THIRD QUARTER 2020 REVIEW AND COMMENTARY

Market Review: The Standard and Poor's 500 Stock Index posted a stellar return of 8.9% in the third quarter despite September being the first negative return month since March. The large cap U.S. market continued to lead all categories as the Russell 2000 Small Cap Index gained 4.9% and the MSCI All World ex-U.S. International Index gained 6.3%. Growth again easily outperformed Value but sector performance was a bit more style neutral this quarter. With a gain of 14.9% Consumer Discretionary was the top sector, followed by Materials 12.7%, Industrials 12.0%, and Technology 11.7%. Energy was down 20.9%, posting its ninth worst quarter since 1972. The S&P 500 has gained 5.6% for the year while the Russell Small Cap Index and the MSCI International Index remained in the red, down 8.7% and 5.1%, respectively. The Barclay's Aggregate Bond Index returned 0.6% in the quarter and 6.8% year-to-date. Gold's return of 5.8% in the quarter brought the nine-month gain to 24.0%.

Mega-Cap Tech: We have been detailing the outsized impact a handful of mega-cap technology-related stocks have had on the broad market indices and have attached a graph illustrating this relationship. In tracking this dynamic, Ned Davis Research combines Facebook, Amazon, Netflix, Microsoft, Apple, and Google into the "FANMAG" Index. Since the beginning of 2015, FANMAG has returned 29.4% annualized while the other 494 stocks in the S&P 500 Index have returned an annualized 5.9%. Equity diversification has diluted returns. Year-to-date through October 19th, the difference is 44.9% versus -1.7%. There is no question the pandemic has underscored the durability of these companies' business models, but over the past year the FANMAG's price-to-earnings ratio has expanded from 27 to 40 and price-to-sales has moved from 4.7 to 6.9. These valuations are quite stretched, and we have included another Ned Davis report that overlays the current FANMAG price action with a composite of four well-documented "bubbles" from 1929 to 2000. Despite this overlay, we are not positing that the technology category is currently in a bubble nor due for a severe correction, rather prudence continues to demand that portfolios include distinctly dissimilar equity exposure to these stocks, as well as a margin of safety, given the valuations of these market leaders.

Portfolio Positioning: After a placid quarter, there are any number of potential events that could drive increased volatility through the fourth quarter. We believe we have positioned your portfolio appropriately for a range of scenarios and will respond to, rather than anticipate, the news flow. Equity exposure is highly diversified across industries and style categories, even if it means owning companies that are completely ignored in the current market. As an example, CVS Health trades at a price/earnings ratio of 8 and pays a 3.4% annual dividend. The stock is down 20% year-to-date with the average Wall Street analyst target price 33% above the current price. Other areas of diversification include overseas non-dollar equity exposure, hard assets such as gold and cash and short-term bonds. Fixed income is no longer a reliable source of return in the case of an equity bear market. The six-month Treasury bill yields 0.1% and the ten-year Treasury yields 0.70% with both offering negative real returns after inflation with the ten-year carrying significant price risk. While this interest rate environment and consistent disinflation have provided a huge tailwind for risk assets, particularly momentum and growth stocks, an increase in inflation expectations would likely lead to a more challenging market or potentially new leadership.

Longer-Term: In tracking the global purchasing managers index, the global economy has rebounded from a record low activity and back to expansion in only six months. The coordinated government stimulus programs have been massive and the impact on the U.S. government's finances is alarming. At $3.1 trillion, the U.S. budget deficit reached 16% of GDP in the just completed fiscal year-end, the highest percentage since World War II. Federal debt outstanding exceeded GDP for the first time in seventy years and there is likely no turning back with aging demographics having an increasing impact. Though the pandemic obviously aggravated the scale of the deficit, it had been widening in recent years despite the economic expansion. Currently, the Fed is aggressively monetizing Treasury debt as it holds a record 22% of outstanding Treasuries. The indebtedness of the U.S. will increasingly become a material secular challenge, particularly if higher rates lead to increased interest costs. As we move beyond the pandemic, hopefully to a more conventional economy, this "wet blanket" on economic growth will move to the headlines.

We hope you, and your family and friends are well, we thank you for your ongoing trust, and we are always available for a specific discussion of your portfolio.

YOUR STALEY CAPITAL INVESTMENT TEAM