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Market Outlook & Strategy

Third Quarter of 2020

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Executive Summary

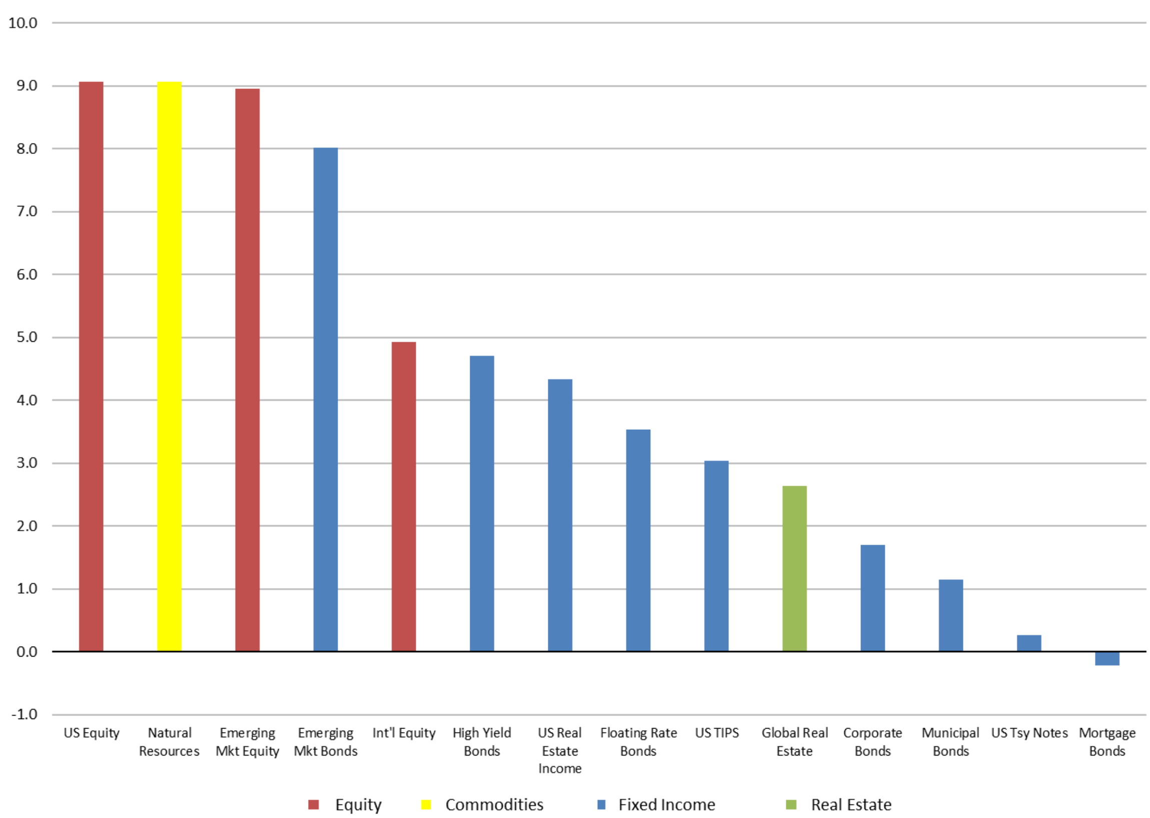
- Equity markets continued their march upward in Q3, supported by more signs of economic recovery and loose monetary policy. The leaders were emerging markets and the U.S. market, both rising about +9% during the quarter.

