Cliff Notes – Early Hibernation

The 4th quarter has started with a bang, sending the bears running for early hibernation.

Low interest rates forever, gigantic stimulus now or later, less-worse-than-feared earnings reports – and Apple 5G phones and Amazon Prime Day coming soon had the market up nearly 4% last week, and another 2% today.

Cyclicals and value stocks faded again, as the FAANG stocks continue their complete global domination- and we comment on the market's current concentration.

Stimulus and Election risks remain, as we discuss below.

Weekly Index Returns & Commentary (ending 10.12.2020)

WEEK ENDING 10/9/2020 (CUMULATIVE TOTAL RETURNS)

Equities[1]		Week		YTD		1-Year	Close
S&P 500	▲	3.89%	▲	9.2%	▲	21.4%	3,477
DJIA	▲	3.31%	▲	2.0%	▲	11.1%	28,587
NASDAQ	▲	4.57%	▲	30.0%	▲	47.9%	11,580
Foreign Stocks	▲	2.98%	▼	-3.9%	▲	6.0%	
Emerging Markets	▲	3.78%	▲	2.9%	▲	16.0%	

Top Three S&P 500 Equity Sectors[1]		YTD
Information Technology	▲	32.5%
Consumer Discretionary	▲	28.7%
Communication Services	▲	10.6%

Bottom Three S&P 500 Equity Sectors[1]		YTD
Energy	▼	-46.7%
Financials	▼	-16.4%
Real Estate	▼	-2.5%

Bonds[2]		Week		YTD		1-Year	Yield
10-Yr. Treasury[3]	▼	-0.68%	▲	9.7%	▲	7.3%	0.79%
US Bonds	▼	-0.17%	▲	6.6%	▲	6.3%	1.21%
Global Bonds	▲	0.34%	▲	6.1%	▲	6.2%	0.91%
Munis[4]	▼	-0.33%	▲	2.9%	▲	2.9%	1.41%

Market Indicators[5]		As of
Fed Funds Target	0.25%	10/9/2020
Inflation (Core CPI)	1.70%	8/31/2020
Unemployment	7.90%	9/30/2020
GDP	-31.40%	6/30/2020

Weekly Major Asset Class Commentary

Global Equities

Markets climbed last week on hopes of an economic recovery despite near-term setbacks. In the US, equities stumbled mid-week when President Trump opted out of negotiations for further pre-election stimulus, but ultimately rallied on the prospects of an eventual package. The S&P 500 Index finished the week up 3.89%, and cyclical stocks notably outperformed their defensive counterparts by 45 bps.

Commodities

Oil prices jumped as markets turned risk-on and supplies were shut off. Hurricane Delta's approach limited output in the US Gulf, while a labor strike in Norway limited production in the North Sea, and Saudi Arabia considered production cuts. WTI and Brent crude prices finished the week up more than 9% at $40.60 per barrel and $42.85 per barrel, respectively.

Bonds

US Treasury yields rose across the curve last week on hopes of fiscal stimulus progress despite a brief mid-week pause. Bond prices fell as investors anticipated that a bill of the magnitude being discussed ($1.5-$2 trillion) would require increased issuance of US government debt. US 2-year and 10-year Treasury yields ended the week 2 bps and 8 bps higher, respectively.

FX

The US dollar index slipped last week, falling -0.81% as hopes for further fiscal stimulus measures saw investors moving away from the safe haven currency. In the UK, increasing Brexit pressure ahead of the upcoming October 15 deadline kept the pound range-bound against the USD, ending the week at $1.3037.

(Source: GS Weekly).

Market Commentary: Market Concentration

The stock market's strong performance since March has not been shared by all parts of the market. Some sectors, notable technology-driven ones, have fared better than those directly impacted by the pandemic and social distancing. What's more, the outsized contribution of tech stocks resulted in a brief period of volatility in September. It's understandable that this may feel "fragile", "unsustainable" or even "artificial" to some investors. How should long-term investors respond to these recent dynamics and the changing nature of the stock market?

