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Equity Outlook

FRANKLIN STREET PARTNERS

Rounding the Final Corner of a Turbulent 2020

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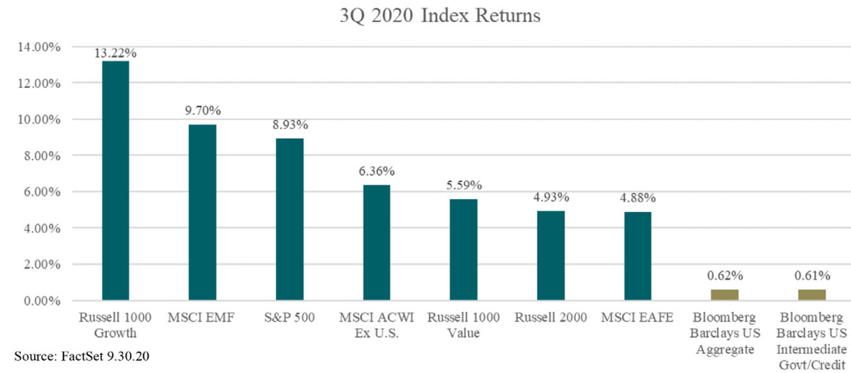
In the third quarter, global equities added to one of the strongest intra-year rallies in market history and continued their robust recovery from pandemic-induced weakness earlier in the year. The benchmark S&P 500 index is now up 5.6% year to date even as the pandemic remains at large. During the third quarter, familiar large cap growth companies continued to lead the recovery, raising questions over concentration risk and the potential for cyclically-oriented rotation. Overall, we believe the largest risks to equity performance relate to the ongoing Covid-19 pandemic – the potential emergence of a damaging second wave, delayed vaccine development and/or distribution, and other related issues that threaten to derail progress toward recovery and the return toward normalization. Additional concerns include the looming November U.S. election season, possible fiscal and/or monetary policy missteps, and continuing geopolitical tensions with China. Despite these worries, remain constructive overall on equities, particularly given the absolute low levels of global interest rates and the continued improvement in the corporate earnings outlook. While many investors are wondering if the market is exhibiting irrational exuberance, we think the rebound has been broadly warranted, and we forecast a sustainable long-run recovery in the U.S. economy.

EQUITY MARKET RECAP

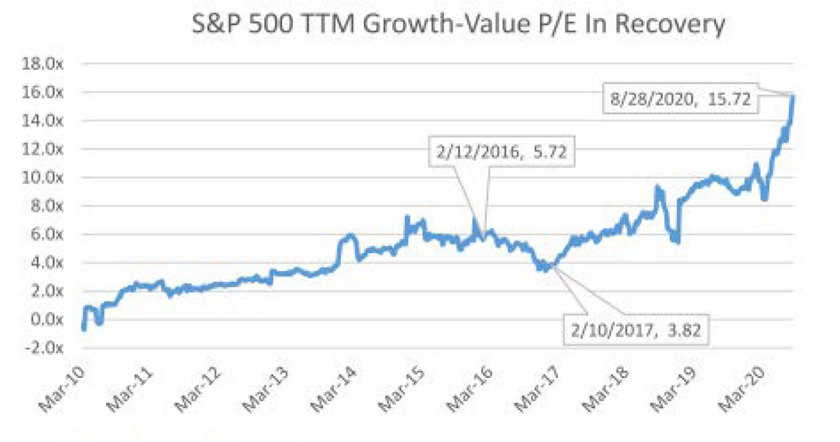


For the third quarter of 2020, the benchmark S&P 500 gained +8.9%, another solid quarter of performance and, along with the June quarter, part of the best two quarter performance since 2009. Following the S&P 500's 2020 closing low on March 23, the index increased +51.8% and remarkably stood higher on the year by +5.6%. Smaller U.S. stocks also enjoyed a solid rally, with the mid cap S&P 400 and small cap Russell 2000 advancing +4.8% and +4.9%, respectively. Growth stocks continued their long-running outperformance relative to value counterparts, as the Russell 1000 Growth Index provided a +13.2% gain versus +5.6% for the Russell 1000 Value Index for the September quarter. International stocks also participated in the move higher; the MSCI ACWI ex-U.S. index gained +6.3% for the third quarter while the MSCI Emerging Market Index was up +9.7%. The Japanese Nikkei 225 and Shanghai CSI 300 led major international markets, while indices in the U.K., France, and Spain lagged.

