MIDWEST CAPITAL ADVISORS™

October 9, 2020

To Our Clients and Friends:

We are pleased to bring you our report for the third quarter of 2020.

Despite September's -3.8% return for the S&P 500 Index, the markets had a good quarter. The S&P 500 Index gained 8.93% (this is on top of the 22%+ it returned during the second quarter) and is now up 5.57% for the year (more on how this return was achieved, and the risks that poses, below)[1]. International markets continued to struggle: While the MSCI World ex-USA Index (gross dividends) gained 5.01% during the quarter, it is still down —6.75% for the year[2]. It was no surprise that the technology-heavy NASDAQ Composite Index was up, although the sheer magnitude of the gains is breathtaking[3]. The Bloomberg Barclays U.S. Aggregate Bond Index was down ever so slightly in September but was up 0.62% for the quarter, on top of the 2.91% it gained during the second quarter. It is now up 6.79% for the year[4].

In addition to the topics on which we usually offer some perspective, being that we are now less than four weeks from the presidential election, we will reserve some space at the end of this letter for some perspective on that as well.

<u>The Markets</u>. Many continue to question how U.S. equity markets can continue to show strong gains in spite of the fact our economy is in recession. First, remember that markets are forward-looking, and the economy is backward-looking (we touched on this last quarter). Second, the ability of many key sectors of the economy such as health care, technology and consumer staples to ride out the pandemic relatively unscathed is contributing to the market's resilience[5].

This year the market-cap-weighted S&P 500 Index has made most of its gains due to market concentration. To illustrate, as of September 9, the five largest publicly traded companies in the world, measured by market cap, are Facebook, Apple, Amazon, Microsoft and Alphabet (Google)[6]. When the S&P 500 Index's performance is fueled by companies that represent only 1% (in number) of the companies in the Index (and have many similarities to each other) the market lacks the breadth that is more indicative of a healthy and well-rounded economy. The risk of course is that when these big names lose their momentum[7], the Index as a whole is more

[1] As with our last letter, we feel it is important to point out to long-term investors, that, despite the horrendous 2nd quarter of 2020, the S&P 500 Index has returned in the last 1-, 3- and 5-year periods 15.15%, 12.28% (annualized) and 14.15% (annualized), respectively. Source: Dimensional Fund Advisors.

[2] Its 1-, 3- and 5-year performance of 0.63%, 1.14% (annualized) and 5.86% (annualized), respectively, is also anemic, both in absolute terms and relative to the U.S. *Id.*

[3] Even with a -5.10% drop in September, the NASDAQ is up 25.33% for the year, including 45.66% in the last six months alone. *Id*.

[4] Continuing our long-term returns reporting, the Index was up 6.98%, 5.24% (annualized) and 4.18% (annualized) over the past 1-, 3- and 5-year periods. *Id.*

[5] Source: JP Morgan's Chief Strategist, David Kelly.

[6] Source: Oxford Financial Group, September 9, 2020.

[7] Lest anyone jump to conclusions that the current tech blowout is necessarily going to suffer the same fate as the dot com tech bubble during the late 1990s, bear in mind that there are stark differences between then and now. For one thing, the tech giants that are driving the gains are profitable, have diversified revenue streams and provide products and services that have become an increasingly significant part of our lives. *Id.*

susceptible to downturns because the other 495 companies are, collectively, not contributing to the Index's returns. In fact, they are detracting from the returns: An iShares ETF (ticker: RSP) that equally weights companies that make up the S&P 500 Index was down more than 6% as of September 13[8]. Viewed another way, as of September 11, YTD price returns of the top five companies was 34%, while that of the bottom 495 was -4%[9]. All five of the largest S&P 500 companies have thrived in a COVID-19 economy and there is reason to believe that market breadth will increase as and when the economy begins to improve and "normalize" and more industries and sectors begin to participate in the economic recovery to a greater extent than they have so far. For this to happen, more states need to "open" (and, importantly, stay open, and safely), which is not going to happen until there is an effective and widely distributed vaccine, and when an economic stimulus package is put into place.

