

November 2, 2020

**BLUME CAPITAL MANAGEMENT**  
**Fourth Quarter Newsletter**

The global economy continued to recover and asset prices climbed in the third quarter as the world gradually opened from Covid-19 induced shutdowns. The S&P 500 rallied to a new all-time high at the end of August before reversing course and correcting 10% in the early part of September, a welcome development in a market that had become frothy and speculative. In the end, the S&P 500 returned 8.9% and is now up 6% for the year. However, the mega-cap, technology-heavy index continues to mask a tougher road for most companies as 280 of the 500 index stocks have declined year-to-date through September with the median stock losing 3.4%.

Foreign stock markets, with a lower weighting to technology companies, trailed U.S. equities despite a nearly 4% tailwind from a depreciating dollar (assets priced in foreign currencies appreciate when the dollar declines). The broader MSCI All-Country World Index Ex-U.S.<sup>1</sup> gained 6.8%, and emerging market equities, led by China which is a few months ahead in its recovery, outperformed with a 9.6% gain.

A somewhat surprising development in a quarter that saw significant equity gains and a recovering economy is that yields remained very low. The 10-year Treasury yield started the quarter at .66% and closed at .68%. The modest increase in yields (bond prices move inversely to yields) were a slight offset to an already paltry income stream and U.S. bonds generated a slightly positive return of 0.5%.

INDEX	Third Quarter <i>06/30/20 – 9/30/20</i>	Nine Months YTD <i>12/31/19 – 9/30/20</i>	Twelve Months <i>9/30/19 – 9/30/20</i>
S&P 500 Total Return <sup>2</sup>	8.9%	5.6%	15.2%
DJIA Total Return <sup>2</sup>	8.0%	0.7%	5.7%
MSCI All-Country World Index Ex-U.S. <sup>1,2</sup>	6.8%	-5.2%	3.5%
Barclays Int Agg. Bond Index	0.5%	5.2%	5.7%

**Market Perspective**

According to the legendary 20<sup>th</sup> century investor, Sir John Templeton, “Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.” In our view, the market ascent from 2009 to early 2020 never reached the euphoric phase. Alternatively, the bull market met an untimely death when faced with the economic shutdown imposed by the global pandemic, and investors then proceeded through the bear market emotions (denial, fear, panic, etc.) with unprecedented speed.

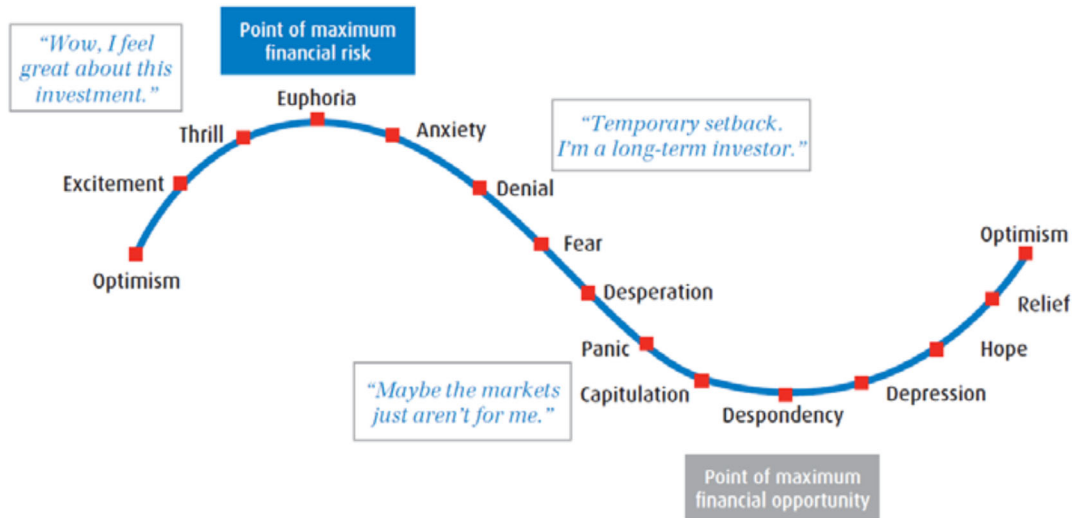
<sup>1</sup> The MSCI AC World Ex-U.S. index measures equity market performance in foreign developed and emerging markets excluding the U.S.

