SilverOak

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Third Quarter 2020 Market Summary

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Third Quarter 2020 Market Summary

After living with the disruptions the COVID pandemic has caused over the past seven months, people and the economy seem to be settling into new norms. The cloud of uncertainty has been somewhat eased by increased testing, better understanding of treatments, and improved social distancing practices, which has allowed the restart of economic activity. Although, the dust has not completely settled, consumer and business confidence has improved, in spite of continued COVID outbreaks. With schools resuming and the winter months approaching, we are likely to face additional challenges as we wait for a vaccine.

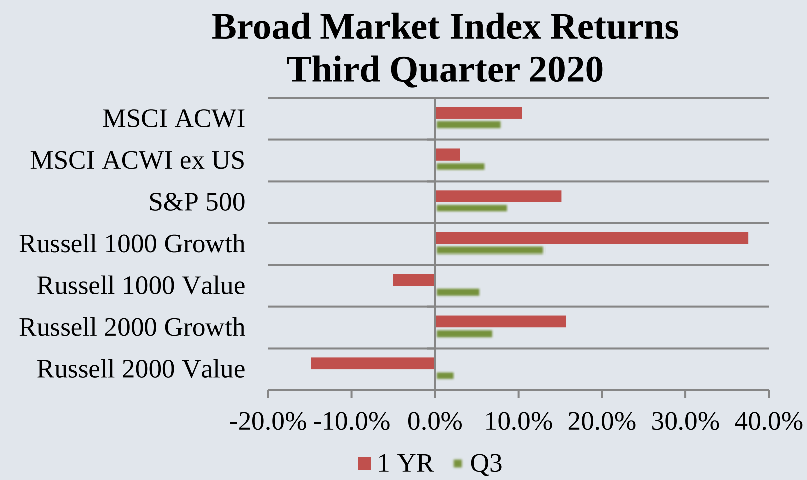
Many are painfully aware of the economic impact the virus has caused. The cumulative real GDP decline has been 10%. The only larger declines in GDP were in World War II and the Great Depression. However, as we often reference, the direct correlation between annual GDP and equity market returns is not high. We are seeing this play out once again this year.

COVID has disproportionately impacted certain sectors such as restaurants, travel, leisure, etc. These sectors employ a lot of people; however, they account for a lower percentage of national income and an even lower weighting in public equity markets. This is one reason equity markets have performed better than the private sector. In addition, fiscal stimulus has supplemented lost wages and monetary stimulus has dampened volatility and encouraged risk taking.

U.S. large company stocks, represented by the S&P 500 Index, were up 8.9% during the third quarter of 2020, despite a 10% pullback in September. U.S. small company stocks, represented by the Russell 2000 Index, were up 4.9% during the quarter but returns remain in negative territory year-to-date. The market breadth of the recovery has been shallow and dominated by large technology growth companies as investors seek companies they feel will benefit in a post-COVID world. Financials and Energy have lagged YTD. International stocks, represented by the MSCI ACWI ex US Index, were up 6.3% during the quarter. Asian equities, in particular, have performed well year-to-date.

The top five largest companies in the S&P 500 (Apple, Microsoft, Amazon, Alphabet, and Facebook) have returned 35% year-to-date (through 9/30) vs. 4% for the S&P 500. If you excluded those five stocks, however, the remaining 495 stocks have returned negative 3% year-to-date. The strong performance of only a handful of stocks has led to an increase in concentration of the index. The market capitalization of the top five names in the S&P 500 now accounts for 24% of the index, which is the highest level of concentration in over 40+ years.

These top five companies are all in the technology industry and thus there has been a lot of media coverage comparing the current concentration to the last time it was this high, which was in the early 2000s. While there is certainly speculation in certain parts of the markets, you don’t have to dig too far to find the differences in these top names compared to their early 2000s counterparts. The current largest companies are mature, have lower valuations and account for a more significant percentage of the S&P 500’s earnings. Thus, the concentration is more reasonable. While the current concentration is high relative to the recent past, if we look back over the past century, we would see that concentration in the index’s largest names is common and can last decades.



Turning to fixed income, the Bloomberg Barclays U.S. Aggregate Bond Index, which represents a broad basket of bonds, was up 0.6%. The Fed indicated that the Fed funds rate will likely remain low for many years, and they are committed to the bond purchase programs to support the fixed income markets. In addition, they adjusted their inflation guidance, indicating they will let inflation run higher than the 2% target for an extended period of time to recoup the low inflation periods of the past ten years. This change in policy has led to concerns by some that inflation is around the corner. However, the Fed has had a difficult time achieving the 2% target. Therefore, a significant rise in inflation over the short-term is not likely.

Third Quarter 2020 Market Summary (continued)

We expect there will be more volatility over the remaining year with the upcoming U.S. elections and the economy continuing to find its footing. Much of the returns year-to-date have been due to valuation expansion. Stock prices may pause or slow their advancement as companies grow into their valuations. High valuations of the equity markets, and in particular, growth stocks could be considered a concern, as it may be a source of volatility. However, higher valuations, in isolation, are not a major issue. It can be reasonably argued that valuations should be higher due to the very low interest rates and lack of inflation. Companies can be priced by the discounting of their future cash flows and lower rates mathematically increases the valuation multiple. The other side of the coin is, if interest rates rise, stock prices would likely be pressured.

