Market & Economic Outlook 2020 – October Update: GDP & Earnings Growth vs. Emerging Risks

Major Indices	Value (9/30/2020)	3Q20 (6/30/2020 - 9/30/2020) Price Return	Total Return	2020 YTD (12/31/2019 - 9/30/2020) Price Return	Total Return
S&P 500	3,363.00	8.5%	8.9%	4.1%	5.6%
Dow Jones Industrial Average	27,781.70	7.6%	8.2%	-2.7%	-0.9%
NASDAQ Composite	11,167.51	11.0%	11.2%	24.5%	25.3%
Russell 2000	1,507.69	4.6%	4.9%	-9.6%	-8.7%
MSCI EAFE (USD)	1,855.32	0.6%	1.3%	-11.2%	-9.1%
MSCI Emerging Markets (USD)	1,082.00	7.8%	8.8%	0.8%	2.9%
Bloomberg Commodity Index	70.85	9.0%	9.1%	-12.4%	-12.1%
Barclays U.S. Aggregate Bond	110.09	-0.3%	0.6%	4.2%	6.8%

Data Source: FactSet

Outlook Summary:

In Q3 2020, global equity markets continued a powerful rally from the March lows, as a combination of economic recovery, government relief packages, and massive central bank support provided a shot of adrenaline to investor sentiment. We see both risks and potential catalysts ahead for equities as we complete 2020 and look toward 2021. Our equity outlook remains modestly bullish, although we believe that elevated valuations will reduce expected portfolio returns in future periods. The equity market and initial GDP recovery from the depths of April has been impressive and carried through the third quarter. Large companies have fared better, using size to weather the storm, invest in growth and innovation, and strengthen competitive positions. The recovery benefitted from government intervention, first from massive Federal Reserve Bank (Fed) liquidity, and then from nearly $3.0 trillion (T) of congressional relief, which helped hiring and both consumer spending and savings. The economy weathered a late June/July increase in COVID-19 cases, as the recovery slowed, but remained significantly above depressed levels in April. Large cap has beat small cap, growth has beat value, and the Nasdaq Composite has continually established all-time highs. Investor optimism remained high due government stimulus, low interest rates, and hopes for a COVID-19 vaccine that appears likely. While economic shutdowns are no longer the standard response to ongoing COVID outbreaks, social distancing, work-from-home, and reduced personal interaction remain in place, and the economic recovery ahead is expected to follow a more normal post-recession process, following the Q3 surge. We look for continued GDP growth, although at a slower pace than Q3, and believe that full-year GDP in 2021 will approach 2019 levels. In addition, we expect an additional one or two rounds of COVID relief spending from Congress (one in 2020 and one in 2021) even if it does not pass this month, prior to the election. **Due to improved visibility for double-digit percentage earnings growth in 2021 and continued highly accommodative monetary policy and stimulus, we increase our S&P 500 fair value estimate by 9% to 3,500, from 3,200. This estimate is 4.1% above the index closing price on 9/30/20.**

Our S&P 500 fair value estimate of 3,500 represents a price to earnings ratio (P/E) of 21.2x the 2021 FactSet consensus EPS estimate of $165. Current S&P 500 estimates reflect a 2020 earnings decrease of 19% to $131 (weighted average of index earnings), but then rebounding nearly 26% in 2021. Since late June, 2020 and 2021 consensus estimates have increased by 5% and 2%, respectively. This is an indication that corporate performance coming out of the COVID-recession has exceeded expectations. Forecasting earnings growth for 2021 remains difficult, but visibility has improved since mid-year as companies have benefited from a gradual reopening of both the U.S. and global economies. Several companies are expected to remain constrained in 2021, especially in the leisure, hospitality, and transportation industries. This creates potential earnings headwinds over the near-term, but strength in other industries could compensate for those declines. We also see the potential for ongoing volatility as we look to 2021. While we do not expect another 34% decline like we saw in February and March of this year, market pull backs of 10% or more are quite common. Since the March lows, the S&P 500 had a 6.9% decline in mid-June and a 9.7% decline in September, but the index has still managed a year-to-date (YTD) gain of nearly 9%.

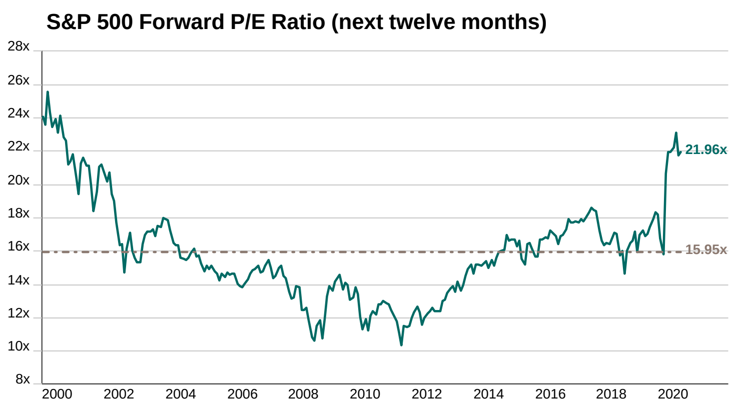
We advise investors to stay committed to their long-term investment plans, remain diversified cross sectors and asset classes, and use volatility to rebalance holdings to align with portfolio objectives.

