

Quarter-In-Review – The gains of the second quarter carried over into July and August before we proceeded to correct roughly 10% in September. For the third quarter the S&P 500 gained +8.9%, pushing the index into the black for the year. We should point out, though, that the average stock has materially underperformed the S&P 500 this year. The S&P is a market-cap weighted index and Microsoft, Apple, Amazon, Facebook, and Google have a roughly 22% weight in the index simply due to their massive market capitalizations. If you look at the S&P 500 on an equal weighted basis (each holding has a 0.2% weight), that index is actually down -4.8% this year. You have to go back to the late 1990s to find such a wide disparity. As you can see from the table to the right, other major equity indexes are also lagging the S&P 500 this year. Small-cap stocks are still down -8.6% YTD and global equities are up just +1.0%. REITs and large-cap value stocks are down -12.8% and -11.7% respectively through the end of the third quarter.

The fixed income markets were relatively boring. Interest rates didn't move much during the quarter, and returns on government bonds were muted. For example, intermediate Treasury bonds gained just +0.2% in the third quarter while short-term Treasuries were up +0.1%. Corporate bonds performed somewhat better, with investment-grade bonds picking up +0.8% and high-yield +4.1%. Bonds in general have performed well this year given the large drop in interest rates. Emerging market bonds remain one of the few fixed income assets down on the year (-8.2%) despite a weaker dollar.

Now the Hard Work Begins – The global economic downturn earlier in the year will go into the record books as both the deepest and quickest on record. As we are all painfully aware, activity hit a brick wall late in the first quarter as authorities around the world instituted 'shelter-in-place' orders. No travel, no eating out, work from home if you can. Unsurprisingly, we saw a massive contraction in economic growth in the first half of the year. The U.S. saw GDP contract -5% in the first quarter and over -31% in the second quarter at annualized rates. Global growth was down almost -12% and -20% respectively. These are depression

Market Benchmarks			
Market Indices	3 rd QTR	YTD	3-Yr An
S&P 500 Index	+8.9%	+5.5%	+12.1%
Russell 2000	+5.0%	-8.6%	+1.7%
Global Equities	+8.4%	+1.0%	+6.9%
Int'l Index (EAFE)	+4.6%	-7.0%	+0.5%
Emerging Mkts	+9.0%	-1.5%	+2.3%
Other Indicators	9/30/20	6/30/20	12/31/19
Fed Funds Rate	0%-0.25%	0%-0.25%	1.5%-1.75%
2-Year Treasury	0.13%	0.15%	1.57%
10-Year Treasury	0.68%	0.66%	1.92%
S&P 500 P/E Ratio*		21.7	18.2
Crude Oil	\$40.22	\$39.42	\$61.16
Core Inflation	1.6%	1.0%	1.6%

*Forward 12-month operating earnings per S&P

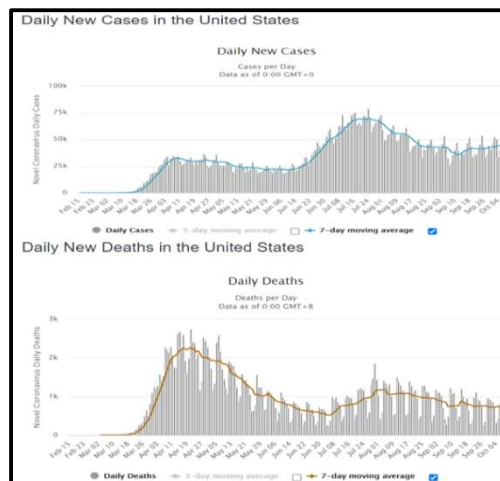
type numbers. However, the reaction to the downturn was equally unprecedented. Both massive monetary and fiscal stimulus was thrown at the problem to prevent a health crisis from turning into a deep and prolonged financial crisis. This, combined with moderating trends on the infections front, meant growth snapped back in the just completed third quarter. Global growth is expected to grow at over +35% at an annualized pace, the U.S. at +33%, Western Europe at over +60%.

