"Everyone, take a deep breath… but don't forget your mask."

Alex Thompson

Lance Hollingsworth

John Laughlin

Sarah Haizlip

Leslie Drummond

Dear Clients and Friends: October 15, 2020

Sometimes we just need to take a deep breath and calm down. This seems like one of those times. Undoubtedly, 2020 deserves the moniker *annus horribilis*. We have endured a plague, social unrest, political dysfunction, environmental cataclysms of fire and water, and an economic dislocation of historic proportions. It's time for 2020 to end, but with the pandemic spreading, the President in COVID recovery, and the election less than a month away, it still feels like we have a long way to go.

From an investment standpoint, the quarter offered plenty for bulls and bears alike. Stronger than expected employment results, continued strength in large cap growth stocks, monetary support from central banks, hope of additional stimulus, better than expected corporate earnings and forward guidance, and the prospects for a vaccine led markets higher in July and August. By late August, the S&P 500 was hitting all-time highs again.

However, news in September curbed much of the enthusiasm. Signs started to show that fiscal and monetary support for the economy had likely peaked, small businesses were continuing to struggle, and employment gains were slowing. Markets retreated but still added to the considerable gains seen in the second quarter. As has been the case for a while, the S&P 500 led global markets. The index finished up over 8% for the quarter, pushing year-to-date gains to 5%. Other markets improved during the quarter as well but still lag the large-cap growth component of the S&P. Smaller companies were up 3.0% for the quarter but remain down -15% on the year. Developed international and emerging markets added 4.0% and 9.0% respectively for the quarter but also still have negative year-to-date returns.

Pandemic Update

During the past quarter, the Commerce Department confirmed what was generally known: the COVID lockdown had devastating consequences to the economy. Second quarter GDP contracted at a mind-numbing -31.7% annual rate. At the beginning of the shutdown, a stunning 20.8 million jobs were lost, erasing the last decade's growth and pushing the unemployment rate to levels not seen since the Great Depression. Congress has countered with an unprecedented $3 trillion in fiscal support for households, businesses, health care providers, and state and local governments. This equates to about 14% of GDP and far exceeds the $939 billion in stimulus provided during 2008's Great Recession.

Subsequently, the overall employment situation has improved rapidly. September's job report showed that we have gained about 10.5 million jobs back and pushed the unemployment rate down from a peak of 14.7% to 7.9%. Regrettably, three million people decided to leave the workforce, reducing the pool of available workers.

The shape of the economic recovery we are seeing is often referenced in the news. You may recall from our last letter, economists were hoping for a "V", feared an "L", but somewhat expected a "W". It looks like we are actually experiencing a "K", a type of recovery in which prospects vary significantly. In this case, the majority of

the middle and upper-class workforce saw limited job disruption. This compares to those in lower paying jobs who have seen significant and longer-lasting disruption. Most notably, the services sector has seen hundreds of thousands who work in retail, leisure and hospitality industries facing job losses.

This crisis, and the "K" recovery, reminds us of the "new economy" and an "old economy" idea that was advanced during the 1999-2000 period. Today, there is a similar idea of "COVID winning" companies and "COVID losing" companies. Investors have piled into the winners (companies like Apple, Amazon, Microsoft, Facebook, Netflix, Google, and Zoom) driving both their prospects and stock prices ever higher. Conversely, they have shunned the supposed losers (energy, financials, hospitality, real estate), leaving them for dead and allowing their valuations to fall to historical lows. Unlike the dot.com bubble, many of today's COVID winning companies are extraordinarily good businesses, well positioned in their markets and highly profitable. However, it appears a lot of future growth has already been baked into current prices. Equally, many of the COVID losing companies are perfectly good businesses that should come back to life as the economy starts to recover.

The "K" can easily be seen by looking at two indices. Year-to-date, the Nasdaq 100 Index, representing large growth-oriented companies like the ones listed above, is up almost 30%. Conversely, the Russell 2000 Value Index, reflecting smaller and more economically sensitive companies, is down -20%. This is a <u>50%</u> spread in performance in just 9 months. Over the last 5 years, the performance spread is <u>155%</u>. A similar dynamic was present during the 1999-2000 period. The quality of today's tech companies is substantially better, relieving some concerns, but this is still a historic disparity in performance.