<sup>2</sup> Includes dividends in addition to price appreciation.

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## The Market Cycle of Emotions

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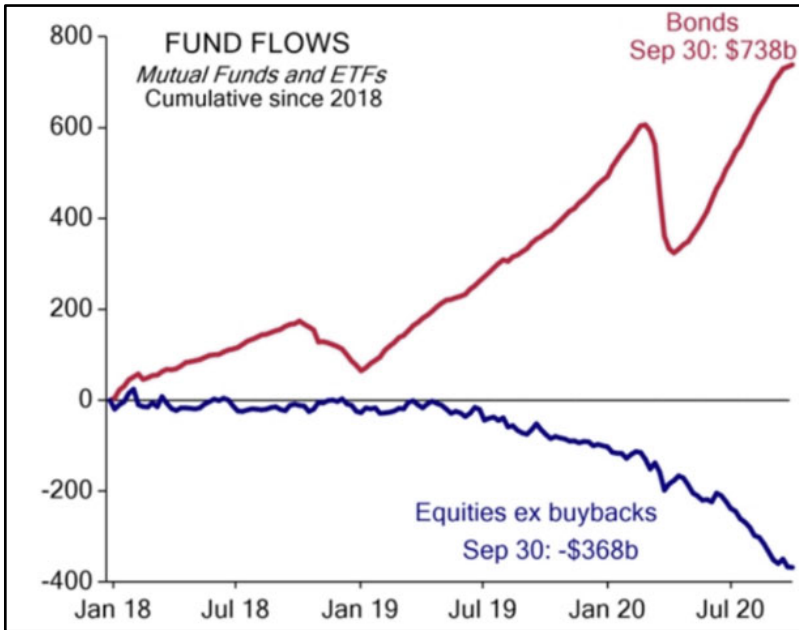


In response to the pandemic, global authorities unleashed the most massive and coordinated stimulus ever conceived. The bear market troughed after an unprecedentedly short ~35 days and has rallied back to all-time highs in record time. Indeed, in just a few months we experienced a full market cycle that typically unfolds over several years.

We explored some of the reasons behind the gains in last quarter's letter (record low interest rates below inflation, massive cash on the sidelines, lack of alternatives for investment funds, etc.), so we won't repeat those details. However, the speed and magnitude of the run has left many investors questioning whether we are back at the euphoric top of the curve and poised for yet another large decline.

Of course, it's impossible to say where we are in the market cycle with any certainty, but we don't see the traditional signs of a euphoric top. Outside pockets of speculative excess, investors generally remain cautious. They are positioned defensively, sitting on large amounts of cash, and, despite negative real interest rates (after accounting for inflation), continue to buy bonds and sell stocks. This is not the type of behavior you traditionally see around a stock market peak.

Investor Fund Flows (Jan. 2018 – Present): Bonds (red) vs. Equities (blue)

