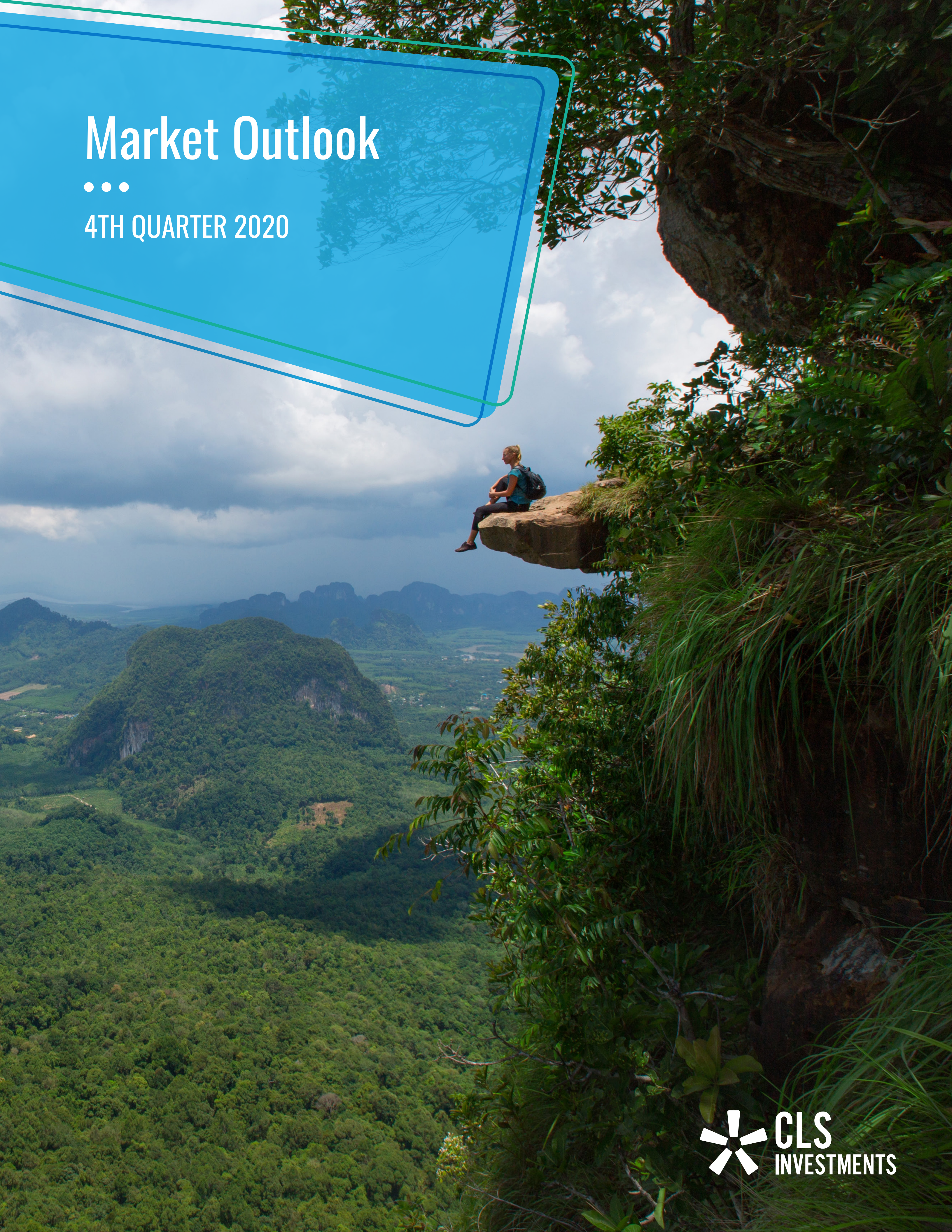
# Market Outlook

4TH QUARTER 2020



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# Quarter in Review

Following the best second quarter since the 1980s, the market was positive again in the third. However, the market experienced a significant jump in volatility. After the best August since the 1980s, a pullback and correction in September marked the first down month since March.

The bull case as we head into the fourth quarter includes stronger than expected payroll data, strength from big tech firms, continued unprecedented monetary stimulus, better than expected corporate earnings, and optimism for an effective vaccine against COVID-19.

However, the bear case includes stretched U.S. valuations, particularly in the tech sector, still-elevated unemployment numbers which are reinforced by a lack of business and leisure travel, and mounting fiscal deficits that appear likely to increase even further.

The S&P 500 climbed 9% during the third quarter. Growth stocks led the way, rising 12%[1], while value lagged, climbing only 3%[2]. Value was primarily dragged by energy, which fell 19%[3] in the quarter. Cyclical stocks jumped 20%[4], and small-caps rose 5%[5].

