3Q2020 Market Review and Outlook
The Hard Work Begins

Investors welcomed the "v" shaped rebound in economic growth that we saw in 3Q20. After the pandemic related global lockdown caused 2Q20 GDP to plummet at a record pace, as the U.S. economy reopened so did economic activity. The third quarter is likely to post its best quarterly GDP on record. Manufacturing has recovered and is flourishing; housing is surging with low interest rates and the pent-up demand in consumers is seen by increased spending on consumer discretionary items (e.g. autos, furniture, electronics). The global equity market continued its fastest move out of bear market in U.S. history and several Indices notched fresh new record highs in 3Q (e.g. NASDAQ, Russell 1000 Growth). That does not mean it was a smooth rise to the top, September lived up to its historical seasonal weakness and the S&P 500 posted its worst September in nine years while the tech heavy NASDAQ dropped into correction territory for the first time since the pandemic.

As we move into the end of 2020, the easy economic rebound is likely behind us and now the hard work begins. In this quarterly we will discuss some of the diverging paths we are seeing in this economic recovery, outline the risks going forward and suggest how to invest in these highly uncertain times. Especially as many asset classes are at or near record highs and finding value is just as difficult, if not more, than before the pandemic.

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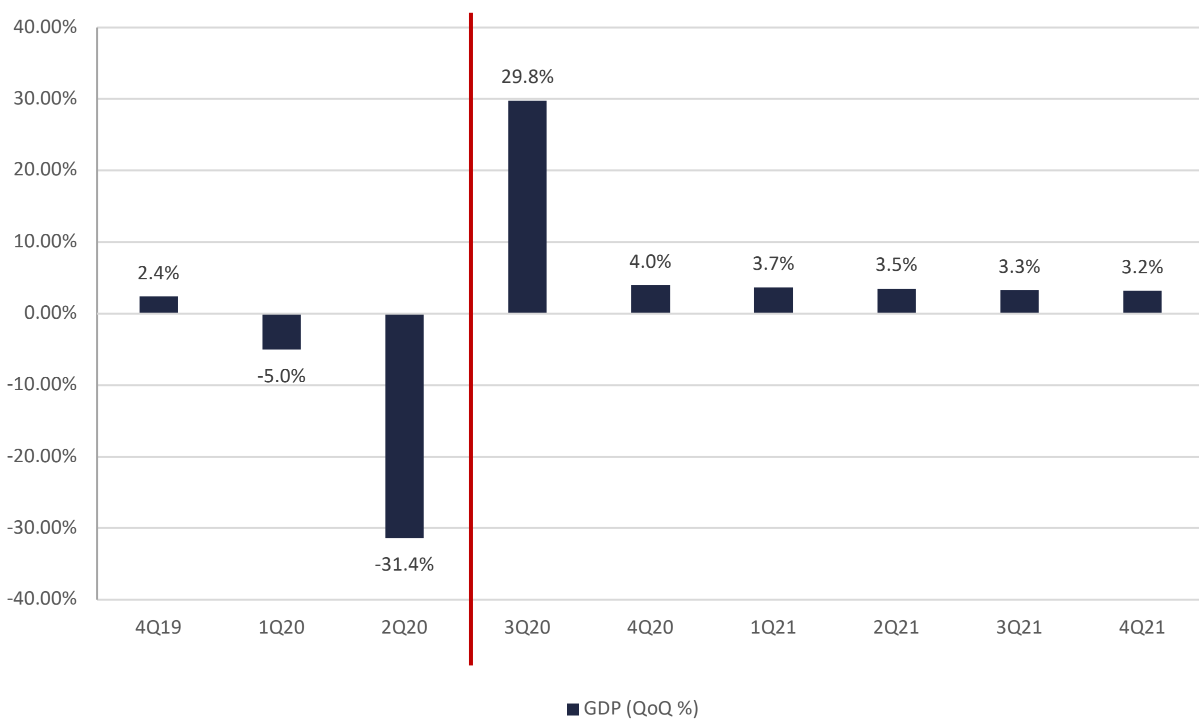
U.S. Economy – The Easy Rebound is Likely Behind us

The aggressive measures taken by the Federal Reserve and the Federal Government have contributed to the sharp "v" shaped recovery we have seen in U.S. growth **(Chart 1).** In fact, the recession of 2020 may go down as one of the shortest in U.S. history. While we remain confident the fiscal stimulus and gradual reopening of the economy can keep the economy moving in the near term, we acknowledge that the easy recovery is behind us and now the recovery will likely be choppier. We can also start to decipher between what the long-lasting damage is after the "self-inflicted" recession. Especially, regarding the labor market and the consumer which makes up the majority of GDP.