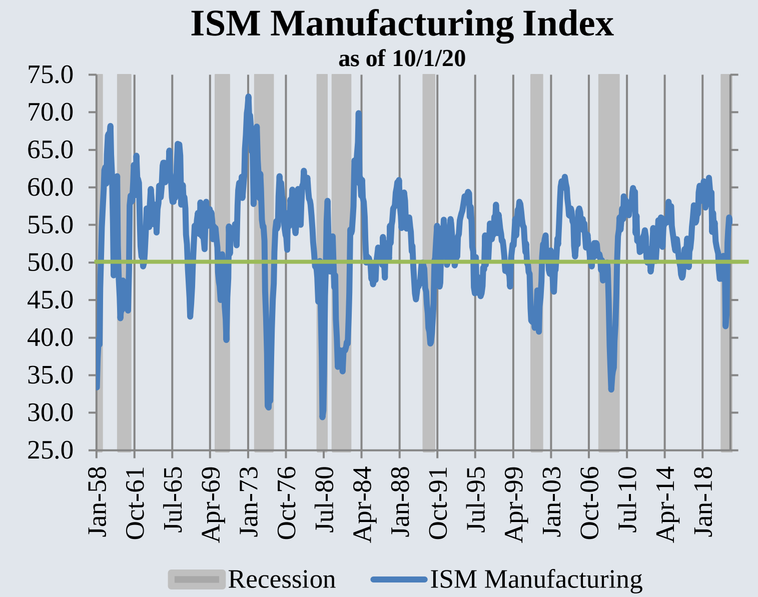
Despite the considerable macro unknowns, there are positive catalysts including the likelihood of additional fiscal stimulus, the Fed's significant untapped buying power, and the large amount of cash on the sidelines. Fund flows have continued out of equities over the year, despite the markets advances. A rotation back into equities could be an additional support for equity markets. There are fundamental reasons for optimism as well. Economic data is improving. The housing sector is as strong as it has been since prior to the Great Recession. U.S. employment has been better than expected, despite millions still displaced. Consensus S&P 500 earnings in 2021 are expected to get back to 2019 levels. In addition, corporate capital expenditures have been suppressed over the past few years and inventories are low and will need to be rebuilt.

Diversification is often lauded when looking at past returns and is promoted as a rational plan when assessing future expectations. However, in any given moment, it can cause heartburn. While diversification helps to achieve more consistent returns and reduces volatility, there will always be parts of the portfolio that have higher or lower returns. Over the long-term, diversification provides benefits and allows investors to participate in strong areas of the market while reducing the impact of weaker areas. The expectation that all parts of the portfolio could outperform at once would be at odds with the fundamental objective of diversification.

As such, the declining interest rate environment, coupled with low growth and minimal inflation, has favored certain assets such as large cap growth stocks and bonds for many years now. However, regimes ultimately change. If growth rates pick up, a COVID vaccine is approved, or interest rates and/or inflation rises, then there would likely be a shift in asset leaders. There could be a rotation in asset classes, and value, small caps, and international would likely see better results. Recent events can often greatly influence perspective; however, it is important to remember to not let biases impact the pursuit of long-term goals.

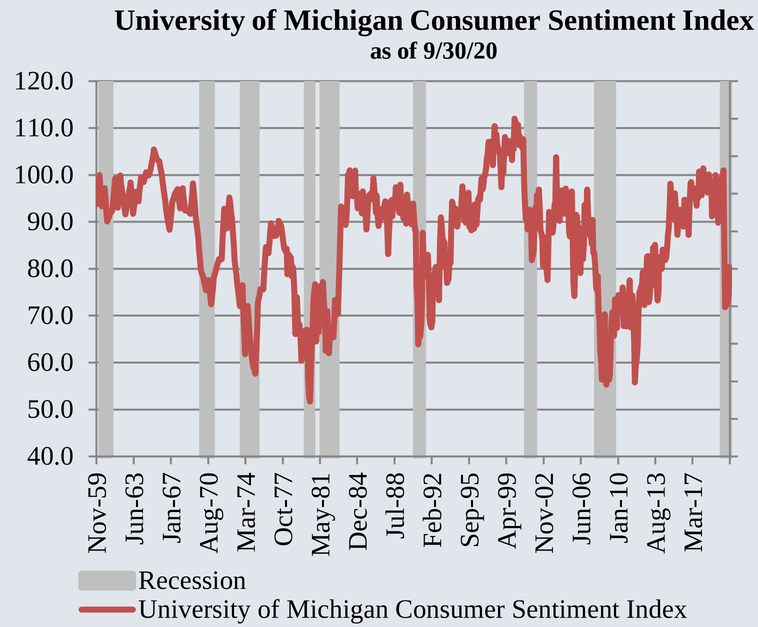
MACROECONOMICS

- The Bureau of Economic Analysis released the advanced estimate of third quarter 2020 real GDP, an annual rate increase of 33.1% from the preceding quarter. The dramatic increase in GDP was due to the resumption of the economy following the lifting of the "stay-at-home" orders across the U.S. in the second quarter.
- The bounce in economic activity was due in part to monetary and fiscal stimulus. The U.S. government is looking to pass another round of stimulus to support businesses, individuals and state and local governments; however they have yet to come to terms and the past stimulus programs have rolled off.
- The ISM Manufacturing trended higher during the quarter, finishing at 55.4 versus 52.6 in June. Typically, when the ISM Index is above 55 it is bullish and when it is below 45 it is bearish. The ISM Non-Manufacturing Index also continued its rebound finishing at 57.8 in September.
- In September, the Conference Board Leading Economic Index increased 0.7% month-over-month to 107.2. The index, which is a composite of leading employment, housing, manufacturing, and market indicators, has increased since April after falling significantly from January highs.
- The price of WTI Crude Oil was $40.05 at the end of September, which is 2.0% higher than $39.27 at the end of June. The price of Brent Crude Oil ended the quarter at $40.30, which is 3.2% lower than at the end of June. The price of oil has been extremely volatile over the past year due to a supply and demand imbalance; however, the price has been more stable in the past few months.
- Inflation had remained stable over the past few years around 2.0%; however, the CPI fell considerably in the first half of the year. In the past few months, inflation has risen but remains below the Fed's target. In September, headline CPI increased 1.4% year-over-year. Core CPI, which does not include food and energy, had a 1.7% increase.