A weaker U.S. dollar (down nearly 4% during the quarter) helped international stocks participate in the strong quarter. International developed stocks rose 5%[6], and emerging market equities added approximately 9.5%[7]. China, which climbed more than 12%[8], led international markets.

While stocks and commodities have experienced outsized volatility, the bond market has proven to be a safe haven. The U.S. Treasury yield curve remained basically unchanged throughout the third quarter. The yield on the two-year U.S. Treasury note fell 3 basis points to yield 0.13% at quarter end. At the longer end of the yield curve, the 10-year note and 30-year U.S. Treasury bond rose 3 and 5 basis points respectively, to yield 0.69% and 1.46% at quarter end. Credit spreads in both high-yield[9] and investment-grade corporate debt[10] narrowed meaningfully during the quarter. High-yield bonds returned nearly 5%.

The Federal Reserve will likely be on hold for the foreseeable future, so expect interest rates to remain subdued. Fed members probably aren't even thinking about raising rates until 2023. Stable interest rates and tighter credit spreads help to keep mortgage rates low, which is aiding an already strong housing market.

We are just several weeks away from the presidential election. Expect volatility to continue, but remember to keep an eye on the long-term picture and try to put aside the persistent short-term noise.

*1 Morningstar U.S. Growth TR USD*
*2 Morningstar U.S. Value TR USD*
*3 Morningstar U.S. Energy TR USD*
*4 Morningstar U.S. Consumer Cyclical TR USD*
*5 Morningstar U.S. Small Cap TR USD*
*6 Morningstar DM ex U.S. Large-Mid NR USD*
*7 Morningstar EM Large-Mid NR USD*
*8 MSCI China NR USD*
*9 Barclays Barcap U.S. Corporate High Yield TR USD*
*10 Barclays Barcap U.S. Agg Bond TR USD*

# Outlook and Positioning

Since 1933, the average quarterly return for the S&P 500 has been just less than 2% (median is 2.75%). Over the last two quarters, the market has returned 20% and 8.5% in quarters two and three respectively, substantially above average as the global market and economy continue to dig out from the hole created by the pandemic. Another strong quarter would lead one to believe that more of the same is playing out — growth over value, large over small, domestic over international — surely a broken record at this point. But signs are emerging of an important market shift.[1]

At CLS Investments, our positioning remains fairly consistent with previous quarters. We are favoring areas such as emerging markets, international stocks, small-caps, and in particular value stocks. In fixed income, we prefer to be shorter duration with higher credit quality, although we are comfortable taking some credit risk as opportunities arise. We are also maintaining positions in commodities and alternatives as diversifiers in the face of very low bond yields and signs of upward inflationary pressures.

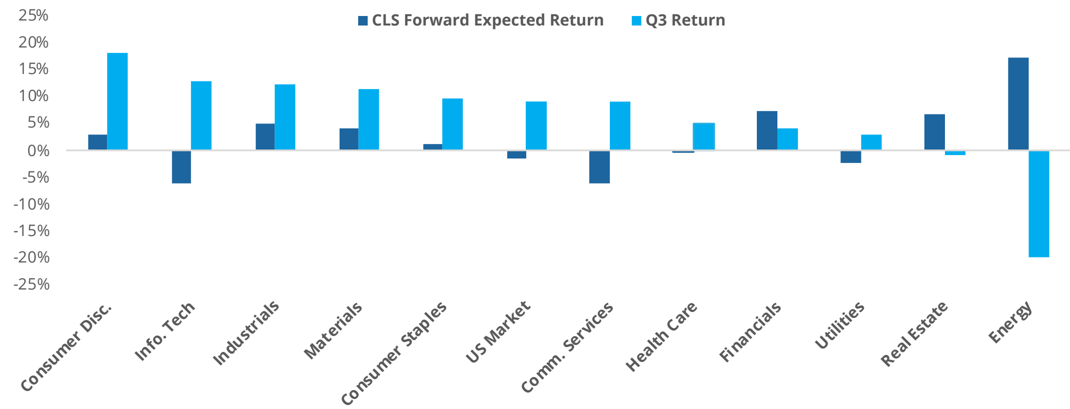
In equities, the shift can be summed up in one word: cyclicality. As the economy and market recover, areas tied to economic growth are recovering, too. We've written on this before: Value, small-caps, commodities, emerging market stocks and specific sectors are all explicitly linked to global economic growth and should reflect that in performance. The "issue" is there are always outliers. Technology stocks have become far and away the biggest sector of the U.S. market and as a result are dragging the market up with their movement, making it more difficult to parse out other, more attractively valued areas that are recovering.

