Dillon Capital Management
Economic & Capital Markets Strategy 3Q-2020

Highlights

- US stocks recovered ahead of the economy
- Bond returns will be low with growing risk
- Cash and dividend stocks should be considered

Economy

The US economy recovery continues, but the rate of recovery is slowing. There is more to come, but it will take a while.

Economists' average estimates for GDP are: -4.8% for all of 2020, and +3.8% in 2021. There are many winners and losers on this roller coaster. People and businesses recognized as essential have prospered while other workers and a host of non-essential businesses continue to suffer. Stay-at-home related staples, tech, communications, and housing have prospered. Travel and retail-related businesses remain weak.

Non-farm payrolls gained over 660,000 jobs in September, weaker than the two prior months; unemployment dropped to 7.4%. **Personal income declined 2.7% in August in the absence of another government stimulus**, but this may change in the coming weeks. Government stimulus programs have been a critical underpinning for this economy, but this can't go on forever. Bridgewater's Ray Dalio asks: how long will it take for incomes to return and replace the need for monetary supplementation?

The US is a service-oriented economy, and one of its biggest components is travel: airlines, hotels and restaurants are important parts of the service chain, critical to a long list of large and small businesses that rely on travel activity. A new wave of infections pushes out a recovery in this segment and impacts jobs for millions of people.

Low interest rates have boosted asset valuations across the economy. Housing construction growth has been torrid the last 18-months and is now at full throttle. Alternatively, the Covid-19 lockdown and ensuing work-from-home model has put pressure on office, hotel and retail space. Money tied up in commercial real estate is in jeopardy. Banks are aware and have carved out billions from profits the last two quarters to boost reserves for potential non-performing loans. Reserve building has dampened bank profits, resulting in tighter lending terms – a hurdle for economic recovery at this time.

Capital Markets

The S&P 500 has gained 52% from the March low to September 30, and despite the unprecedented fallout due to the pandemic, the index is up 5.6% YTD.

Major Indexes	3Q-2020	YTD
Short-Term Treas. (1-3 Yr.)	0.1%	3.1%
Barclay's Aggregate Bond	0.6%	6.8%
S&P 500 Index	8.9%	5.6%
Russell 2000 (Small Cap)	4.9%	-8.7%
MSCI EAFE (International)	4.8%	-7.1%
MSCI Emerging Mkts.	9.7%	-0.9%
Wilshire REIT (Real Estate)	1.3%	-16.7%

Large US stocks, mostly technology related, led the recovery in prices through the summer. Apple, Microsoft, Amazon and Facebook, the four largest companies in the S&P 500, representing 20% of the index weight, had an average 45% increase, YTD. That's a lot of return from just four companies and means that the return from the other 496 companies was not so great. An equally weighted S&P 500 is down 4.8% for the same period.

Certainly, those aren't the only stocks that have had high returns and it doesn't mean that the laggards aren't good businesses. But it does suggest that investment dollars went into those four at the expense of others, including small cap and international companies – both segments that remain in negative territory for the year.

Now I don't want to start on a narrative that its time to switch to value stocks (energy, financials, real estate), after a big run in growth tech stocks, but if the recovery spreads out to capture the laggards, it will underpin the broad market.

Bonds: the broad bond market in the US, represented by the Barclays Aggregate Index (AGG) is up 6.8% year to date, yet today the current yield on the index is only 1.2%. Most of the YTD return came from price appreciation during 1Q, when the Fed lowered interest rates and stepped up its bond purchases.

Forecasting bond returns for the next 5-10 years, given the current yield (0.66% for the 10-year US Treasury and 1.4% for investment grade corporates) and adding the effect of compounding, leads us to a most likely return of just 1.5% on the AGG.

To get more yield, investors have returned to leveraged loans and the high yield markets. The risk for these sectors is an extended period of recession and an increase in defaults. But the fed has been buying these too, providing artificial support to investors.

Investment Strategy

The best part of the recovery rally is behind us. Equities will rise over the next year or two, but corrections may be violent. Bonds carry more risk now, than the value of their defensive characteristics.

The fed reaffirmed its commitment to low interest rates, the government will pass another stimulus package and despite an apparent second-wave, businesses are reopening. Investors have increasingly looked forward to a better economic environment in 2021. That's enough of a bridge to support our opinion that, unless the US takes more steps toward socialism during and after the upcoming election, we'll exit this year with reasonable expectations for the future.

Overall, corporate earnings should be higher in 2021-2022. While valuations on stocks are higher than they have been historically, **the low rate environment supports higher price valuation multiples**, particularly for well positioned companies.

Diversification within the equity space will be important as volatility picks up and the recovery spreads to other sectors.

For balanced portfolios **with a long-term investment horizon**, we recommend maintaining an overweight toward equities but paring an allocation where positions have become an outsized percentage of a portfolio. This might include cutting the allocation to growth mutual funds or growth/tech stocks. Proceeds from this move could be invested in dividend-oriented funds/stocks which have underperformed YTD.

From a sector perspective, we favor tech, industrials, consumer staples and select materials companies. Also, it looks ok to start a small, steady allocation to high-quality energy companies and real estate, outside of office and retail.

Bonds have never been more expensive in US history. They aren't a good place to invest when interest rates are this low. Sure, treasuries still offer a safe-haven, or hedge, if equities were to decline, but the yield is below today's inflation rate.

For tactical investors, cash is an alternative for a portion of a traditional bond allocation in this environment. Cash eliminates the risk of loss from a bond portfolio if rates rise or defaults pick up, and provides dry powder to invest when yields improve, or stocks experience a correction.

We plan to keep cash levels higher and use short-term bond funds to generate safe yield.

G. Foley – October 2020

Please call or email with questions or comments!

All investing is subject to risk, including the possible loss of money you invest.