QUARTERLY INVESTMENT REVIEW AND OUTLOOK

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Summary and Major Conclusions:

A shift in market leadership from growth stocks to value stocks seems virtually assured over the next one to two years, but the timing awaits unequivocal evidence that a self-reinforcing economic recovery is imminent. Value stocks have outperformed growth stocks during the first several years of an economic recovery in all business cycles dating back to the 1970s. Value stocks have also outperformed growth stocks during periods of above-average growth in GDP and company earnings. My forecast assumes profit growth of 20% in both 2021 and 2022, well in excess of its long-term trend of 6%.

- Financial markets continue to be buffeted by a wide range of negative headlines, including a slowing economy, weakening employment, worsening public health trends, intense partisan politics in Washington, and growing hostilities between China and the US.

- Despite the plethora of risks and uncertainties, financial asset prices moved higher in the third quarter, as investors appeared to be impenetrable to the increasingly negative headlines dominating the news.

- Financial assets have benefitted from unprecedented monetary and fiscal support since March, record amounts of cash reserves, and rapid progress in developing a vaccine for COVID-19. With fixed-income yields close to zero, the lack of viable investment alternatives to stocks also boosted equity market valuations.

- There is a binary relationship between the financial markets and the pandemic: Stock prices and government bond yields will remain under downward pressure until there is a scientific solution to COVID-19. Conversely, a smooth roll-out of a vaccine will be the catalyst for higher stock prices.

- Monetary policy is not a critical issue in the short term, but will become increasingly important over time. The primary long-term risk associated with monetary policy is rising inflation, as the Fed desperately seeks to restore the economy to normal.

- These inflationary risks are also binary: Either the Fed will begin to tighten monetary policy in 2023 as business conditions strengthen; or it will persist with its highly accommodative policies, thereby sowing the seeds of future inflation.

- Fiscal policy is a critical variable in the outlook. The huge income and cash flow gap brought about by the economic lockdown will not be closed until a vaccine permits a reopening of the economy, leaving businesses and households at risk.

- The economy will remain vulnerable to further weakness in consumer spending and business hiring in the absence of additional federal assistance, raising the risk of a renewed economic downturn. Bitter partisan politics has been a huge impediment to agreement on another badly needed spending package.

- The pandemic has provided firms with a unique opportunity to restructure in transformative ways by becoming more productive and competitive. I expect corporations to adjust staffing requirements in order to minimize operating costs and maximize profit margins.

- The long-term trend toward industry concentration in recent decades has been turbocharged by the coronavirus pandemic, as millions of small and mid-sized firms have declared bankruptcy, leaving the largest firms to become more dominant. This trend could persist for many years.

- The primary investment implication of industry consolidation is that dominant firms in various industries could experience accelerating growth in sales and earnings stemming from increased market share. Company earnings could increase at a 20% rate in both 2021 and 2022.

- The investment outlook can be divided into three timeframes: The next six months; the eight quarters ending in mid-2023; and the period beyond 2023. The equity market could be at risk to a consolidation phase during the next several months, as economic, political, and public health news turn negative.

- The combination of record-low current yields, a rising risk of inflation beyond 2022, and a rising trend in interest rates is a recipe for negative rates of return in diversified bond portfolios over the next several years.

- Equity market prospects should improve markedly in 2021 when official plans for mass distribution of a vaccine are announced, hopefully early in the new year. Stocks have always performed well in the early years of a new business expansion cycle, and 2021 and 2022 should follow the historical pattern.

- A shift in market leadership from growth stocks to value stocks seems virtually assured over the next one to two years, but the timing awaits unequivocal signs that a self-reinforcing economic recovery is imminent.

- COVID-19 has dealt a severe blow to the commercial real estate market, as major structural changes in behavioral and lifestyle patterns have undermined the demand for commercial space. Property values could decline by 10% to 20% over the next 12 months.

FINANCIAL MARKET REVIEW

Financial markets were buffeted by a wide range of negative headlines in the quarter, pertaining to a slowing economy, historically elevated unemployment, worsening trends in the public health domain, intense partisan politics in Washington, and growing hostilities between China and the US.