On the other end, value stocks in general have been dragged down by energy companies struggling mightily due to supply and demand issues. Financial companies have also struggled as yields have been reduced to zero by the Federal Reserve. We see value in both sectors, but investors must be selective and patient. However, there are still areas that have attractive valuations and are beginning to show signs of responding to the cyclical recovery.

The chart below shows third quarter performance and our proprietary performance expectation that blends valuations, quality, risk, and technical factors. Consumer sectors, industrials, and materials have been good additions to many CLS portfolios.

*1 Source: Morningstar as of 10/1/2020*

# Domestic Sectors[1]
## Q3 Returns and Forward Expected Return




*1 Source: Morningstar as of 10/1/2020*

Not pictured above are emerging markets, which share some of these cyclical characteristics. Broad emerging markets outperformed U.S. stocks during the quarter. They have strong forward expected returns and will continue to be an important allocation in CLS portfolios.

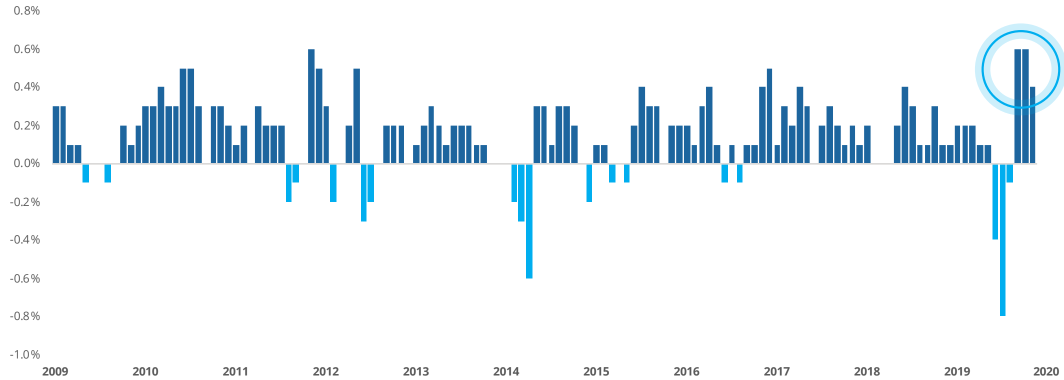
Inflation also has a positive impact on these cyclical areas. In recent months, we've seen highs in monthly inflation numbers. Of course, much is due to the deflationary impact of the pandemic and month-over-month basing effects. However, there are several reasons inflation could be returning in a more meaningful way.

- **The Fed.** The Federal Reserve has flooded the system with liquidity and pledged to keep interest rates low for years to come. According to economic textbooks, this should lead to inflation, although that did not happen following the great financial crisis. This time around, the Fed balance sheet is even bigger, and it has indicated tolerating above-target inflation for longer.
- **Economic recovery.** While there has been some progress here, the economy is nowhere near the previous levels of demand that can lead to price increases in goods, services, and commodities.
- **Fiscal policy.** The government has attempted to stimulate, or at least keep afloat, the economy via fiscal stimulus. We are still waiting to see if future stimulus can be agreed upon, but this effect cannot be overlooked. There also seems to be more tolerance to run larger deficits than usual. Historically, there have been only a couple ways out of a fiscal deficit — growth or inflation.
- **Changing globalization.** The pandemic has caused a global shift from some of the worldwide supply chains of the past. Suppliers were beginning to move manufacturing closer to the end product assembly prior to this year, and that trend has now accelerated. This can lead to diminished ability for supply and demand shocks to be absorbed by other countries.

On top of all this, inflation expectations have been rocketing upward for some time now, which benefits Treasury Inflation-Protected Securities. The impact of inflation on various asset classes has been mixed, but we view it as a positive tailwind to many of the cyclical areas mentioned. Whether inflation is a necessary ingredient for value outperformance is up for debate, but it's likely to help many traditional value sectors.

## US Consumer Price Index

### M/M SA




*Source: Bloomberg, 9/1/2020*

Within fixed income we prefer to be shorter duration. Even with the Fed on hold for the foreseeable future, the incremental yield gained by extending maturities is not worth the risk of doing so. If economic growth and/or inflation pick up meaningfully, longer-dated bond yields may move higher while the Federal Reserve is fixated on the short end of the yield curve. Instead of duration risk, we prefer the incremental yield pickup from credit, as there are still areas recovering from the worst of the pandemic that offer some value.

A meager outlook for fixed income and the potential for increasing inflation have prompted us to maintain allocations to commodities and alternatives. Commodities have been a very divergent asset class this year, more so than usual, so security selection matters (particularly with oil futures contracts!). We prefer diversified approaches that provide more exposure to precious metals, industrial metals, and agriculture.