Ten of eleven S&P 500 sectors posted positive performance during the third quarter. Performance varied wildly during the period. While traditionally "growth-oriented" sectors such as Consumer Discretionary, Technology, and Communication Services outperformed the broader benchmark, economically-cyclical sectors in Materials and Industrials also bested the overall index. Energy remains a troubled sector and was down over -20% for the September period; despite relatively range-bound crude oil prices and an impressive rally in natural gas, energy-related equities continue to struggle from concerns over both oversupplied conditions and a long recovery in underlying demand.

The discussion over "growth versus value" has been a popular topic, as the gap in performance has been significant for some time. Since growth stocks began their relative outperformance at end of the second quarter of 2013, the Russell 1000 Growth Index has recorded a cumulative total return of +232.1% versus +70.8% for the Russell 1000 Value Index and +142.7% for the S&P 500. Speculation over the reasoning for this outperformance has been wide and includes anything and everything from interest rate policy to the rise of systematic and quantitative trading strategies. During the crisis, growth has only expanded its P/E premium over value as illustrated in the chart below. However, there have been several occasions in 2020 where year-to-date growth leaders trail more cyclically-oriented laggards that are often more commonly found in value indices, i.e., the rotation trade. This pattern has occurred on multiple occasions – from mid-May to mid-June, from early to mid-July, and most recently, from early to mid-September. In each instance, market watchers debate the likelihood of a more lasting rotation from growth to value.

How do we manage the growth versus value positioning at FSP? Specifically, we manage concentrated large-cap equity strategies, all benchmarked to the S&P 500, with a variety of style tilts that reflect risk, return, and income objectives. Our investment process does not focus on a simple growth versus value framework; rather, we try to identify businesses in all sectors with sustainable structural, competitive, and/or economic advantages with attractive valuations. We have favored growth-levered companies in 2019 and 2020, particularly technology and consumer-related companies in industries such as digital graphics and video gaming, financial technology, and differentiated consumer businesses with a strong e-commerce presence. However, the portfolios' are not overwhelmingly levered to growth in any of our concentrated strategies at the current time. During the most recent period, we have selectively been adding companies with more economic sensitivity to a recovery, yet continue to meet our definition of an advantaged business.



Source: Bloomberg and Raymond James research
As of 9.03.20

WHAT TO EXPECT GOING FORWARD

The outlook for global equities in 2020 dawned with reasonable optimism; trade tensions between the U.S. and China, the world's two largest economies, had begun to thaw and suggested a stabilization of global economic growth. However, the entire tenor of the year quickly changed in mid-February, as the rapid spread of the Covid-19 virus led to the World Health Organization declaring the first global pandemic in over a century in mid-March. Since that point, Covid-19 and the responses to the pandemic by global monetary and fiscal authorities have been the most important factors affecting risk assets in all geographies. We expect this to continue for the balance of 2020 and into next year. The biggest determinant of equity performance remains the Covid-19 pandemic and its impacts on both global economic growth and corporate profitability.