Chart 1

"V" Shaped Rebound in Economic Activity

Estimates are as of October 20, 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Parts of Economy Driving Recovery – manufacturing, housing, consumer, easy monetary policy:

- **Manufacturing** is robust as plants have reopened and are rapidly replenishing the stockpiles that were left unfilled during the global lockdown. There has been a tremendous backlog of orders from all aspects of the economy so new orders and production have jumped to levels not seen since before the pandemic. **(Chart 2).** In addition, as of now the manufacturing sector has added a little more than half the amount of jobs that were lost in March and April.
- **Housing** has been surging as interest rates drop to a record low and Americans accept a new "at home" lifestyle. Whether it is renovating their current home or taking advantage of the low interest rates to upgrade to a bigger home, housing is booming. Homebuilder sentiment is at a record high and the 30-year mortgage rate has made its 14th record low this year. **(Chart 3).**

Chart 2

Manufacturing Production Quickly Reaches Pre-Pandemic Levels

Data is as of September 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

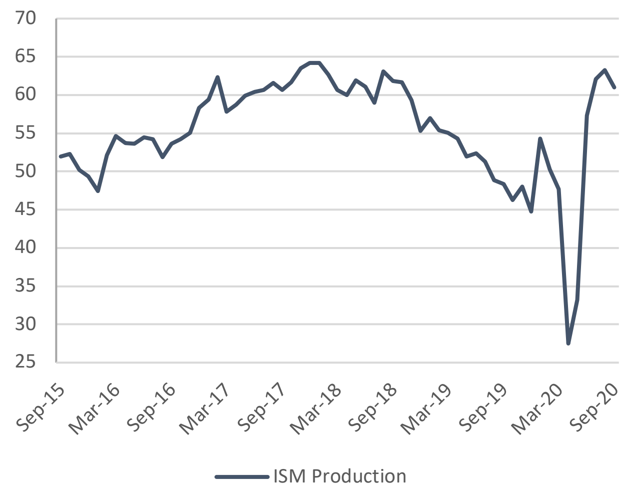
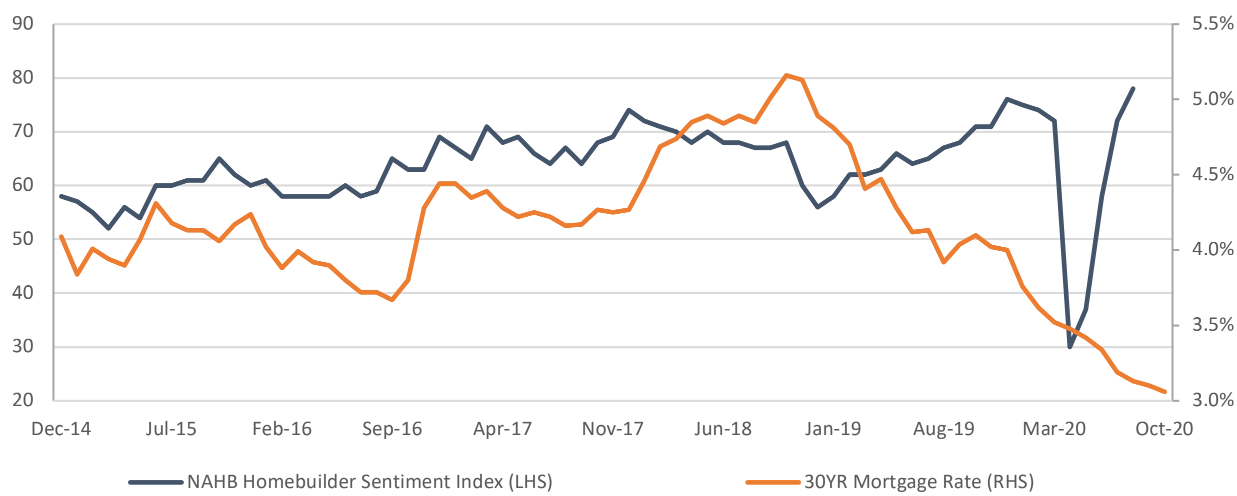


Chart 3

Housing Surging on Low Interest Rates

Data is monthly and as of October 2020. Mortgage rate is as of October 9, 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Consumer spending** data has been mixed in recent months but the one thing that has been consistent is that consumers are spending on big ticket or discretionary items. This is rare because usually in a recession or time of economic uncertainty, especially high unemployment, consumers slowdown buying things like autos, furniture and cars and stick with the essentials. However, our proprietary discretionary spending index is rising at the fastest year over year pace since prior to the pandemic (January 2020). **(Chart 4).**