But just as we shouldn't have extrapolated the downturn back in March, we almost surely should not extrapolate the rebound at this point in time. The global economy is unlikely to boom going forward and there is much uncertainty about the next few months. Obvious variables going into 2021 include:

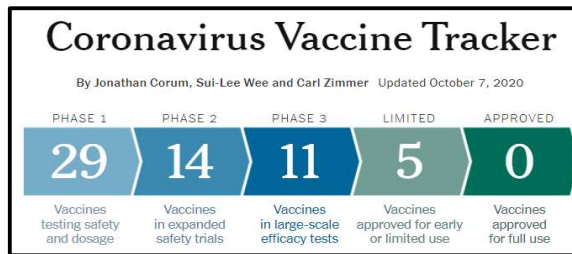
- The evolution of COVID infection rates, how do the authorities respond, and when do we see commercial vaccines?
- How does the U.S. election resolve itself and what will this mean for policy?
- How will central bankers respond to either a renewed downturn or an uptick in inflation?

From First to Second to Third Waves

– The battle between COVID and the human desire to do something (anything!!) continues. As you can see from the chart to the left, the first wave of infections hit the U.S. in late March followed by a second wave in June. We



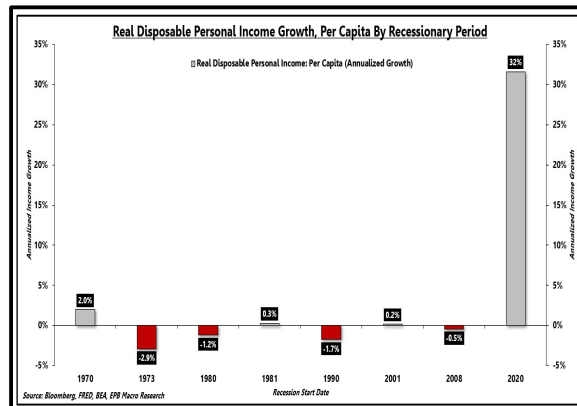
appear to be moving into a third, hopefully more modest, wave. It is a similar story around the world, although the magnitudes differ significantly between countries. We are clearly oscillating between the fear of the disease coupled with the need to restrict activity and the very human and economic needs to socialize and do business. We see little reason to think that this battle is resolved before a vaccine (or vaccines) is available.



The odds of a vaccine in the next few months are open to debate, and we must accept the reality that few of us are in a position to reasonably assess the odds. As you can see from the chart above, 59 separate vaccines are in some phase of trials. Maybe one or more work, maybe none of them do. We lean towards the optimistic side of the ledger in thinking some cocktail of treatments will evolve in the first half of next year. Maybe not a cure, but hopefully a treatment for those most at risk. Just recently Bill Gates predicted the best-case scenario is that by ‘...late next year you could have things going pretty close to normal.’ We certainly hope he is right!

The Policy Outlook is Still Key – Let’s bring this back to the markets (after all this piece is titled Markets in Focus). During the depths of the late March and early April bear market, it was easy to make the mistake that a bad outlook for COVID automatically equaled a bad outlook for the stock and bond markets. In retrospect the major variable that the pessimists missed was the massive policy response from governments around the world. Both fiscal and monetary authorities pulled out all the stops to prevent a re-run of the Great Depression, and in general these polices were effective. For example, as you can see from the chart below, real disposable income in the U.S. during the recession of 2020 grew by over +30%. We’ve never seen this before during any other recessionary period. Of course, this was entirely due to the CARES act passed by Congress on March 25th. To gauge what the future holds over the coming months, policy will still play a critical role. This brings us to the upcoming election and the Federal Reserve’s role going forward.

