CURBSTONE FINANCIAL
MANAGEMENT CORPORATION

From the Curb

Letter to Clients
Quarter Ending September 30, 2020

2020 continues to be one of the most unpredictable years in recent memory. Despite a resurgence in coronavirus cases, markets rallied to new all-time highs in the third quarter before declining moderately in late September. The rally was fueled by a combination of accommodative Fed policy, hopes for a COVID-19 vaccine and a stronger-than-expected economic rebound.

The third quarter began with a resurgence of coronavirus cases in the United States, as new daily cases of COVID-19 smashed through levels seen in March and April, eventually topping out at a record 78,871 new cases on July 24th. But unlike March and April, stocks did not decline following the spike, as state governments enacted more surgical economic shutdowns instead of the wholesale lockdowns that occurred in the first half of the year. That change in strategy, combined with the fact that hospitalization rates and mortality rates of COVID-19 remained far below previous levels, helped the stock market look past the increase in cases, and the S&P500 rose 5.51% in July.

The rally continued in August, aided by the peak and subsequent decline of coronavirus cases in some of the largest U.S. states (California, Florida, and Texas). Additionally, despite the expiration of the CARES Act, U.S. economic data continued to improve throughout the month, powering stocks higher. Finally, in late August the Federal Reserve formally announced the adoption of an "average inflation target," which effectively signaled the Fed would tolerate higher inflation in the economy more so than in recent history. That policy shift is a potentially longer-term bullish event for stocks as returns are positively correlated to higher inflation. Led by gains in the tech sector, the S&P500 hit a new all-time high in mid-August and finished the month up 7.01% and in solidly positive territory on a year-to-date basis.

The final month of the third quarter, however, provided a reminder that the macro-economic outlook remains uncertain and markets can still quickly become volatile. The tech rally in August was so relentless that it elicited comparisons by the media to the tech bubble of the 2000s. Apple, Tesla, Nvidia, Salesforce and Microsoft are a few of the names whose strong returns dwarfed all other components of the major cap-weighted indices. Their impact is most obvious when you compare the year-to-date cap-weighted return of the S&P500 (5.57%) to the equal weighted S&P500 (-4.75%) and the cap-weighted, tech heavy, Nasdaq Composite (24.46%). The pace of the gains in the tech sector were simply not sustainable and, in the first few days of September, the tech rally became exhausted, the Nasdaq peaked, and stocks began a correction process that would last for most of the month.

While buyer exhaustion was a catalyst for the initial decline there were also some incrementally negative events in September that weighed on stocks. First, it became evident that there would be no new economic stimulus bill in September, as both Democrats and Republicans remained far apart in negotiations. Second, economic data began to imply a "plateau" in the economic recovery. Finally, late in the month, coronavirus cases surged in Europe and began to move higher again in certain U.S. states, prompting some concern about a return to various levels of economic lockdown in Europe and the U.S. The S&P500 declined modestly in September, -3.8%, but remained solidly positive for the third quarter.

Markets and the economy have staged a historic rebound since the late March lows, and while we all welcome this impressive comeback, we enter the final quarter of the year keenly aware that some of the biggest unknowns for the markets and the economy will be resolved positively or negatively in the next three months.

Starting with the obvious, November 3rd is Election Day, and apropos for 2020 this election will be one of the most closely watched in our lifetimes. Beyond the most important question, "Who will win the Presidency?" markets are also focused on whether the Democrats will be able to take control of the Senate. If so, and Biden wins the Presidency, Democrats would control both the legislative and executive branches of government, a scenario dubbed the "Blue Wave" by the media. Such a scenario would result in the increased potential for policy changes which would likely create short-term market volatility.

However, any near-term volatility associated with a Blue Wave would likely be small compared to the worst-case scenario for the election, namely that there is no clear winner by the end of Election Day and the election becomes contested which would result in the entire country being dragged through a similar episode of Bush vs. Gore in the early 2000s. In that outcome, we should expect significant short-term market volatility until a winner is declared, potentially as late as mid-December.

Additionally, the election is not the only source of potential uncertainty and volatility coming in the next three months. Hopes for a COVID-19 vaccine have helped stocks rally to current levels, and there are now three separate vaccines undergoing final Phase III trials. Those trials will likely reach their conclusion in the coming weeks, perhaps before the election. If those trials fail to produce a viable vaccine candidate, that will also create volatility as markets are expecting widespread COVID-19 vaccine distribution by early to mid-2021.

Finally, by the end of the fourth quarter, investors will learn the fate of the stimulus bill currently stuck in Congress. There's near-universal agreement the economy could use more stimulus, but the politics of the election, combined with Republican and Democrat differences about how much money should be spent and where that money should go, have prevented a bill from being passed. Markets expect action by year-end, and if that fails to materialize, it will create more volatility.

Bottom line, the resiliency of the U.S. economy and markets is encouraging, as the economic and market recovery from the worst pandemic in 100 years has been nothing short of extraordinary. Our experience has taught us not to be complacent and we continue to focus on the quality of the companies held in your asset base. We believe that the resolution of several of the uncertainties weighing on the stock market will bring the clarity that investors are looking for. While short-term volatility might reappear between now and year-end, the markets in 2020 have once again demonstrated that a long-term approach combined with a well-designed and well-executed investment strategy can overcome periods of elevated volatility, market corrections, bear markets and even global pandemics.

Therefore, it's critical for you to stay invested, remain patient, and stick to the plan. We've worked with you to establish a unique, personal asset allocation target based on your financial position, risk tolerance, and investment timeline. Please reach out with any question regarding the enclosed reports or any other questions you have regarding the management of your assets.

Finally, we thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

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