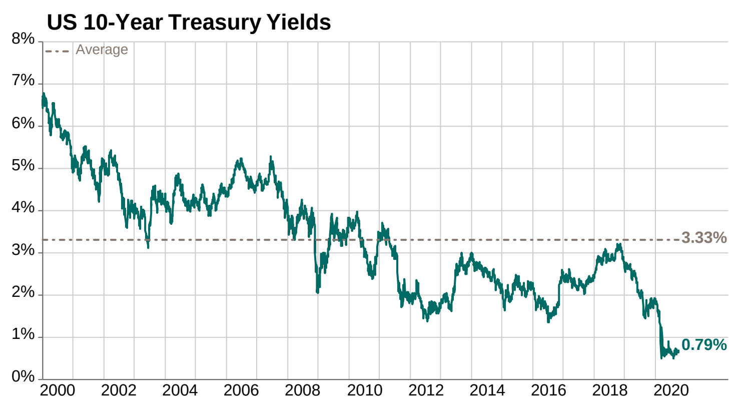
Data Source: FactSet as of 10/7/20

The S&P 500 gained 8.9% including dividends in Q3 2020 as U.S. large cap stocks and the Information Technology sector led a global rally that drove strong returns for equities and commodities. In Q3, the Nasdaq Composite total return was 11.2%, the MSCI Emerging Market index gained 8.8% and the Bloomberg Commodity index rallied 9.1%. For the nine-month YTD period, equity returns were mixed however; while the Nasdaq Composite and S&P 500 posted total returns through September of 25.3% and 5.6%, respectively, the Russell 2000 (U.S. small caps) dropped 8.7%, MSCI Developed Markets was down 9.1%, and MSCI Emerging Markets gained 2.9%. The S&P 500 has exceeded many forecasts (including ours) as the U.S. economic recovery from recession exceeded expectations; the decline in S&P 500 earnings has been less than feared, and leading companies with dominant Internet and cloud-based platforms have shown they are well-positioned for a COVID and post-COVID economy.

Market Risks over the next few quarters include elevated valuations, a slowing economic recovery held back by COVID disruptions, and election uncertainty. Each of these risks is a concern in early October, and likely to remain relevant throughout the fourth quarter. This does not mean that the powerful market rally over the past 5 ½ months will come to an end, but headwinds could limit gains over the balance of the year and cause ongoing market volatility punctuated by periods of market decline. Below is a discussion of how we view these risks.

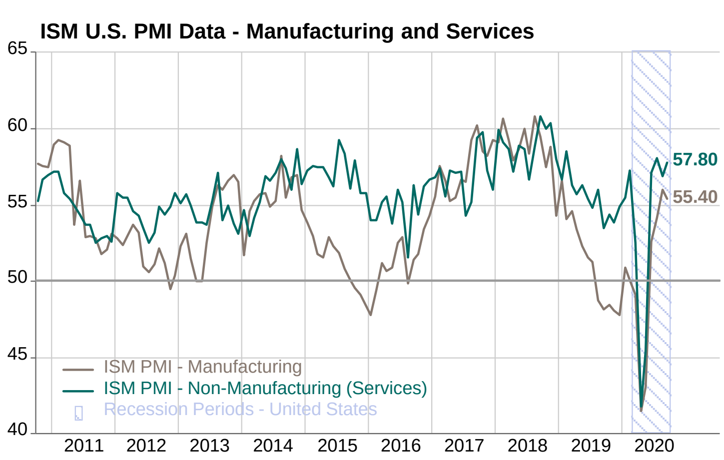
Equity valuations are elevated. The S&P 500 currently trades at 21.9x the consensus earnings estimate over the next four quarters. This is a 37% premium to the index' average P/E of 16x since the year 2000, and close to the high-end of the forward P/E range over that period. Several factors have contributed to higher valuations in our view, including historically low interest rates (increases the present value of future cash flows), massive economic support from the Federal government, and investor willingness to look beyond 2021 for future earnings growth. We expect these factors to remain in pace for the foreseeable future, but we do not expect continued multiple expansion from current levels thus earnings growth will be a key variable. Elevated P/E ratios are correlated with lower equity returns in future periods and we believe that investors should scale back return expectations.

