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FINANCIAL MANAGEMENT, INC.

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2020 Third Quarter Review: Still *Attempting a Return to Normal with COVID-19*

Executive Summary

- The recovery in the economy has been strong, although uneven. Spending on services is down and spending on goods exceeds the pre-pandemic level.
- The pace of recovery is and will continue to slow down, especially so with the resurgence of the pandemic.
- Optimism will spike with the introduction and completion of vaccination.
- The support via the Cares Act and the Federal Reserve was very successful. More fiscal support is likely needed prior to vaccination.
- Collectively, management of personal balance sheets has been very good and will help in getting through this pandemic.

Macro-Economic Perspective

With respect to the economy and the investment marketplace, we are well towards the top end of expectations we held at the end of the 1st quarter. To date, we are looking at a "V" shaped economic recovery. The goal of this letter is to review the economic recovery to date and make comparisons to the state of the economy prior to the pandemic.

First quarter real GDP decreased at a 5% annual rate. Revised second quarter real GDP decreased at an annual rate of 31.4%. Third quarter real GDP increased at an annual rate of 33.4%. This recoups two thirds of the ground lost in the 2nd quarter. Projections for the year now stand at a decline of 2.7%, an improvement over last month's estimate of a decline of 3.6% for the year and June's estimate of a decline of 7% for the year. **A return to the pre-pandemic level of economic output is projected for mid-2022. This outcome would indicate that the "V" shaped recovery would become more of a "Square Root sign" shaped recovery. Meaning gains from this point forward will come more slowly than what we have experienced in the 3rd quarter.**

The 3rd quarter also gives us an up to date look at the impact of the CARES Act ($2.1 Trillion Federal package) and the Federal Reserve Bank purchasing of assets and lending programs ($3 Trillion) as well as the return to work and consumption. The full economic effects of the COVID-19 pandemic cannot be quantified in the personal income and outlays estimate. But government social benefits and unemployment insurance payments declined $1.4T from 7/31/20 to the end of Q3, yet total personal income declined a much lower $0.33T. The savings rate at the end of Q2 was 25.7%, at the end of Q3 was 15.8% For some perspective, as a nation, we have been averaging a savings rate of 8%. **This indicates two take-aways: 1. The private sector more than made up for the reduction in government sector transfer payments after July 31st. 2. Collectively, consumers have an improved savings habit. In fact, personal debt levels have declined this year.**

With Covid-19 numbers accelerating, it is difficult to say what the shape of the recovery will be from this point forward. We are in a race against the clock to contain growth in COVID-19 cases and to receive the promising vaccines from Pfizer and Moderna. Vaccination of US citizens is estimated to be able to be completed by this coming Spring to mid-2021. **Will the market overlook the pandemic risks immediately in front of us with the hope of vaccination as it did with the prospects of massive fiscal and monetary stimulus action earlier in the year? So far, the answer to the question is yes**.

Besides the huge turn-around in real GDP growth, what evidence do we see in the recovery underway? We will try to make comparisons to the economic status attained in February of this year. **Forecasting the time to full**

recovery is very difficult and dependent upon COVID-19 containment (or lack thereof) and access to vaccines.

Employment: The unemployment rate and the number of unemployed in February was 3.5% and 5.8 million, it is now 6.9% and 11 million. By the end of April, 20 million jobs had been lost and the official unemployment rate was 14.7%. Since then, we have seen an improvement of about 14.7 million jobs. Accounting for under-employment and the employment participation rate, we need a 6.8% gain in jobs to achieve the level attained in February. Job openings are within 2% of the level achieved in February. **The estimated time to return to February 2020 employment levels is 12 to 18 months.**

Consumer spending (70% of GDP): Personal consumption expenditures (annualized) topped out in February at $14.88T. They bottomed out in April at $12.1T, a decline of 18.7%. For comparison purposes, the decline in personal consumption expenditures during the Great Financial Crisis was 3.9%. **As of September, personal consumption expenditures are within 2% of the February level at $14.58T.** This exceeds the level last experienced in June of 2019.

- The Institute of Supply Management (ISM) reading for service rose to 57.1 in June and has leveled off since to a reading of 56.6 in October from 41.8 in May. A reading of 50 is the dividing line between decline and growth. We are heading in the right direction. **Spending on services at Q3 end remains 6.3% below the February peak level.**
- **Spending of goods at Q3 end are 7.7% above the level reached in February with durable goods spending 15.6% above the February level.**

Manufacturing (11% of GDP): The ISM reading for manufacturing has steadily risen to 59.2 in October from 41.5 in May. **Manufacturing output (data recorded quarterly) at Q3 end has recovered significantly but remains 6% below the peak which was attained in Q4 2019.**

Construction (4.1% of GDP): This data is less volatile than other economic measures, but **total construction spending at Q3 end is 1.5% higher than the year ago level**. Residential spending is up 10.1% and non-residential spending is down 4.4%.

