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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Fireside Chat.*

As of this writing, the results of the Presidential election continue to hang in the balance. While the most recent ballot counts portend a Biden victory, there are also strong indications the Trump campaign will continue to question the election process and outcome. Despite the uncertainty, U.S. financial markets have reacted well to the prospect of a split government – one where Democrats control both the office of the Presidency and the House of Representatives while Republicans maintain control of the Senate. This scenario would make an immediate tax hike and increasing regulatory restrictions less probable, increasing the prospects for recovering corporate earnings to be less affected by increased corporate taxes.

Meanwhile, the news that real (over inflation) U.S. economic output (GDP) surged 7.4% in the third quarter has been no surprise as we have been receiving steadily improving monthly data for some time now. While this news is good, current GDP is still down 3.5% from the fourth quarter of 2019.

Morningstar and other research sources continue to reinforce the unique nature of the 2020 recession – one that has been the result of a pandemic as opposed to an underlying economic issue. Consumer spending in the service sector accounts for the biggest part of the overall economic decline, which is down 7% year-over-year. A severe decline such as what we've experienced in 2020 is highly unusual in a more typical recession. For example, during the Great Recession, the service sector was down only 0.6% year-over-year *at its low point* in the second quarter of 2009. Note that consumer services spending accounts for roughly 70% of total personal consumption and nearly **one-half of U.S. GDP**, explaining why the decline in U.S. GDP has been so severe during this recession.

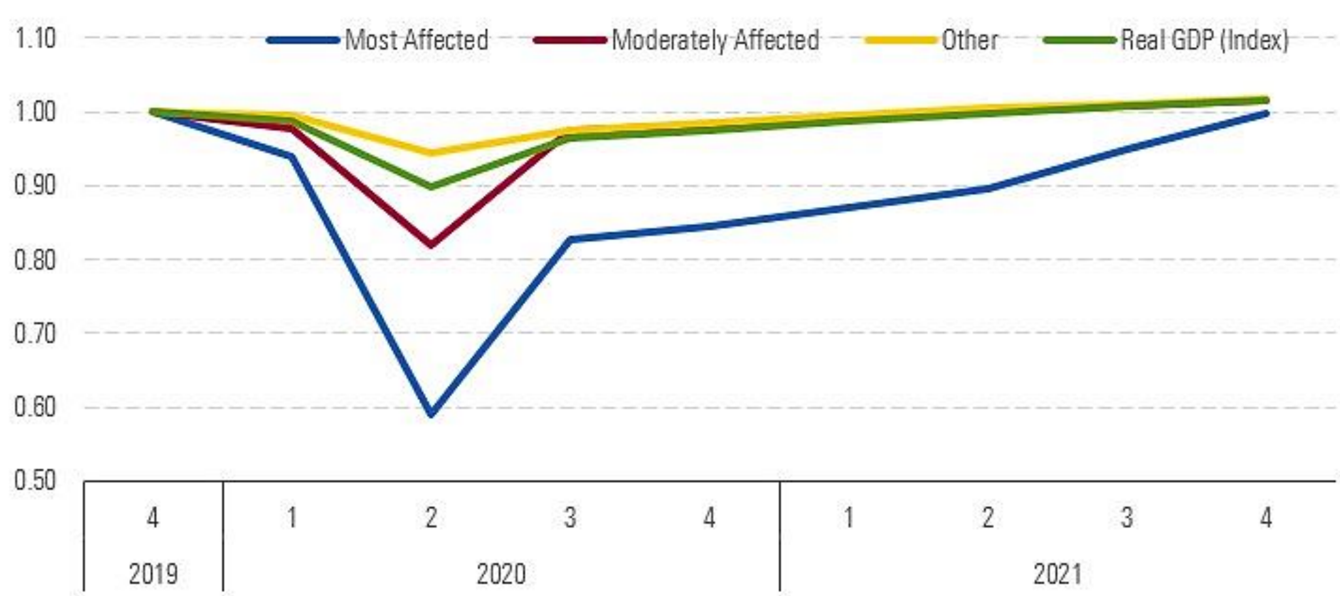
By contrast, spending on consumer goods (especially on durables like appliances, home furnishings and electronics) typically weakens during a recession, but has been a major positive force in the current "stay at home" recession. Consumer durable goods spending was up 13% year-over-year in the third quarter, **the strongest growth in any year – recession or not – since 1986.**

SFG's "Thread the Needle" scenario continues to be viable despite numerous "whack-a-mole" COVID-19 outbreaks occurring more frequently around the U.S. and overseas. In Thread the Needle, enough variables go right that economic progress gets on a solid footing in 2021 and companies regain earnings growth to support the next leg up of stock prices. Key variables in this scenario:

1. **Pandemic progress** – treatment and vaccine development remain in the positive category for a 2021 recovery despite hospitalizations on the rise and having reached last week a record new daily case count in the U.S.