CONFIDENCE METRICS

- Consumer confidence has been trending higher the past few months, recovering from the collapse earlier in the year.
- The University of Michigan Consumer Sentiment Index final reading for September was 80.4, which is slightly higher than 78.1 in June.
- The Conference Board's Consumer Confidence Index September reading was 101.3, up from 98.3 in June.

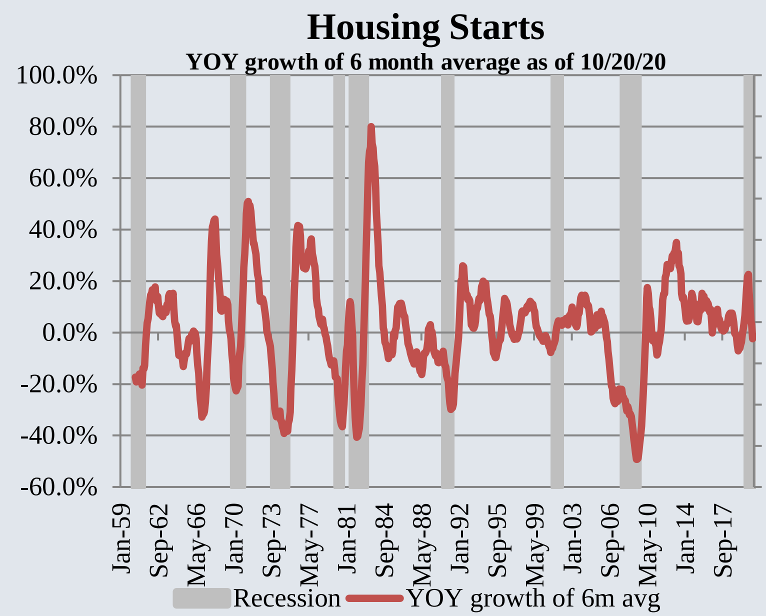


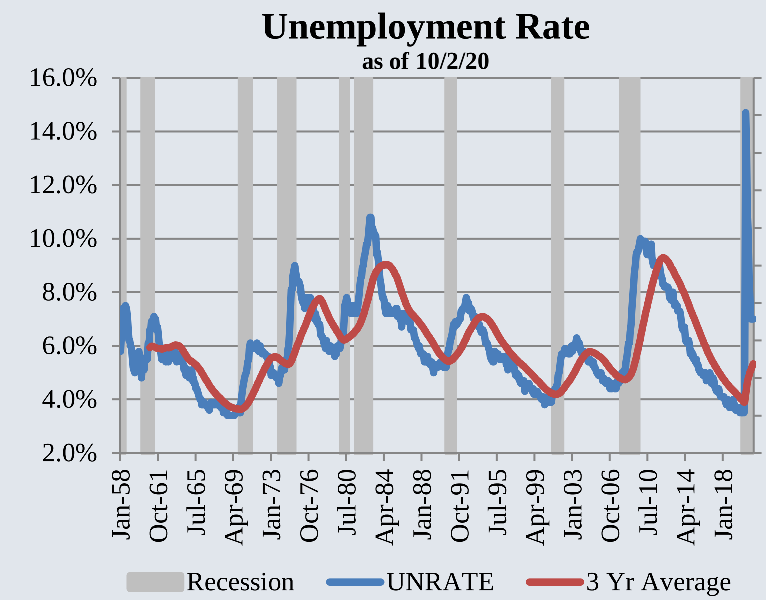
HOUSING

- The housing sector has been very strong the past few months with pent-up demand fueled by low interest rates and low inventory levels. Low mortgage rates will continue to support the sector.
- Preliminary existing home sales increased significantly in the quarter, with a monthly average annualized rate of 6.13 million units, up from 4.31 million units in the second quarter. Unsold home supply remains at low levels.
- The preliminary existing home sale prices for September were 14.8% higher than the levels of one year ago. Prices have been trending up since the beginning of 2012 and are currently at all-time highs, as constrained supply has boosted prices.
- New home sales were up significantly during the quarter, reaching their highest level since 2006. Median new home prices were higher during the quarter on a year-over-year basis.
- S&P Case-Shiller 20-City Home Price Index (seasonally adjusted) showed home prices rose over 5.2% year-over-year in August. Of the locations in the Index, home prices in many major cities in western states have risen the most since 2011, while many major cities in eastern states have seen weaker growth. However, we are starting to see housing trends shifting in many regions as a result of COVID-19.
- Housing starts bounced back strongly in the third quarter.

EMPLOYMENT

- The labor market has seen mixed data. While some jobs have come back, in some areas, temporary layoffs have turned into permanent losses. The labor market was strong prior to the impact of COVID-19 and thus it will take years to get back to those levels.
- During the quarter, nonfarm payrolls averaged 1,304,000 jobs added per month.
- The unemployment rate decreased during the quarter to 7.9% in September from 11.1% in June.
- Initial Jobless Claims remain at very high levels. Many of the jobless claims are in the restaurant, leisure, retail and education sectors.