There appear to be two separate but related issues that worry some investors. First, many are concerned by the outperformance of technology-driven stocks. The so-called FAANG stocks, along with other large tech companies and more recent IPOs, have significantly outperformed the rest of the stock market both this year and over the past decade.

Many of these companies have benefited from trends in digital transformation which have only accelerated during the COVID-19 pandemic. In many ways, the performance of these stocks reflects the economic success of the underlying companies. Unlike the dot com bubble of the late 1990s and early 2000s, many of these companies have profitable and proven business models. Although their valuation levels can certainly be debated, the performance of these stocks reflects the fast-changing nature of businesses and the economy.

As a result, it's also undeniable that the composition of major market indices has shifted over the past decade. The five largest stocks in the S&P 500 are Apple, Amazon, Microsoft, Alphabet (Google) and Facebook. Many sectors are driven by technology stocks including Information Technology, Communication Services and Consumer Discretionary. This trend has also influenced other market factors such as Growth stocks outperforming Value ones.

The stock market is reflecting the importance of technology companies and the evolution of what is considered a tech stock. For instance, the pandemic and shifting consumer habits have blurred the line between technology and retail. This is not to say that these stocks will outperform forever, and it's always the case that past performance is no guarantee of the future. However, the rise in these stocks is a reflection of how the economy looks today - a fact that benefits diversified investors. Investors ought to remain balanced across a variety of sectors and styles that are tied to trends in the underlying economy.

The second issue is that a small group of companies has had an outsized impact on the overall stock market. It's understandable that this feels untenable for some investors.

Perhaps the simplest way to see this is to compare the standard S&P 500 index, which places a weight on each stock based on its size or market capitalization, to one which gives an equal weight to each stock.

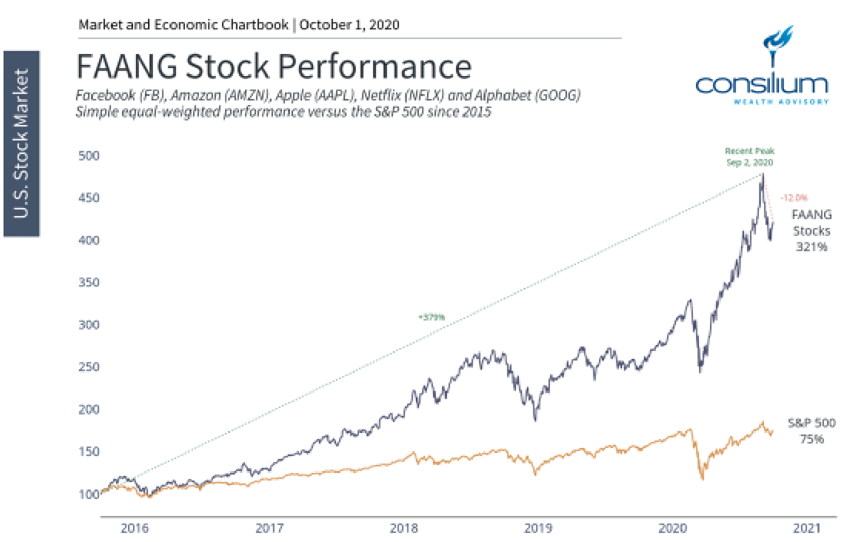
The theoretical reasons to use one over the other is beyond the scope of this discussion but suffice it to say there are good reasons for both. Using market cap weights provides a more accurate sense of the composition of the stock market - i.e. where the dollars are. Using equal weights helps investors to benefit from a broader base of companies.

Due to the outperformance of large tech stocks, the market cap-weighted S&P 500 has significantly outperformed its equal weight counterpart. This is even more pronounced when looking at only the largest 50 companies in the S&P 500. Over the past two years, the biggest companies have outperformed the overall index by a cumulative 10%.

But once again, this reflects the growing importance of these large companies to the economy and the world over the past decade. In fact, it's not the case that large companies necessarily dominate stock market returns. For much of the history of the stock market, the largest companies were often seen as the most boring (e.g. "blue chips") - perhaps serving as a source of stable dividends, but little more. Over the past 15 years, an equal weight index has actually outperformed the market cap-weighted one since it benefits from returns across a wider array of stocks.