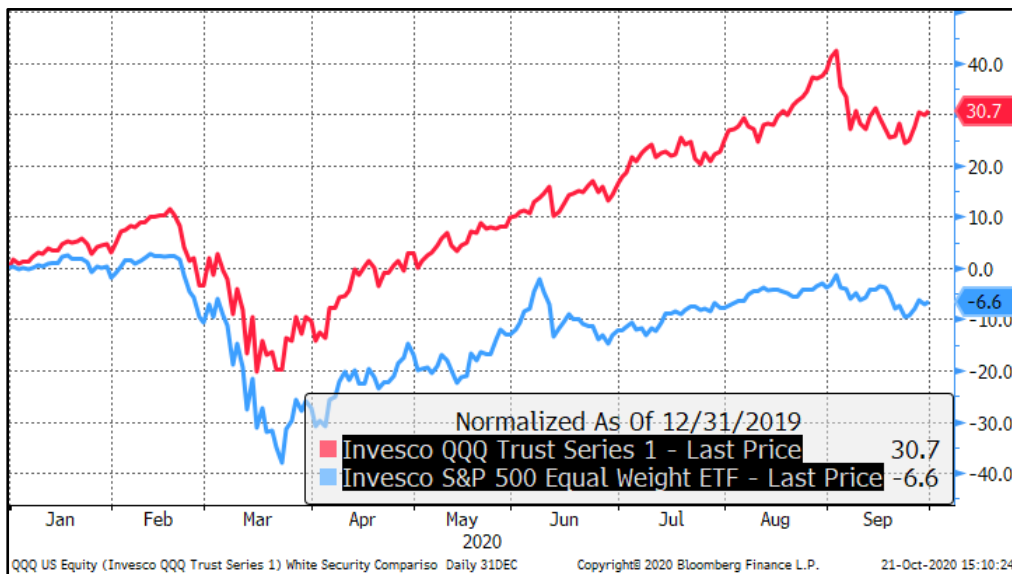


Source: Evercore ISI

While acknowledging the inherent risks of equity investing, we are nevertheless struck by the extreme crowding into low yielding bonds, which, from our perspective, provide an unattractive risk/reward proposition.

**At this point, what is far more noteworthy than the broader market direction is that Covid-19 has now created the most divergent stock market in history.** The chart below shows the year-to-date performance of the Nasdaq 100 (“QQQ”) versus the S&P 500 equal-weight index (“RSP”). In just nine months, the QQQ has outperformed by 37%, led by five mega-cap tech leaders (Apple, Microsoft, Amazon, Google, and Facebook) that make up nearly 50% of that index.

% Change of Nasdaq 100 QQQ ETF (red) vs. S&P 500 Equal-Weight RSP ETF (blue) (12/31/19 – 9/30/20)



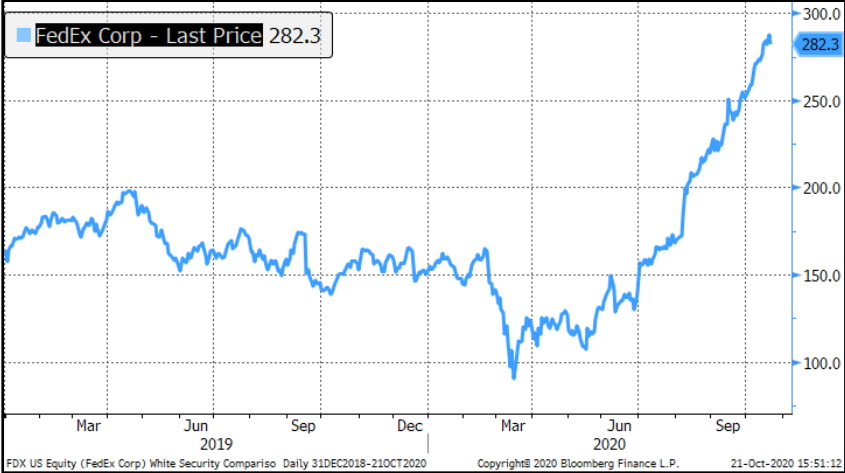
Source: Bloomberg

As we wrote in last quarter’s letter, these mega-cap tech stocks are now expensive, but understandably so in a world of low interest rates and anemic economic growth. Future returns will almost certainly be lower, but still superior to bonds. Consequently, we have modestly trimmed exposure to the sector, but we continue to hold significant positions.

On the other hand, companies that are more exposed to near-term economic headwinds remain very inexpensive as investors fear being exposed to a renewed downturn. We understand this concern. Nevertheless, with strong underlying businesses, many of these stocks present limited risk and offer a very attractive upside when the world normalizes.

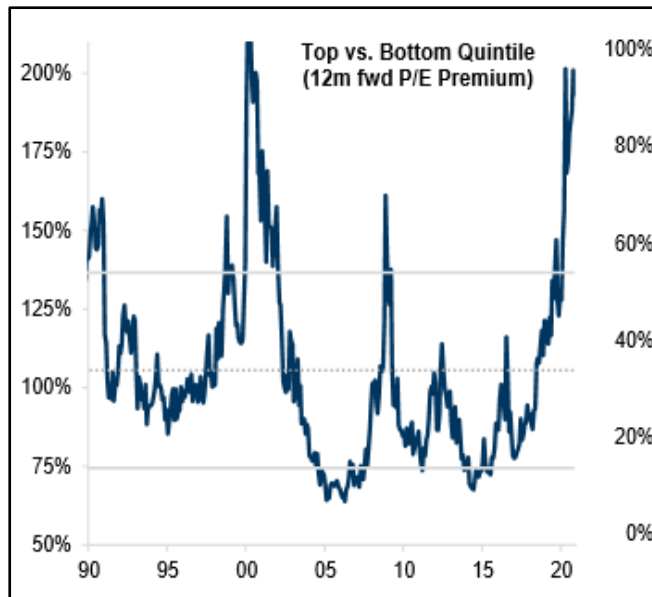
One example of such a stock purchased in client portfolios during the March selloff that has already rebounded sharply is Federal Express (see chart). Perceived as a cyclical company reliant on a healthy global economy to prosper, the stock fell nearly 50% in the March downturn before tripling off the bottom. In our view, the market was mispricing the stock as investors remained overly focused on the company’s near-term challenges despite the long-term secular growth opportunity in package and freight delivery.

