The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets October 2020

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***The U.S. Economy Continues to Recover, but the Coronavirus Remains a Threat to Consumer Spending.*** *On the domestic front, additional fiscal stimulus is needed for the U.S. economy to fully recover.*

- ***The Global Economy is Now Growing at a Reasonable Pace as the Outlook for 2021 is Starting to Look a Bit Brighter.*** *While manufacturers continue to cut jobs, they have recovered much of the ground lost during the lockdowns earlier this year.*

- ***The Actions Within the Equity and Fixed Income Markets Point to Better Days Ahead.*** *In the equity markets, we are seeing some shift taking place with investors moving towards the consumer cyclical side of business. Fixed income yields will remain low for the foreseeable future while the economy gets back on its feet.*

THE ECONOMY

The economy continues to reopen slowly; however, profits of large U.S. companies are now projected to drop 21% from a year earlier in the third quarter. This is an improvement from the 32% decline in the second quarter. The third quarter is expected to mark the beginning of a turnaround for corporate earnings, which analysts projected bottomed in the second quarter when much of the economy was locked down in an attempt to slow the spread of the virus.

U.S. manufacturing activity continues to rebound from the sharp downturn in the spring. Manufacturing surveys show firms with solid demand domestically and from abroad, leading to a backlog of new orders. September was the fourth straight month of expansion. Despite these gains, manufacturing activity remained 7.3% below its February level. About 12.1 million people worked in American manufacturing in August, roughly 700,000 fewer than before the pandemic. The employment side, however, generally lags everything, but it has been doing better since its trough several months ago.

Companies, in turn, have reported a marked upturn in demand for plants and machinery, which indicates firms are increasing their investment spending again. Fuller order books help drive further job creation as firms expand capacity. In Europe and Asia, manufacturers continue to cut jobs, even though they have recovered much of the ground lost. The Manufacturing Purchasing Managers' Index for the Eurozone rose to 53.7 in September from 51.7 in August.

A final word on the inflation front. The Federal Reserve has a new inflation strategy. In the past, record stimulus packages would have marked the beginning of a rate hike cycle, as the Fed has historically aimed to move ahead of a higher inflationary environment driven by low unemployment. In recent years, record low employment hasn't fueled higher inflation, so employment levels beyond estimates for "full employment" will no longer jumpstart the Fed into action.

FINANCIAL MARKETS

EQUITIES

U.S. equities continued their upward momentum in the third quarter, but stocks fell back from new peaks in September amid worries over increasing coronavirus cases in the U.S. and Europe ahead of the upcoming U.S. election. Still, the bounce back from the March lows remains impressive, as reflected in the following chart, with the S&P 500 index setting a new high on September 2nd. The Russell 2000 index of small cap companies, although positive for the third quarter, lagged the other major indices for both the quarter and year to date.

	Equity Returns*			
Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	8.93%	20.54%	-19.60%	5.57%
Dow	8.22%	18.51%	-22.73%	-0.91%
NASDAQ	11.02%	30.63%	-14.18%	24.46%
Russell 2000	4.93%	25.42%	-30.61%	-8.69%

*Total: price change + reinvested dividends

The third quarter showed an easing of volatility from its historic heights seen in the first quarter. Value companies, defined as companies whose shares trade at a low multiple of their book value or net worth, outpaced growth stocks for the month of September, as investors turned away from the fast growing technology companies that had long powered the markets higher. As soon as there is a whim of a broad-based economy in the making, investors scoop up shares in industries such as materials, industrials, transportation and utilities, any of which have been badly beaten down by the pandemic this year. While some analysts will say this shift simply reflects temporary profit taking of the expensive stocks and moving into those less expensive, others will say a trend could be starting, signaling a slowly mending economy. Whatever the reason for the shift taking place, we suggest caution with a concentration into the cyclical sectors. Although growth stocks may well be expensive from a statistical relationship with the overall market, these companies are, nevertheless, enjoying an increasing revenue base.

Information Technology stocks, which, as stated above, have been driving the broader markets of late, took a breather in September, but still ended the third quarter with a double-digit positive return behind only Consumer Discretionary, Materials and Industrials. Despite the challenging month, Technology was still the highest performer for the year to date, followed by Consumer Discretionary. Energy, the only negative sector for the quarter, continued to lag due to stubbornly flat oil prices, and has remained the worst performer for the year thus far. Financials ended the period with the only other double-digit negative return for the year to date, as banks have been struggling with loan losses and the low interest rate environment.