The Warren Buffett quote, "You don't know who's swimming naked until the tide goes out" applies very much to liquid alternatives after the first couple of quarters. Many products were more correlated than many investors thought, had limited hedging abilities, and still haven't recovered. We continue to be selective here.

# Does the Election Matter? (For Stocks)

An important point to keep in mind when analyzing election statistics is the limited amount of data. We have good data for a whopping total of 37 elections! Most statisticians agree that a minimum sample size for anything to be statistically significant is 100. Keep that in mind first and foremost when reviewing stats on election results and stocks.

Now, the data. As the top row in the chart below shows, markets go up 60-70% of the time, every year of the election cycle. I could just stop writing here. There is some significance in the year leading up to an election being stronger than others, and we saw that in 2019. Interestingly, as shown in the bottom two rows, in the years leading up to an election, markets are strongest when the incumbent party loses, regardless of party. But again, we have a whopping 16 elections worth of statistics. (The numbers in red for effect.) Even in years when it appears one party has an advantage, there tends to be underperformance the prior or following year. Similar results are shown here and here.

| | Number of Cases | Post-Election Year | Mid-Term Year | Pre-Election Year | Outgoing Election Year |
|---|---|---|---|---|---|
| Percent Up Years/Total Years | 37 | 59.5% | 59.5% | 70.3% | 69.4% |
| Mean Gain Per Year | 37 | 4.4% | 3.9% | 10.3% | 6.1% |
| Median Gain Per Year | 37 | 7.1% | 2.7% | 12.3% | 8.3% |
| **Mean Gains Breakdown By Party** | | | | | |
| Under Republicans | 21 | 3.0% | 3.0% | 8.0% | 6.4% |
| Under Democrats | 16 | 6.1% | 5.0% | 13.3% | 5.7% |
| Incumbent Party Wins | 21 | 4.0% | 4.5% | 5.6% | 12.3% |
| Incumbent Party Loses | 16 | 4.8% | 3.0% | 16.4% | -2.0% |
| Incumbent Republican Wins | 13 | 4.7% | 0.4% | 2.7% | 14.0% |
| Incumbent Democrat Wins | 8 | 2.9% | 11.1% | 10.4% | 9.5% |
| Incumbent Republican Loses | 8 | 9.3% | -1.0% | 16.2% | -5.9% |
| Incumbent Democrat Loses | 8 | 0.3% | 7.1% | 16.6% | 1.9% |

*Source: Ned Davis Research 10/1/2020*

There are a million and one things that affect markets, but over time we know what direction they go — up and to the right. Stay focused on the long-term, and don't let the noise (even when it gets REALLY loud) affect your portfolio.

The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks.

Emerging market investing refers to the practice of investing in a developing market of a foreign nation. The pre-requisites of this practice include a market within the foreign nation along with some form of regulatory body. Emerging markets involve greater risk and potential reward than investing in more established markets. Diversifiable risks for emerging markets include, but are not limited to, political risk, currency risk, and liquidity risk.

Fixed Income is an investment style designed to return income on a periodic basis. Generally, fixed income strategies invest in bonds, real estate, loans, and other types of debt instruments. Diversifiable risks associated with fixed income investing include, but are not limited to, opportunity risk, credit risk, reinvestment risk, and call risk.

International investing is an investment strategy where investors chose global investment instruments. International investing can be accomplished utilizing a variety of investment vehicles including, but not limited to, ETFs, American Depository Receipts, or a direct investment in a foreign stock exchange. Diversifiable risks include, but are not limited to, political risk and currency risk.

The Morningstar U.S. Growth Index is an index that tracks the performance of stocks that are expected to grow at a faster pace than the rest of the market as measured by forward earnings, historical earnings, book value, cash flow and sales.

The Morningstar US Value Index tracks the performance of stocks with relatively low prices given anticipated per-share earnings, book value, cash flow, sales and dividends.

The Morningstar US Energy Sector Index tracks the performance of US companies that produce or refine oil and gas, oilfield services and equipment companies, and pipeline operators.

The Morningstar U.S. Consumer Cyclical Index measures the performance of US retail stores, auto & auto parts manufacturers, companies engaged in residential construction, lodging facilities, restaurants and entertainment companies

The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. 6 Morningstar DM ex U.S. Large-Mid NR USD

The Morningstar EM Large-Mid index measures the performance of Emerging Market's targeting the top 90% of stocks by market capitalization.

The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 714 constituents, the index covers about 85% of this China equity universe. Currently, the index includes Large Cap A and Mid Cap A shares represented at 20% of their free float adjusted market capitalization

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded

The Bloomberg Barclays US Aggregate Bond Index measures the performance of the total United States investment-grade bond market.

An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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