Federal Express (“FDX”) 12/31/18 -- Present



Source: Bloomberg

Certainly, Federal Express has benefited from the acceleration in online shopping demand due to Covid-19, but there are numerous examples of strong businesses with highly attractive valuations. Indeed, while the S&P 500 is at an all-time high, 125 stocks, or one-quarter of the index, remain more than 30% off their peak. As shown in the chart below from Goldman Sachs, the premium now afforded to the most expensive stocks over the least expensive is now slightly below the all-time high witnessed in March of 2000.



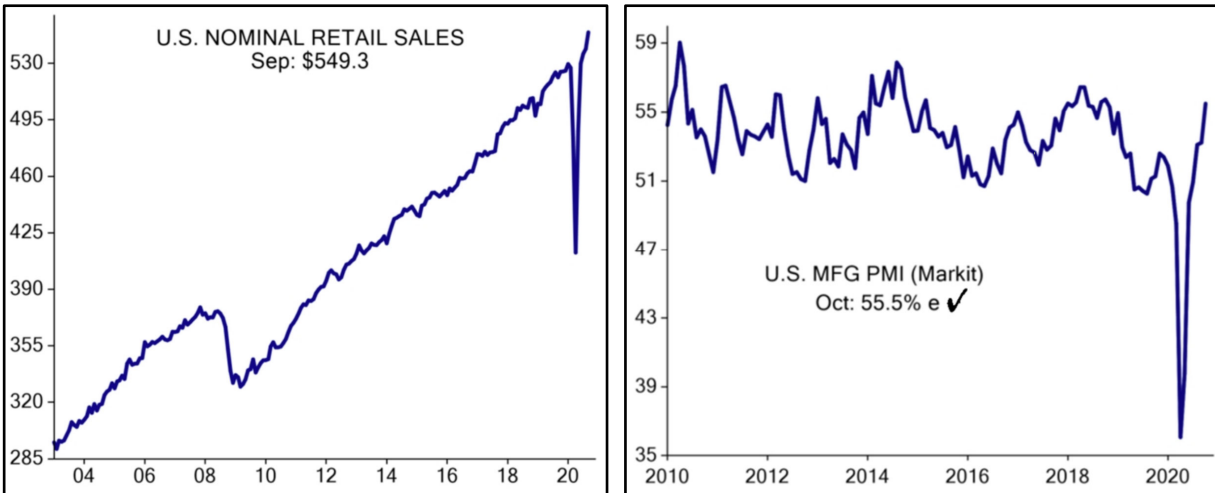
Source: Goldman Sachs

Given that large categories of stocks are trading in such a bifurcated manner, with the widest valuation disparities in history, we don't think it is very useful to think about a single "market" today.

## Outlook

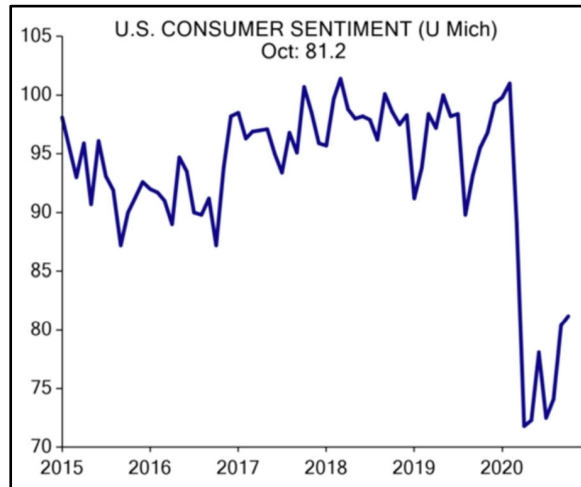
The shutdowns triggered by Covid-19 have left a deep economic hole, but, while it won't be officially determined by the National Bureau of Economic Research for some time yet, it's important to note that the recession likely ended several months ago. Moreover, the recovery to date is exceeding nearly all post-pandemic expectations.