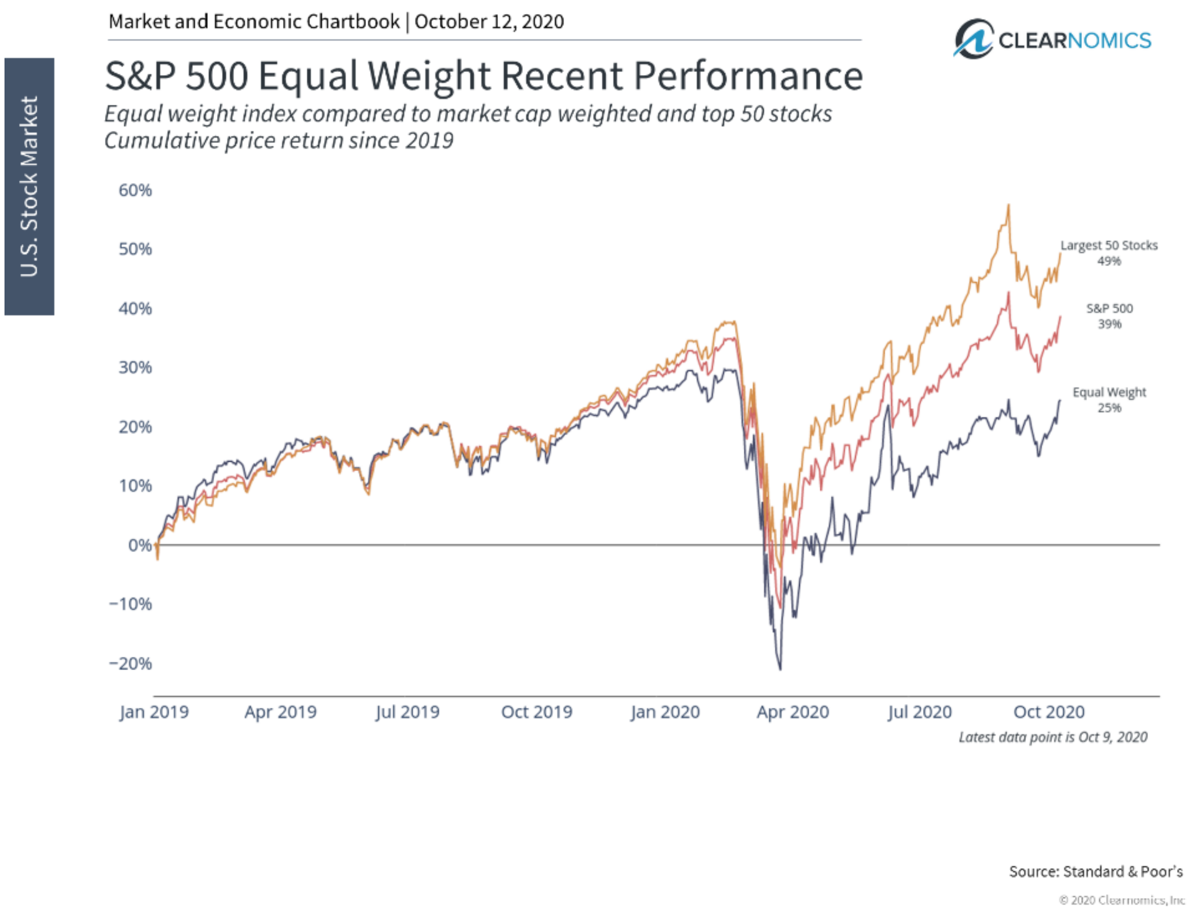
Thus, although mega cap companies have driven overall stock market returns recently, whether this will continue depends on the balance between tech trends and the importance of size/scale to companies. It's important for long-term investors to remain diversified across many parts of the market to benefit from these economic trends. Below are three charts that highlight the impact of tech stocks and market concentration.

