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# What's in store for 2020 and beyond.

## The stock market's recent performance was strong, but also reflects a disconnect with the economy.

Stock markets defied continued uncertainty about the pandemic and the economy to reach all-time highs in the 3rd Quarter of 2020. By the end of August, the S&P 500® Index had recovered completely from the market's swift downdraft in March, gaining more than 35% since the low and marking the best five-month return since 1938 according to Bespoke Investment Group.

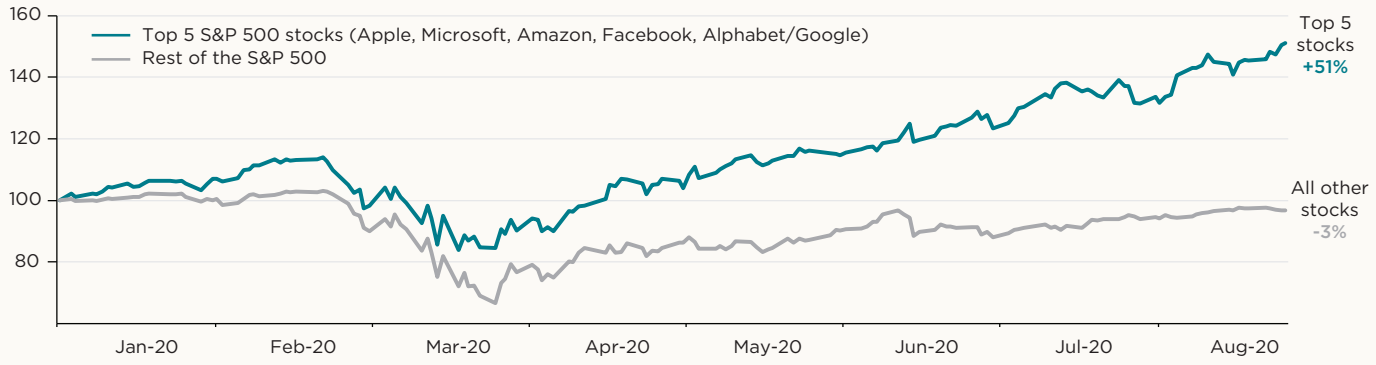
While the recent strong performance is good reason to cheer, it does reflect a worrisome disconnect from the fundamentals. Elevated stock prices currently reflect higher investor expectations for a robust economic rebound and a dramatic shift from pessimism to optimism. No matter which equity investors are polled, from global fund managers to individual investors, sentiment has swung decisively from fear to greed.

As we approach the final quarter of a turbulent year, investors are faced with tough asset allocation decisions; the market rebound has extended equity valuations and made stocks generally expensive, but historically low yields in the bond market do not offer a compelling alternative. A traditional 60%-equity/40%-bond portfolio has delivered attractive and consistent returns over the last decade, but at current market levels this allocation may need to shift in the years to come to provide adequate returns for investors' long-term goals.

## A bifurcated stock market

The record-shattering run of the major equity indexes and the dramatic headlines which followed masked a concerning reality; only a handful of stocks are driving the S&P 500's recent gains. The top five stocks in the index based on market capitalization—Apple, Microsoft, Amazon, Facebook and Alphabet/Google—collectively gained over 50% from the start of the year through August 21, while the remaining S&P 500 stocks are down over the same time frame. (See chart below.) These tech behemoths currently account for 22% of the index's total market capitalization, the highest level of concentration since at least 1980. At present levels, these five firms have the same market cap as the bottom 394 stocks. The biggest of the bunch, Apple, added $420 billion to its market cap over the past month. That gain itself is larger than the market cap of all but seven S&P 500 companies.

**2020 year-to-date growth through August 21, 2020; indexed to 100**




Source for chart data: FactSet Research Systems.

The outsized outperformance of these stocks has potential implications for the overall market. While the strength of this group has led to better performance for the broad index, the market is now susceptible to weakness in one or more of these leaders. Moreover, the group is highly valued with an average price/earnings ratio of 42-times forward earnings, nearly double the forward P/E of the entire S&P 500 and up from 26-times at the beginning of 2019. While the fundamentals for these companies are strong, these lofty valuations embed a tremendous degree of optimism. It's not clear what catalyst could keep their recent momentum going in the foreseeable future.