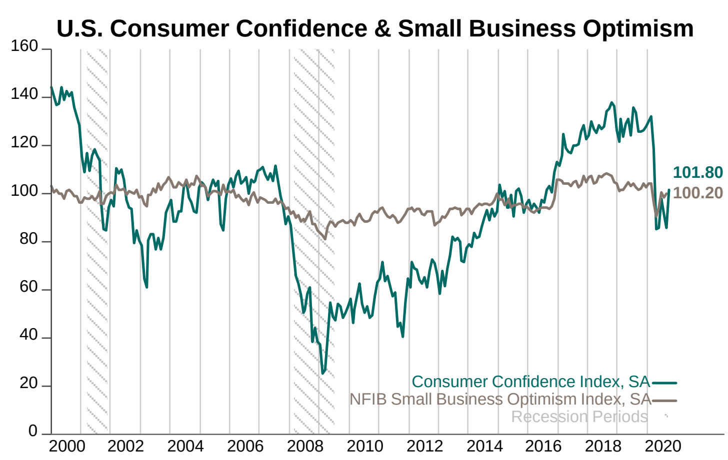




Data source: FactSet as of 10/7/20

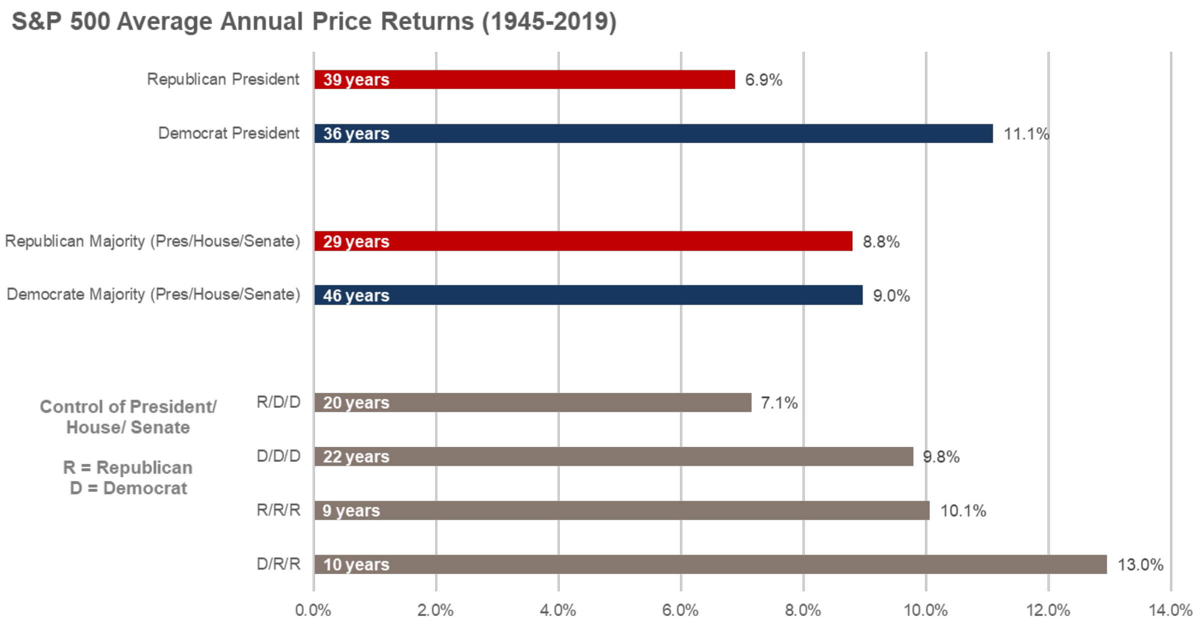
Ongoing COVID uncertainty and vaccine timing could disrupt the economic recovery. We have seen significant economic improvement since April and May, including dramatic gains manufacturing and services purchasing managers' surveys, and improvement in consumer confidence and small business optimism. This was also reflected in improving economic data, including jobs growth, retail sales, automobile sales, housing starts and home purchases. While most GDP categories remain below pre-pandemic levels, it is relatively clear that the worst of the shutdown is in the rear-view mirror and the recovery is underway. Data has slowed however over the past several weeks, as retail sales have levelled, weekly new jobless claims are higher than ideal, and net jobs growth has slowed. We attribute the pause to pockets of COVID-19 positive cases and hospitalizations across both the U.S. and Europe. We believe that achieving a new version of sustained growth is dependent upon vaccine approval with widespread distribution and the timing of that remains uncertain. We remain optimistic regarding a vaccine due to a large number of trials underway, most of which are run by high-quality experienced companies, with a track record of proving drug efficacy and safety; but, the timing could stretch out to the middle of 2021, which would delay the economic recovery.