Once one or more vaccines are deployed to the CDC first priority recipients (first responders and those more susceptible to negative COVID-19 infection outcomes) in the first quarter of 2021, and widely deployed by mid-2021, we believe a near-complete recovery should occur even for the most-affected industries as people return to normal patterns of behavior. As a result, Goldman Sachs, Morningstar and other credible research entities now believe that U.S. GDP (green line in the chart below) should reach the fourth-quarter 2019 high-water mark by the third quarter of 2021.

Most-Affected Industries Will Need Vaccine for Full Recovery

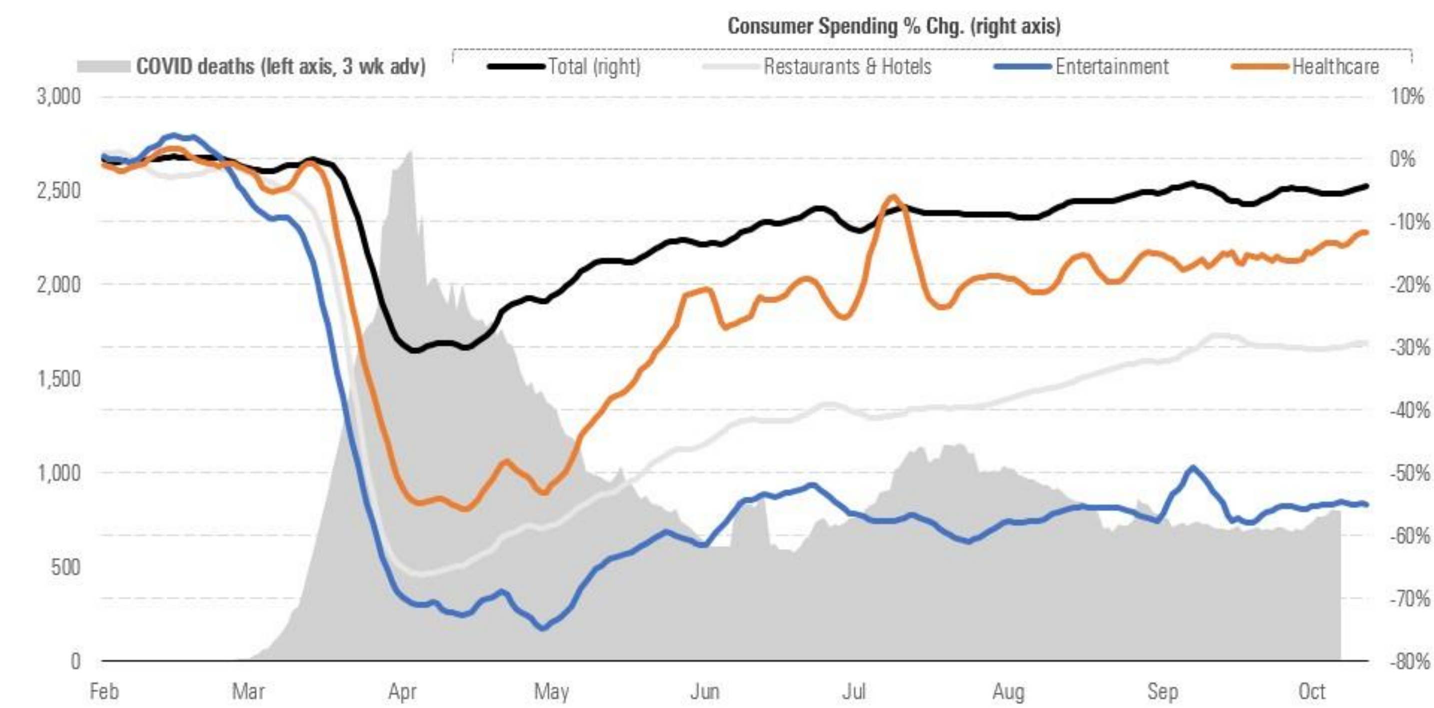


Source: U.S. Bureau of Economic Analysis, International Monetary Fund, Morningstar.