Since the U.S. and a majority of the developed world began voluntarily shutting down much of its economic output and overall activity in early March, investors have speculated about the shape of the recovery and the path of the "reopening" process. Domestically, reopening has not been a coordinated, linear progression – the virus affected various regions at different times and individual states and localities have pursued vastly differing reopening policies based on any number of factors. As expected, there have been ebbs and flows during the process, with both pullback and accelerations requiring close attention as to the potential impacts on economic activity. Not surprisingly, economic data has been extraordinarily volatile, but reports have largely surprised to the upside. Second-quarter U.S. GDP estimates were feared as low as -40% to -50%, but the revised figure currently stands at -31.4%. Further, estimates of the recovery in the third quarter have also steadily increased with the Atlanta Fed's GDPNow assessment moving from +20% in early August to +35% as of October 9th. Reported employment statistics have also recovered more quickly than expected; the U.S. unemployment rate peaked in April at 14.7% but has since fallen to 7.9% in September. The consistent flow of better-than-expected economic growth has been a key factor in positive equity performance from the March bottom. We believe the rebound is broadly warranted, and we forecast a sustainable long-run recovery in the U.S. economy.

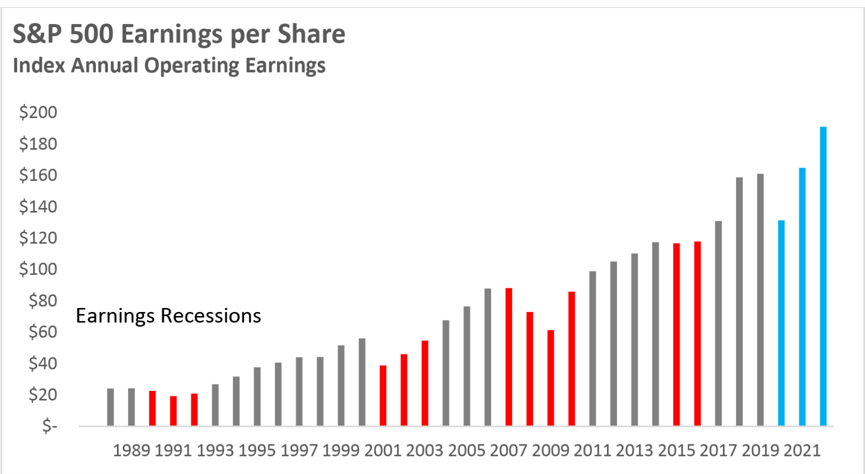
Fears of an intensifying reemergence of Covid-19 cases (the "second wave") have been discussed since the pandemic's start. While scientists have learned much about the disease in a relatively short period of time, the likelihood of a second wave is not truly known; this has not stopped speculation that cooler temperatures in the Northern Hemisphere's autumn and winter seasons, along with seasonal common cold and influenza concerns, could slow reopening progress and put a damper on expected economic growth. In the last weeks of the third quarter, there was a rise in positive cases in many European countries, and daily positive cases in New York State exceeded 1,000 on September 29 for the first time since mid-June. Certainly, potential second wave data will be monitored closely given its importance in the progression of recovery.

As we move into the fourth quarter of 2020 and into 2021, a key catalyst for equities, in our view, will be the successful development and distribution of an effective vaccine as well as therapeutic options. Progress toward the vaccine goal accelerated in the third quarter, as no less than 8 potential vaccines (of at least 180 in development) were in large-scale efficacy and safety trials (Phase 3). The U.S. government's Operation Warp Speed has a stated goal of producing and delivering 300 million doses of an effective vaccine with initial doses available by January 2021, and there have been numerous rumors and whispers of an accelerated schedule. As we've discussed previously, the significance of continued progress toward an effective vaccine should not be underestimated, given its importance to renewed economic growth, and will continue to strongly influence the direction of stocks.

Despite the importance of the pandemic toward future equity performance, there are other risks worth monitoring that potentially heighten market volatility – the November U.S. elections, fiscal stimulus mistakes, and a flaring of U.S./China geopolitical tension. Ahead of the November U.S. elections, campaign rhetoric has intensified and led to predictions of market doom if one candidate or another wins the race for the White House; historical data suggests that U.S. large cap equities are not driven by the party occupying the presidency, as stocks have performed both strongly and poorly under both Republican and Democratic administrations. However, a contested result that extends the process and raises legitimacy concerns could create uncertainty in the minds of investors and lead to elevated volatility. Other volatility triggers include the potential for a policy mistake from either monetary or fiscal authorities, such as an ineffective stimulus program from Congress, and a flaring of U.S./China geopolitical anxieties. While none of these issues would constitute our "base case," we do consider their potential effects on economic growth and corporate profitability.

