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Market Newsletter
September 30, 2020

EXECUTIVE SUMMARY

- All asset classes rallied in the third quarter.
- The US economy is recovering better than expected, although the rate of recovery has moderated recently. Same with the global economy.
- Covid-19 cases continue to rise globally. Several vaccines are in late stage clinical trials. An effective vaccine is the ultimate solution to the pandemic.
- Stocks are likely to remain volatile in the run up to the elections. Research indicates, investing based on one's political views or expected election outcome has historically been a bad strategy. Staying invested for the long term is a better strategy.

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	8.93%	7.33%	15.15%	12.28%	14.15%
S&P Mid Cap 400	4.77%	-8.62%	-2.16%	2.90%	8.11%
S&P Small Cap 600	3.17%	-15.29%	-8.29%	-0.33%	7.20%
MSCI Emerging Markets	9.70%	-0.91%	10.91%	2.79%	9.37%
MSCI EAFE	4.88%	-6.73%	0.93%	1.11%	5.77%
Investment Grade Credit (C0A0)	1.69%	6.61%	7.17%	6.38%	5.96%
Non-Investment Grade Credit (H0A0)	4.71%	-0.30%	2.30%	3.84%	6.61%
Bloomberg Commodity Index Total Return	9.07%	-12.08%	-8.20%	-4.18%	-3.09%
Dollar Index (DXY)	-3.59%	-2.59%	-5.52%	0.29%	-0.52%
Vanguard Total Bond Market Index (VBMFX)	0.60%	6.92%	6.93%	5.20%	4.09%
10 Yr Rate	0.68% 09/30/2020	1.92% 12/31/2019	1.68% 09/30/2019	2.33% 09/30/2017	2.06% 09/30/2015

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 10/06/2020			
	Latest Release	Recent Trend	Notes
Non Farm Employment	661,000	Positive	Employment is gaining back lost ground, but the latest number shows it is happening at a slower pace. Unemployment is at 7.9%. It was 3.5% before the pandemic started.
Weekly Claims for Unemployment Insurance	837,000	Positive	Jobless claims are reducing but still significantly high as compared to earlier in the year, when it was at record lows in the 200,000 range
ISM Manufacturing Index (Number over 50 points to growth)	55.4	Positive	Manufacturing activity expanded for the fifth time in a row, despite a contraction in employment. 14 of the 18 industries included in the industry expanded.
ISM Non Manufacturing Index (Over 50 points to growth)	57.8	Positive	The services sector grew for the fourth consecutive month and the index is now at the pre-pandemic level.

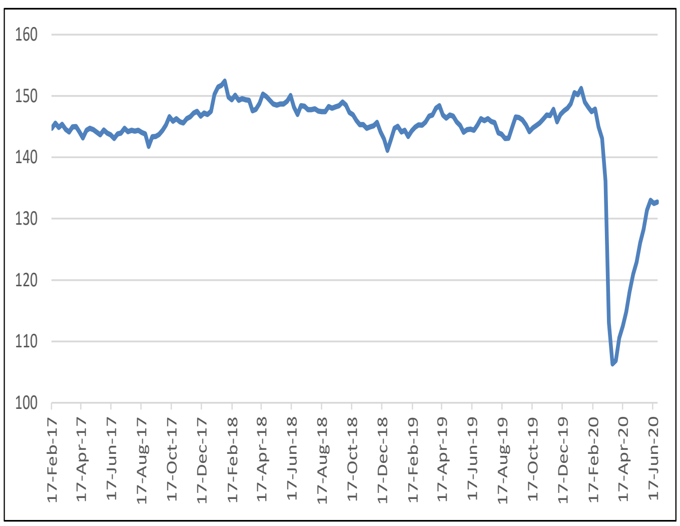
	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.4%	Positive	Consumer prices are low and stable having increased 0.4% month over month and 1.3% year over year. Core inflation (removing food and energy inflation) increased by 0.4% and 1.7% respectively.
Producer Prices (Month over month change)	0.3%	Positive	Producer prices increased 0.3% over a month and fell 0.2% over the last year. Removing the volatile food and energy component, producer prices were up 0.4% over the last month and 0.6% over the last year.
Retail Sales (Month over month change)	0.6%	Positive	Fueled by stimulus money, consumers continued spending and retail sales increased for the fourth consecutive month. The gains were however smaller than in previous months.
Consumer Confidence (Conference Board)	101.8	Negative	With improvement in the jobs situation, consumer confidence index increased to 101.8 in September from 86.3 in August but well below the record level before the pandemic started. The index had decreased in the past two months.
Durable Goods Orders (Month over month change)	0.4%	Negative	Headline durable goods was up 0.4% in September. Orders for non-defense capital goods excluding aircraft, rose 1.8% indicating companies were investing in their businesses.
Industrial Production (Month over month change)	0.4%	Negative	After sharp increases over the previous three months, industrial production grew at a slower rate in August. It remains about 7% below the pre-pandemic level.
Capacity Utilization	71.4%	Positive	Capacity utilization is making its way up from a trough of 64% In May. However, it is way below its long term average of 80%
Housing Starts	1.416 Million	Positive	After increasing in the previous three months, housing starts fell 5% in August.
Home Prices (Case-Shiller 20 city Index- Month over Month)	3.9%	Positive	Home prices in 20 major cities increase 3.9% over the last year. Record low mortgage rate is providing support for prices even if transaction have been affected by the pandemic.
GDP (Real, Annualized)	-31.2%	Negative	GDP shrunk by a record 31.2% in the second quarter. This number is on an annualized basis.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