- Coronavirus infections within the US remain elevated, while many regions of the world are dealing with major new outbreaks, most worryingly Europe.

- Domestic economic growth showed clear signs of slowdown as the quarter unfolded, as reflected in monthly data on retail sales, factory production, and employment.

- The labor market remained depressed in the quarter, as the level of weekly jobless claims stabilized at historically high levels.

- Following the expiration of the original $3 trillion federal spending package at the end of August, Congress failed to agree on a new fiscal relief package to support unemployed workers, small businesses, and state and local governments.

Impervious Investors: Despite the plethora of risks and uncertainties, financial asset prices moved higher in the third quarter, as investors appeared to be impenetrable to the negative headlines. Financial assets have benefitted from unprecedented monetary and fiscal support since March, record amounts of cash reserves held by institutional investors, and rapid progress in the development of a vaccine for COVID-19.

- **No Alternative**: With fixed-income yields close to zero, the lack of viable investment alternatives to stocks also boosted equity market valuations. In the end, the surge in ***excess liquidity*** provided by the Federal Reserve was the major factor driving stock prices higher since the end of the first quarter.

Stocks Beat Bonds: Common stocks globally outperformed bonds, while international stocks outperformed domestic stocks, led by emerging Asia. The S&P 500 generated a total return of 8.9% in the quarter, comfortably ahead of the 0.6% return on the Bloomberg Barclays US Aggregate Bond Index. The Russell 3000 Growth Index (+12.9%) beat the Russell 3000 Value Index (+5.4%), while small-capitalization stocks (+4.9%) lagged the large-cap indexes.

Non-US Equity Markets: The best-performing index in the quarter was the technology-heavy NASDAQ with a total return of 11.2%. International stocks registered a total return of 6.3%, as measured by the MSCI World Index (excluding the US). Within the international market, emerging Asia performed best with a total return of 10.8%. Within the fixed-income market, corporate bond returns exceeded those of the government bond sector. Investment-grade corporate bonds generated a total return of 1.5% in Q3, while high-yield (speculative-grade) corporate bonds did even better with a return of 4.6%.

INVESTMENT OUTLOOK

The investment outlook remains extremely challenging because of the wide range of economic, political, geopolitical, and policy unknowns. The direction of world financial markets over the next two years will be dictated by the following independent variables:

[1] Public Health Developments: There is a ***binary*** relationship between financial markets and the pandemic: Stock prices and government bond yields will remain under downward pressure until there is a scientific solution to COVID-19. A vaccine will be the necessary catalyst for a reopening of the economy, an acceleration in economic and profit growth, and a sustained rise in stock prices and bond yields.

[2] Federal Reserve Policy: *Monetary policy is not a critical issue in the short term, but will become increasingly important over time*. The primary long-term risk associated with monetary policy is rising inflation, as the Fed desperately seeks to restore the economy to normal. These inflationary risks are also ***binary***: Either the Fed will begin to normalize policy in 2023 as business conditions strengthen or it will persist with its highly accommodative policies, thereby sowing the seeds of future inflation. A scenario of rising inflation is poison for government bonds and the US dollar.

[3] Fiscal Policy: Fiscal policy is a critical variable in the outlook. The huge income and cash flow gap brought about by the economic lockdown will not be closed until a vaccine permits a reopening of the economy. This means that the economy will remain at risk to further retrenchment in consumer spending and business hiring in the absence of further federal assistance, raising the risk of a renewed economic downturn. Bitter partisan politics has been a huge impediment to agreement on another badly needed spending package.

[4] Business Sector Restructuring: The pandemic has provided business firms with a unique opportunity to restructure and transform their operations by implementing new efficiencies to become more productive, competitive, and profitable. Specifically, I expect corporations to alter staffing requirements in order to minimize operating costs and maximize profit margins.