A popular, and arguably overwrought, debate in the financial press has been how the recovery can be described in terms of a shape (as a letter or otherwise). While we believe that oversimplifies the discussion, the recovery in many sectors does in fact seem to be unfolding in a "V-shaped" pattern. As shown in the charts below, retail sales and the manufacturing PMI (Purchasing Managers Index) have recovered to exceed pre-Covid-19 levels. Home prices and consumer net worth have reached new all-time highs. After the unemployment rate spiked to 15%, it is now under 8%.



Source: Evercore ISI

On the other hand, large segments of our economy including travel, retail, restaurants, urban real estate, and state and local municipalities continue to languish. Many smaller businesses do not possess the financial resources to withstand an extended period of social distancing, and millions of lower-skilled jobs will be slow to return. Relative to the pre-Covid-19 era, this is the primary reason that consumer sentiment remains depressed (see chart) and why many describe the economic trends as “K-shaped”, with many doing very well while others struggle.



Source: Evercore ISI

It appears that we will be living with the pandemic for some time. Cases are rising again as winter approaches. Vaccine developments are promising, but, even if one or more are approved this year, they won't be widely distributed for several months. The massive stimulus enacted last spring to cushion the blow for struggling businesses and individuals expired in July, and politics is obstructing the passage of further aid before the election.

## The Election

As clients read this letter, the results of the election may already be known or should be clear shortly. Polls and betting odds suggest a Biden victory is highly probable, but, for investors, the balance of the Senate is likely to have a more significant impact.

Regardless of the outcome, we are likely to see further stimulus to support struggling segments of the economy. In the event of a Democratic “blue sweep”, that amount is likely to be substantially (trillions) higher. The increased spending would boost near-term growth but also likely be offset by higher taxes. As we noted in last quarter’s letter, we don’t expect the fundamental macro impact of the election to be overly significant, but we do anticipate that it will create winners and losers across different industries and segments of the population.

Notably of late, markets appear less concerned about the prospect of higher taxes in a “blue sweep” and have turned their focus towards the massive potential stimulus, which could provoke a rotation within markets. For investors, all else equal, higher spending would accelerate growth, boost inflation and interest rates, and put downward pressure on the U.S. dollar. Labeled the “reflation trade”, the combination of these forces could drive investors towards cyclical, value, and international stocks that benefit from higher nominal GDP growth.

In contrast, those same forces could be a headwind to fixed income (bonds) and the very popular tech and growth trade, which has benefited tremendously from the low growth and interest rate environment of the past several years. Furthermore, if the market anticipates higher capital gains rates, those same winners of recent years could see the most selling pressure as investors realize gains before rates go up.

Of course, it’s impossible to predict exactly how markets will respond to the election near term (as evidenced by 2016). The scenario investors seem to fear the most is the absence of a clear outcome or a contested election, which could incite significant volatility. With the cost of insurance against a stock market decline around the election reflecting significant concern though, perhaps any definitive outcome could result in a relief rally as the overhang of uncertainty is removed.

Every day that passes brings us closer to the end of the pandemic. Assuming we get additional stimulus following the election, that should be sufficient to support the economy until a vaccine is widely available and a self-sustaining expansion can take hold. With the Federal Reserve backstopping the stimulus spending/borrowing with the most expansionary policy in history and explicitly targeting higher inflation, the economic recovery is likely to continue, and we believe that we’ll eventually see significant outperformance from the “reflation trade”.

Since its inception 27 years ago, our business has grown almost exclusively by referrals from existing clients. This has allowed us to focus our time and energy on investments, financial planning and serving our client’s needs. We continue to believe in this approach and always appreciate any referrals that you choose to make.

As always, please reach out if you have any questions or concerns. We appreciate your continued trust.

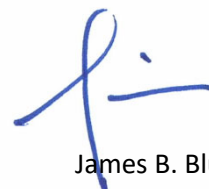
Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire



James B. Blume

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