Similarly to evaluations of economic growth, the range of estimates on corporate earnings have been wide and volatile but have largely surprised to the upside. Aggregate estimates for S&P 500 earnings per share in 2020 have moved from $176 to begin the year, to $125 at the end of the second quarter, to $131 currently. However, 2021 estimates have emerged as the more important factor in valuation; the range of forecasts remains wide but has narrowed and risen as economic and corporate recoveries have proven more resilient than expected. As of the end of September, the consensus 2021 S&P 500 EPS estimate stood at $165 – importantly for market sentiment, this figure is above 2019's $161. We believe that it is safe to assume that the level of economic activity and earnings will be higher in 2021 than in 2020, barring a second wave of the virus resulting in a generalized lockdown of economic activity or a policy error.

Likewise, in addition to various earnings outcomes, we must contemplate a wider range of valuation considerations. Over the last twenty-five years, the average P/E multiple on next-twelve-month S&P 500 EPS has been 16.4x. While the current P/E multiple of 2021 estimated earnings currently stands well above average, it is important to consider that stock prices are ultimately a function of future earnings and interest rates, and the absolute low levels of U.S. Treasury rates suggests a higher P/E multiple is justified.



Source: FactSet 9.30.20

ASSET ALLOCATION AND INTERNAL STRATEGIES

As we've previously discussed, several client portfolios have deviated from longer-term strategic weightings due to the extreme volatility in investment markets and deviations of performance in various asset classes. In these instances, we continue to prudently rebalance, which involves selling asset classes that have outperformed and buying those that have underperformed. During the third quarter, we made a few tactical changes in terms of asset allocations; due to interest rate expectations and anticipation of continued U.S. large cap growth outperformance, FSP reduced both passive U.S. mid-cap equity and passive S&P 500 index exposure and added to the existing passive position in the NASDAQ 100 QQQ ETF. Proceeds from the passive mid and large-cap reductions will also be allocated to an additional emerging markets manager when appropriate. While we made these moves from a long-term perspective, early returns have been promising. We continue to maintain a slight bias toward growth over value and domestic over international equities.

In internally-managed portfolios, we continue to focus on companies with truly advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to believe that advantaged companies with strong balance sheets, high free cash flow generation, and the capital flexibility to navigate this unique period will emerge as stronger competitors over the longer term.

Much has been written about the concentration of performance in a relatively small number of stocks, and acronyms like "FANG" have become important parts of the investment lexicon. Currently, the five largest names in the S&P 500 – Apple, Microsoft, Amazon, Alphabet (Google), and Facebook – comprise nearly 23% of the index's total market value; this compares with 11.6% at the end of 2013 and represents the highest level of concentration in five companies since 1977 (IBM, General Electric, General Motors, AT&T, Exxon). While we are mindful of the dangers of excessively consensus thinking, we are not necessarily troubled by the idea of large positions as, by our own design, we manage concentrated equity portfolios. In addition, we own positions in each of the five largest weightings in various portfolios, as we currently believe each represents the pinnacle of an advantaged business with sustainable longer-term opportunities. While there are notable differences between the five companies, each shares a number of similarities – namely, asset light business models with a significant component of sticky, service-oriented revenues, strong balance sheets, and high switching costs.

The first three quarters of 2020 have been historic with unprecedented economic and investment volatility, and we understand the impact that such activity can place on investor anxiety. We are always available for questions and concerns, and welcome the opportunity to discuss markets and individual holdings. We thank you for your continued confidence.

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