**The record-shattering run of the major equity indexes masked a concerning reality—only a handful of stocks are driving the recent gains**

## Capital markets interplay

While extended equity valuations are concerning, they are less extreme when compared to bond yields. As of the end of August, real interest rates (which are adjusted for inflation) were below zero across nearly the entire Treasury yield curve. Negative yields shift the interplay between bonds and others asset classes, as the "opportunity cost" to hold Treasuries has evaporated and discount rates in financial models have shrunk. Historically, the yields offered by U.S. Treasuries were "risk-free" rates, reflecting the opportunity cost of allocating to other asset classes. With returns on Treasuries unable to keep up with inflation, investors are looking more toward stocks, gold and other alternative asset classes and willing to pay higher prices for these investments.

Still, the low interest rate environment has not dissuaded bond issuers or investors. With near record-low Treasury yields and tight credit spreads, corporate borrowers have been able to tap the bond market at discounted rates. High-yield bond issuance was essentially shut down in March, but that window has opened materially since then; high-yield bond issuance is on pace to reach $385 billion in 2020, eclipsing the previous record of $332 billion in 2013. Investment-grade issuance never really slowed, with $264 billion of new bond issues in March alone. Investment-grade issuance could potentially reach $2.2 trillion in 2020, nearly double the level of 2019.

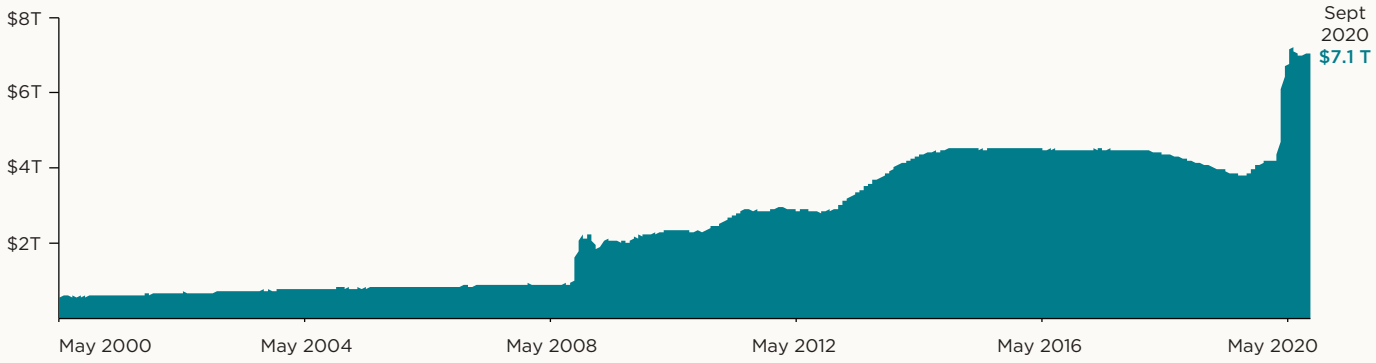
The U.S. dollar has steadily depreciated since March's flight-to-quality, reflective of the protracted struggle to contain the coronavirus outbreak in the U.S. While a falling dollar could dissuade foreign investment in our stock and bond market and spur inflation, it also helps corporate earnings by boosting the value of overseas profits and making U.S. products and services more competitive in global trade markets. The outbreak has been a boon for technology-focused industries, particularly those that benefit from a work-from-home environment, causing growth indexes to be quite expensive relative to value. The market continues to embed the expectation for an additional stimulus deal to be signed, though the odds are fading as partisanship controls the conversation.

## External forces at work

Markets have largely shrugged off other potentially stress-inducing developments, including tense relations between the U.S. and China, the partisan divide in Congress and a hotly contested presidential election in the offing. That shows the power of the "glass half-full" mindset of investors. Historically, market volatility rises in advance of presidential elections, but little about 2020 has followed historical precedent. Investors tend to act emotionally around elections, though there is little evidence to suggest the party in power has a disproportionate impact on market performance. Investors should avoid trading on emotion, as it has not added value historically.

The Federal Reserve has provided tremendous catalyst to the economy and financial markets this year, jaw-boning markets through the downturn and recovery with pledges to support the financial system and keep liquidity flowing. The Fed's balance sheet grew 86% over the last year, while the monetary base (the total amount of currency either in general public circulation or in commercial bank deposits held by the Federal Reserve) swelled 44%.