- U.S. equities were buoyed by fairly good economic data. The unemployment rate dropped to 8.4% in August, down from 10.2% in July and below consensus expectations of 9.8%. Industrial production also rose for the fourth consecutive month, as did retail sales. In addition, the Federal Reserve announced a new inflation-targeting policy, which had the effect of demonstrating to investors how accommodative the Fed is going to be until the economy fully recovers.
- Developed markets outside of the U.S. did not fare as well. European markets slowed due to sharply rising covid-19 infections in many European countries, leading to the re-imposition of localized restrictions. Japan had a better quarter, recording a total return of +5.2%. In total, the international stock index gained +4.9%.
- In terms of fixed income, U.S. Treasuries were flat, with the 10-year yield ending the quarter at 0.68%, only three basis points higher than at the start of the quarter. Corporate bonds had a better run (+1.7% for investment grade), as riskier assets were broadly buoyant and monetary policy helped anchor yields at low levels.
- As for alternatives, commodities, (as measured by the Bloomberg Commodity Index), delivered a return of +9.1%, due to rising precious metal prices. Global real estate continued to struggle, increasing by only +2.6%.
- This quarter we focus on “Bidenomics” and what a Biden presidency might mean for the overall economy and the stock market. We look at a handful of studies from both right- and left-leaning organizations that have analyzed the Biden economic platform. Most studies conclude that, as a whole, the long-term impacts are largely positive for growth.
- In the near term, our view is that we may even see a ‘mini-boom’ in 2021 as Biden is committed to passing a large stimulus bill (although he will need a decent lead in the Senate to get one.) Regardless, a stimulus bill should be forthcoming shortly after the electoral season hence, as usual, we plan to stay fully invested.
- *Artemis Strategy*. Apart from rebalancing a bit in July, we did not tinker with the portfolios much this quarter as we continue to be happy with the pivots we made to all portfolios in May.

Q3 in Review

Equity markets continued their march upward in Q3, supported by more signs of economic recovery and very loose monetary policy. For the first time in a while, emerging markets matched U.S. market returns, both rising about +9% during the quarter. (See Figure 1.) In emerging markets, Taiwan, South Korea, and China led the way, as manufacturing activity in these countries returned to pre-covid-19 levels.

Figure 1. Asset Class Index Returns in Q3 2020



The U.S. equity market was supported by fairly good economic data. In particular, the unemployment rate dropped to 8.4% in August, down from 10.2% in July and below consensus expectations of 9.8%. (The latest reading for September is 7.9%.) Industrial production also rose for the fourth consecutive month, as did retail sales, although both rose at a slower rate than earlier in the summer. In addition, homes sales were robust, as were auto sales, and inflation was muted at +0.4% YoY. Finally, the Federal Reserve announced a new inflation-targeting policy, which had the effect of demonstrating to investors how accommodative the Fed is going to be until the economy fully recovers.

The market was also underpinned by investors' continued optimism that a second fiscal stimulus package would be passed, although timing became uncertain by the end of the quarter. In terms of style, large capitalization growth stocks continued their outperformance during the quarter, but we did begin to see a bit of a rotation toward value and smaller stocks in September.

In contrast, European markets did not fare as well, with Eurozone equities virtually flat over the quarter. The main problem was sharply rising covid-19 infections in many European countries, most notably in Spain and France, leading to the re-imposition of localized restrictions. Japan had a better quarter, recording a total return of +5.2%. In total, the international stock index gained +4.9%.

In terms of fixed income, U.S. Treasuries were flat, with the 10-year yield ending the quarter at 0.68%, only three basis points higher than at the start of the quarter. Corporate bonds had a better run, as riskier assets were broadly buoyant and monetary policy helped anchor yields at low levels. Investment-grade corporates returned 2.0%, while high-yield debt returned 4.7%.

As for alternatives, commodities, (as measured by the Bloomberg Commodity Index), delivered a return of +9.1%, due to rising precious metal prices (silver in particular). A weakening dollar during the quarter also helped. Finally, global real estate continued to struggle, increasing by only +2.6%. See Figure 1 again.

What are the investment implications of a Biden Presidency?

The debate on September 29th, Trump's illness and his chaotic behavior since, have increased the odds by a lot of a Biden becoming our next President. While some of you might think talk of a Biden victory is premature given what happened at our last election, in my view, the sheer size and steadiness of Biden's lead in the polls suggest that it is time to begin to study what a Biden presidency might mean to the economy and to your investment portfolio.

The conventional wisdom is that a Biden presidency would have a negative impact on the stock market because he has stated a desire to raise the corporate tax rate, institute a $15 minimum wage and increase regulation, all of which can weigh on corporate profitability. In addition, he would raise income tax rates on mostly wealthy individuals +$400k in income). Indeed, just a few days ago, the very conservative Hoover Institute of Stanford University came out with a study that concludes that the overall Biden platform (at least the parts they quantified) would reduce real GDP per capita by more than 8% by 2030.[1] However, other studies show just the opposite (to be discussed below).