Stocks and bonds rallied in the third quarter although the rally lost steam and stocks gave up some gains in September. Among global stocks, only US stocks are up for the year, helped considerably by growth stocks, especially the 'stay at home' stocks, which have had a banner year. Low interest rates and tightening credit spreads helped bonds, both high-quality and low-quality bonds, rally in the third quarter. All kinds of bonds are up for the year.

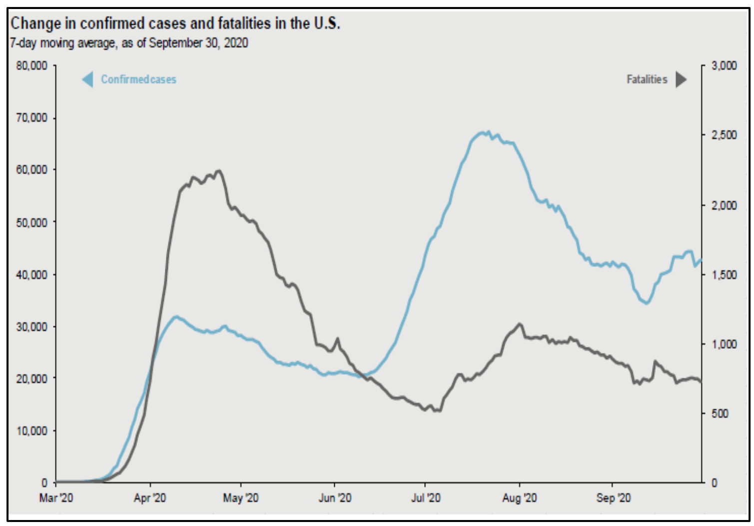
As seen in Table 2, the US economy has recovered nicely from the depths reached in the second quarter, helped in no small measure by the extremely easy monetary and fiscal policy. The US Federal Reserve expects to keep the current interest rate target range of 0-0.25% until it sees inflation to 'be on track to moderately exceed 2% for some time'. This is a change in policy that signals that interest rates will be low for an extended period. Fiscal policy was highlighted by the $2.2 trillion CARES act passed in March and Congress is now discussing another round of stimulus package which should provide further support to the economy. Analysts have revised their expectations to a smaller decline in the economy in 2020 followed by a smaller rebound in 2021- median of analyst's consensus is for a decline in GDP of -5% in 2020 followed by a growth of 4.1% in 2021, as per FactSet. The expected improvement in the economy in the short term followed by some moderation is reflected in leading indicators such as the ECRI index seen in Fig 1.

Fig 1: ECRI Weekly Leading Index



Source: ECRI, Sarsi

Fig 2: COVID-19 cases in the US



Source: JP Morgan, John Hopkins CSSE

The global economy is also expected to fare better than was previously expected. Government intervention around the world and a strong recovery in the Chinese economy are expected to help stabilize the global output. According to the IMF, the World GDP is expected to decline by -4.4% in 2020 and grow by 5.2% in 2021. Earlier estimates pegged the numbers at -5.2% and 5.4% respectively.