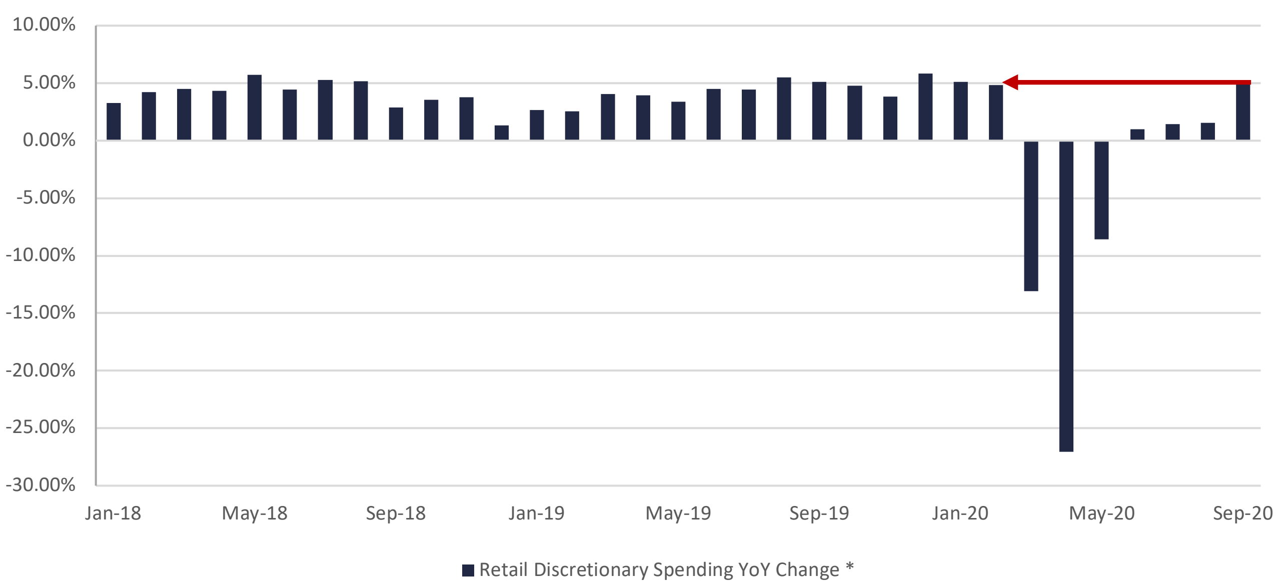
- **Stimulus** at both the Federal and monetary level has been supportive of the recovery and has helped to bridge the economic gap until our economy could gradually reopen. The Federal Government has released more than $2 trillion in fiscal stimulus with more likely on the way. In addition, the Federal Reserve has expanded their balance sheet in excess of $7 trillion and has suggested they will not raise rates until 2023, at the earliest.

Data shows that **consumers are spending on big ticket or discretionary items,** which is atypical during high unemployment.

Chart 4

Consumer Spending on Big Ticket Items

Data is as of September 2020. *Discretionary spending is spending on autos, electronics, furniture, clothing, sporting goods, general merchandise, internet, restaurants. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Past performance is not indicative of future returns

Parts of Economy Still Struggling – employment, income, bankruptcies/delinquencies rising:

- The **U.S. labor market** has improved substantially since the global lockdown. In five months, the U.S. economy has gained back approximately half of the jobs lost in March and April. However, it is not enough. Initial jobless claims remain elevated as the grace period where employers could not lay off employees if they took loans from the Government is coming to an end. Those filing continuing jobless claims remains high and the long term unemployed (those out of work for more than 27 weeks) has surpassed 2 million individuals. **(Chart 5).** Lastly, women are leaving the work force at an alarming rate as they choose between their careers and home schooling their kids. A weak labor market could challenge ongoing strength in consumer spending. This is important because the consumer makes up ~70% of GDP.

- **Personal income** jumped as the Federal stimulus made its way into the hands of Americans. However, the stimulus has not been sustainable in keeping incomes higher. Fading stimulus and high unemployment has caused incomes to decline consistently after their April record increase. **(Chart 6).** In addition, while it is still elevated, the personal savings rate has been trending lower giving consumers less cushion in the event the economic recovery slows.

