Third Quarter 2020
Quarterly Letter to Clients
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Just when 2020 seemed like it could not get more bizarre, fate delivered a number of surprising twists that puts the highlights of the past quarter into a distant light. The country, still feeling the aftereffects of a nationwide shutdown to slow the deadly impacts of the Covid19 virus, has begun the long process of reopening and conducting commerce, albeit at a significantly lower level of economic activity. The extremes of the speed and decline of the 2nd Quarter GDP, which dropped 31.4% on an annualized basis, were expected to be matched and offset by the recovery of the 3rd Quarter GDP, allowing the economy to find its footing. For the most part, the combination of policy responses from extraordinary actions taken by Congress and the Federal Reserve provided the relief necessary to keep a major depression from occurring. The fiscal stimulus, embodied in the CARES Act in the form of the Payroll Protection Plan, delayed the devastating impacts from an economy intentionally put in suspended animation. The monetary policy response by the programs initiated by the Federal Reserve provided the necessary liquidity to keep the credit markets working and provide the lubricant to an economy that saw its gears grinding to a halt.

The world, as we now know it, is dominated by the constant threat of the pandemic. This disturbing emotion is magnified by a presidential election that is mired in the promises and pitfalls of politics, and all the uncertainties that accompany the election cycle. Finally, social unrest adds an additional layer of uncertainty and angst to a nation that is trying to redefine what the American Dream of tomorrow might be. Through it all, the United States economy continues to forge ahead. Sure, the toll of the pandemic and related costs will be in the trillions, which implies that the recovery will take years of rebuilding to return to some semblance of its former levels. However, the American spirit of innovation and technological improvements have allowed many businesses to pivot and respond to the significant challenges they face in a post-Covid19, post-election world. Consumers and businesses alike are finding ways to live with the virus, which will be with us until the global population either achieves a high level of immunity, or a safe, effective vaccine is created.

The Third Quarter of 2020 will most likely be considered the beginning of the economic recovery. In August, consumer confidence posted its largest gain in 17 years, boosted by improving short-term financial prospects and higher income levels. Attitudes towards spending and making big purchases reversed from the dim outlook seen during the early summer. However, the job market is still front and center, as recent surveys show Americans are still pessimistic about future work prospects. This is a direct reflection of the estimated 30+ million folks still receiving some form of government assistance. Unemployment statistics show remarkable improvement, with the latest U3 Unemployment rate at 7.9% in September, down from its peak of over 14.7% in April. Weekly first-time filings for unemployment continue to track above 800,000, an improvement over prior weeks but still extraordinarily high when compared to the historical pre-pandemic levels. State reopenings of their economies added to the employment rolls during the summer, putting over 10 million people back to work. Yet, with all that improvement, the job market finds itself at a level that is about as bad as it was during the depths of the global financial crisis. With the $600 of additional monthly government assistance ending July 31st, consumer spending softened, taking some of the air out of the job recovery sails.

Still, numerous sectors of the U.S. economy are exhibiting healthy growth trends. The most obvious is related to the productivity and mobility needs of businesses faced with having a significant portion of its employee base working away from the office. But technology growth, both in hardware and software, was already seeing positive trends before the pandemic turned our world upside down. Capital spending, an improved regulatory environment, and favorable tax incentives all combined to add significantly to tech company sales. However, to compete in the new Covid19 world, many companies scrambled to invest in technology and retool their strategies to keep employees productive as they work from home. In addition, the housing sector is benefiting from low-interest rates and pent up demand, partially from Millennials looking for a lifestyle change, and partially from an exodus out of major metropolitan areas to the suburbs. Finally, as corporate America reassesses the safety and reliability of its numerous supply chains, industrial America (mostly the former “rust belt”) is experiencing a renaissance in investment, as companies consider bringing home critical portions of their manufacturing processes.

The economy is still subject to many of the risks it was facing prior to the pandemic. U.S. - China trade tensions, while on the back burner, are still a concern. Further, the increased possibility of inflation accelerating as a consequence of the hyper-stimulative Fed monetary policies could impact long-term interest rates. In addition, the gigantic issuance of U.S. Treasury Debt to fund the deficit created by the expanding fiscal relief programs, not to mention the possibility of even higher levels of spending in the next few years, could cause rating agencies to downgrade U.S. Government debt. This could put upward pressure on the U.S. Government’s cost of funding future debt, as investors demand a higher rate of interest for the deterioration in credit quality. Finally, the ever-increasing levels of household and corporate debt are flashing warning signs.

When combined with Federal, State and Local debt, the ratio of Debt to GDP is greater than 325% and climbing. High debt levels historically have magnified the severity and length of recessionary periods, while retarding the pace of recoveries.

It is increasingly obvious that the pandemic will be with us longer that we might have first hoped. The events that unfolded between January and Mid-March of this year followed the chaotic paths seen in most crises. Reliable information on the virus was sparse, and no one in the world really knew what the best practices were in handling the outbreak. Most folks feared the worst. Many experienced something better than they expected. Even after 8 months since the first case was documented in the United States, scientists and medical professionals are still struggling through the process of coming to a consensus of what constitutes the best practices in prevention and treatment. It may be too early to determine whether people's behaviors will be changed permanently as a result of virus. Thus, while we can only speculate on the future impacts and whether they are temporary or permanent, the one thing we can count on is that we will find ways to adapt over time.

