Making Sense of Finance

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Third Quarter 2020 Review

STOCK MARKET

Stock markets in the US continued to advance in the third quarter. In fact, the S & P 500 and the Nasdaq Composite closed at record highs during the quarter. Both indexes were positive for the year at the end of September. The S&P 500 index gained over 8% in the third quarter and the Nasdaq performed even better, adding 11% last quarter. Another widely followed index, the Dow Jones Industrial Average, although gaining 8% last quarter, still was negative for the year. Stocks continued to climb higher as hopes for a vaccine and effective therapeutic drugs for Covid-19 kept investor sentiment optimistic overall. The economy is still waiting on another round of stimulus, which is also critical to sustain investor enthusiasm. Also contributing to the positive outlook for stocks, they continue to remain attractive relative to bonds. The S&P 500 index has a dividend yield of 1.68%. Although low when compared to historic norms, is still much higher than the yield on a 10 Year Treasury, 0.69% at quarter's end. And even though the number of companies in the S&P 500 paying dividends decreased from the previous quarter (383 versus 480), among those companies 309 had increased their dividend in the third quarter.

After a significant rebound in the second quarter, energy stocks were the only sector that declined last quarter. As a group, energy stocks decreased 21% even though oil prices were basically flat in that time period. Financial and utility stocks again, although showing positive returns in the third quarter, lagged the overall market. The best performing sectors were consumer discretionary, industrial and information technology (even after the latter sector's selloff in September). Large cap growth stocks continue to dominate the market as we head into October. Due to their enormous price appreciation and the lack of a broader rally, the top five companies in the S&P 500 represent 22% of the index value (Apple being the largest).

Foreign stock markets again lagged their US counterparts in the third quarter. The MSCI EAFE index, which is a measure of developed country equity markets, gained 4.2% last quarter when measured in US dollar terms and is still negative year to date. The performance this time was helped by the recent weakness in the US dollar, or the returns would have even been lower. Some of the better performing international markets were those with lesser market values such as Ireland, Sweden and Denmark. The United

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Kingdom market posted losses both in local currency and US dollar terms last quarter as the country deals with post Brexit negotiations with the European Union. The MSCI Emerging Market index performed better with a gain of over 6% in the quarter in US dollar terms. Markets in China, India, and Korea all had double digit percentage increases in local and US dollar terms. However, Latin American and Eastern European markets reported mostly losses last quarter.

BOND MARKET

Bonds in the aggregate did not fluctuate much over the third quarter. The Bloomberg Barclays Bond Index had a total return of 0.4%. Riskier bonds continued to outperform quality bonds. High yield (junk) and emerging market bonds returned 4.8% and 2.7% respectively last quarter; even though the trailing twelve month default rate for high yield bonds is at a ten year high, 5.7%.

The Federal Reserve maintained the Fed Funds rate at a target range of 0-0.25%. Many financial experts believe it will remain at that extremely low level for a very long time. The Federal Reserve last month issued a slight change in how they perceive their mandate. Previously their aim for price stability targeted 2% inflation. Now the Fed has said it "will likely aim to achieve inflation moderately above 2% for some time". This has created an environment where inflation adjusted "real" yields are negative across almost all Treasury maturities and may continue for an extended amount of time. Inflation is currently at a subdued level; the latest CPI number is at a 1.4% rate over a trailing twelve month period. At the end of the quarter, going the furthest out in maturity, a 30 year Treasury only yielded 1.46%. This was a slight increase in yield from the end of the second quarter but far below the rate of 2.39% at the end of 2019. Shorter term yields, such as a One Year Treasury yield of 0.12%, were even lower than last quarter. The persistently low Treasury yields have resulted in near historically low mortgage rates. These low mortgage rates have fueled a boom in home buying, which is one of a few robust areas in the current economy.

OUTLOOK

Even though the S&P 500 index is trading near all-time highs, we don't see a bubble forming. Recall, that this index is cap weighted; meaning the larger the company value, the greater the weighting. Companies such as Facebook (FB), Microsoft (MSFT), and Alphabet/Google (GOOG) are technology based and have in many ways benefited from the Covid-19 Pandemic. Coupled with low interest rates and their valuations based on earnings seem quite reasonable to us. Still, valuation is not the determining factor for market direction.

Constant media attention on the Presidential election could be a benefit for the markets, in our opinion. From past experience, we know that surprises are what upsets markets and causes panic. This is sure to be a very contentious presidential race, but attention-grabbing headlines, could mitigate reactions whomever wins. Recall that when Donald Trump was declared the winner of the 2016 election, markets plummeted initially, only to roar back the same day to positive territory. It may be that a inevitable non-government induced recession could bring the markets down after the elections. We simply don't know what we don't know. With current valuation levels, we are still finding pockets of decent value, i.e. assets that are not overpriced with reasonable growth prospects.

Corporate equities remain our top asset class. We have genuine concerns regarding commercial real estate, though. We think office consolidation will continue into 2021. Now that it is more acceptable to work from home, large office complexes seem unnecessary. This attitude will probably remain for years, but eventually, we believe the market will find some equilibrium and the value of in-person relationships will come back. Looking at public REIT prices, this does not seem to be reflected in their valuation. Bond returns should stay anemic for years. Given that high quality corporate bonds yield only 1.5% to 2.5%, an investor could probably get the same dividend yield with the same company by owning its stock (if it has a dividend) with potential for capital gains if it truly is deserving of an "A" credit rating. In our view, even if interest rates go below zero, the upside is minimal, given that negative rates historically don't last long. For the most risk-averse individual, an investment in gold coins and cash hidden under your floorboards and/or U.S. short-term treasuries would be most appropriate.

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