Chart 5

Long-Term Unemployed a Discouraging Signal

Data is as of September 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

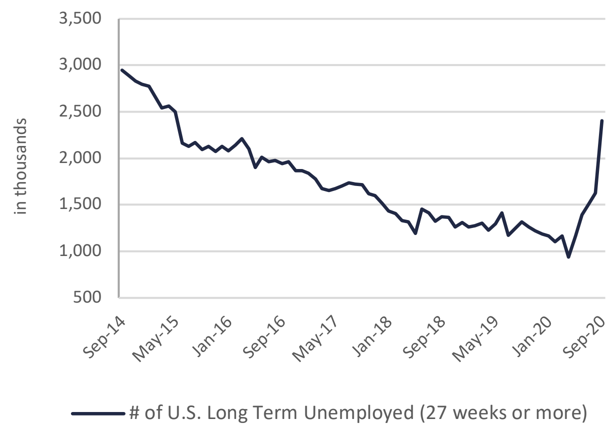
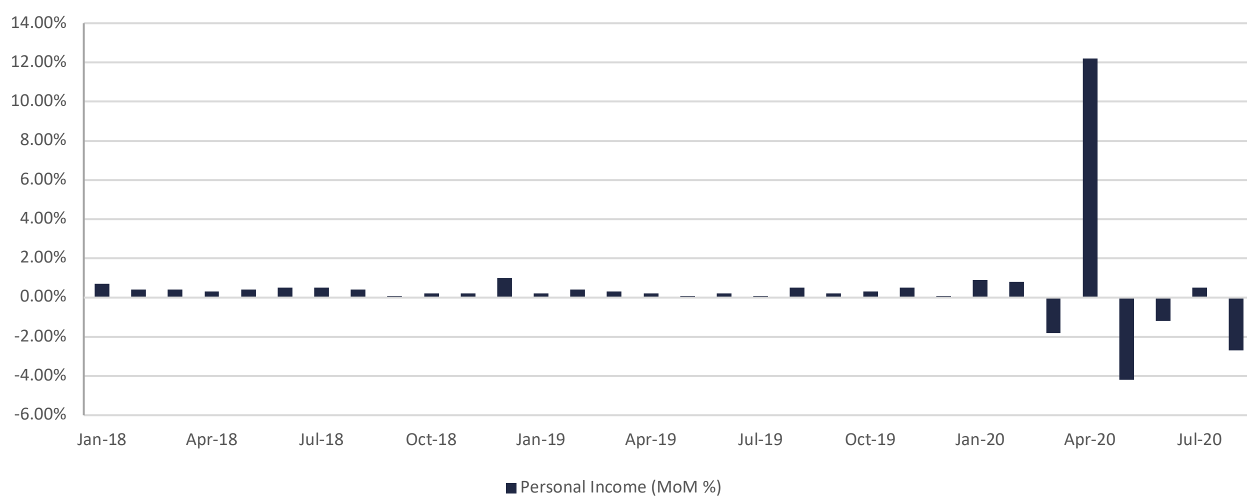


Chart 6

Incomes Have Been Weak Since Fiscal Stimulus Wore Off

Data is as of August 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Bankruptcies and delinquencies** are rising across many areas of the U.S. due to the countrywide lockdown in 1H20. **(Chart 7).** Not only at the residential sector but also in the commercial and retail real estate space. While the foreclosure/eviction moratorium has helped, additional stimulus and the creation of more jobs should help these statistics decline.

The fiscal and monetary stimulus implemented this year was desperately needed and has kept the economy afloat for the past several months, and it will likely keep us modestly growing in the coming quarters. However, the long-term damage from the lockdown is going to be harder to repair, especially in the labor market. Unfortunately, without consistent improvement in the labor market, the outlook for the economy remains less certain. We believe a combination of another round of fiscal stimulus and more parts of the economy reopening to full capacity could help to address these challenges.

Long-term damage from the lockdown is going to be harder to repair

Chart 7

Mortgage Delinquencies on the Rise

Data is as of 2Q20. Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Do Presidential Elections Matter?

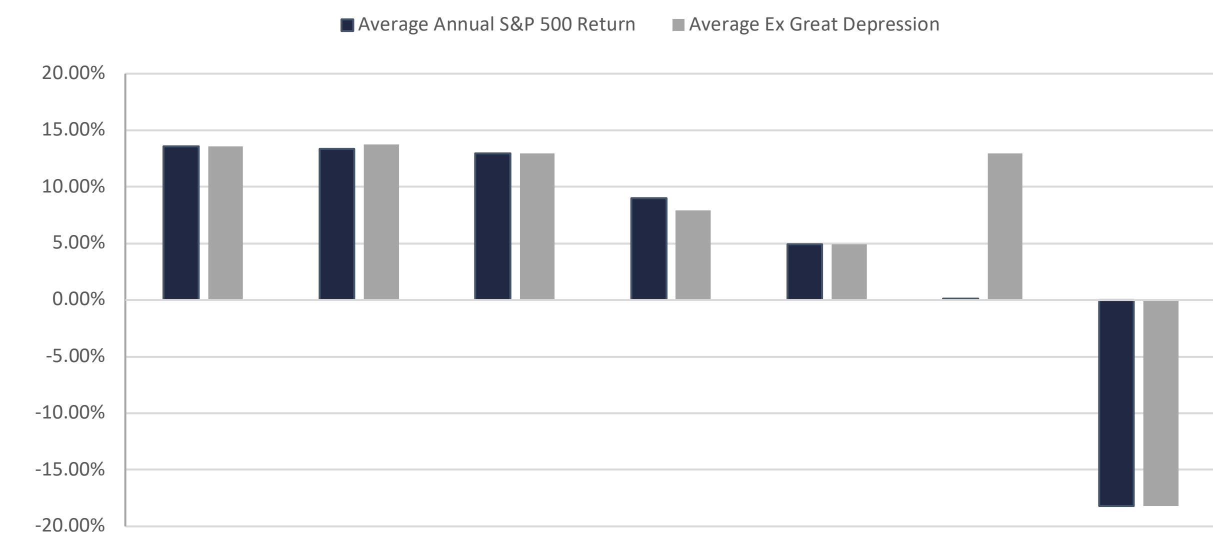
Elections will always matter, but policy is more important than politics. While this Presidential election has brought unnecessary anxiety, we remind investors that politics is just one factor when deciding asset allocation. The overriding factor should always be underlying economic fundamentals. Political parties will swing multiple times and taxes will even change throughout an investors long-term investment cycle. Therefore, it is dangerous to let emotions drive short-term investment decisions until we know what, if any, changes will take place and how they will impact your individual financial situation.