	S&P 500				
		Returns*			
Sector	**Weight**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	2.1%	-19.72%	30.51%	-50.45%	-48.09%
• Materials	2.6%	13.31%	26.01%	-26.14%	5.47%
• Industrials	8.3%	12.48%	17.01%	-27.05%	-3.99%
• Cons. Discretionary	11.6%	15.06%	32.86%	-19.29%	23.38%
• Consumer Staples	7.0%	10.38%	8.12%	-12.74%	4.13%
• Health Care	14.2%	5.87%	13.59%	-12.67%	5.01%
• Financials	9.7%	4.45%	12.20%	-31.92%	-20.22%
• Info Technology	28.2%	11.95%	30.53%	-11.93%	28.69%
• Commun. Svcs	10.8%	8.94%	20.04%	-16.95%	8.60%
• Utilities	3.0%	6.14%	2.73%	-13.50%	-5.68%
• Real Estate	2.6%	1.92%	13.22%	-19.21%	-6.78%

09/30/20
*Price + income
Source: S&P Dow Jones

As we conclude these remarks on equities, we again reiterate our position of maintaining a diversified portfolio of stocks that we believe will continue to safely reflect what is going on in the business community.

FIXED INCOME

The Federal Reserve announced a major policy shift on August 27th that will allow inflation to overshoot the two percent target that had been in place since 2012. Near zero interest rates are expected to remain for the next several years. This is a change to the Fed's historical tendency to lift interest rates to manage rising inflation brought on by a strong labor market. As markets stabilized and hiring picked up in the third quarter, inflation steadily rose. With this, real yields (nominal yields less inflation) fell into negative territory. The rise in inflation and increasingly negative real yields, coupled with low interest rates, pushed investors further out on the risk spectrum in search of income.

Our view is that moving too far down the quality spectrum could be problematic, given the uncertain outlook for industries more permanently affected by the pandemic. Most high-quality sectors generated modest positive gains in the quarter, with Treasuries gaining the least, as reflected in the chart below. Although not shown, high yield debt had a negative return and moved lower in tandem with the stock market on the lack of a second fiscal relief package and virus-related concerns. Also of note is the strong demand for credit on the part of corporations interested in shoring up their balance sheets as a defensive move to build cash and refinance outstanding obligations.

Fixed Income Returns

Index	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**YTD**
Corporate/Govt.	0.82%	3.57%	3.48%	8.06%
Int. Corporate/Govt.	0.67%	2.89%	2.12%	5.77%
Long Corporate/Govt.	1.20%	5.35%	7.24%	14.34%
U.S. Treasury	0.18%	0.21%	8.80%	9.22%
- Intermediate	0.19%	0.42%	5.26%	5.90%
- Long	0.17%	-0.44%	21.28%	20.95%
Corporate	1.69%	9.27%	-4.05%	6.62%
- Intermediate	1.49%	7.88%	-3.43%	5.73%
- Long	2.07%	12.04%	-5.29%	8.31%
- Quality				
- AAA	1.01%	4.72%	4.49%	10.52%
- AA	0.93%	5.85%	0.69%	7.56%
- A	1.32%	7.45%	-1.18%	7.58%
- BBB	2.14%	11.61%	-7.40%	5.57%
Municipal	1.19%	2.66%	-0.68%	3.18%
- Intermediate	0.94%	2.59%	-0.62%	2.91%
- Long	1.35%	2.70%	-0.72%	3.34%

Source: ICE BofA

Strong issuance also extended to the municipal market, which has been hamstrung by growing liabilities related to the pandemic fallout. Municipal debt issuance topped $40 billion during each month in the quarter. This is approximately 25% greater than it was over the same span a year earlier. As with the corporate side, risk was similarly rewarded with lower-rated bonds outpacing higher-quality paper.

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In conclusion, U.S. index averages finished September with a monthly decline despite positive economic news but ended the full quarter on a strong note. Manufacturing and services, new and existing home sales and jobless claims all reported positive numbers. Earnings and sales growth momentum also reported improvement over the second quarter. While considerable concern persists about the economy and, thus, business conditions, what is behind the scene arising from this concern is improved home product companies, from home appliances, heating and air conditioning and other basic consumer needs products. The oil sector continues to struggle, as this will be one of the last groups to pick up speed.

In summary, the highlights for the past quarter are as follows:

- The market gained 8.9% during the quarter, as measured by the S&P 500 Index, despite a 3.8% drop in September.
- Consumer Discretionary stocks performed the best, rising 15%.
- Large cap growth stocks led the quarter with large blend narrowly placing second.
- Global and emerging market indexes also fell in September.
- The Federal Reserve's policy shift towards greater flexibility was met with cautious optimism, as reflected by higher gold prices and a decline in the dollar of 2.7% from the start of the quarter.

Philadelphia Investment Management Group
105 Clarke Avenue
Pocomoke City, MD 21851