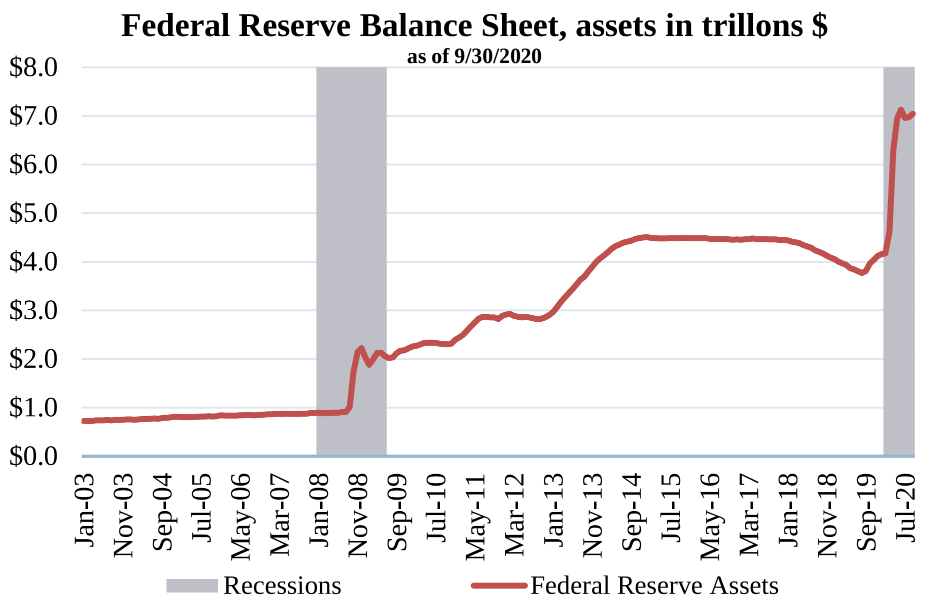


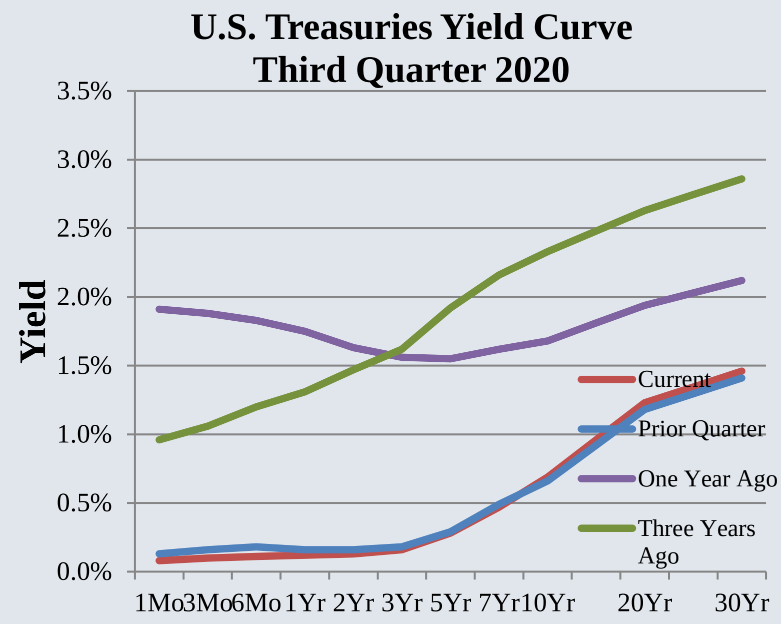
FED POLICY

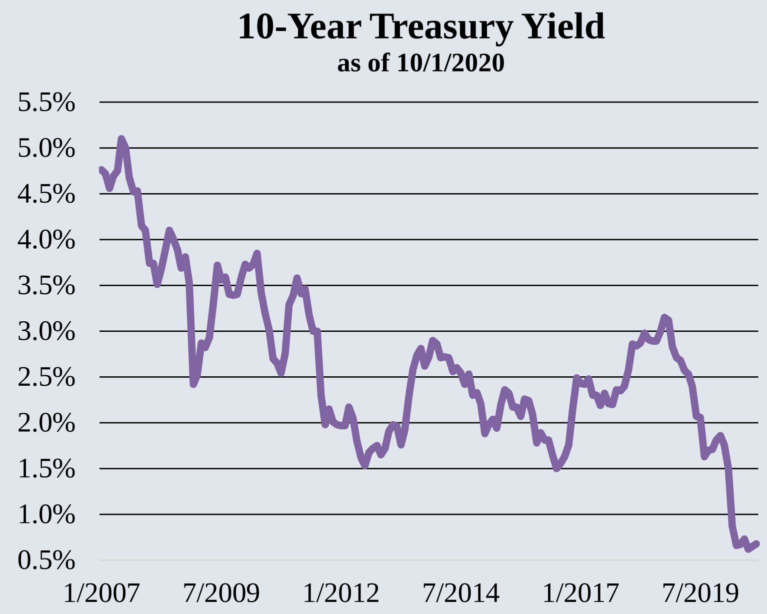
- The Federal Open Market Committee (FOMC) kept the federal funds rate at a target range of 0.00% - 0.25% in September. The Fed will keep the fed funds rate low for an extended period of time.
- The Fed changed their policy on inflation guidance and will now use an average target of 2%. Since inflation has been below that target for many years, the Fed will allow inflation to exceed the target for a multi-year period. This indicates the Fed will remain accommodative for years before they increase interest rates. Over the past decade, the markets have seen asset price inflation but consumer price inflation has been minimal.