While history can produce many statistics around what party may or may not be better for the economy or the equity markets, we think economic data can be misleading. On average, economic cycles in the U.S. have lasted ~four years and we have a Presidential election every four years. A new President or party can benefit from an economic cycle that is moving into expansion territory after a downturn or be at a disadvantage of policies administered from a prior political party that cause the economy to move into recession. The one key takeaway that we have from political cycles is that investors favor gridlock in the White House and Congress more than a full sweep by one party. **(Chart 8).** Even if Democrats gain control of the White House and Senate, there are many variables up in the air (e.g. can they override a filibuster, can they raise taxes with high unemployment) before we would make portfolio decisions around what may or may not happen with taxes.

Chart 8

Investors Prefer Gridlock in Washington

Time period reflects 1929-2019. Source: Bloomberg Finance LP, senate.gov/history, history.house.gov, Verdence Capital Advisors.



President	D	R	D	D	R	R	R
Senate	D	R	R	D	D	R	D
House	R	D	R	D	D	R	R

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It is important to note that we have historically seen a candidate make campaign promises with aggressive plans, only to move to the middle after elected, in order to satisfy more Americans and boost their approval ratings for the midterm elections. It is difficult to campaign for fiscal stimulus then raise taxes at a time when the economy is still navigating through a pandemic and high unemployment.

Investors can make short-term emotional mistakes in their portfolios in anticipation of what the market will do given a predicted outcome and then prove to be painfully wrong as the market reaction was wildly different than expected.

For example, in 2016 there were many predictions that the S&P 500 would fall ~50% should President Trump be elected. If an investor sold then, in anticipation of his win and on the predicted S&P plummet, **they would have missed out on a 20%+ rally in the one year following his election.**

Fixed Income – Clipping your Coupon at Best

The Federal Reserve's aggressive actions to anchor interest rates at or near historical lows has left fixed income investors with little choice but to take on additional risk. The yield and coupon that investors are earning on core fixed income (e.g. Bloomberg Barclays Aggregate Index) has ground to record lows. At the same time, the amount of interest rate risk an investor takes to purchase bonds (e.g. duration) has climbed to near record highs. **(Chart 9).** This makes core fixed income (e.g. Treasuries and Government agencies) look expensive.

We still believe fixed income holds an important part in a well-diversified portfolio. However, we continue to hold a more defensive positioning as we believe that higher yielding fixed income is not rewarding investors for the added risk. We recommend the following allocation in fixed income:

- **Investment grade over high yield bonds:** The extra yield investors demand to take on the risk of owning a corporate bond instead of a Government backed bond has narrowed substantially since the pandemic high. In both investment grade and high yield debt. There is still room for spread compression as spreads remain above their pre-pandemic low and the Federal Reserve has resorted to buying a variety of corporate bonds. However, we would recommend investment grade bonds over high yield bonds at this time. The rise in bankruptcies is likely to continue as we navigate through the negative ramifications of our pandemic lockdown and we do not believe high yield investors are being rewarded for that risk. Especially since current estimates suggest that while default rates will be elevated, the recovery rate investors get in a bankruptcy is also likely to remain below average for the coming years. **(Chart 10-next page).**

Chart 9

Yields Near Record Lows Offers Little Reward with Immense Risk

Data is weekly and as of October 9, 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.