What a Year for an Election – Generally, we steer well clear of politics in these letters, not so much because of the risk of offending half the readers, but more due to the fact that the political winds usually don’t mean much for broad market trends. As much as Presidents want to take credit for a good economy and assign blame for the opposite, we’ve long felt they have little control over either. Pundits will



make the case that markets perform better under particular combinations of Presidential affiliation and Congressional make-up, but the usefulness of any of the data is questionable. We subscribe to the idea that the big challenge for most people is length of time in the

market, not trying to time the political cycles. As you can see from the chart at the top of the next page, returns over the years in Democratic or Republican administrations are very similar. However, simply being invested regardless of who is in power makes all the difference.

We think the same applies this cycle. Market jitters set in during September about the election, not so much because Biden or Trump was polling well, but more simply that the closer to the election we get the greater the uncertainty about a clean outcome. The old cliché is that markets hate uncertainty, and with that we totally agree. But this too shall pass, and we will very likely know the election outcome before inauguration day. When uncertainty lifts the markets will move on to the next thing.

Does the market care who wins? When people hear this question, they automatically hear the question ‘do I care who wins.’ And of course, the answer is always in the affirmative!! But does the market? We doubt it, or more accurately, we doubt the market cares enough one way or the other that someone should make a big change in their asset allocation. There is always a massive disconnect between election rhetoric and what actually gets done. We suspect the market doubts that Biden will be as radical as his detractors say. Alternatively, Trump, will be contending with gridlock in Congress if he wins another four years. Let’s take one example. Much is being made of the fact that Biden might increase corporate taxes and how this would hammer equity prices. However, this analysis is probably too narrow. Higher corporate taxes are a clear negative for earnings, but we shouldn’t lose sight of the fact that Biden will also probably roll back some of the trade tariffs as well as run a more expansionary fiscal policy, both of which should help earnings. On balance the impact will be a wash.

Almost certainly some people disagree with parts or all of the above. We all think our guy will fix the problems of the world while the other guy portends disaster. But we would contend that markets are discounting mechanisms. To make a bet on something you have to be sure the markets haven’t fully discounted it. COVID in February and March wasn’t discounted in the least because no one had experienced such a scenario in

living memory. We bet few people will be surprised by a Trump or Biden victory. The surprise may be how little either can accomplish in today's highly partisan environment!!

The One Thing They Have in Common

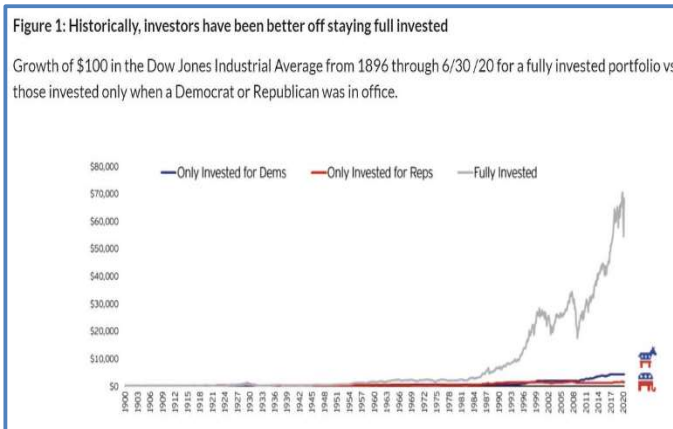
– What we think the markets will care about when it comes to the election is what happens with fiscal policy. On this score both sides see the world in a similar light for once!! Regardless of who wins we think we are going to see more spending, quite possibly a lot more. A Trump victory will probably mean he's out to burnish his legacy. COVID relief, infrastructure spending, incentives to move production onshore, you name it. One thing we can be sure of is that the fiscal hawks in the Republican party have seen their wings clipped (and in reality, as long as the spending was on what they favored, they were never that hawkish). We seriously doubt we see a swing towards austerity during a second Trump term.

A Biden administration will probably be no different, especially if the Democrats control the Senate for a couple years. Again, COVID relief will be high on the agenda as well as some form of Universal Basic Income (either in explicit or implicit form). Infrastructure spending with an emphasis on climate control will also be top of the list. Some left-leaning economists are proponents of Modern Monetary Theory that argues that deficits don't matter as long as inflation is low. This will get a welcome hearing.