Data source: FactSet as of 9/30/20

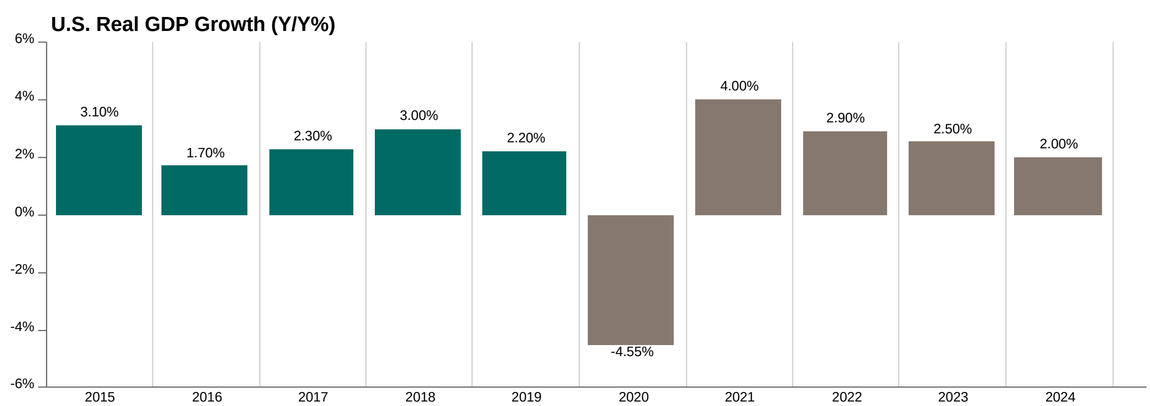
Election uncertainty remains high, but we believe investors should avoid making significant portfolio decisions based upon election predictions. We analyzed party leadership since 1945, a span of 75 years and 13 presidents. Through 2019, the U.S. was led by a Democratic President for 36 years and a Republican for 39 years. The S&P 500 index price return has averaged 11.1% annually under Democratic presidents, and 6.9% annually under Republican presidents. However, the numbers change somewhat when overlaying congressional party affiliation. When Republicans hold all three offices (President, House, and Senate), the S&P 500 has gained 10.1% annually; when Democrats hold all three the market has gained 9.8%. This suggests that one party control has been good for equity markets overall. The best annual market performance has come from a Democratic president and Republican control of the House and Senate. But, over time, the dominant party has been less correlated with higher returns, as annual returns when Democrats control two or three of the offices averaged 9.0%, vs. 8.8% when Republicans have control. **The numbers can be analyzed in several different ways, but we conclude that, historically, U.S. equities have produced solid annual gains over time with either Democrat or Republican leadership. The S&P 500 has performed better with a Democrat President, although the best returns have come when Republicans control both the House and Senate, regardless of which party holds the Presidency**



Sources: FactSet, www.house.gov, www.senate.gov

Many of the risks discussed above have been evaluated by investors in 2020, contributing to high volatility and a series of market pullbacks. But bullish sentiment has prevailed driving markets higher. Several bullish factors remain in place that could keep sentiment positive and provide support for market pullbacks as buyers seek attractive entry points. Market catalysts include an expected large GDP growth number for Q3, continued better than expected earnings results, and additional COVID stimulus passed through Congress.

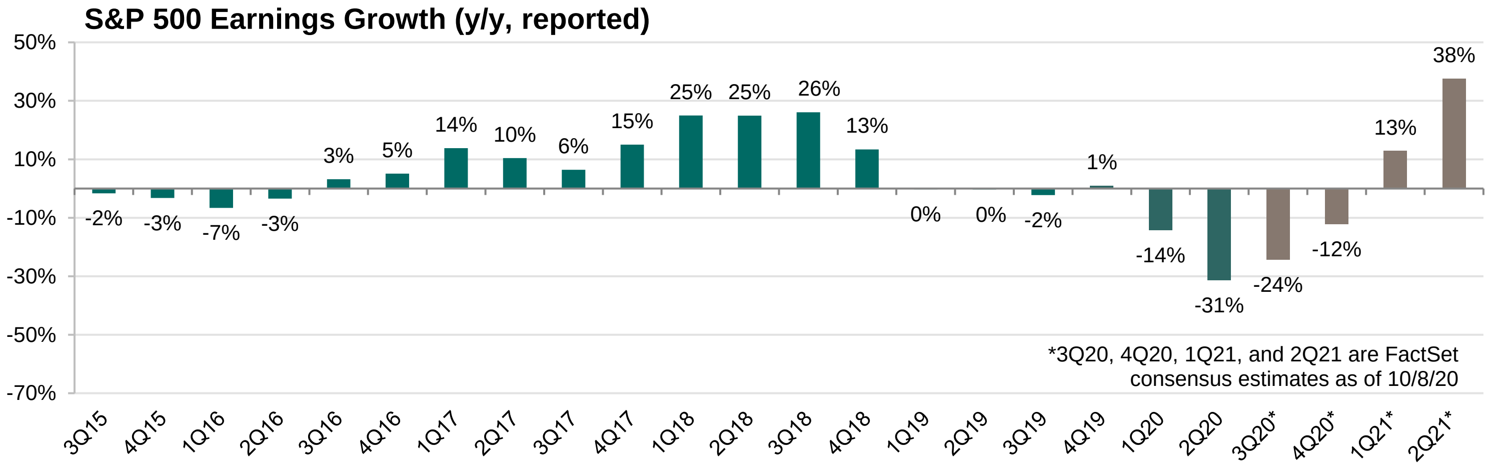
Q2 2020 GDP declined 31.4%, a severe drop, but better than the down 34% that was expected. GDP is reported on a sequential annualized number, so the quarterly number can distort the full year impact. When comparing Q2 GDP on a year-over year (Y/Y) basis, the decline was 9.0%. We know that Q3 will reflect a strong recovery from the depths of Q2, and the estimate of sequential annualized growth is 26.2%. Not only has this estimate increased from 18% three months ago, but a companion measure of GDP growth, the Atlanta Fed GDPNow estimate, which tracks relevant monthly GDP as reported, reflected a Q3 GDP growth trend of 35.3% on 10/6/20. This suggests that the GDP number, when reported on 10/29/20, could exceed the consensus estimate and stoke investor sentiment. It should be noted that even a 26% GDP increase in Q3 (from Q2 annualized) would reflect a Y/Y decline of 3% to 4%. But that would be a strong number given the recession and GDP declines in Q1 and Q2 this year.