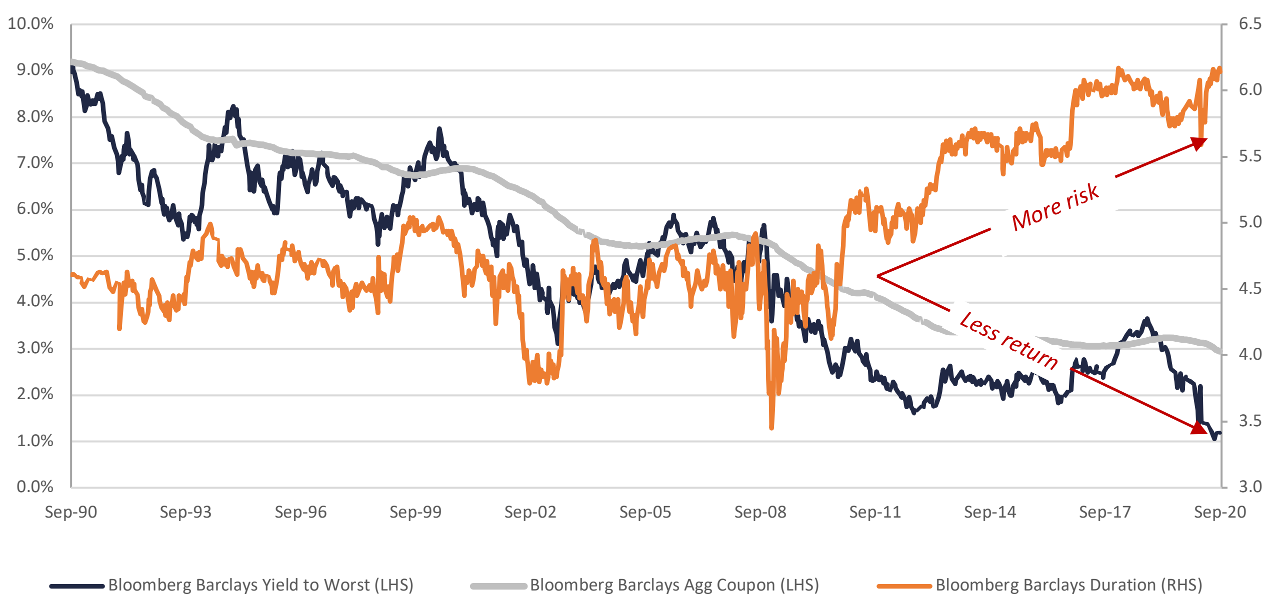
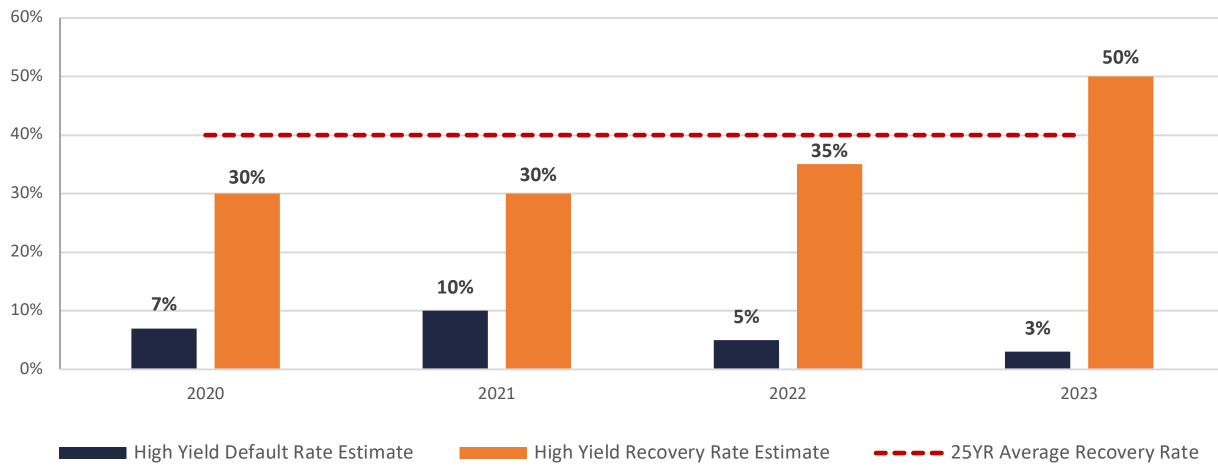


Chart 10

High Yield Recovery Rates to be Below Average

Data is estimates from Strategas Research Partners as of September 2020. Source: Strategas Research Partners, Verdence Capital Advisors.