Back in 1938 during wrangling about New Deal spending Senator Everett Dirksen is reported to have said ‘..a billion here and a billion there, and by and by it begins to mount up into real money.’ Today the price tag starts at a trillion and goes up from there under either party.

The Fed's New View of the World

– When the history books are written on the COVID crisis, at least from an economic perspective, the Federal Reserve under Jerome Powell will get a lot of credit. They moved aggressively in March and April to stop a health crisis from turning into a protracted financial crisis. Aggressive rate cuts, renewed quantitative easing, and innovative lending programs all played a role in stabilizing the markets and the U.S. economy. The Fed learned from their mistakes in 2008.



The new mantra is that when a crisis hits move quickly and hold nothing in reserve.

But going forward there isn't much the Fed can do with their traditional tools to spur growth. Rate cuts have lost their effectiveness and quantitative easing does little to incent lending because the banks are already sitting on massive amounts of excess reserves. The Fed knows they

only really have two levers to pull going forward: 1) jawbone Congress into spending more money, and 2) promise not to raise rates at the first sign of inflation.

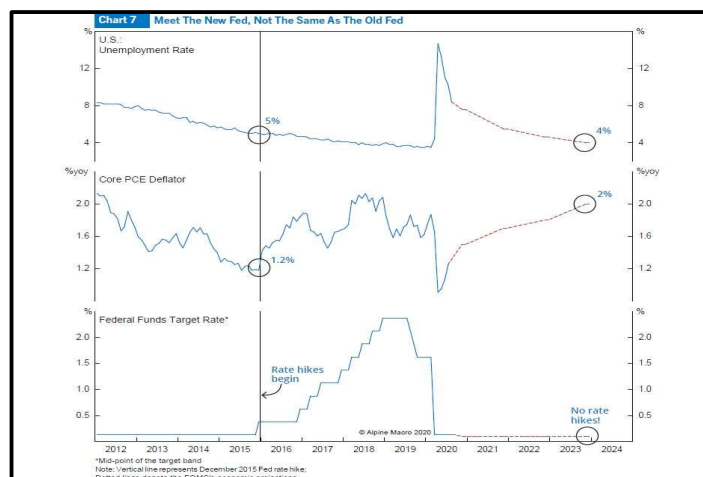
On the first point Chairman Powell has been growing more and more vocal. Every speech seems to have the obligatory section about how future growth depends on Congress ramping up fiscal spending to prevent a COVID related relapse. This is the Fed's way of telling Congress that they have done all they can do. The only game in town going forward is fiscal, not monetary.

On the second point, much has been made of the Fed's new 'average inflation targeting' policy. In a nutshell the Fed is saying they won't hike rates if inflation moves above their target of 2% for a period of time. For example, in 2015 the Fed started to hike rates even though inflation was only 1.2% (see the chart below). Unemployment was low and their models were telling them that low unemployment = faster wage growth = higher inflation. They moved proactively. Inflation did in fact move higher, but it never really got above 2% and they were forced to reverse course when the market cratered in the fourth quarter of 2018.

Now the Fed is saying they won't move rates until inflation averages 2% for a period of time. For example, if you have two years of 1% inflation you theoretically need two years of 3% inflation to get an average of 2%. What this means in practice is that the Fed wouldn't have hiked rates in 2015 under the new policy. They also wouldn't have hiked rates in 2016, 2017, 2018, or 2019.

The Fed is basically telling us two things:

1. They won't act in a counter-cyclical manner anymore. The Fed used to try and take the punch bowl away before things got too crazy. Now they'd like to see a little bit of a party get going first.