U.S. Quarterly GDP Actual / Estimates (Q/Q%)	
1Q20A	-5.0%
2Q20A	-31.4%
3Q20E	26.2%
4Q20E	5.3%
1Q21E	4.5%

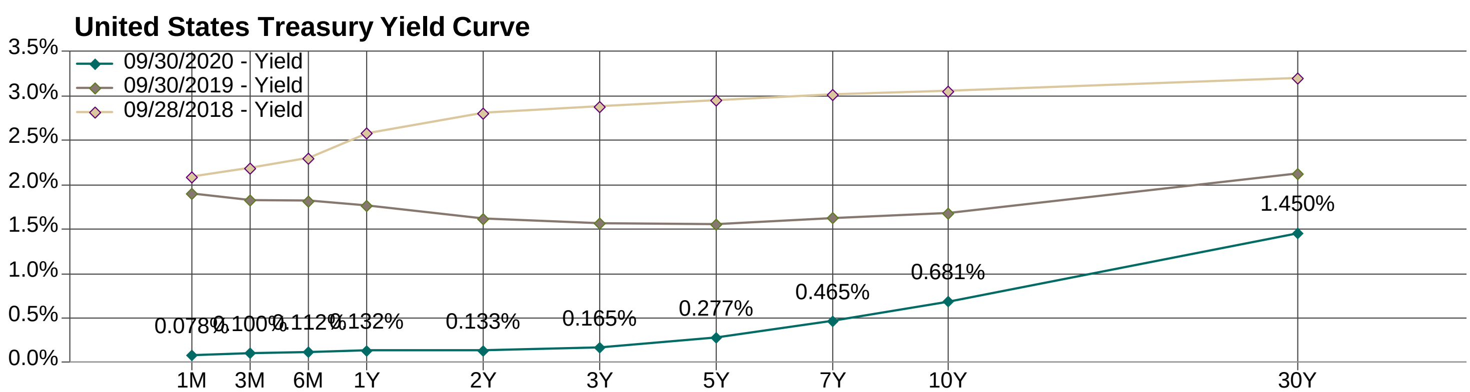
Data source: FactSet as of 10/8/20

Q2 2020 S&P 500 earnings came in better than weak expectations, but were down substantially Y/Y and are expected to remain negative in Q3 and Q4 as well. Primarily due to the global COVID-19 shutdown, Q2 S&P 500 earnings declined 31% (compared to estimates of -44%) as revenue declined 9% and operating margins were lower. Earnings are estimated to decline 24% and 12% Y/Y in Q3 and Q4, respectively, before returning to 13% growth in Q1 2021. On a full year basis, S&P 500 earnings are estimated to decline 19% in 2020, but recover strongly, up 26% in 2021. We have been skeptical of such strong earnings growth in 2021 (26% growth would put 2021 earnings 2% above 2019 levels despite expected higher unemployment), but we believe that results have exceeded expectations and more companies than we expected are thriving. Q3 earnings season has just begun and better (less negative) than expected results would improve the visibility for earnings growth in 2021.