- **Capital Versus Labor**: Substitution of capital (automation) for labor will be an integral part of this process. Profound weakness in labor markets means that businesses will enjoy considerable negotiating power over workers in coming years, thereby suppressing wages to the benefit of profit margins. *The macroeconomic implications could be a combination of a jobless recovery and record corporate profitability*.

[5] Industry Consolidation: The long-term trend toward industry concentration in recent decades has been turbocharged by the coronavirus pandemic, as small and mid-sized firms have failed and the largest firms have become more dominant. This trend could persist for many years.

- **Implications**: There are at least three implications for equity investors. First, the dominant firms in various industries could experience accelerating growth in sales and earnings as they capitalize on market share gains. Second, greater dominance usually implies increased pricing power, which should result in higher profit margins. Finally, from a broad economic perspective, increased pricing power for firms could result in higher inflation.

[6] Corporate Earnings: Pulling it all together, prospects for company earnings appear favorable, with expected growth approaching 20% in both 2021 and 2022. There are five primary sources of robust profit growth:

- Company revenues should rebound strongly consistent with solid growth in GDP, industrial production, and residential construction.
- GDP growth should be led by manufacturing and construction, rather than by services. Company profit margins are highly leveraged to the industrial economy and much less for the service economy.
- Businesses are keenly focused on cost containment, especially with respect to labor costs. Job growth will likely lag GDP growth, while increases in unit selling prices should easily outdistance those in unit labor costs.
- Company profit margins will also benefit from lower expenses for discretionary business travel and office rents.
- Depreciation of the US dollar will support earnings of US multinational firms.

INVESTMENT TIME HORIZON

The investment outlook can be divided into three discrete timeframes: (1) The next six months; (2) The eight quarters ending in mid-2023; and (3) The period beyond 2023.

Short Term: There are numerous risks to the outlook for common stock investing over the next three to six months:

- Deterioration in public health conditions as coronavirus cases spike higher
- Disappointing economic news, especially with respect to employment
- The possible failure of Congress to agree on another fiscal relief package
- Increased political uncertainty associated with the election
- Growing hostility between China and the US

The upshot is that the equity market could be at risk to a consolidation phase during the next several months, as the economic, political, and public health news turn temporarily negative. Long-term investors should await a more favorable entry point. The bond market should provide downside protection to the equity market, as market yields decline modestly in sympathy with a decline in stock prices.

Medium Term: The medium term is defined as the period when widespread availability of a vaccine permits a broad reopening of the economy and an acceleration in economic growth. I expect this period to begin in the middle of next year and extend into the middle of 2023. ***These two years should be the sweet spot in the economic cycle, with optimal conditions for equity investing*.**

- **The Sweet Spot**: The early years of an economic expansion are characterized by strong GDP and corporate profit growth, a lingering trend of low interest rates and inflation, and rising business and investor confidence. The equity market should discount these favorable economic conditions in advance, implying the potential for common stock returns of 10% to 15% during calendar years 2021 and 2022.

Long Term: The years beyond the early recovery phase of the current business cycle expansion could be challenging for investors in all asset classes. The central theme of my outlook for long-term economic growth is that adverse long-wave structural forces will begin to dominate economic trends, especially after the favorable business cycle-related forces begin to fade in 2023. These adverse long-term forces include the following:

- An anticipated reversal of monetary policy toward restraint
- A reversal in fiscal policy stimulus in the form of higher taxes
- An acceleration in inflation in lagged response to previous policy stimulus
- Strengthening in de-globalization forces that emerged several years ago
- A continued rise in populism and anti-business sentiment

As a rough approximation, these forces will emerge around 2023 and be manifested in sluggish economic growth, rising inflation, a rising trend in public and private borrowing costs, slowing growth in productivity, and most importantly, a rising trend in long-term interest rates.

FIXED-INCOME MARKET

Bond market investors face daunting challenges in coming years, stemming from gradually less supportive monetary policy, rising inflation, stretched valuations, and an expected rise in private credit demand associated with more rapid economic growth. Unprecedented debt issuance by the US Treasury could also exert upward pressure on market interest rates. The combination of record-low current yields, a rising risk of inflation beyond 2022, and a rising trend in interest rates is a recipe for negative rates of return in diversified bond portfolios over the next several years.