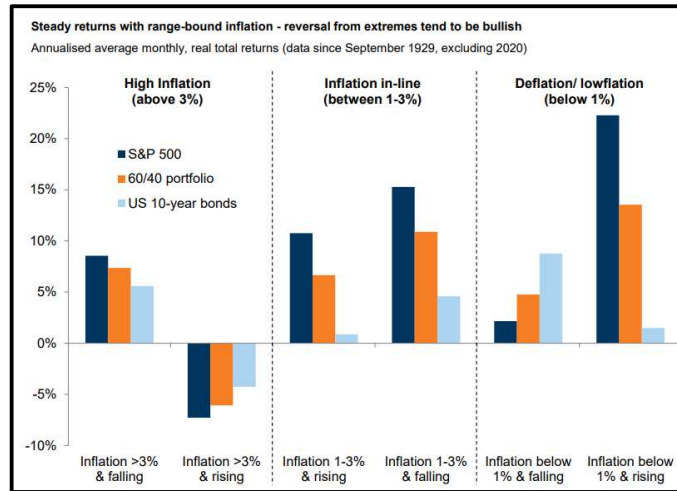


2. They aren't sure they can create inflation. They've missed their inflation goals ever since the financial crisis in 2008/2009 and they now think the only path to higher inflation is through expansionary fiscal policy.

What are the Implications for Inflation

– The knee jerk reaction to the discussion above is naturally ‘inflation - run for the hills!!’ However, as with most things in life, timing is important. Over the next nine-to-twelve months it is hard to make the case that inflation is the new existential threat. Consider the fact that over the last few years we saw basically no pick-up in inflation even though unemployment fell to roughly 4%. Few think we will be at this level by the end of 2021. For inflation to take off we think we need a number of things to fall into place. First, the election outcome is relatively clean and resolution doesn't drag well into 2021. Second, whoever wins the executive branch can exert some control in Congress to pass new fiscal spending. Either they control both houses or they develop a bipartisan package similar to the CARES act. Third, a partially effective vaccine is rolled out and people feel comfortable resuming their old habits. Finally, the Fed doesn't blink and doesn't tighten policy too soon.

What are the odds of this scenario? We'd say better than 50/50, but you have to admit there are a number of hurdles between here and there. And in our mind, this leads us to the view that we shouldn't overreact to the inflation threat yet. We don't think it makes sense to sell your bonds simply because inflation might tick higher. A portfolio of 100% gold or Treasury Inflation Protected Securities is likewise not a great idea. What does history tell us? The chart above shows the returns of stocks, bonds, and a 60/40 portfolio under different inflation regimes since 1929. The first thing that jumps out at you is that returns tend to be positive under any scenario, at least on a nominal basis. The only scenario where returns are uniformly negative is when inflation is above 3% and rising (think the late 1970s). This very clearly is not the situation today. The



best returns come from the extremes – either moving from deflation to inflation (far right section) or moving from higher inflation to lower inflation. Where are we today? Core inflation is in the mid-1% range today, but deflation worries still persist. After all, the yield on the 10-year Treasury is still below 0.8% - an unthinkable low number this time last year. We'd contend that for now, at least, a move from worrying about

deflation to modestly higher inflation could very well be good for portfolios, at least initially, if it means the risk of renewed recession has disappeared.

Looking Ahead – We covered a lot ground in this piece and still didn't touch on important issues. What will happen with corporate earnings? What about valuations? What role does gold play? We will address these issues in future letters, but today we think the outlook for the global economy and the markets hinges on three questions: 1) when do we see a widespread rollout of a COVID vaccine, 2) will the political system get to a point where it can pass meaningful spending legislation, and 3) will the monetary authorities stick to their promise not to snuff out any nascent recovery? Opinions will differ, and a positive resolution for each is no sure thing. Certainly, the equity markets today are pricing in positive answers to each question given current valuations. Over the next month or two this might be problematic. However, if your time horizon is six-to-nine months or more such assumptions seem much more reasonable. By the middle of next year questions about vaccine trails have hopefully morphed into questions about vaccine distribution. Furthermore, whoever surpasses 270 electoral college votes in November has moved onto legislative initiatives. And ideally the Fed has become very quiet as a durable economic recovery unfolds.

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