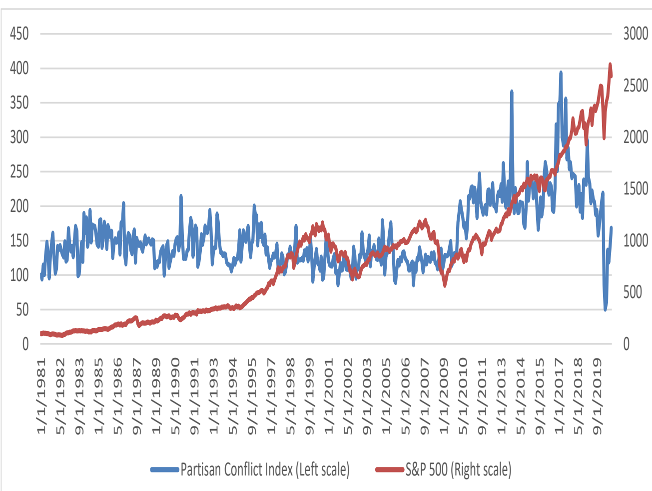
COVID-19 cases continue to rise globally. Europe is experiencing a second wave and the US has seen a rolling wave of infection, with over 200,000 deaths, the highest in the world. The quality of testing and treatment through therapeutics has improved vastly as we learn more about the disease. The ultimate solution to curtailing the pandemic is developing an effective vaccine that can be mass produced. At present there are 9 vaccines in late-stage clinical trials. The most optimistic scenario is for at least one to be approved by late 2020, which will probably be offered to vulnerable people, healthcare, and essential workers. Policy makers are avoiding a total shut down like in the Spring, but until a vaccine is developed, people will be uncomfortable resuming life as before.

US Corporate earnings fell by -31.6% year over year in the second quarter of 2020 as per FactSet. This turned out to be better than the -40% decline that analysts had expected at the beginning of the quarter. Third quarter 2020 earnings are set to be released in the days ahead and the consensus is for it to drop by -20.5% which is also better than previously thought. The decline in third quarter earnings is expected to be the second worst performance since 2009. However, the actual earnings are usually better than expected and applying the magnitude of historical surprise, earnings may decline by about -17% year over year, still a significant drop.

The Markets, The Economy, Politics and Elections

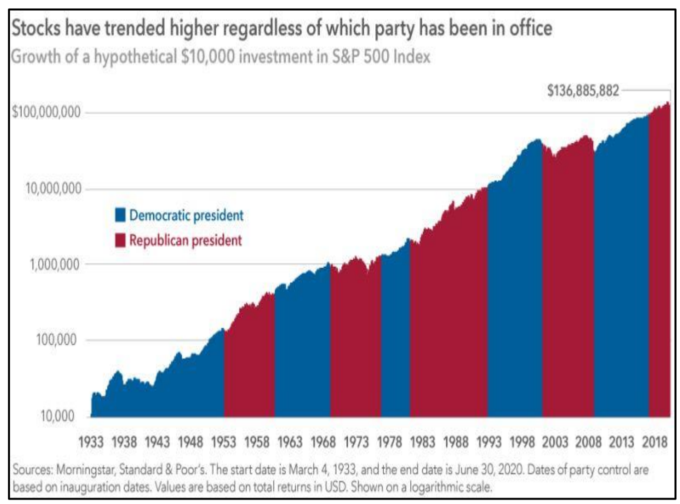
Apart from the economy, corporate earnings and COVID-19, the US elections are likely to play a role on how markets behave in the short term. It is also a topic about which we have received several questions. The temptation is to either stay out of the market because of the high level of political conflict being witnessed or make guesses on the results of the election and invest accordingly. Both approaches are harmful to long term portfolio performance. As we discussed in the fourth quarter of 2017, "research indicates that increased partisan conflict increases uncertainty among firms and households, which has been shown to slow economic activity by delaying business investments and consumer spending, but the immediate effect on the markets is unclear". We updated our research on this subject and looked at the correlation between stock market performance and the Federal Reserve Bank of Philadelphia's partisan conflict index. The index 'tracks the degree of political disagreement among U.S. politicians at the federal level by measuring the frequency of newspaper articles reporting disagreement in a given month.' The index itself is not as elevated as it was in 2017, but the correlation between the index and the performance of the stock market is still negligible (0.02). This can be seen graphically in Fig 3

