKET JOURNAL

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COVID-19 Update

The Covid-19 pandemic will end up costing the U.S. approximately $16 trillion.

For some perspective, this amount represents four times the cost of the Great Recession, or 90% of the annual U.S. GDP. It will also exceed the combined U.S. spending on the wars with Afghanistan, Iraq and Syria.

This staggering number is offered by American economist Larry Summers, who calculates that about half the cost will come from lost gross domestic product as a result of broad-based business closures, with the other resulting from health-related losses associated with premature death and the present value cost of long-term health impairments.

Summers suggests that the magnitude of the Covid-19 expense will result in a fundamental shift in government spending from acute treatment solutions spending, to spending on public health serves and infrastructure.

Market Overview & Key Themes

Key Insights:

- Covid-19 captured headlines throughout the third quarter.
- Infections spiked in the U.S., with most new confirmed cases reported in the Midwest.
- The Fed adopted a program to increase inflation to 2% by keeping interest rates at 0-0.25%.
- Market gains were broad-based for the second consecutive quarter, but fears of a "Second Wave" of confirmed Covid-19 cases stalled momentum in September.
- Investors shifted capital back into risk assets in anticipation of a faster economic recovery.

The third quarter was profitable for most investment strategies despite a modest pullback in September. Covid-19 dominated headlines in July and August, but tech stocks contracted in September as the sector experienced a much needed repricing. Despite experiencing a 13% drop during the first half of September, the information technology index was still up 29% for the year. Technology companies represented 25% of the S&P 500 Index at quarter-end and have led the market all year. With tech stocks performing so well, the dispersion between growth and value segments has increased. On a cap-weighted basis, the S&P 500 Index was up 9% for the quarter and about 6% year-to-date. On an equal-weighted basis, the S&P 500 Index was up about 5% for the quarter, but still down 5% for the year.

The good quarterly results were not isolated to the U.S. stock market. Foreign equities and U.S. bonds also performed well, with the MSCI All Country World Index (ex-US) and Barclays Aggregate Bond Index gaining about 6% and 1%, respectively. International developed and emerging markets countries continued to report fewer new cases of Covid-19, which has resulted in broader business reopenings and a faster economic recovery.

A quarterly market paper would not be complete without an update on Covid-19. The pandemic has been shown to directly impact levels of economic activity, and sharp spikes in new confirmed cases causes uncertainty, which reverberates through to markets. In the third quarter, the U.S. experienced a meaningful spike in new confirmed cases, mostly in the midwestern states, which contributed to the broad market decline in September. The virus is also responsible for a very high level of unemployment. Although nonfarm payroll employment increased by 660,000 in September, over $23 million Americans continue to rely on benefits.

By the end of the quarter, investors were probably noticing that they were earning very little on cash, as the Federal Reserve elected to keep its federal funds rate at a range of 0-0.25%. This accommodative action has been unfavorable for income seeking investors, but it should serve as a catalyst for growth over the longer-term. Note that in August, the Fed adopted an "Average Inflation Target" operating system, which means it intends to keep interest rates near zero for the foreseeable future, and until inflation exceeds the 2% target.

Third Quarter at a Glance

In this section we have highlighted certain quarterly results using visual aids accompanied by brief explanatory language.

The table below compares the returns of the U.S. stock market by style and market cap. During the third quarter, growth again outperformed value, but the latter made up some ground in September when tech led all growth stocks lower.

	Value	Blend	Growth
Large	5.6%	8.9%	13.2%
Mid	6.4%	7.5%	9.4%
Small	2.6%	4.9%	7.2%

In the table to the right, we see bond yields declined further during the third quarter, with the exception of longer dated U.S. Treasuries, which moved incrementally higher.

