OCTOBER 15, 2020

"As a rule, the more bizarre a thing is, the less mysterious it proves to be."
– Arthur Conan Doyle, *The Complete Sherlock Holmes*

Many observers, both casual and professional, find both bizarre and mysterious the apparent disconnect between the booming stock market and suffering economy. We believe that there are two key factors that help to explain what seems like an historic misalignment. The first is the mountain of money created by central banks in response to the global pandemic. Thanks to aggressive action by the Federal Reserve, the supply of money has increased almost $4 trillion since February; the faltering economy has been able to absorb only a portion. The excess must go somewhere, and much of it has found its way into financial markets. Virtually all financial assets have increased in value, most notably riskier ones like certain stocks, lower quality bonds and gold.

The second factor is more technical. It is not so much that the whole stock market is roaring, but more so the part that gets measured. The table below sheds light on the really significant differences between equity benchmarks.

Benchmark	YTD Return	Comments
S&P 500	5.57%	Five companies with disproportionate impact
S&P 500 Equal Weight	-4.75%	More representative of the average stock
Growth Stocks[1]	24.33%	Tech & e-commerce represent 50%+
Value Stocks[2]	-11.58%	Mostly economically sensitive & cyclical
Russell 2000	-8.69%	Represents smaller companies

Because the S&P 500 is calculated using a market capitalization weighted average, a handful of very large companies dominate, giving the appearance of a more robust overall market. Apple, Amazon, Alphabet (Google), Facebook and Microsoft together represent approximately 25% of that index. On a weighted average basis, those stocks are up 42.34%. Were they excluded from the calculation, the return of remaining 495 stocks would be almost 3% ***negative***.

Each of those five companies is very profitable, and benefits from, or is not harmed much by, the impact of Covid on the broader economy. Especially in the case of Amazon, Facebook and Alphabet, those profits come at a cost to traditional competitors (that have many more employees). E-commerce has grown at the expense of brick and mortar retailing; social media

[1] As measured by the Russell 1000 Growth Index
[2] As measured by the Russell 1000 Value Index

and search engines have commandeered a share of the advertising market from television and print media.

The smaller companies that make up the Russell 2000 (referred to as Small Cap) are, generally, dependent on the economic health of the United States. It is little mystery that these companies (like their somewhat larger, non-tech counterparts in the S&P 500) face greater challenges, a fact accurately reflected by the negative year-to-date return of this benchmark.

Our equity investments have benefited from these trends to a certain extent. We have very little invested in companies that are considered Small Cap. Though we do have meaningful investments in large technology and e-commerce providers, our portfolio exposure is not as extreme as the S&P 500. We have also benefitted from strong returns from such diverse sources as healthcare, beverage cans, home appliances and select foreign stocks.

While the first six months of the year saw a high level of trading activity in our equity portfolios, during the third quarter there were only modest moves. We trimmed some big winners and added to an existing position that we believe is attractively valued.

Fixed Income

The Federal Reserve's announcement during its annual Jackson Hole symposium was the highlight of the third quarter for interest rates. Chairman Jay Powell reassured markets that the Fed would not raise interest rates until inflation was evident. This is a notable change from precedent. The Federal Reserve has historically increased rates when it believed that the economy was at full employment, assuming that inflation would soon follow.

We believe that the pre-pandemic record low unemployment (3.5%), which was accompanied by minimal signs of inflation, may need to be seen again before the Fed raises rates.

The 10-year U.S. Treasury Note ended the quarter at 0.68%. For that rate to climb higher, some, but not necessarily all, of the following factors will likely have to occur: 1) a credible announcement of a vaccine; 2) the virus staying in check throughout the winter; 3) a fairly smooth election process; 4) continued investor enthusiasm for risky assets; and 5) the resumption of normal seasonal factors, which usually see U.S. rates increase slightly toward the end of the year.

What we'll be watching for in 2021 is more coordinated stimulus from both the monetary side (Federal Reserve) and the fiscal side (U.S. government). The Fed alone may be able to get inflation back to its 2% target but will find it difficult to sustain those levels in the longer term without cooperation on the fiscal side.

Looking Forward

Today's market is a bit like a Sherlock Holmes mystery. Just as surely as we know that Sherlock will crack the case, we know that: growth won't always outperform value; large won't always outperform small; the 10-year Treasury won't be below 1% forever; and one day we'll talk about Covid in the past tense. Also like a Sherlock Holmes mystery, we don't know which plot twists

lie ahead or how many turns the story will take before the conclusion is reached. What we do know is that, in a year that has already included more than its fair share of plot twists, the fourth quarter seems set to deliver a few more.

Politics and the pandemic will be the two major story lines. Like almost everyone, we read the newspapers and listen to our leaders and global health officials. We have also listened to, read transcripts of or participated in scores of conference calls with scientists working on data analysis and vaccine research, companies developing and producing tests, as well as major hospital system executives and other businesses in the healthcare supply chain. While this gives us no unique or special insight, it appears reasonable to expect that widespread adoption of an effective vaccine is likely to be at least a year away and that the number of people infected will rise over the winter months.

If this is correct, it also seems reasonable to expect continuing economic turbulence in the coming months. We believe that we can count on the Federal Reserve to maintain its low interest rate policy for the foreseeable future. Fed Chairman Jay Powell promised as much in his most recent testimony. The federal government (congress and executive branch) policy response is much more difficult to predict. It appears to us that uncertainty over a new Covid relief bill has been a leading factor in market gyrations over the last month. While negotiations continue, the outcome is anybody's guess.

Likewise, for the upcoming elections. Under normal circumstances, one would point to four possible combinations and contemplate the potential market reaction to each.

		Conventional Wisdom (Not SAA)	
President	**Senate**	**Stocks**	**Interest Rates**
Trump	Republican	Positive	Stable to lower
Trump	Democrats	Neutral	Stable
Biden	Republican	Neutral	Stable
Biden	Democrats	Negative	Stable to higher

But these are far from normal times. We will leave predicting the results to polls, pundits and prognosticators. The right forecast is less important than knowing whether markets will be surprised or if investors have fully digested each potential outcome. As of the end of September, we believed that investors had not yet factored in the possibility of both a Biden victory and change of control of the Senate. Conventional wisdom is that a Democratic sweep would result in higher taxes, more regulation and a possible return of inflation, which would likely create a challenging environment for both stocks and bonds. But there would likely be positive offsets. More aggressive fiscal stimulus, including aid to states, would likely be positive for the economy and supportive of municipal bonds.

One thing is certain. We are in the midst of a particularly contentious election season. The path will be tortuous (some would also say torturous). We will watch closely but are unlikely to be

tempted to make significant changes based on politics. Should there be clear evidence of substantial changes to the tax code, we will discuss potential ramifications and specific courses of action. In our view, surprising news about the course of Covid-19 could have a much bigger impact on financial markets than election results. In either case, we believe that 2020 will continue to prove the merit of our discipline to invest with uncertainty in mind.

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