FIXED INCOME

- During the third quarter, U.S. Treasury yields did not change much across the curve as the Fed remains committed to their bond buying programs.
- Short-term interest rates are controlled or heavily influenced by central banks, whereas long term interest rates are controlled by market forces and economic growth.

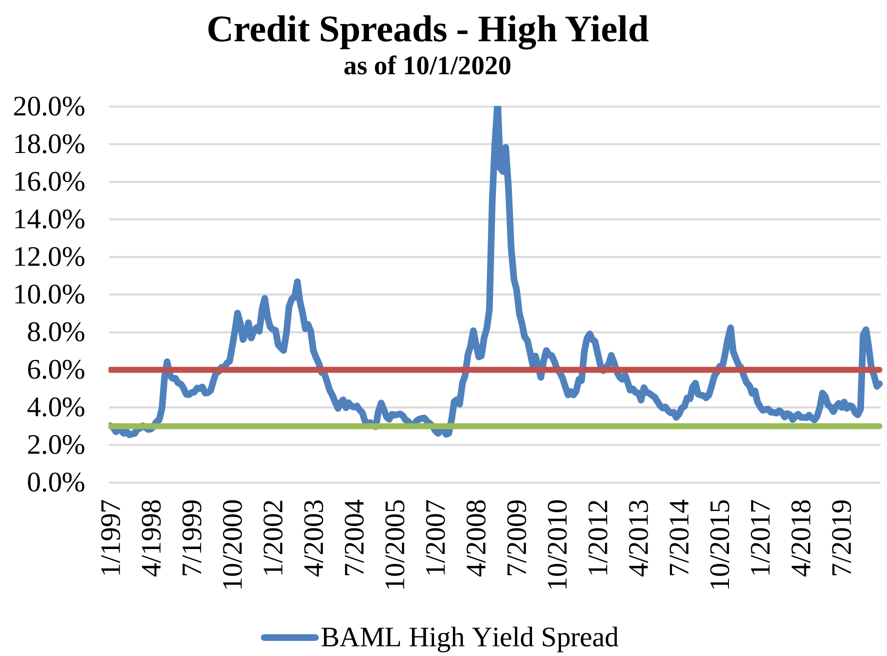


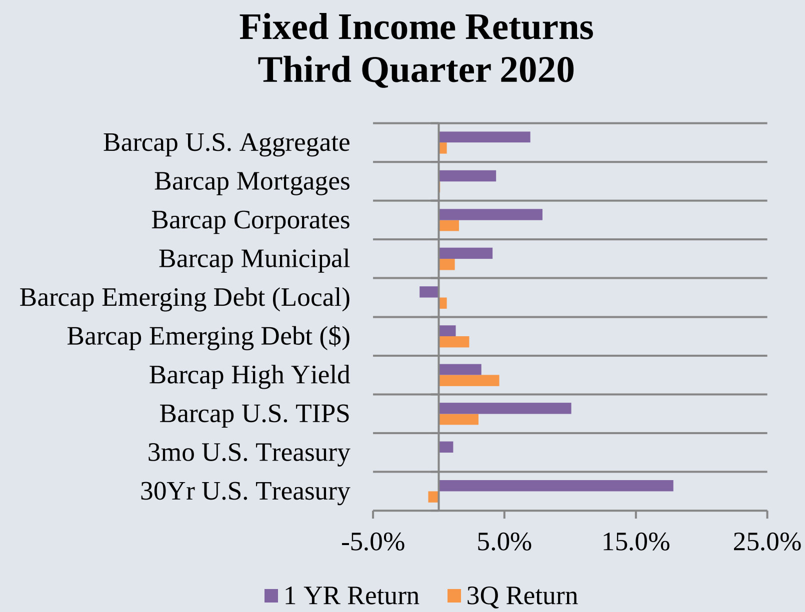


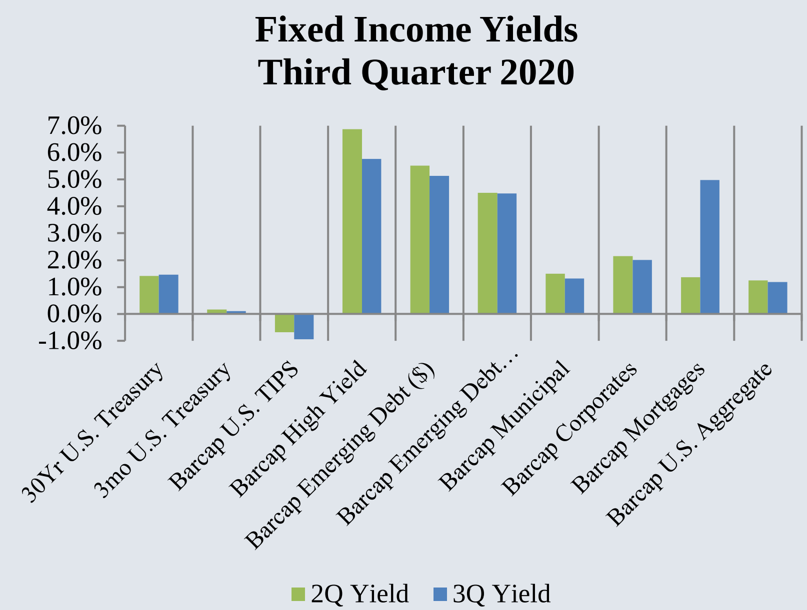


FIXED INCOME (continued)