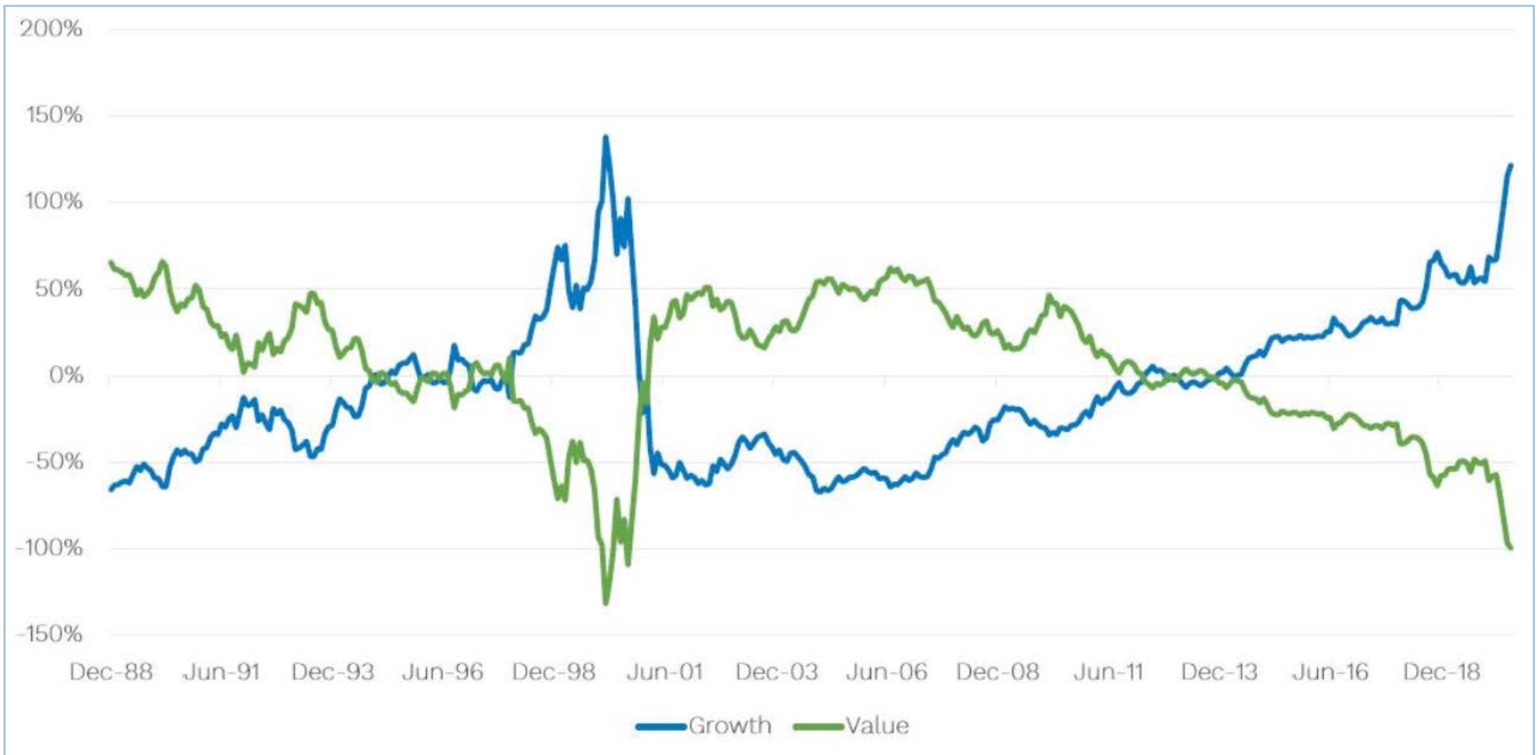
Note the Fed's willingness to purchase almost unlimited quantities of U.S. Treasuries will continue to impact investment grade bonds.

High yield bond yields decreased 1.1% between mid-year and the end of the quarter, but this was offset by a 4.6% total return.

At quarter-end, the tax-equivalent yield on municipal bonds was 2.23%, which is well below the yield offered by investment grade corporate bonds.

	Yield	
U.S. Treasuries	9/30/2020	6/30/2020
2-Year	0.13%	0.16%
5-Year	0.28%	0.29%
TIPS	-0.94%	-0.68%
10-Year	0.69%	0.66%
30-Year	1.46%	1.41%
Sector		
Corporates	2.01%	2.15%
U.S. Aggregate	1.18%	1.25%
Convertibles	4.98%	6.83%
High Yield	5.77%	6.87%
Municipals	1.32%	1.50%
MBS	1.29%	1.36%
ABS	2.50%	3.10%
Floating Rate	0.63%	0.94%

The graph below compares the excess returns of the Russell 3000 Growth and Value indexes over a rolling 120-month period. The indexes tend to outperform one another over long periods of time and are now at historic extremes, with growth strongly outperforming value during the most recent expansion. However, we have noticed a recent reversal in momentum favoring value stocks that could indicate the beginning of a mean reversion.