But before we go further, let's take a look at the Biden platform. Specifically, Biden's tax platform includes:

- Increasing the corporate tax rate from 21% to 28% (Trump lowered the rate to 21% from 35% in 2018).
- Raising the minimum wage to $15 per hour.
- Doubling the global minimum tax on offshore profits from 10.5% to 21%.
- Imposing a minimum tax on corporate book income in excess of $100 million.
- Repealing the 2017 tax reform (Tax Cuts and Jobs Act – TCJA) components for high-income filers; e.g., for individuals and couples earning over $1.0 million and taxing capital gains and dividends as ordinary income, increasing the rate from 20% to 39.6%.
- Imposing a 12.4% Social Security payroll tax and increasing the ordinary income tax bracket to 39.6% for household and individual income above $400k.
- Restoring the Pease limitation on itemized deductions for taxable incomes about $400k and also phasing out the qualified business income deductions for this same group.
- Eliminating the step-up in basis for all and eliminating 1031 exchanges for taxpayers with annual income over $400k.
- Reducing the exclusion amount for estate and gift taxes, from $11.58 million to the pre-2017 tax reform level of $5.79 million
- Eliminating the tax deduction for contributions to IRAs, 401(k)s, 403(b)s and other pre-tax accounts, and replacing it with a new credit equal to a specified percentage

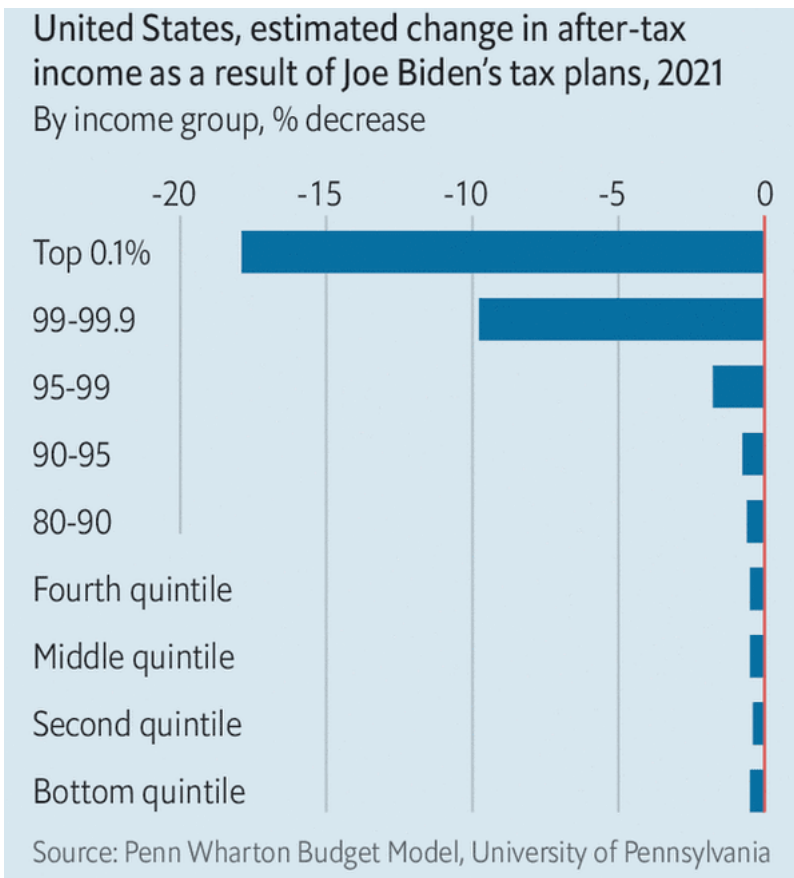
[1] Fitzgerald, Timothy, Kevin Hassett, Cody Kallen, and Casey B. Mulligan. "An Analysis of Vice President Biden's Economic Agenda: The Long Run Impacts of Its Regulation, Taxes, and Spending." Hoover Institution Study. October 2020.

of the amount contributed to the pre-tax account. (Current estimate is that the percentage will be 26%.)

- Expanding a variety of tax credits for child and dependent care, low-income housing, and first-time homebuyers.

By one estimate, the reduction in corporate profitability and tax increases could lead to an average decrease in after-tax income of -17.7% for those with adjusted gross incomes above $400k. For those earning less than $400k, while they would not see their taxes increase directly, they would experience modestly lower investment returns and slightly lower wages (as corporations try to pass on some of their tax increase), leading to an average decrease in after-tax income of -0.9%. (See Figure 2.)