- During the quarter, the Bloomberg Barclays U.S. Aggregate Index returned 0.6%. Credit sectors continued their outperformance of Treasuries. Emerging market debt, high yield and investment grade corporates had the strongest performance. TIPS also performed well as inflation rose from the very low levels in the second quarter.
- Defaults and downgrades have increased; however, credit spreads have continued to contract with the Fed backstopping the fixed income market and investor's demand yield.
- Another sign that there is strong demand for yield is that the market was able to absorb significant new issuances in municipals, investment grade credit and high yield during the quarter.
- After the compression of investment grade corporate spreads, the sector looks richly valued compared to many parts of the securitized markets, which have lagged in the recovery.
- U.S. and foreign developed government yields are the lowest they have been in history. The compensation for the interest rate risk is not compelling. That being said, Treasuries remain one of the only asset classes negatively correlated to equities.



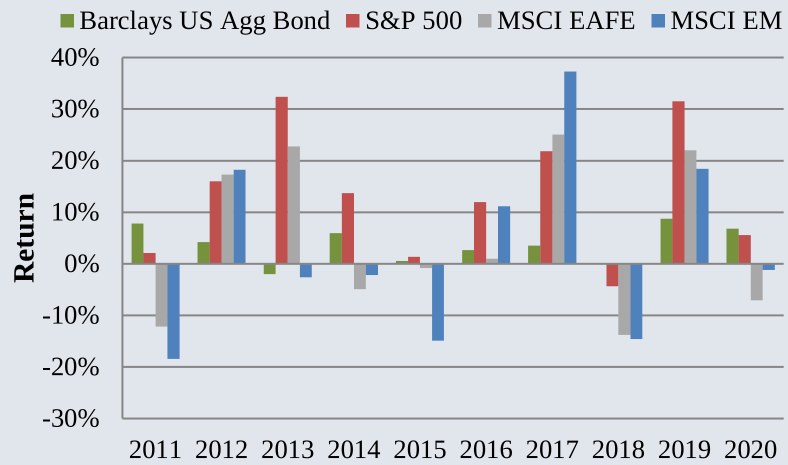




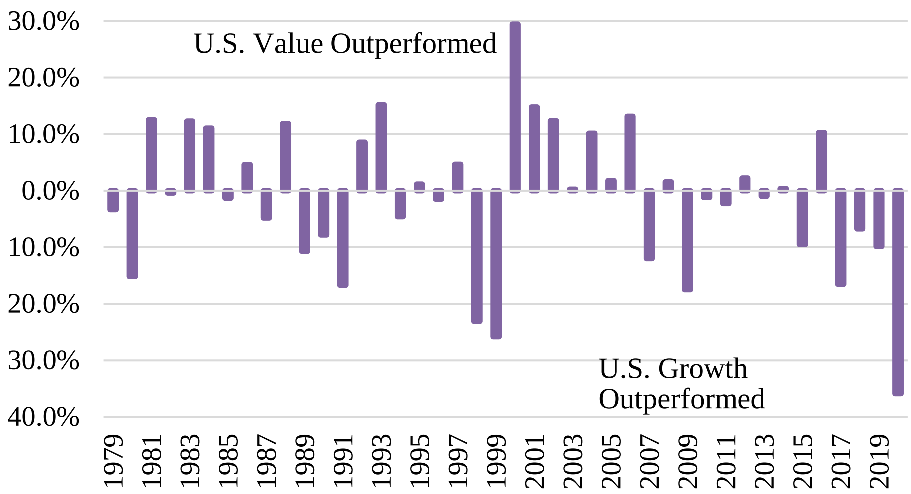
EQUITIES

- For a second quarter in a row, equities posted strong returns. The S&P 500 and the NASDAQ Composite Index even reached all-time highs in August before a weaker September.
- Risk assets continue to perform well, in part, because the economy appears to be rebounding faster than many expected. Many economic data points remain weak; however, the trend and expectations built into prices are often what fuels the direction of risk assets.
- As a style, growth continued to outperform versus value. Companies that benefit from the stay-at-home economy continue to outperform.
- The top 5 names by market cap (Apple, Microsoft, Amazon, Google and Facebook) in the S&P 500 Index make up over 25% of the index. The concentration of market cap in the top names in the index is at historical levels.
- Sources of potential volatility still stem around the upcoming U.S. elections, additional waves of COVID-19 cases and geopolitical events, such as the U.S./China rivalry.

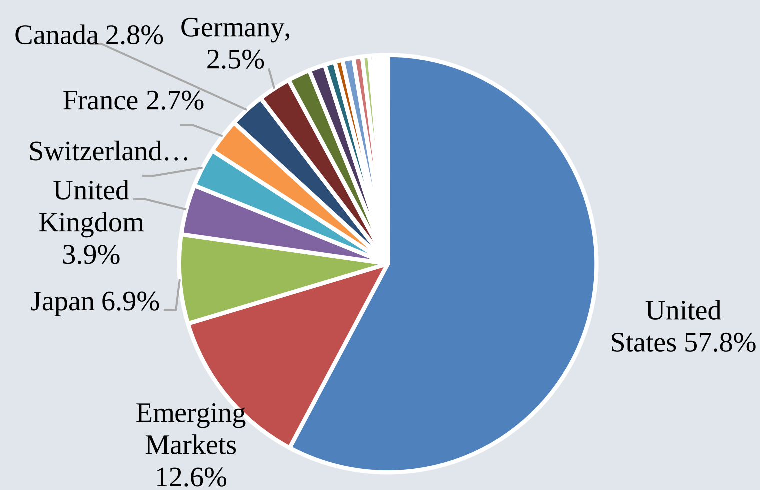
Equity & Fixed Income Market Annual Returns
(as of 9/30/2020)