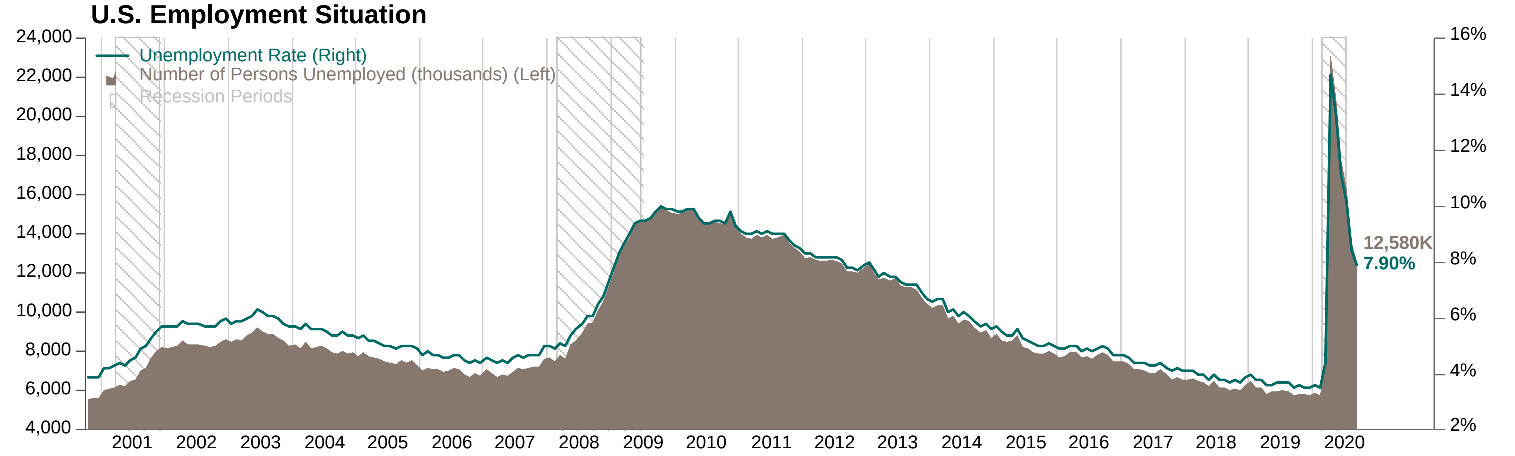
Data source: FactSet as of 10/8/20

The Federal Reserve made a major change to its full employment and inflation framework. The Fed acted rapidly in 2020 to address the COVID economic shutdown and provide stability and liquidity to the financial markets. This included cutting its target overnight fed funds lending rate to 0% from 1.5%, increasing quantitative easing to support the Treasury and mortgage markets (and other securities if needed), and pledging more than $2.3 trillion of loan availability for small businesses and municipalities. The Fed is committed to keeping interest rates at zero for an extended period (years) and in June Fed Chair Jerome Powell said he was "not even thinking about, **thinking about** raising rates." In late-August the Fed published a revision to its approach to its dual mandate to foster price stability and maximum sustainable employment. The Fed has sought to balance jobs growth with an inflation target of 2.0%. With unemployment now elevated due to the recession and inflation well below the 2% target, the Fed will focus on maximizing employment, especially for "low- and moderate-income communities" and seek an average inflation rate of 2% over time. This means that the Fed is willing to let inflation run significantly above 2% for a time if job growth continues. With inflation having remained below 2% for several years we could see many quarters or even years of above 2% inflation for the average to trend above the target. We believe that this could lead to higher inflationary expectations over time and we would expect to see long term interest rates higher, and a steeper yield curve if GDP growth moves consistently higher in 2021. The prospect for higher long-term interest rates in the future creates some risk for financial markets given increasing levels of federal and corporate debt, which could lead to a higher proportion of budgets allocated to interest expense and debt service.