Fig 3: Partisan conflict versus Stock markets



Source: Philadelphia Federal Reserve, Sarsi

Fig 4: Stocks appreciate irrespective of party in power

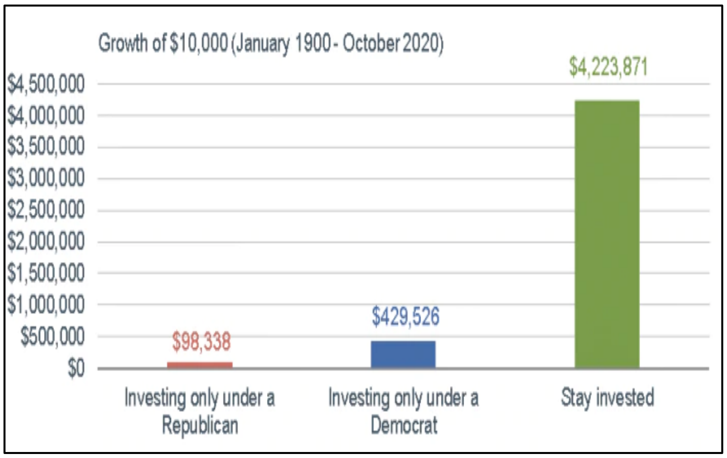


Source: Capital Group

The result of the elections can have a short-term impact on the markets, and the volatility of stocks increases around election time. However, historically stocks have appreciated no matter which party was in power as seen in Fig 4. As seen in Fig 5, between 1900 and 2020, $10,000 invested in the US stock market when a Democrat was the President would have grown to about $430,000, while the same amount would have grown to about $98,000 if invested only when a Republican was the President. However, if an investor had stayed invested throughout the period, the $10,000 would have grown to $4.2 Million. As for the difference in stock performance during a Democrat Presidency versus a Republican Presidency- before you draw any conclusions, know that a similar difference in performance would have been experienced over the last 50 years if investments were made in odd years (1971, 1973 etc.) versus even years (1970, 1972 etc.). As seen in Fig 6, in the last 50 years an initial $10,000 would have turned to $348,000 if you had invested in stocks in odd years and stayed in cash in even years. Whereas, if you invested in stocks in even years and stayed in cash in odd years, you would have turned $10,000 to only $44,000. Needless to say, there is no fundamental reason for this difference in performance and the relationship is at best spurious. As they say in statistics, correlation is not causation.

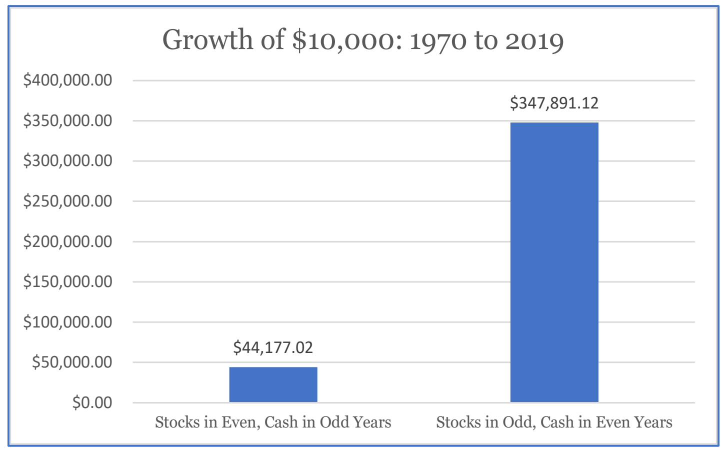
Looking at history, there are a few reasonable conclusions that can be drawn regarding elections and the markets/economy. One is that the economy affects the elections more than the elections affect the economy. According to research by Charles Schwab, in the 14 election years since 1900 when there was a bear market and/or a recession, 9 times the incumbent President lost the elections. Since 1952, the incumbent lost the race all 6 times.

Fig 5: It is best to stay invested throughout



Source: *Charles Schwab*

Fig 6: Beware of spurious relationships.



Source: Sarsi

The second conclusion that can be made is that the markets do not like uncertainty and unless major policy changes are expected or feared certainty of any kind (Real or perceived) helps the markets rally. As examples, in 2016 the markets rallied after the current incumbent won the elections despite fears to the contrary. In recent weeks, the market seems to be rallying on expectations that Joe Biden will handily win the elections (Based on various polls). Just a few months ago, his victory was expected to hurt the stock market.