1. Technology stocks have driven index returns recently



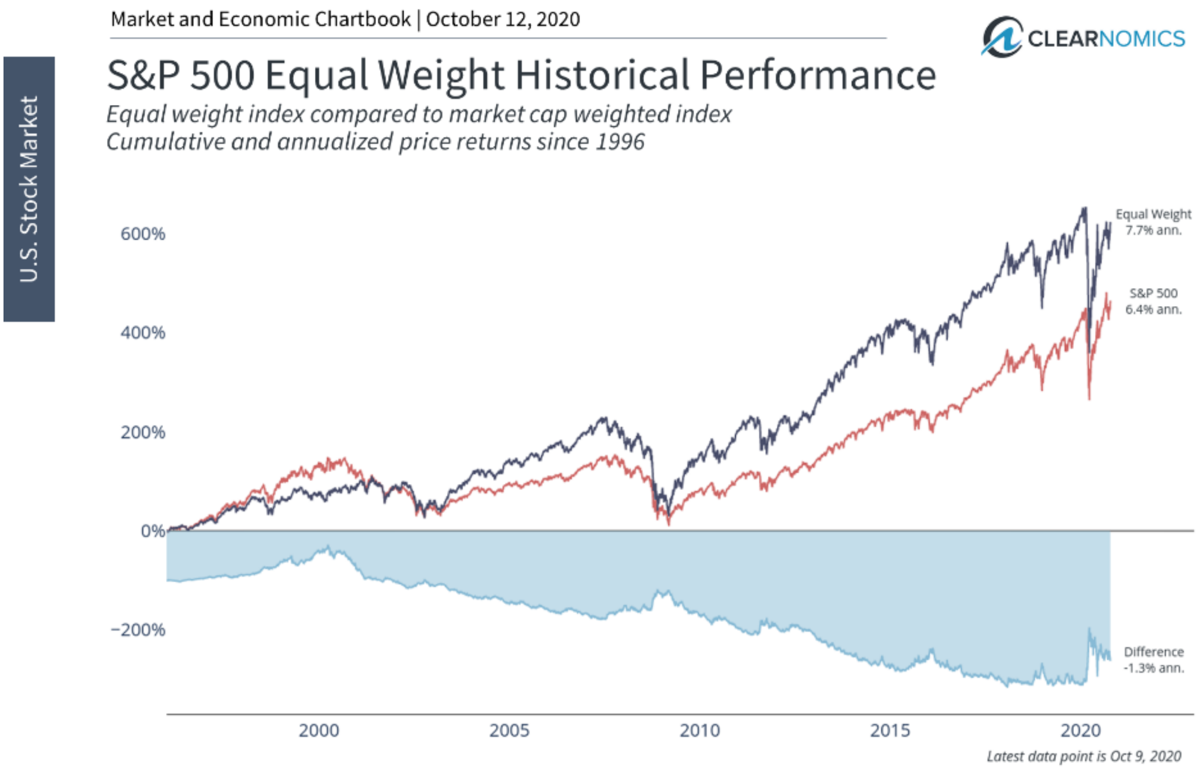
Technology stocks - both mega cap ones and recent IPOs - have helped to propel overall stock market returns this year and over the past decade. The so-called FAANG stocks have outperformed traditional tech-led sectors, which have in turn outperformed the overall stock market. These stocks reflect the fact that their companies have benefited from trends in digital transformation.

2. Overall market returns have been supported by the largest stocks



As a result, the stock market has been influenced by large technology stocks. An equal weight index of S&P 500 stocks has significantly underperformed the market cap-weighted and the top 50 stocks. This trend accelerated in 2020 due to the COVID-19 pandemic.

3. This is not always the case but reflects an evolving market and economy



However, many of these trends are the result of changes to businesses and the economy. It is not the case that large companies always have an out-sized impact on the overall stock market. Historically, an equal weight index has done well too. Thus, investors should continue to stay diversified among all parts of the market to benefit from on-going economic trends.

The bottom line? While some may be concerned by the impact of large tech stocks and the influence of the largest companies overall, long-term investors should remain disciplined and diversified to take advantage of all parts of the market.