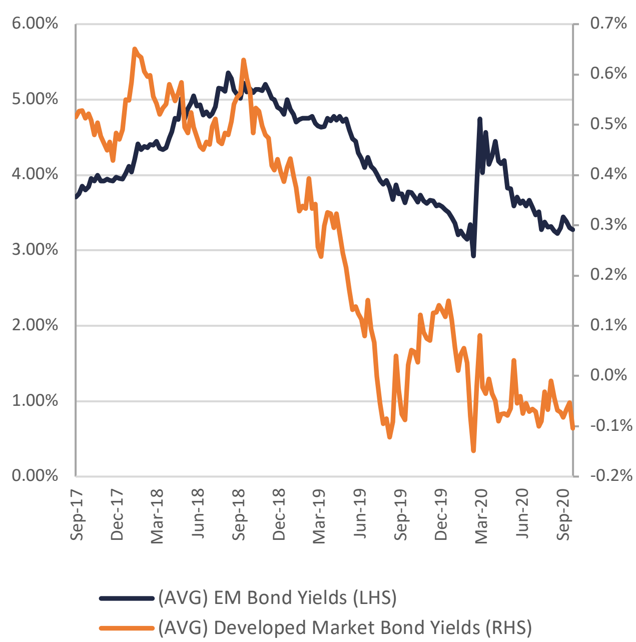


- **Emerging market bonds offer additional yield:** For those clients that have a higher risk tolerance we see opportunity in emerging market bonds. Emerging market bonds offer attractive yields compared to the developed markets where central banks have pushed interest rates to historic lows (negative in some cases). **(Chart 11).** In addition, while the Coronavirus may have originated from the emerging markets, they are expected to experience less of an economic contraction in 2020 and higher rebound than the developed markets. Lastly, according to the IMF the emerging markets should see lower inflation in 2021 while the developed economies are expected to see inflation rise. This should aid with price appreciation and they carry attractive yields.

Chart 11

Looking to EM for Yield

Data is weekly and as of October 16, 2020. EM average bond yields are Brazil, Mexico, Indonesia, Turkey, Russia while developed market bond yields are U.S., Germany, UK, Japan. All USD based. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Global Equities – Patiently Optimistic; Concentration Remains a Risk in the U.S.

Global equities in 3Q20 posted another stellar quarter as global economic growth continued to improve as the world reopened and central banks remained accommodative. The MSCI AC World Index surpassed its pre-pandemic high on September 2, 2020. Even after a brief 5% pullback in September, the Index posted solid returns for the second consecutive quarter.

In developed markets, the rally in the U.S. has not been broad-based. Instead, it has been focused on a select area of the market (i.e. U.S. large cap growth and technology). Year-to-date, Apple, Amazon, Microsoft, Facebook and Google have made up 140% of the S&P 500 total return. **(Chart 12)**. Investors can see how concentrated the U.S. large cap market is by comparing the equal cap weighted index to the market cap weighted index. The market cap weighted index gives more influence on the largest market cap names while the equal weight does not differentiate. On a rolling one-year basis, the market cap weighted Index is beating the equal cap weighted index at the fastest pace since prior to the dotcom bubble bursting. **(Chart 13).** We do not believe this is sustainable, and we would be cautious chasing momentum in these names and sectors. We saw similar levels in 1999 only to see a reversal for several years.

Chart 13

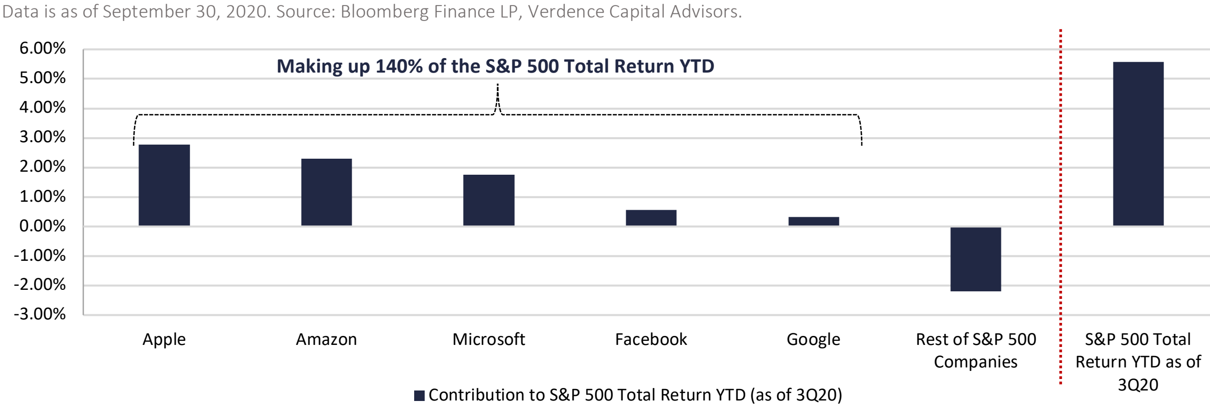
Market Cap Weighted vs Equal Cap Weighted S&P 500 at 1999 Valuations