U.S. Value vs. Growth Relative Equity Performance (as of 9/30/20)



Country Weighting in MSCI ACWI
(as of 10/2/2020)



DOMESTIC EQUITIES

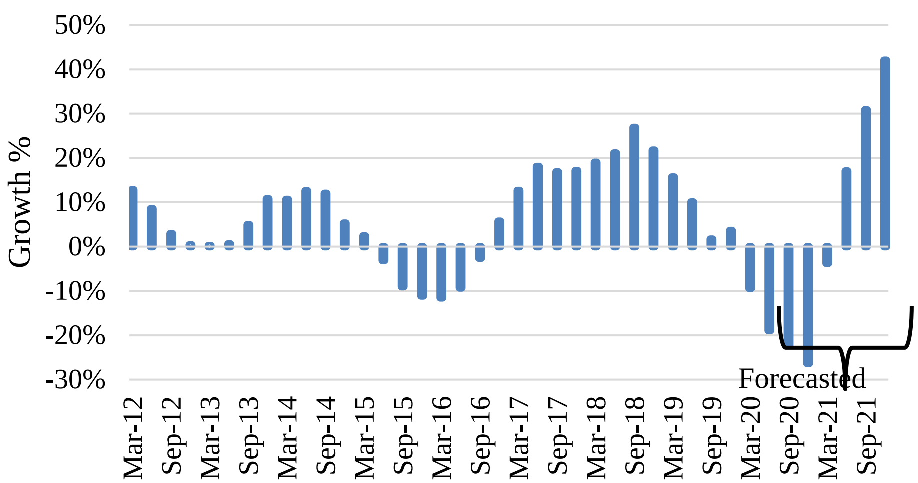
- The Russell 1000 Index, comprised of large and mid-capitalization stocks, posted a total return of 9.5% during the third quarter. All sectors, except Energy, were up during the quarter led by Consumer Discretionary and Materials. On a year-over-year basis, the Russell 1000 Index has increased 16.0%.
- Small capitalization stocks, as represented by the Russell 2000 Index, increased 4.9% during the third quarter. On a year-over-year basis, the index has increased 0.4%.
- Corporate earnings are expected to see a strong rebound in 2021. Global manufacturing has pick up strongly, consumer balance sheets are healthy and business capital expenditures could increase after being delayed the past few years. All of these items could provide tail winds for increasing corporate earnings.
- Valuations based on P/E have risen to highs last seen in the late 1990s, as markets have rebounded despite falling earnings. Valuations relative to fixed income provide a more compelling view. In addition, valuations across sectors and market caps are not uniform. Over the short-term, valuations tend to have little influence on returns but over longer periods they tend to be more correlated.

Third Quarter 2020 Returns			
	Value	**Core**	**Growth**
Mega Cap		11.8%	
Large Cap	5.6%	9.5%	13.2%
Mid Cap	6.4%	7.5%	9.4%
Small Cap	2.6%	4.9%	7.2%
Micro Cap	2.0%	3.7%	6.1%

S&P 500 Earnings Growth

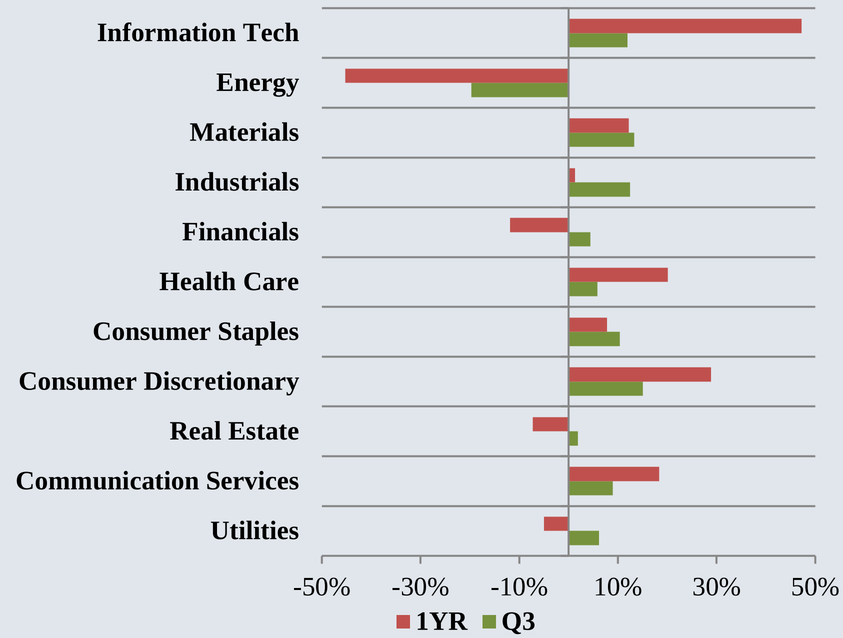
Trailing 12-Month Operating Earnings Growth YOY

(as of 10/22/2020)