**Federal Reserve total assets, May 2000 to September 2020 ($ = trillions)**



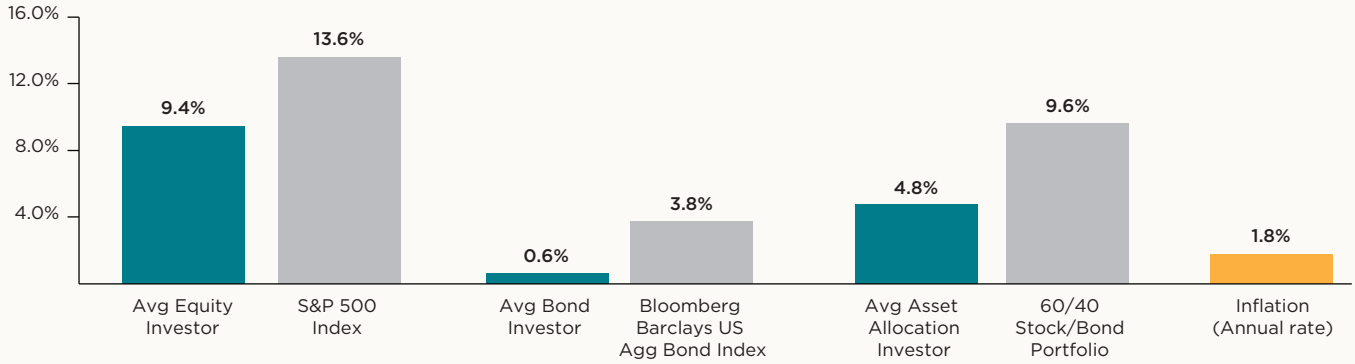

Source for chart data: Federal Reserve Bank of St. Louis (FRED data).

A change in the central bank's focus on a 2% average inflation target, announced by Fed Chair Jerome Powell in August, represented the most significant shift in the Fed's framework since 2012, which they had first adopted the 2% target. For investors, this shift signals the Fed is intent on keeping interest rates near zero for an extended period and creating conditions for the U.S. economy to run hot. Basic economic principles suggest all this money creation through expansionary monetary policy should lead to faster price increases. However, inflation (as measured by the core PCE deflator, the Fed's preferred inflation gauge) has averaged just 1.4% since 2012 and crossed above the Fed's 2% inflation target rate just 12 times in those 103 months.

## Forward drivers of performance

While the current level of inflation remains low, expectations for future inflation are on the rise. So have the intermediate-term risks to equities. Investors should expect the road ahead to be bumpier than the last five months, but the potential is there for a generally robust upswing for stocks in the years ahead, given clear monetary support from the Fed and growing participation from retail investors. Investors would be wise to remain informed and vigilant but avoid the temptation to want to "do something" in periods of uncertainty. This often leads to panic selling (as we saw in March) and panic buying (as we likely saw in August).

**Annualized returns, 2009-2019**

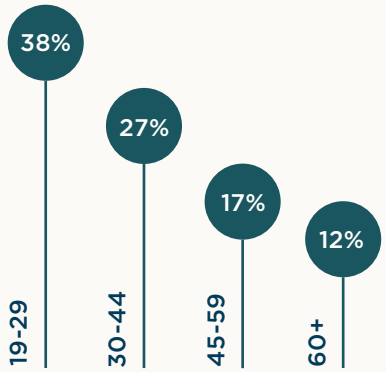



Source for chart data: Dalbar "Quantitative Analysis of Investor Behavior", 2020 report.

There are some structural headwinds the market will face in the months to come, including weakening revenue growth, deteriorating balance sheets, slowing share repurchases and limited growth in dividends. Investors should monitor the trend in earnings estimates, as the S&P 500 currently trades at its highest valuation on forward earnings since the technology bubble of the late 1990s. Estimates have inflected higher in recent months, with the current expectation for 2021 at $166, compared with $163 in June.

Two groups of investors—those at or near retirement and millennials—withdrew from the stock market in large numbers in March. At present, many of these investors are likely positioned conservatively in their portfolios. For older investors, this year's downturn will refresh the scars of the 2000 and 2008 corrections. For younger investors, the wounds have yet to heal. The months and years to come will tell us whether the wild ride of 2020 will lead these investors to permanently avoid the market.

**Percentage of Americans with no retirement savings in 2019, by age group**




Source for data: Federal Reserve.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S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

Bloomberg Barclays US Aggregate Bond Index: An unmanaged, market value-weighted index of U.S. dollar-denominated, investment-grade, fixed-rate, taxable debt issues, which includes Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities and commercial mortgage-backed securities (agency and non-agency).

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