Employment and the Economy. Employment is improving but has a long way to go. The Department of Labor's September jobs report showed that the nonfarm payrolls rose 661,000, well below the consensus estimate of 859,000 (and far below the 1.489 million in August)[10]. On an encouraging note, private-sector payroll gains narrowly beat expectations, rising 877,000 vs. a consensus estimate of 850,000[11]. Also positive is the fact that the service sector continued to show improvement in September, with the ISM Non-Manufacturing index rising to 57.8 and beating the consensus estimate of 56.2 (any level above 50 signals expansion)[12].

Employment is not going to meaningfully improve in the short run absent an economic stimulus package, more states permitting businesses to open, and the U.S. consumer feeling sufficiently comfortable to purchase goods and services in those industries (particularly travel and leisure, hospitality, and sporting events), that have suffered the worst. And, since many of the jobs losses due to the pandemic are likely to be permanent, getting the unemployment rate back to pre-COVID levels (which were around 4%) will likely require a longer-term stimulus package such as funding the rebuilding of our aging infrastructure[13].

The Election. While the outcome of the election will not be known for several weeks at least, currently Joe Biden maintains a significant lead in the popular vote nationwide[14]. There is also a chance that the Senate may swing to Democratic control, resulting in a relatively rare unified government. One would think that the prospect of a Biden win and possible unified government would scare the markets, given Mr. Biden's stated goal of raising taxes on companies and individuals making more than $400,000. But, so far anyway, that has not been the case. Why? The stock market seems to either be betting against a Biden win or indicating that it can live with a democratic president and even a unified government. There is data to support the latter view. Schwab's Chief Investment Strategist, Liz Ann Sonders, pointed out in an October 5 commentary that, in cases where there was either full Democratic control or full Republican control, the Dow Jones Industrial Average had almost identical annualized returns (~7.25%).

Some credible commentators have opined that, not only would the stock market tolerate a Democratic sweep, it would actually perform better than the alternative. For example, Goldman Sachs

[8] Source: CNN Business "Before the Bell" September 13, 2020.
[9] Source: Goldman Sachs Asset Management, September 14, 2020.
[10] Source: Department of Labor.
[11] Source: First Trust Advisors 10/2/2020.
[12] Source: First Trust Advisors 10/5/2020.
[13] Interestingly, as reported by CNN Business on October 6, Moody's Analytics predicted in an October 6th piece that Biden's economic proposals, if enacted, would create 7.4 million more jobs than would Trump's proposals and lead to full employment nearly two years earlier.
[14] The Biden lead, when viewed in the context of electoral votes, however, is much smaller. The race is still very close in some of the states most needed to win the presidency.

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told its clients this past Tuesday that "all else equal, such a blue wave would likely prompt us to upgrade our forecasts[15]." Goldman cites the expected bonanza of government spending[16], coupled with extremely low interest rates, as likely reasons for the economy to accelerate more quickly. That report concluded with the statement that the fiscal spending "would at least match the likely longer-term tax increases on corporations and upper-income earnings."

It is always a good principle to not let emotions regarding politics override how you think about investing[17]. As your strategic advisor and planner, we always recommend against viewing the election as an investable event. Remember that on average since World War II, the economy has achieved both economic growth and good stock market gains under a variety of political scenarios.

October is Cybersecurity Awareness month. We want to remind you that there are precautions you can take to keep your account portals secure. Turning on the two-factor authorization (2FA) feature on any of your online financial accounts is an easy way to add an extra layer of security to your accounts. Choosing 2FA usually involves having a code or pin sent to your email or smartphone after you have entered your login credentials. This extra step inhibits would-be predators. We encourage you to audit your online financial account portals and turn on 2FA where available[18].

The MCA Team thanks you for your confidence in us and, as always, we welcome your thoughts and questions.

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[15] As reported by CNN Business October 6, 2020.

[16] The federal deficit is already at an all-time high and will go higher under any stimulus package. At some point, the government will need to bring it under control (likely by either raising taxes or curbing spending) or risk much higher interest rates and high inflation down the road. That is a topic for another letter.

[17] Many Republicans assumed the stock market would fall under President Obama, and many Democrats assumed the stock market would fall under President Trump. Both turned out to be wrong.

[18] More information on cybersecurity can be found at: https://www.cisa.gov/national-cyber-security-awareness-month.

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