Home sales: New single-family home sales this year are up 30+% over 2019 levels. As of September, existing home sales are at the highest level since 2006! Supply stands at a meager 3.6 months. Six months is considered a balanced marketplace for buyer and sellers. Interest rates are quite helpful, and the Federal Reserve intends to keep them lower for longer. Building permits remain high. **This data bodes well for construction prospects and home prices**.

Securities Market Perspective

By the end of the 3rd quarter, a 100% stock portfolio with 20% invested in international was up approximately 0.7% with dividends reinvested. Intermediate term bonds were up 6.79% (Barclay's Aggregate Bond Index) and short-term bonds were up 2.68% (S&P Short Term Bond – Gov't/Corporate Index). The highlighted trends in manufacturing, construction and consumer spending have driven a considerable recovery in equities; even while investors continued to value the relative safety of fixed income.

Valuation discussion points:

- By the end of the 3rd quarter, as measured by price to book value, growth stocks were 128% above their long-term average of 4.83 (up from 115.7% at the end of the 2nd quarter). Value stocks were 2.3% below their long-term average of 2.18.
- By the end of the 3rd quarter, growth stocks were up 29.48% and value stocks were down 1.46%.

- Statistically speaking, the performance of growth stocks relative to value stocks over the last 14 years is now at a plus 4.5 standard deviation event. For perspective, one would expect this to happen once in 400 years.
- The market capitalization weighting of the worst performing industries (department stores, travel services, oil and gas equipment and services, resorts and casinos, hotel and motel, and the next 15 lower performing industries) have little impact on index returns. **The top five companies in the S&P 500 account for 25% of its capitalization.** These companies (Amazon, Apple, Microsoft, Facebook, and Google) enabled the S&P 500 Index to return to positive territory by the middle of July, meanwhile the rest of the remaining 495 companies still remain slightly in the red.
- Although, there appears to be a rotation beginning from growth investments into value investments. Beginning on July 10th, we noticed a trend towards higher returns for value investments as compared to growth. The trend is noticeably more prevalent in mid-cap stock and small cap stock asset classes. On 11/5/20, Pfizer released information regarding the strong success in phase 3 testing of their Covid-19 vaccine. At this point, the trend for greater return with value stocks gained steam and included large cap stocks as well. Will this trend continue? It is difficult to predict, but if the vaccine proves successful, it is likely the economic recovery will strengthen in traditional value-oriented industries. These are the sectors where performance and valuations have lagged with the stay at home economy this year.
- Low interest rates continue to validate higher valuations. 10-year Treasury is presently yielding about 0.9% (or 0.009). So, a company with a P/E ratio of 50 would have an earnings yield of 2% (or 0.02), exceeding the yield of the 10-year Treasury. Therefore, this hypothetical company could be considered reasonably valued on a relative basis. A company with a P/E ratio of 111 (1/111 = 0.009) would have an equivalent yield to the 10-year Treasury. For comparison, Amazon and Tesla have P/E ratios of 92 and 844, respectively.
- There is a saying, "you can't fight the FED (Federal Reserve Bank)", let alone the federal government. The Federal Reserve has many monetary levers at its disposal to carry out its mission of full employment and stable inflation. It is their mission to help the economy return to health. Many people credit the FED with aiding the longest bull market in history that ended in March at the hands of pandemic hysteria.

Valuation conclusions:

- The valuation of certain growth stocks is made more reasonable based upon their enormous success in this COVID-19 environment.
- Low interest rates continue to provide cover for higher valuations.
- Near term evidence points to a rotation into less expensive or lower valuation stocks with the prospect greater freedom of movement that would be possible through successful immunization.

Bonds:

- Yields on all types of bonds are being anchored at very low levels by Federal Reserve policy action of holding the Federal Funds rate at nearly 0% and monthly bond purchases. DBFM's investment committee is seeking additional avenues to enabling greater bond return and portfolio income in this low interest rate environment.
- With successful vaccination of America, the economy and interest rates will likely trend up. Avoidance of intermediate and long-term bonds will become the order of the day in the investing world. DBFM is positioned for such an environment.

We conclude this quarter's letter with an open question: will the pace of the pandemic be overlooked by the investing world with the promise of effective vaccines? We look forward to addressing this topic in the coming quarters.

Please be safe and stay healthy. We wish you and your families a happy Thanksgiving holiday.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

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