# 3rd Quarter 2020

# Market Recap
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## Market Recap

As we reflect on market action during Q3, we are reminded yet again that the economy and the markets are not always in sync. While the rapid descent in markets during Q1 was an understandable reaction to locked-down economies and collapsing global growth, the pace of the market rebound during Q2 and Q3 are arguably out of step with economic reality.

Policymaker efforts, in lending historic fiscal and monetary support early during the downturn in economic activity, reduced near-term downside risk in the markets. The Federal Reserve's traditional dual-mandate of price stability and full employment necessarily evolved into insuring capital markets remained liquid, investors stayed confident, and allowing Congress to spend whatever amount of money necessary to bridge the gap. Investors, as a result, were able to look distantly into the future to quantify the value of businesses and financial assets.

As in the Q1 2020 *Near-term Outlook*, our base-case scenario remains that a weaker, more prolonged economic recovery, one with some permanent GDP output loss, is most probable versus the consensus view of a more rapid recovery with no permanent GDP loss. Emerging data continues to support our base-case scenario, and it is this scenario in which I continue to frame investment decisions. We remain cautiously positioned as a result.

U.S. and international markets did continue to rebound for most of Q3. U.S. markets, as measured by the S&P 500® Index, did retake pre-Covid market highs on August 18th. But the first week of September saw selloffs across the board. A dawning realization that talk of a quickly available Covid-19 vaccine was a false promise, and an ineffectual Congress dead-locked over additional stimulus measures, were reality-checks for investors who had pushed valuations too high, too fast.

> "The function of economic forecasting is to make astrology look respectable."
>
> John Kenneth Galbraith

Six of the largest stocks — Apple, Microsoft, Amazon, Alphabet, Facebook and Tesla — shed $1 trillion in value over just three trading days. A 9.60% pullback in the S&P 500® Index over the following three-week period returned asset prices to more reasonable valuations. Despite the pullback, U.S. markets finished higher for Q3. U.S. stocks, as measured by the Russell 3000 Index — a measure of the largest 3,000 U.S. companies, and a proxy for the complete U.S. stock universe — climbed +9.21% during Q3, for a YTD return of +5.41%.

Investment styles, company size, and sector performance were widely mixed. This type of soft market "breadth" is one signal that all might not be well. The potential problems appear far more acute when looking through market index data to the underlying economic data.

The Advanced Estimate for Q3 U.S. GDP will not be released until October 29th. But the Atlanta Fed's GDPNow model estimates real Q3 U.S. GDP growth of +35.2%. In Q1 2020, real GDP decreased -5.0%, or $186.3 billion in current dollar terms. In Q2 2020, real GDP decreased by -31.4%, or $2.04 trillion in current dollar terms. Geometrically-linking the 2020 quarterly GDP data, including the estimated +35.2% Q3 GDP growth, means that the U.S. stood with a YTD real GDP loss of -11.9% as we started Q4.

Weekly Initial Jobless Claims hover at about 4X pre-Covid levels, according to Labor Department data. Weekly Initial Claims had been falling, but recently reversed, and are once again moving higher. While the U.S. did recover about 11.4 million jobs, that is but half of the more than 22 million jobs lost during the shut-down. As well, Continuing Jobless Claims remain stubbornly about 10 million jobs. As the job-protection provisions of the Paycheck Preservation Program expired at the end of Q3, it is expected that a significant number of temporary job loses will now be made permanent.

Examining corporate earnings, for S&P 500® Index companies the year-over-year (YOY) earnings decline for Q3 2020 is expected to be down -21.8% versus earnings in Q3 2019. While an improvement from the Q2 downturn in corporate earnings of -35.7% YOY, it demonstrates the long-road to recovery that remains for the average company.

## Performance Review

Lake Jericho managed and advised portfolios are, most typically, balanced, globally diversified strategies that incorporate varying combinations of multiple asset types. Each asset type, and geographic location, will have a meaningful impact upon returns. Reviewing the benchmark returns below, you see where, and how, Lake Jericho managed or advised portfolio returns were impacted.

Within the table below, we present the iShares (by Blackrock) Core Allocation ETF Portfolio Series benchmarks. Lake Jericho provides this information for a relative performance comparison against independent, balanced, globally diversified strategies managed to similar risk profiles. As iShares information is publicly available, and return data is available within the Interactive Brokers Portfolio Analyst benchmark database, Lake Jericho clients can easily incorporate the data points into their own analysis.

- The Dow Jones Industrial Average, 30 "blue-chip" U.S. companies with an industrial company bias, finished Q3 with a total return of +8.22%, for a YTD total loss of -0.91%. The rolling one-year total return has been +5.70%.
- The S&P 500® Index, a broad, but committee selected index of 500 large-cap U.S. companies, finished Q3 with a total return of +8.93%, for a YTD total return of 5.57%. The rolling one-year total return has been +15.15%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index finished Q3 with a total return of +11.24%, for a YTD total return of +25.33%. The rolling one-year total return has been +40.96%