Election Update

If we thought 2020 couldn't add more uncertainties to the mix, we were reminded again late last week that we're still in the throes of it. While the President testing positive for COVID further clouds what the month leading up to the election will look like, it really doesn't change the possible outcomes. Most are concerned about two scenarios. The first being a Democratic sweep and the second being a contested election that extends uncertainty beyond November 3rd. We believe the more extreme concerns of the latter may be overstated given that our democratic process and electoral system were designed to "enforce" a peaceful and timely transfer of Presidential power.

The conventional wisdom is that a Biden win and Democratic sweep will bring higher taxes which will be bad for business and the stock market. While taxes for corporations and highly compensated individuals would likely go up, most of these increases would only be a return to where we stood before Trump became president. Data shows that the economy grew at about the same pace in the years before and after the Trump tax cuts. We suspect it could handle similar tax rates and continue growing at that same pace. A Democratic sweep would likely use the new tax dollars to launch a much larger infrastructure and economic aid program, injecting additional fiscal stimulus into the economy over the next four years. This would almost certainly bolster economic growth and employment.

If Biden wins but the Republicans retain control of the Senate, then it is less likely there will be any tax increases or major new spending programs. Should Trump win re-election, taxes will remain low, but deficits will rise. The high level of uncertainty related to global trade would also likely remain.

Depending on their political persuasion, many clients have expressed concern about one or more of these outcomes. Investors have a habit of not only getting outcomes wrong, but also the outcome of the outcome. It was assumed in 2016 that if Trump won, the market would tank. It did… for about 8 hours. Then it rallied strongly for the next 14 months. Today, the belief is that a Biden victory will be bad for markets. While higher taxes would be a real possibility, they could be offset by fiscal spending and a greater sense of stability.

Outlook

This year can best be described as unpredictable. Looking ahead to the fourth quarter, it appears to be more of the same. We have no more insight than any of the many experts about how things will play out in the near-term. The pandemic has changed the economy, business, work, school, and our lives in ways we never envisioned just nine months ago. Questions regarding COVID-19, a vaccine, the election, the path of corporate earnings, additional fiscus stimulus, and economic growth we hope will become clearer by year end.

However, our investment strategy does not assume that one side or the other will win. We are looking only for the election to ultimately resolve itself and for life to move on. The stock market currently offers both opportunity and concern. Many of the growth stocks everyone wants to own look fully valued. The stocks that no one wants to own may offer good value when the economy returns to normal. Although bonds play the role of safe haven when storms approach, with interest rates at historically low levels, they offer very little yield and potential returns. Our investment approach of being well diversified and owning many of these markets has worked reasonably well this year. Given the continued uncertainty, we are maintaining this approach and know we will ultimately get through the current situation and that things will eventually return to normal.

By now, hopefully you have taken a couple of deep breaths. We also wanted to leave you on a positive note. Since the end of World War II, much of the United States' growth can be tied to many of our most identifiable projects. The interstate highway system, the space program, and the internet were bold and unifying initiatives that placed infrastructure, science, technological innovation and global trade as priorities. This progress was also facilitated by close cooperation between the public and private sector. No matter who wins the next election, our nation needs a forward-looking and unifying plan for the future. This will be a necessity for us to compete effectively in the 21st century.

Rest assured, the U.S. economy is a $20 trillion economy, in a $140 trillion global economy. It is an intricate, yet robust, network of millions of businesses and organizations. It serves hundreds of millions of employees, customers and participants. It is far larger, more dynamic, and resilient than it might seem on a news clip, commercial or newspaper headline. It has a natural tendency to grow and develop that is hard to stifle, no matter which party is in power.

We thank you for your continued confidence and trust, and we welcome your comments, questions, and referrals. Please don't hesitate to contact us, and stay safe and well. We will get through this together!

Summit Asset Management LLC