DOMESTIC EQUITY MARKET

The domestic equity market entered a long-awaited correction toward quarter end, with a cumulative decline of 10% in the S&P 500 from its all-time peak in early September. Equity investors had become overly optimistic in July and August with respect to the economic outlook and too complacent regarding the path of the coronavirus pandemic.

- **Reality Strikes**: There is growing evidence that economic growth could weaken further between now and the early months of next year, prior to a major scientific breakthrough. Currently at 3363, the S&P 500 could test the 3000 mark, a cumulative decline of 15% from its early September peak of 3580. A more severe downturn in stock prices could occur in response to a renewed lockdown of the economy as in March and April and/or a constitutional crisis associated with the outcome of the presidential election.

Vaccine Catalyst: Equity market prospects should improve markedly in 2021 when official plans for mass distribution of a vaccine are announced, hopefully early in the new year. While the real economy will not begin to benefit from a vaccine until the second half of next year, financial markets should respond immediately to the news of the roll-out, with both equity prices and bond yields moving higher. The trigger for higher stock prices will be widespread upward revisions in corporate profit estimates for 2021 and 2022.

Growth and Value: A shift in market leadership from growth stocks to value stocks seems virtually assured over the next one to two years, but the timing awaits unequivocal signs that a self-reinforcing economic recovery is imminent. <u>My recommendation to overweight value stocks in equity portfolios is consistent with history, in two important respects</u>:

- Value stocks have always outperformed growth stocks during the first several years of an economic recovery in all business cycles dating back to the 1970s.

- Value stocks have always outperformed growth stocks during periods of above-average growth in GDP and company earnings. My forecast assumes profit growth of 20% in both 2021 and 2022, well in excess of its long-term average of 6%.

Economic sector leadership should be in industrials, materials, consumer discretionary, financials, health care, and transports over the next two years.

International Equities: My forecast for global equity markets assumes a major shift in leadership over the next several years in favor of non-US stocks, following an extended period of US equity market domination. The catalyst for this shift in leadership will be concrete evidence of a robust and self-sustaining recovery in the world economy.

- *History reveals that US stocks perform best when world GDP growth is below trend; conversely, non-US stocks perform best when the global economy is expanding at a rapid pace*. My assumption is that world economic growth will begin to accelerate approximately one year from now when a vaccine is available for mass distribution.

World GDP Growth: The rationale behind this relationship between world economic growth and relative equity market performance is straightforward: As a defensive economy, the US attracts investment flows when world economic risks are elevated. Conversely, *a robust world economy benefits international stocks because of their greater cyclicality and sensitivity to broad economic growth*. Non-US stocks outperformed those in the US in 2017, a year of very strong growth in world GDP and world trade. I expect equity markets in Europe, Japan, and emerging Asia to outperform the S&P 500 in 2021 and 2022.

COMMERCIAL REAL ESTATE

COVID-19 has dealt a severe blow to the property market, as major structural changes in behavioral and lifestyle patterns have undermined the demand for commercial space. All property types have been negatively impacted. The demand for retail space has been devastated by the surge in e-commerce; and empowered by Zoom, the increasing trend in work-from-home arrangements has accelerated, reducing the demand for office space.

The collapse in business travel and tourism has resulted in a slump in hotel occupancy rates, while high-end apartments and condos in major urban centers have suffered from the surging demand for single-family homes in the suburbs. Property prices could decline by 10% to 20% over the next several years, with only a modest recovery likely by 2025. A portfolio of commercial real estate equities could generate annualized total returns of less than 2% over the next five years, as current income returns are offset by capital losses.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

NASDAQ Index: Is a stock market index that includes almost all stocks listed on the Nasdaq stock market. Along with the Dow Jones Industrial Average and S&P 500 Index, it is one of the three most-followed stock market indices in the United States.

Russell 3000 Growth Index: Is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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