Bond and Stock Markets

The capital markets spent most of the third quarter shifting their focus between the political ping pong match regarding a second stimulus program and whether a potential vaccine could be developed, tested, and ready for use before the end of the year. Federal Reserve Chairman, Jerome Powell, repeated his support for additional fiscal policy action, while assuring markets that the Fed would continue to maintain low rates until employment and inflation return to levels consistent with the committee's long-term expectations. (Translation: We will not take the punch bowl away!). The result was a bond market that traded in a relatively narrow range, and a stock market that continued to climb on the expectation of additional fiscal support to a crippled economy.

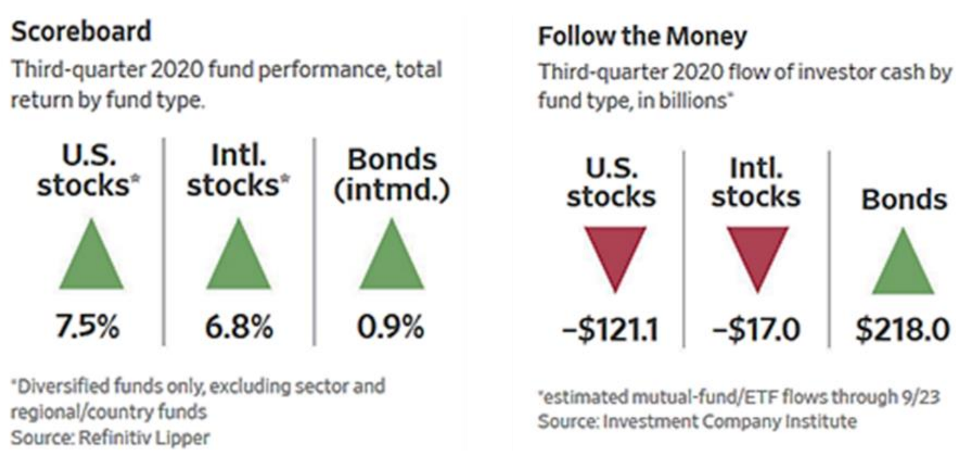
For the quarter, U.S. Government Obligations stabilized with minimal change. Across the entire maturity range, U.S. Treasury yields varied only about 5 to 10 basis points. Fixed income investors maintained the trends seen last quarter, with spreads on poor-quality credits remaining tight and buyers in the below-investment grade category still "reaching for yield" and purchasing the lower quality bonds. The yield on the U.S. Treasury 10-year increased only slightly from its June 30, 2020 level of 0.66% to end the third quarter at 0.69%. As the performance table on the next page shows, lower-quality and longer-duration credits outperformed their higher-quality brethren, with stocks outperforming bonds during the quarter.

Time-Weighted Rate of Return Summary *As of 9/30/2020*

Bond Indexes	Quarter	1-Year	3-Year	5-Year
US Treasury Bills	0.0	1.1	1.8	1.3
Barclays US Gov 1-3 Year	0.1	3.9	2.9	2.0
Barclays Intermed Gov/Corp	0.6	6.3	4.4	3.4
Barclays Muni Bond 5 Year	1.3	4.6	3.3	2.8

Stock Market Indexes	Quarter	1-Year	3-Year	5-Year
DJ Industrial Average	8.2	5.8	9.9	13.9
Dow Jones TTL Stock Mkt US	8.6	12.7	9.5	11.4
NASDAQ Composite	11.1	39.8	20.1	19.6
S&P 500	8.9	15.2	12.3	14.2
MSCI EAFE (NET DIV)	4.8	0.5	0.6	5.3

As reopenings and stimulus money worked their way through the economy, the hoped for rebound in economic activity took place, albeit not as vigorous as originally expected. Stocks continued their recovery, challenging prior all-time highs. During the past quarter, the S&P 500 climbed +8.9%, while the Dow Jones Industrial Average (DJIA) increased +8.6%, and the tech-heavy NASDAQ rose +11.1%. Investors continued their love affair with "stay-at-home" mega cap equities, while spreading some of the love into the more traditional and cyclical stocks. As the Scoreboard graphic on below shows, the average diversified U.S. stock fund was up +7.5%. [1] International stock funds continued to lag the broader U.S. Market, climbing +6.8% during the quarter.



[1] https://www.wsj.com/articles/u-s-stock-funds-rose-7-5-in-a-choppy-quarter-11601841278?mod=searchresults&page=1&pos=2

As we have written repeatedly in our quarterly letters to you, finding value without sacrificing quality in a high and rising valuation environment can be challenging, and require an extra dose of patience. Our preference continues to be to assemble and maintain a well-diversified portfolio of companies with a history of earnings, dividends, and cash flow growth that can provide exposure to most sectors of the economy. We will continue to be methodical in our process, acquiring those stocks that can be bought at prices that provide us an acceptable margin of safety, while still meeting our investment standards. Similarly, we will reduce or sell those stocks that exceed our estimate of fair value, irrespective of the vagaries of the markets.