Figure 2. Biden's Tax Plan by Income Group



But this is not the end of the story by far because the Biden plan also proposes spending all of this tax windfall and more on a range of priorities that could generate positive returns to the economy and certain segments of the population.

Specifically, Biden's spending plan includes investments in five key areas:

- **Education**: Universal pre-K; expanded funding for Title 1 schools; two year of debtless college; free public college for students from low-income families.
- **Infrastructure and R&D**: New investments in water and "green" infrastructure including high-speed rail; clean energy R&D and"breakthrough" technology R&D (e.g., 5G and artificial intelligence).
- **Housing**: Section 8 housing to all who qualify; expanding the low-income housing tax credit; other programs to support low-income housing.
- **Social Security**: Closing the dual-earner, single-earner gap; increase the Special Minimum Benefit and its growth rate; provide a uniform increase to beneficiary's primary insurance amounts; switch the cost of living adjustment from the CPI to the CPI-Elderly.
- **Healthcare**: Lowering the Medicare eligibility age from 65 to 60 years old; expand the Affordable Care Act (ACA) insurance marketplaces; expand long-term elder care; allow Medicare to negotiate drug prices and allow consumers to import drugs from abroad.

As shown in Figure 3 (next page), the net effect of Biden's overall revenue and spending plans over the next 10 years is a net increase in the primary deficit of $1.975 trillion, according to the Penn-Wharton Budget Model. Taking account of everything, including the multiplier effect of additional spending, and the tax increases, the Penn-Wharton analysis concludes that the Biden platform as a whole decreases GDP by 0.4% in 2030. But they also find that by 2050, the Biden platform would decrease the federal debt by 6.1% and increase GDP by 0.8% relative to current law. Another model by researchers at the conservative-leaning American Enterprise Institute analyze Biden's tax plan and conclude that it alone (i.e., without any spending increases), would reduce GDP by only 0.16% over the next decade.[2]

Figure 3. Overall Revenue and Spending Effects of the Biden Platform, 2021-2030

Spending/Revenue Category	Billions of $
Total Tax	***3,375.4***
Corporate	1,438.5
Payroll	992.8
Individual Income	944.0
Total Spending	***5,370.0***
Education	1,929.5
Infrastructure and R&D	1,600.8
Housing	650.0
Social Security Benefits	290.7
Healthcare - Prescription Drugs	-1,253.0
Healthcare - Other New Spending	1,605.0
Paid Leave*	547.0

Source: Penn-Wharton Budget Model

Other researchers make the point that irrespective of any long-term consequences, a Biden presidency is more likely to be positive for the economy and the stock market in the short-run because he is much more likely to pass a large stimulus bill shortly after his inauguration and might phase in the tax increases over time to allow more recovery from covid-19. Goldman Sachs, for example, concludes that a robust stimulus would add nearly one percentage point to the annual growth rate during a first Biden term and that by 2024,

[2] For more on these results, see Penn-Wharton, "PWBM Analysis of the Biden Platform." September 25, 2020 and Pomerleau, Kyle and Grant M. Seiter. "An Analysis of Joe Biden's Tax Proposals." American Enterprise Institute. October 2020 Update.

enactment of Biden's full proposed tax and spending policies would cut just 4% off of estimated earnings for the S&P 500 compared with baseline estimates.[3]

In summary, most studies are concluding that Bidenomics may actually be good (or not have much quantifiable impact) on the economy. One of the only studies to disagree (Hoover Institute) argues that the main problem with the Biden tax plan is that the private sector's incentive to invest will decline due to the increased taxes on capital. Yet, we know from very recent experience that Trump's corporate tax cuts in 2017 and his easing of business regulations did little to stimulate corporate investment (most of the money went to share buybacks instead) and little to accelerate growth (the US economy grew at a 2.4% annual rate in the eight quarters before the 2017 TCJA act passed and at 2.5% annual rate in the eight quarters after it passed). Most of these other studies at least recognize this fact, leading them to conclude that Biden's tax proposals alone are not projected to affect the overall trajectory of the U.S. economy by much.