U.S. Equity Market Returns by Major Sector

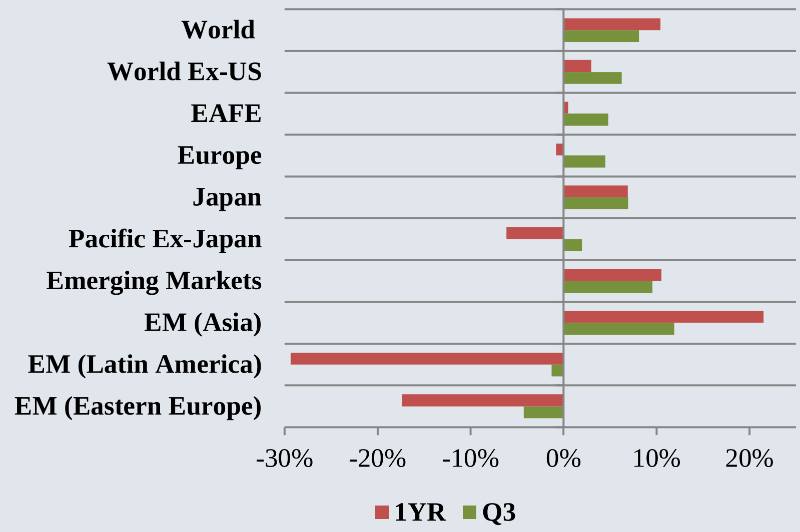
(Securities in S&P 500, Third Quarter 2020)



INTERNATIONAL EQUITIES

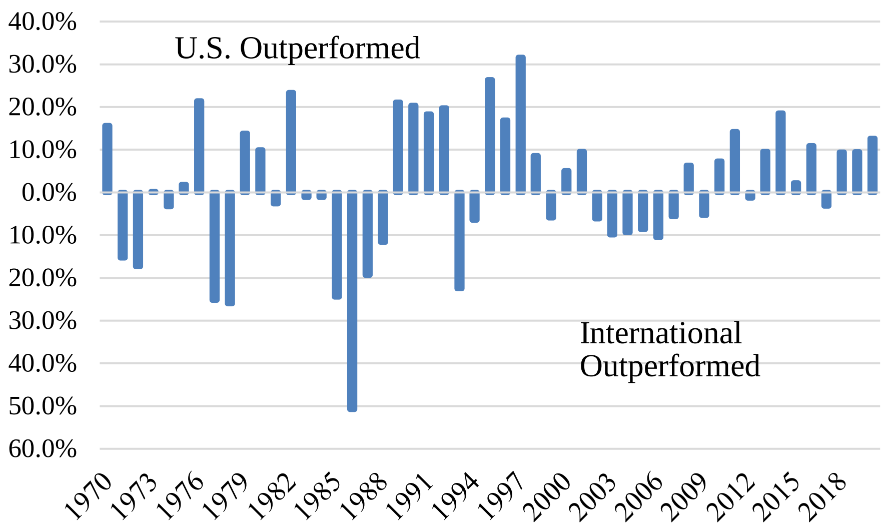
- Developed international stocks, as represented by the MSCI EAFE, were up 4.8% during the quarter. On a year-over-year basis, the EAFE is up 0.5%, performing worse than U.S. domestic equities.
- Europe has seen a resurgence of COVID cases, which is leading to some economic slowness and a reinstatement of some "stay-at-home" orders.
- Emerging market stocks outperformed developed markets during the third quarter as the MSCI Emerging Markets Index rose 9.6%. On a year-over-year basis, emerging market stocks have an edge versus developed markets with a return of 10.5%.
- Asian markets have outperformed over the past year. In particular, China has been able to recover quicker from COVID-19 impacts than many other countries and are reporting solid industrial production, retail sales and employment data. The Chinese government has adopted a new five year plan to focus on growing their economy domestically and becoming a global leader in technology and health care.
- The past few years have seen the rise of populism and de-globalization pressures. Going forward, global asset diversification may provide more benefit than it has over the previous decade.

Non-U.S. Equity Market Returns Third Quarter 2020



U.S. vs. International Equity Performance

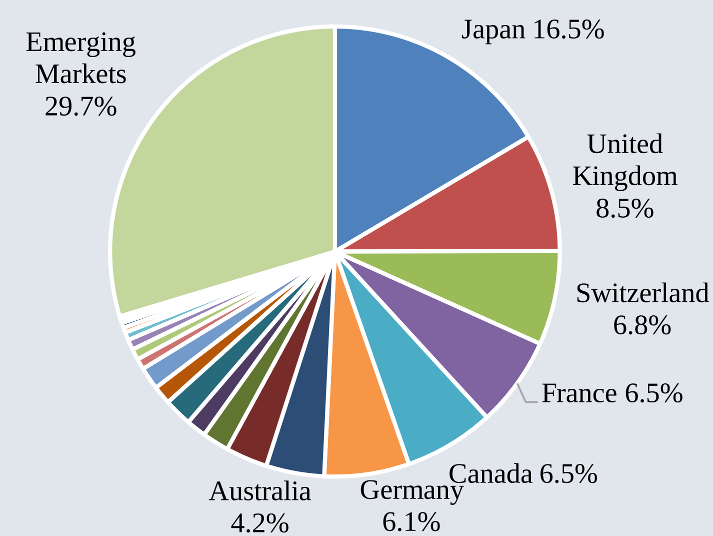
(as of 9/30/20)



S&P 500 TR vs. MSCI EAFE NR

Country Weighting in MSCI ACWI ex US

(as of 10/2/2020)



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