Data is as of September 30, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 12

Select Names Making up all of U.S. Equity Returns Year-to-Date

Data is as of September 30, 2020. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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While we continue to favor equities over bonds for the next 12-24 due to a gradual improvement in global growth, the massive amount of money on the sidelines and historically low interest rates, we think the easy returns are behind us and select global valuations look stretched. Therefore, being patient and selective will be important as we move through the remainder of the year where we expect volatility to remain heightened. We recommend having a healthy cash position to evaluate pullbacks as potential buying opportunities given our favorable long-term outlook for equities. However, as we patiently await better entry points there are some areas of the global market that have not kept pace with the rally and look attractive for the long term:

- **Value vs. growth dichotomy continues:** Value has not been able to live up to its tech heavy growth counterpart for several years now. In fact, on a rolling five-year basis growth is outperforming value at the fastest pace since the dotcom bubble. **(Chart 14).** As we navigate through the economic recovery, we expect to see some rotation into more attractively valued stocks. Instead of paying up for stocks, the massive liquidity created by the Federal Reserve should help to fuel demand into stocks that have lagged in the rally.

- **Developed international equities:** The U.S. has led the developed international markets in the response to the pandemic at the fiscal level by spending the most as a percent of GDP than any other developed economy. However, when you consider the monetary response and extra liquidity measures combined with fiscal stimulus, Europe and Japan have spent more than the U.S. as a percent of GDP **(Chart 15).** This should be supportive of their equity markets. In addition, while all the international markets have rallied strong out of the March bear market, the U.S. has led the rally and is trading close to its all-time high. However, its international developed counterparts are still trading well below their all-time high.

Chart 14

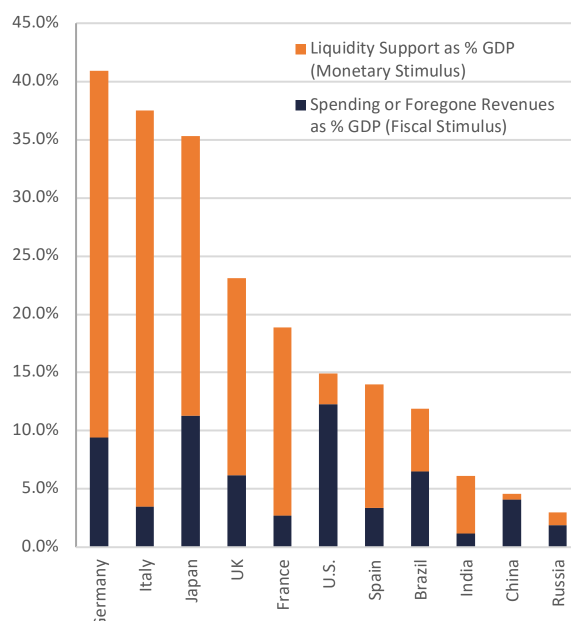
Growth vs. Value Dichotomy Continues

Data is trailing five years as of September 30, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 15

Int'l Developed Economies More Supportive as % GDP

Data is as of June 2020. Source: IMF, Verdence Capital Advisors.



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Alternatives: Benefitting from Dislocations

Investors have had to become more accustomed to volatility in 2020. This has offered a good opportunity for quality hedge funds to capitalize on market dislocations. Given our expectation for a continuation of volatility as we navigate through the recovery, we recommend hedge funds for those investors that are suitable.

In an environment where finding value in public equity and bond markets is starting to entail taking on more risk, the private markets look even more attractive, especially income-producing private equity as interest rates remain near record lows.

While every client's financial situation and investing goals may vary, the ability for a wide array of investors to access the private markets through different structures is growing. We will continue to look for attractive private investments that offer our client a good risk-adjusted returns, that can enhance income opportunities and offer attractive diversification benefits.

The Bottom Line

We remain cautiously optimistic as we move into the end of 2020 and into 2021. We realize that investor anxiety may be heightened given the current political environment and the unchartered territory we embrace with the deadly pandemic. The global government responses have been astounding and should help us to gradually recover from the pandemic related downturn in early 2020. However, the easy work has been done. We now need to repair the damage created by the pandemic, be flexible in stimulus as needed and be thankful for the rapid advancements of therapeutics and number of vaccinations in trials at this quick of a pace. We expect the next wave of the economic recovery will be choppier than the sharp "v" shaped recovery we just experienced so we recommend patience and discipline. From an asset allocation perspective there is nothing wrong with holding a solid cash position. This can not only help to hedge if the economy takes another turn lower, but it also offers us the flexibility to capitalize on pullbacks which are highly likely in such an overvalued world. As always, we will take all our client's investment objectives and risk tolerance into consideration when making portfolio changes.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

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