Global Market Outlook

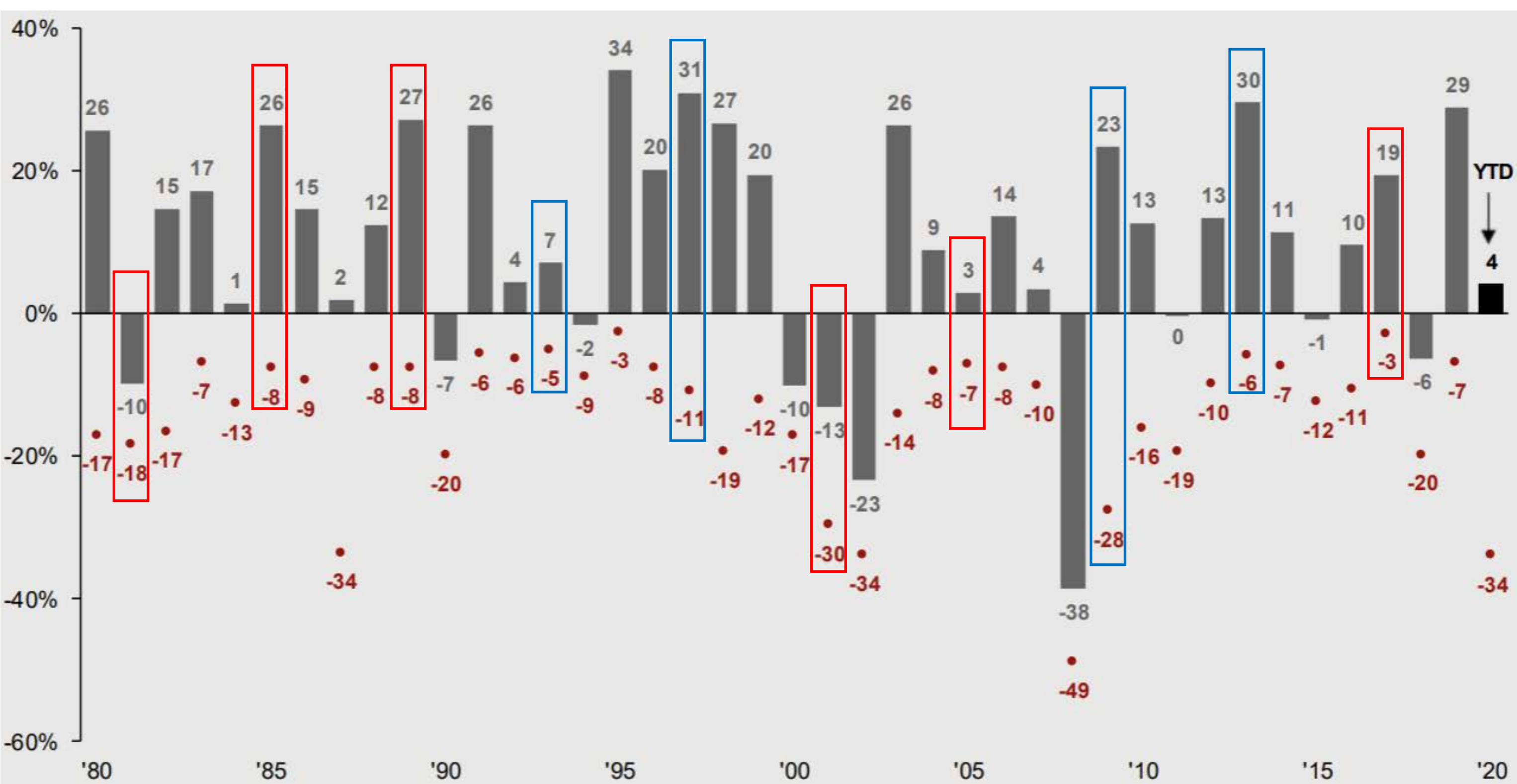
Key Insights:

- Covid-19 will continue to dominate headlines and directly impact the global economy and financial markets.
- The economic recovery will likely continue, albeit at a slower pace.
- Equity market returns will remain sensitive to pandemic headline risk and the 2020 Presidential election.
- We could be entering the beginning of a momentum shift between growth and equity stocks.
- We should expect interest rates and bond yields to remain low for the foreseeable future.

The two biggest unknowns for global investors are the coronavirus pandemic and the 2020 U.S. presidential election. The U.S. election, or more specifically the outcome, is the lesser concern in our opinion. Looking back over the past forty years (see table below), the U.S. has had six republican and four democratic presidents in office. In the year following an election year, the S&P 500 Index was positive 80% of the time with an average return of 14%. Of the two down years, the largest decline was only 13%. We cannot predict which party will win in November, but we can feel some assurance that markets tend to do well in the year following an election, regardless of who takes the office.

More concerning to us is Covid-19. We consider it to be a serious risk to market returns and the sustainability of the synchronized global growth momentum. The final weeks of 2020 will challenge investor discipline as volatility is likely to increase, and markets may trade erratically. The pandemic resulted in the steepest, but also the shortest, recessions on record. The recovery has been exceptional, but as new confirmed cases increase, we can expect job gains to wane and many businesses to remain at lower revenue levels well into 2022. We believe additional stimulus is necessary, but the prospects of a second fiscal package seemed to falter at the end of the third quarter. We are concerned that while some sectors of the market are thriving, notably online retail, home building and improvement, and information technology, other sectors may be permanently impaired.

The chart below shows the ranges of S&P 500 returns by calendar year. It reminds us that many years have periods of significant negative returns, but more than three quarters of years end with positive returns. As we enter the final weeks of the year, we remind you to remain disciplined, stay invested and stay the course.



Sources: JP Morgan

Contacts:

Scott Renninger
President & CIO
scott@iaadvisors.com

Katie Kearns
Vice President & Managing Director
katie@iaadvisors.com

Tom Grugan
Director, Research & Portfolio Management
thomas@iaadvisors.com

Rebecca Saukaitis, CFP®
Client Service & Investment Reporting
rebecca@iaadvisors.com

Eliza Bjorkman
Associate, Administration
eliza@iaadvisors.com

IMPORTANT INFORMATION