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Market Review
Third Quarter 2020

The third quarter was another remarkable period for stocks -- whether a bounce, recovery, or otherwise.

Almost all of the major domestic and international stock markets climbed higher, albeit to varying degrees. During the period, large cap stocks continued to outpace small cap stocks with the S&P 500 and Russell 2000 Indices up 8.93% and 4.93%, respectively. After an atrocious start, the large cap benchmark achieved positive returns for the year in July, and set a record high in August, capping the best five month stretch for stocks since 1928. Growth handily outperformed value (again) across the market cap spectrum, widening an already huge chasm. The NASDAQ was the big winner (again), up 11.02% in the quarter and 24.46% for the year.

The problem, however, is that it doesn't *seem* like we should be feeling this good. While encouraged by the progress in testing, therapeutics, and vaccine development, incidence of COVID-19 remains persistently high, thwarting the country's ability to truly open up. As a result, there are still huge swaths of the economy stuck on life support. This comes to a head in the unemployment statistics; the total number of people claiming benefits for the week ending September 12th, 2020 was 26.5 million, which compares with 1.4 million in the same period one year ago.

The most commonly cited reason for this disconnect between stocks and the real economy is the extreme fiscal and monetary stimulus, which now exceeds $20 trillion in outlays. While the intention of policymakers is to instill confidence and bridge the country to the resumption of a more normal economy, the excess liquidity filters into the equity market amid a dearth of investment alternatives. After three crises in two decades, investors are also well-conditioned to "buy the dips".

But the other issue is that the primary indices aren't capturing the large dispersion in returns. This is evidenced by the 10% year-to-date performance gap between the S&P 500 (+5.57%) and an equal-weighted reconstitution of the same stocks (-4.75%). The divergence is even more apparent in the huge disparity between growth and value throughout the year. In the past nine months, the S&P 500 Growth outperformed the S&P 500 Value by 32%, while the Russell 2000 Growth outgained the Russell 2000 Value by 25%. The intimation is that the rally is narrow, and the market bifurcated.

This dynamic has given rise to the notion of a "K" recovery that seems to work on multiple levels. The concept was initially labor-centric, contrasting the resilience in white-collar employment with the carnage in more service-oriented areas. But it has become equally apropos in defining how winners and losers have emerged from the pandemic in what increasingly feels like a zero-sum game. For example, while the relocation of families to suburban schools and communities has created a boon for homebuilders, it has come at the expense of urban business, commercial real estate, and tax bases. It is also easier for Walmart, Target, and Costco to implement curbside pick-up and delivery than it is for a small chain, which may or may not have been deemed "essential".

The "K" moniker has also been embraced by the market, with investors piling into a small group of stocks deemed beneficiaries of the changes created by the pandemic, while shunning everything else. Although it is hard to argue with this logic in the short-term, too much money chasing, too few assets creates bubbles, and the current situation is no different. This is evident in large and small cap valuations with the Russell 1000 and Russell 2000 Growth Indices trading at 26x and 36x 2021 earnings, respectively. Another indication of the excess is that the technology weighting in the S&P 500 is higher today than it was in 1999 on an apples-to-apples basis. Unprofitable companies comprise almost 37% of the Russell 2000 Growth benchmark, the highest level in history.

Looking ahead, the next obvious milestone for the market is the November election. While we don't expect that anyone is looking forward to the vitriol, the picture seems to be getting clearer with Vice President Biden surging in the polls. But after the death of Supreme Court Justice Ginsburg and President Trump's COVID-19 diagnosis, we are reminded that no one can take anything for granted in 2020, and we are staying braced for whatever the next quarter brings.

Sources: *FactSet, GICS Sector Classification, Jefferies, U.S. Department of Labor*

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S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

The S&P 500 Growth Index represents the growth companies of the S&P 500 Index, a benchmark of U.S. stock market performance that is dominated by the stocks of large U.S. companies. The growth companies of the S&P 500 Index are identified by three factors: three year earnings per share growth rate, three year sales per share growth rate, and momentum (12-month change in price).

The S&P 500 Value Index represents the value companies of the S&P 500 Index, a benchmark of U.S. stock market performance that is dominated by the stocks of large U.S. companies. The value companies of the S&P 500 Index are identified by three factors: the ratios of book value, earnings, and sales to price.

The Russell 2000® Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values. The Russell 2000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the small-cap growth segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect growth characteristics.

The Russell 2000 Value Index measures the performance of the small cap value segment of the US equity market. The index is constructed to provide a comprehensive and unbiased barometer for this market segment, and it is completely reconstituted annually to ensure accurate representation.

The Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

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Index Definition Sources: *Standard & Poor's; FTSE Russell*

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