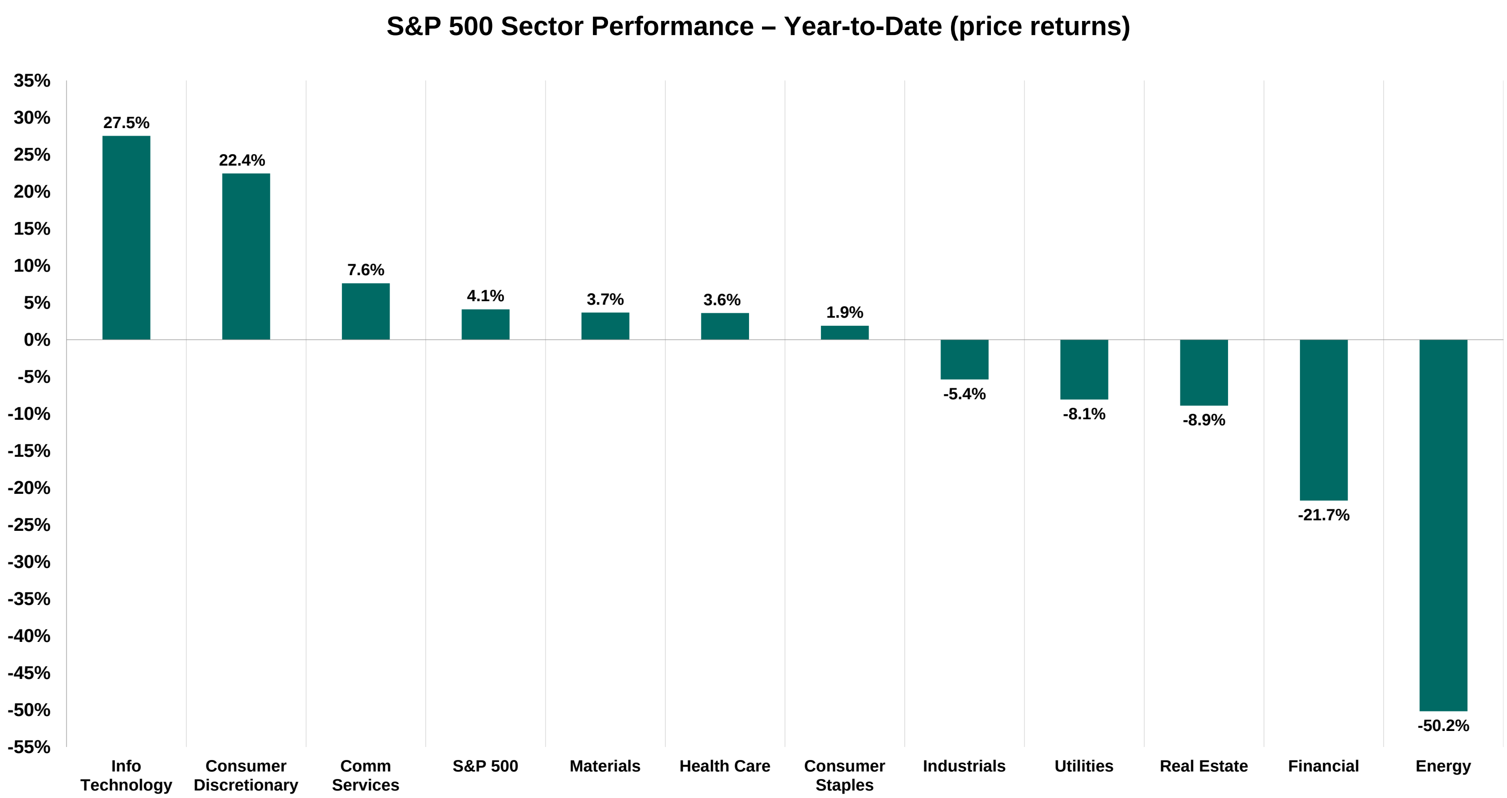
Data source: FactSet as of 9/30/20

Employment trends will be a key indicator in Q4. The U.S. jobs recovery continued in September, but the pace of gains slowed from August, and the number of permanent job losses has increased. Nonfarm payrolls increased 661 thousand (K) in September, compared to 1.5 million (M) in August. Over five months the U.S. economy recovered 11.4M of the 22.2M jobs lost in March and April following the COVID-19 shutdown. In September 12.6M people remained out of work and the unemployment rate was 7.9%. While the jobs gains in September slowed, the improvement over the past five months exceeded expectations. We expect modest jobs gains to continue in Q4 as the economy reopens, with measured gains in retailers, healthcare, manufacturing and construction. Job creation is likely to remain slower in leisure and hospitality, education, and government, at least until a vaccine is approved. If new jobs average 500K monthly in Q4, the year-end unemployment would be 11.1M, an unemployment rate of 6.9%. The February 2020 unemployment rate was 3.5%, reflecting just 5.8M persons unemployed, which is 6.8M below the September reported numbers. This means that the economy has a ways to go to return to full-employment, a process that will drive expected 2021 GDP growth. The number of permanent job losses in September was 3.8M compared to 1.3M in February, indicating that future full employment will likely reflect an unemployment rate above 3.5%. In addition, since February, another 2.5M have left the work force and desire a job, but are not actively seeking work, and thus are not counted as unemployed. We believe that the large number of people still out of work drives bipartisan congressional support for another COVID relief package to provide a bridge to a vaccine. But job creation will be the most important driver of GDP gains in 2021



Data source: FactSet as of 9/30/20

Technology, Consumer Discretionary and Communications are the only sectors to beat the market in 2020, but some sector rotation began in Q3. The strong performance of market-cap leading technology-centric growth stocks has driven the market recovery from the bear market and YTD gains. The three top performing sectors, Technology, Consumer Discretionary, and Communications Services are the #1, #3, and #4 largest by market capitalization (Health Care is #2) which has helped compensate for the relative underperformance of the eight other sectors, and YTD negative performance of five sectors. Combined, the top three performing sectors comprised 50.2% (as of 9/30/20) of the S&P 500's total market capitalization. Outperformance of a narrow group of sectors is typically not sustainable over time as sector leadership will rotate. Q3 did include modest sector rotation and a broadening of the rally, as six sectors beat the S&P 500's gain, with Materials, Industrials, and Consumer Staples joining the three YTD leaders as relative outperformers. This trend continued in the month of September; while the index was lower for the month, eight sectors were relative outperformers.



Data source: FactSet as of 9/30/20

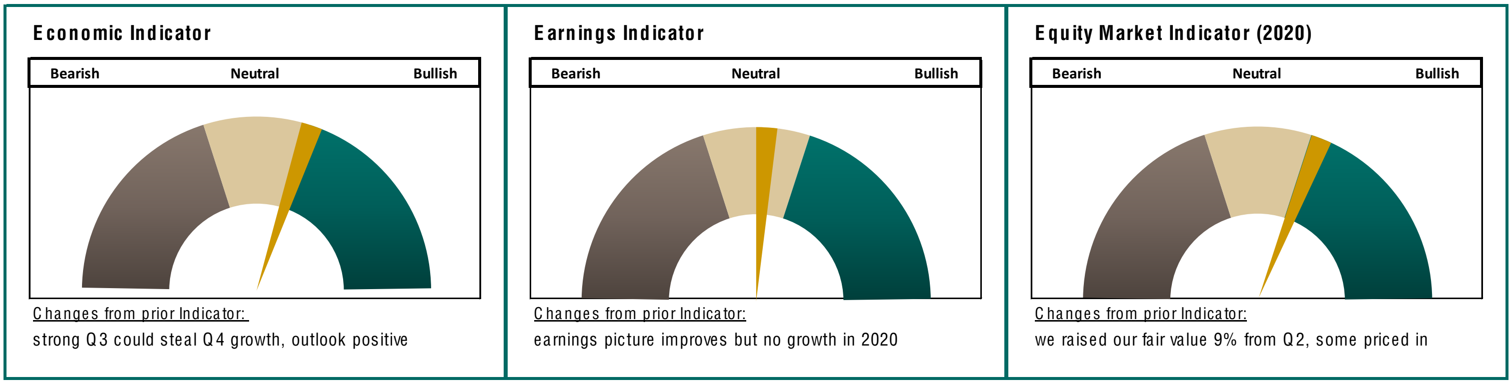
Our S&P sector recommendations are updated below.