The real action is more on how much of Biden's spending plan and his other policies get enacted, many of which are harder to quantify. For example, his plan to increase spending on the nation's infrastructure is likely to boost business competitiveness and productivity. His paid family leave and elder care plans would likely increase labor force participation. In addition, increased global trade and foreign immigration would likelyincrease the size of the workforce, as would his proposal for a national pre-K program for all children ages three and four. Such boosts to long-term growth are likely to more than offset the economic costs stemming from higher taxes.

Investment Implications

One might point out that all of these conclusions are based on models versus reality and, moreover, that nobody really knows which planks of the Biden platform will actually get implemented. In the meantime, what might a Biden presidency mean for the stock market in the near term? My view is that a Biden presidency will be positive overall for the stock market in the near-term. Much of this is due to the belief that he will act soon to launch another sizable stimulus package, will likely delay or phase-in some of the tax hikes, and will

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[3] There is no shortage of studies coming out on Bidenomics and Trumpenomics. Here are a few more for you. Zandi, Mark and Bernard Yaros. "The Macroeconomic Consequences: Trump vs. Biden." Moody Analytics. September 23, 2020. Houton, Nancy Vanden and Gregory Daco, "How Bidenomics Could Boost the Economy." Oxford Economics Research Briefing, September 24, 2020. Watson, Garrett, Huaqun Li and Taylor LaJoie. "Details and Analysis of Democratic Presidential Nominee Biden's Tax Proposals, Septembers 2020 Update.

implement a cohesive national strategy to mitigate the continued negative impacts of covid-19 (e.g., a national mask mandate). Moreover, he has already been told he will get all the help he can from the Federal Reserve via continued low interest rates.

If the above actually happens, we may well start to see a market rotation away from growth and technology stocks into value stocks, as the recovery broadens out. The same is true for smaller-capitalization stocks. (Indeed, recent market behavior suggests that more money is moving in this direction already.)

As to which sectors benefit, this will depend on which proposals get implemented. For example, opportunities will arise in the materials sector if a sizable infrastructure bill passes and higher minimum wages will help the consumer discretionary sector. Other more obvious winners are clean energy stocks if Biden succeeds with his environmental proposals and healthcare if he exceeds in expanding insurance coverage.

Sectors that aren't expected to do well include pharmaceuticals (due to presumed lower drug prices), fossil fuel industries, the defense industry (as increasing global arms deals takes a back seat), and, more generally, industries that utilize a large number of minimum wage earners.

Will technology suffer under Biden? Unlike some of the other Democratic contenders this year, Biden's general stance on the increasing power of the country's technology giants seems unclear to me and his running mate Kamala Harris is not known for beating the antitrust drum. At a minimum though, such companies will likely pay more taxes, especially if the global iminium tax on offshore profits doubles as proposed, and a global transaction tax is implemented, but such companies can easily withstand a tax increase without denting their investment plans.

As usual, irrespective of who wins the election, we will be carefully studying national policy developments and making changes to the portfolios as we see opportunities arise. Personally, I think it is going to be a very interesting 2021 in the markets and look forward to participating.

Artemis Portfolio Strategy

As noted in my introductions, we did very little with the portfolios this quarter. In early July, we sold some equity to rebalance portfolios back closer to their targets as the rapid runup in Q2 had pushed some U.S. equity targets out of the range. Later in the quarter, we announced that we were going to start swapping out conventional funds for their ESG equivalents in most client retirement portfolios due to their superior performance. We expect to complete this process in another month or so.

We did little with the portfolios because we like how they are performing currently and, as usual, plan to stay fully invested through the election cycle. My view is that while the market is currently a bit ‘toppy’ with a P/E ratio of almost 21.5, the fundamental underpinnings of the stock market are solid and there are very few signs of any sort of bubble. Moreover, as mentioned before, the economic data is coming in better than expected. In addition to the fast-dropping unemployment rate, both the manufacturing and services PMI indices are in expansion territory, auto and home sales are exploding, and Americans are starting new businesses at the fastest rate in a decade.

Much of this progress is due to the unprecedented amount of money Congress injected into the economy with the CARES Act. Given that covid-19 is still with us and because we don’t yet have a vaccine, we can expect progress to slow if we don’t see another stimulus package. Indeed, Fed Chair Jerome Powell is practically begging Congress to pass another bill, arguing that without one, there will likely be “tragic” consequences. We’ll know soon.

Don’t forget to vote.

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **S&P Global REIT Index** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.