**The iShares Core Allocation ETF Portfolio Benchmark Series***

**Performance Comparisons For All Periods Ending September 30, 2020**

| Core Allocation Portfolio (Ticker) | Q3 2020 | YTD 2020 | 1 Year | 3 Year Total Return | 5 Year Total Return |
|---|---|---|---|---|---|
| Conservative (AOK) | 2.70% | 4.01% | 6.92% | 16.97% | 34.39% |
| Moderate (AOM) | 3.62% | 3.49% | 7.29% | 17.81% | 38.52% |
| Growth (AOR) | 5.10% | 2.38% | 8.01% | 18.86% | 47.10% |
| Aggressive (AOA) | 6.37% | 1.00% | 8.38% | 19.46% | 55.60% |

* The iShares Core Allocation ETF Portfolio series is designed to meet the needs of investors who would like to maintain fixed target levels of exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds, and other instruments. The Core Conservative Allocation Strategy seeks approximately 30% exposure to global equity markets. The Core Moderate Allocation Strategy seeks approximately 40% exposure to global equity markets.. The Core Growth Allocation Strategy seeks approximately 60% exposure to global equity markets. The Core Aggressive Allocation Strategy seeks approximately 80% exposure to global equity markets. Presented here is the iShares Core Allocation ETF Portfolio Benchmark performance, constructed with no management fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

- Small- and mid-sized companies (SMID), as measured by the Russell 2500™ Index, finished Q3 with a total return of +5.88%, for a YTD total loss of -5.82%. The rolling one-year total return has been +2.22%
- International developed markets, as measured by the MSCI World (ex-U.S.) Investable Market Index, finished Q3 with a total return of +5.64%, for a YTD total loss of -6.70%. The one-year total return has been +1.10%.
- International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, fared better than their developed markets counterparts and finished Q3 with a total return of +9.79%, for a YTD total loss of -1.29%. The one-year total return has been 10.14%
- The Bloomberg Barclays U.S. Aggregate Bond Index, a measure of the performance of the U.S. investment grade bond market, finished Q3 with a total return of +0.62%, for a YTD total return of +6.79%. The one-year total return has been +6.98%.

## Near-term Outlook

The 2020 Presidential election outcome could have a significant impact on both the market and the economy. Perhaps not in terms of long-term policy implications, rather in terms of uncertainty and volatility should a clear winner not quickly emerge. Markets have priced in a "blue sweep", along with the policy measures that would accompany a Democratically controlled White House, House, and Senate. Downside risk is greatest, now, should that blue sweep not happen. Yet, as important as this election cycle is, two factors will have much greater influence on markets in the coming year — the availability of a Covid-19 vaccine, and additional federal stimulus until that vaccine is widely distributed.

For every industry titan such as Amazon, Apple, Docusign — companies experiencing explosive growth in the say-at-home/work-from-home economy, that prop up index returns because of their out-sized market capitalizations — there are dozens, maybe hundreds, of less resilient companies unable to regain solid footing. Banks, insurance companies, and other financial services firms have watched significant revenue streams dry up. Falling global demand has crushed the energy sector. Commercial real estate, travel and leisure, brick-and-mortar retail and hospitality, are all getting battered by changing business and consumer patterns.

State and local tax revenues have dropped substantially. Every state is struggling, as state governments are not allowed to run deficits to bridge this gap. Yet the federal government — which can — remains hamstrung by partisan politics over providing a financial bridge for state and local funding. Without assistance, the result will be drastic spending cuts and significant layoffs of state and local employees early during 2021.

As anticipated, virus numbers are again soaring, meaning that rising death rates will follow. Once again, risk tilts toward containment measures being phased back in, rather than softened, and further economic damage. While we do not anticipate lock-downs of a nature similar to those earlier during 2020, the longer containment measures are necessary to save lives, the more meaningful, and persistent the changes in individual and business behavior are going to be.

A vaccine, or at least a transformational treatment, allowing a return to "normal" economic activity, will not be widely available until Q1 2021. As any vaccine or treatment will take time to deploy, even with widespread acceptance and adoption, we expect economic recovery to remain constrained for much of 2021.

As a result, in a meaningful shift of our own global growth thesis, I am lowering our long-run GDP growth trend line. Our estimates for the long-run sustainable growth rate, and for the productivity growth rate, are being reduced to adjust for what we believe will be permanent changes in consumer and businesses behavior, and the costs associated with those changes.

As our forecasts for expected asset returns flow directly from our GDP growth estimates, I am lowering our 10-year forecast for average annual equity market growth by two full percentage points. To put it plainly, in our new model, the forward looking assumption is that we will not regain the pre-Covid trend line for economic growth or equity returns for at least 10 years.

What does that mean for markets? As the recovery slows, or again reverses, lack of additional policymaker support during 2020 will mean that downside risk could be severe. As long as the election runs smoothly, we believe that a fourth, and final, stimulus package will be passed supporting both the private and public sectors. Although health restrictions remain in place for six to 12 months as an eventual vaccine is deployed, by late 2021 most health restrictions will have been removed, the fourth round of federal action will bear fruit, and companies will be able to resume operating at former capacity levels.

Should all of these things happen, markets should be reasonably stable throughout the coming 12 months. Likely by late 2021, and into 2022, we will then begin grappling with state and federal budget and tax implications resulting from the Covid-19 fight. These costs are among the primary reasons why we now project much lower growth rates, for a much longer time.

As always, I am available at any time, any day of the week, to discuss anything within this Outlook, or specific portfolio performance questions. Until then, be well. And thank you!

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