S&P 500 Sector Recommendations - October 2020

GICS Sector	S&P 500 Weight by Market Cap	WM Research 2020 Outlook	Notes	Change
Technology	27.9%	marketweight	clear 2020 leadership, growth and defensive qualities	
Health Care	14.2%	overweight	on the front lines of COVID-19 battle, valuations attractive	
Consumer Discretionary	11.7%	marketweight	consumer helped by stimulus, now job growth is key	
Communications Services	10.6%	marketweight	look to market leaders, ad spending to improve with GDP	
Financials	9.9%	overweight	2020 Stress Tests positive, cyclical upside, dividends face headwinds	
Industrials	8.4%	overweight	attractive valuations, global exposure a positive as countries reopen	
Consumer Staples	7.0%	marketweight	safe haven in down market, but will lag the recovery	
Utilities	3.1%	underweight	be selective, could benefit from Democratic sweep	
Real Estate (REITs)	2.7%	underweight	vulnerable to dividend cuts, watch exposure to hotels and retail	
Materials	2.6%	marketweight	recent outperforme as commodities rally, stick with specialty products	
Energy	2.0%	marketweight	due for a bounce but watch for uneven recovery	

Data source: D.A. Davidson Wealth Management Research as of 10/8/20; no changes to individual sector outlooks were made from our prior update in July.

Wealth Management Research Investment Cycle Gauge



Source data: D.A. Davidson & Co. as of 10/8/20

James D. Ragan, CFA
Director of WM Research
(206)389-4070
jragan@dadco.com

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Market Indices: The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Indices provide a general source of information on how various market segments and types of investments have performed in the past. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. You may not invest directly in an index. Past performance is not an indicator of future results. The Russell 2000® Index is a market cap weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000® Index. The S&P 400 Index is a market cap weighted index comprised of U.S. stocks in the middle capitalization range, generally considered to be between $200 million and $5 billion in market value. The S&P 500 Index is a market cap weighted index that is designed to measure the US large-cap equity performance. The index is composed of the 500 leading publically traded US companies based on size, liquidity, industry, and profitability criteria. The Dow Jones Industrial Average is a price weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange (NYSE) and the NASDAQ. The MSCI EAFE® Index (Europe, Austral, Asia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

Other Disclosures:

The forward S&P 500 price-to-earnings ratio (P/E) is a valuation measure, calculated by dividing the price of the S&P 500 index over the weighted average earnings per share (EPS) estimate of each company in the index. Earnings are based on “forward” consensus estimates expected over the next 12 months (NTM).

The yield of the 10-year U.S. Treasury bond is a widely followed barometer of the current U.S. interest rate environment.

S&P 500 earnings growth reflect the year over year change in operating earnings on a per share basis. Earnings data are aggregated for all S&P 500 constituents and are measured according to the relative market capitalization weights for each company. Estimated earnings are the combined FactSet estimates of analysts covering each company included in the index.

Non-residential fixed investment is an indicator of U.S. corporate capital expenditures (capex), measured by the amount spent on structures, equipment, and software. Seasonally adjusted annual rate (SAAR) is used to normalize data by adjusting for seasonal changes in business and economic data for a more accurate comparison between different time periods

The ISM Purchasing Managers' Index (PMI) is an indicator of the outlook for the manufacturing (PMI – Manufacturing) and services (PMI – Services) sectors of the economy. The index is based on a wide survey of company executives in these sectors. A reading above 50 indicates expectation for expansion compared to the previous month; a reading below 50 suggests contraction. Seasonally adjusted (SA) is used to normalize data by adjusting for seasonal changes in business and economic data for a more accurate comparison between different time periods. United States and Euro Zone data is provided by IHS Markit, Japan data is provided by Nikkei, United Kingdom data is provided by the Chartered Institute of Procurement & Supply, and China data is provided by Caixin.

The Treasury yield curve displays the market interest rate across different contract lengths for U.S. Treasury bonds, indicating the relationship between the interest rate and the time (“term”) to maturity.

The yields of the 10-year and 3-Month U.S. Treasury bonds are widely followed barometers of the current U.S. interest rate environment. The spread is the difference in interest rates between the two securities.

U.S. Personal Consumption Expenditures (PCE) is an indicator of the growth in consumer spending.

Country GDP estimates are aggregated and redistributed by FactSet. This does not constitute investment advice or recommendations of any kind. Estimates data is provided for information purposes only. IMF-Global GDP estimate is the International Monetary Fund’s World Economic Outlook last published on 10/2/19.