2. **Modest impact of new tax rates** – concerns about higher taxes offsetting earnings growth in 2021 are now diminished, assuming the expected election results stand. As explained above, a split party U.S. government will very likely not be raising corporate taxes in 2021.
3. **U.S. Federal Reserve policy** – The Fed remains in a "lower for longer" interest rate frame of mind. Lower interest rates benefit many parts of the economy and also create more support for stock prices as future earnings are worth more discounted back to 2020 equivalent dollars.
4. **Can the U.S. economy recover properly without significant additional stimulus?** Given the strong 3Q GDP rebound, and with other economic data still indicating positive momentum (U.S. manufacturing, consumer spending, mobility data, tame financial conditions), the need for more stimulus has become less clear, especially given a split U.S. government. Even so, Senate Majority leader Mitch McConnell, who won another term in the Senate, signaled this week a willingness to look at additional stimulus before 2021, a reversal of his previous stance.

Consumer Spending remains within a few percentage points of pre-COVID-19 levels thanks to the factors discussed above. We doubt the current COVID-19 spike will dramatically lower overall consumer spending given the dramatic surge in e-commerce as a result of the stay at home economy. While consumers have figured out ways to spend money at their favorite restaurants with minimal COVID-19 risk, the entertainment and hospitality categories, including many restaurants, still have a long way to go before getting back to "normal."

Consumer Spending Growth Paused When Second Wave Hit in Summer, but It Didn't Collapse



Source: Tracktherecovery.org, Affinity, Morningstar. We use deaths instead of reported cases, as the latter is distorted by varying testing rates over time. We advance deaths by three weeks to account for the lag between new cases and deaths.

SFG's Take: While we believe the zone of uncertainty for a 2021 recovery is narrowing, we still feel risk remains higher than normal. Consequently, we are shifting toward what we believe are good return versus risk opportunities in our growth accounts, while staying well balanced in our growth and income portfolios.

Some U.S. stock valuation metrics remain stretched after the "split government rally" even accounting for the "lower for longer" interest rate environment. According to Ned Davis Research:

- S&P 500 price-to-sales are at record highs.
- S&P 500 total and median price-to-earnings are far above fair value.
- Margin debt and NASDAQ price-to-earnings are extremely high.

Keys to Consider

- **Strategas believes the U.S. Senate will stay controlled by the Republicans** – While unclear at press time, there is a good possibility that Georgia will have two runoff elections on January 5th which would put control of the Senate on the line. Incumbent Senator Perdue, who is leading in the vote count against Jon Rossof, is likely to fall below

50 percent as votes continue to be counted. This would trigger a runoff. Georgia will also hold another runoff that day for the Senate special election and if the Democrats win both seats, they would have 50 members. Should Biden win the presidency, Democrats would control the 50-50 Senate. **Strategas research's current view is that at least one of the Senate Republicans are likely to win in a Georgia runoff election in January, but just having the runoff creates more uncertainty for investors.**

- **One of the World's Fastest Growing Countries is being more Conservative about Future Growth** – President Xi Jinping has delivered his long-term economic outlook, saying the Chinese economy should **double by 2035**. What's raising eyebrows is that projection would imply a **sub-5% annual growth rate**, below the country's 30-year performance.

COVID-19 Updates

Morningstar's latest take on COVID-19 treatments and vaccines – COVID-19 cases are rising this fall due to lack of compliance with masking and social distancing, less-than-ideal diagnostics and contact tracing, and efforts to reopen businesses and schools as cooler weather sets in in the Northern Hemisphere. In the U.S., **Morningstar predicts approximately 20% of the overall population will have been infected by year end**, resulting in over 280,000 deaths. This generally implies increased infection rates but slightly lower death rates, as infected patients skew younger and treatments improve.

Gilead's antiviral treatment remdesivir now has full Food and Drug Administration approval after a solid clinical study showed a 30% improvement in recovery time and trend to mortality [**Editor's note** – in simple terms, less people with COVID-19 die when treated with remdesivir] benefit in hospitalized patients, although efficacy here is still relatively modest. Generic steroid dexamethasone has also shown a reduction in deaths of 20% in later-stage patients, and oral antivirals are in the works at Merck and Ridgeback. Some arthritis drugs like Eli Lilly's Olumiant and Roche's Actemra seem to have a small effect in tamping down any overreaction by the immune system, helping to keep patients off ventilators and improve recovery times slightly. Most promising among treatments are targeted antibodies; both Regeneron and Lilly have filed for emergency use authorization of their antibodies, which show strong potential to improve recovery time among high-risk patients.

We continue to think vaccination will be a key part of ending the pandemic. The most advanced vaccine programs are the mRNA vaccines from Moderna and Pfizer/BioNTech. The first efficacy data from these companies is going to be rolling in very soon, likely in November. The trials are designed so that the first look at efficacy could show positive results if the vaccines are somewhere around 70%-80% effective. If studies fail to meet this higher bar at the first look, they could still clear the FDA's ultimate threshold at just 50% efficacy in December or January. We expect FDA reviews of the initial EUA applications to take a matter of weeks, allowing the first EUAs in December and several other potential EUAs in the first and second quarters of 2021, allowing for broad vaccination in the U.S. in the first half of next year. Assuming 70% of adults are vaccinated, at a 70% efficacy rate, that would mean half of the adult population would be protected. But some already have immunity from COVID-19 or potentially from other coronaviruses, so that should be enough to reach herd immunity.

Morningstar has assigned probabilities of approval to the programs that have reported phase 1 data from 50% to 70%, based on the strength of phase 1 data and experience with vaccine types, which we have a variety of, improving odds of some success. The RNA programs have led with solid data, partly due to rapid design and manufacturing, but the challenge here will be distribution, as they generally require a deep freeze to preserve the vaccine, and there are not yet any approved RNA vaccines. Adenovirus or viral vector vaccines have slightly more validated technology (like Johnson & Johnson's Ebola vaccine) and are also quick to manufacture in large quantities; J&J's one-dose vaccine that only requires refrigeration could be a huge advantage in terms of logistics. Vaccine developers have a lot of experience with antigen-based vaccines, and Novavax had strong phase 1 data; a booster allows the use of very small amounts of antigen, so this increases the dosages that could be available significantly.

We think safety so far looks solid. The six-week FDA hold on AstraZeneca's U.S. vaccine trial due to a case of transverse myelitis in one patient in the U.K. trial and J&J's two-week voluntary study pause of its own trial due to an undisclosed serious medical event (reportedly a stroke) have both come to an end, and trials have restarted. Regulators at the FDA and study investigators could not establish a link between either vaccine and the illnesses, although we note causation is also not ruled out. Overall, we're encouraged by FDA guidelines requiring a median of two months of safety data from the patient's final shot of a vaccine before a company can file for an EUA, since the vast majority of side effects are seen within six weeks of vaccination, and companies will need six months of safety data before full licensure.

https://www.morningstar.com/articles/1008430/we-still-expect-a-strong-us-economic-recovery

Frequently Asked Questions

Q: Your optimistic "thread the needle" scenario for 2021 makes me nervous, since I've always had trouble threading a needle! Does this mean 2021 will be dismal if the needle isn't threaded?

A: Enough is going right with Fed policy, the economic recovery and pandemic response that perhaps we should change the name of this scenario to "driving through a narrow tunnel" instead of using the needle metaphor. The good news is a few things can go wrong with this scenario without dire consequences. One thing that puts the 2021 recovery in jeopardy is if something major occurs to rattle consumer confidence.

Professional financial planners like us always cheer our clients saving more, but as with many things, too much of a good thing is often not good. What could cause savings rates to rocket up and spending rates to go down? Major civil unrest, a disturbing geo-political event overseas with a large impact on the U.S. or the mutation of the coronavirus are in the category of events that could cause consumers to temporarily spend less and prolong the path to recovery.

We are often asked "what if a vaccine development is substantially delayed?" If this happens, we have faith that human ingenuity and pandemic fatigue, fueled by e-commerce, will continue to fuel economic activity at a reasonable level, but delay the recovery to later in 2021 or even 2022. Delayed recovery, not a prolonged recession (unless you work in parts of the entertainment or hospitality industry), is more likely.

The borrowing power of the U.S. government remains very strong and we believe that any dangerous trends moving the economy in a negative direction would be met with more government fiscal action (like the CARES Act), even with a split party government.

Summary

SFG remains positive toward our most likely Thread the Needle scenario. However, we are prepared for a number of post-election scenarios. In general, we are more defensively postured in growth and income portfolios and will be making selected moves in growth portfolios. We will continue to monitor and analyze the many trends colliding today and diversify accordingly.

Our coronavirus investing approach can be summed up by five themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios, and,
- A more defensive stance using different portfolio tools for more conservative growth and income portfolios until we are reasonably confident the COVID-19 crisis has stabilized.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)