<u>Lincoln Capital Mid Quarter Client Investment Update</u>

There are several questions or concerns that arise in our internal conversations and with clients. The following provides a narrative for each topic, as well as our views where appropriate.

<u>COVID-19 Coronavirus</u> – The devastation and disruption this virus has delivered to virtually everyone around the globe is difficult to measure and grasp. While we do not know how this virus plays out, we do know that human beings adapt to environmental changes, and that process is generally underway. At the same time, over 500 companies are working on vaccines and treatments with expectations that they begin distribution before the end of 2020 with more mass distribution in 2021. Our view is that this virus will remain with us in the months and years ahead, though its impact will lesson over time.

<u>The Elections</u> – This election is destined to be very contentious and could be just downright ugly. Those of us that are more "Seasoned" will recall the 2000 election with the results being uncertain for five weeks after election day. In that election, the Democratic nominee, Al Gore, won the popular vote while Gorge W. Bush won the electoral college vote. The election came down to a contested recount in the state of Florida ("hanging chads") that ultimately was decided by the U.S. Supreme Court. In the upcoming election mail-in ballots may once again play a key role in who wins the election and when we know the winner.

From an investment perspective, we view the Senate as the key factor in this election. If Biden wins and the Republicans retain control of the Senate, then we would not expect a large market reaction. If it becomes a Democratic sweep, then the initial reaction would be negative. If Trump is re-elected with Republicans maintaining Senate control, then markets will likely work higher.

<u>The Fed and Government Aid</u> - How long can the Fed continue to provide liquidity and stability to the financial markets, and how much aid can the federal government dish out while maintaining our security and defense capabilities?

The Fed, and our federal government, have provided aid measured in trillions of dollars, and are poised to continue providing supporting actions. Many fret that a day of reckoning will come, based on common sense which tells us that you cannot infinitely spend more than you earn. That logic applies to all entities except the Fed, which is the sole entity capable of creating money and credit. Further, when the Fed and the Treasury combine their resources and work together, theoretically they can continue to provide stimulus without a pre-ordained limit. As the Treasury borrows funds (issues T-bills, T-notes, T-bonds, and others), the Fed may purchase part or all of these bond issues which, in essence, is printing money – (technically, there is no money printing if the added funds are parked at the Fed as bank reserves). Not all countries have this luxury which is derived from (1) the U.S. status as the largest economy and (2) the U.S. dollar being the preferred medium of exchange in international trade and is viewed as a relatively safe asset in a troubled world. While time will tell if, or what, the limit is for the Treasury–Fed tandem act, at present this duo appears able to provide as much accommodation as markets and the global economy need and will allow. A surge in interest rates or inflation expectations would likely cause both entities to change policies and actions. While this may be inevitable, it appears unlikely in 2020 and perhaps 2021.

Interest Rates – Bond investments have had a great year. In-fact, they have had consecutive great years. In 2019 the Barclays Aggregate index posted a total return of 8.7% and in 2020 through July the index is up 7.7%. As interest rates plunge the price of bonds appreciate and these price gains have driven most of bond's above average total returns (interest income +/- price change = total return). While these fixed income returns have been enjoyable, this mechanism has essentially pulled forward future returns. Making this period even more bizarre is that stocks indices are at or near record highs while interest rates are at record lows – these two metrics are usually positively correlated. Whatever the reason, the outcome is low prospective returns for fixed income investors in the months ahead.

Low yields will force many, unwillingly, into longer duration securities, lower rated issues, or even equities (see below), as investors seek to earn some return on their capital. While we understand the temptation, our view is that when you stretch for yield, you are likely to pull a muscle or lose your balance and fall. Many of the high-quality areas of fixed income are artificially expensive as the Fed has greatly reduced the probability of default from the market. Lower quality, higher yielding securities will not get the same support from the Fed, yet they are trading at prices that result in unattractive loss adjusted yields. All is not bleak as there are some areas that are reasonable today, such as parts of structured credit (accessed through some of our mutual fund holdings) that offer good yields with moderate levels of risk. We will continue to look for attractive risk-adjusted yields, while maintaining a shorter than average portfolio duration. We expect this will position us well to take advantage of higher yields and better spreads in the future.

Lastly, as you will recall, we invest in bonds for two primary reasons - to receive income and to protect capital. Our assessment of the current status and probable developments in the future are (1) protecting capital takes precedence over seeking higher interest income or taking higher risks and (2) we expect inflation and other factors to cause interest rates to rise over the next 6 to 18 months and longer. Rather than chasing higher yields with increased risk, being patient and protecting capital are advised, as present interest rates do not provide sufficient returns compared to the downside risk if interest rates begin to rise. Stated differently, it is prudent to focus on return "of" capital rather than return "on" capital.

Stock Market - First, let us note that the composition of many stock market indices, such the S&P 500 Stock Index (SPX), is determined and ordered according to the market value of their outstanding shares (# shares times current share price = market capitalization; a notable exception is the Dow Jones Industrial Average which is price weighted). If we look at the rate of return for SPX, its total return in 2020 from the beginning of the year to August 12th was 5.86%. Yet the mean average return for the 500 companies was -2.98%, and the median return was -2.57%. Why such a return disparity? The reason for the wide return differentials between the SPX return and average returns is that the top 5 holdings in the SPX make up 26% of the SPX index and were responsible for 40% of the SPX return. If you did not own these companies or have exposure to them via mutual funds or ETFs, then your returns most likely lagged the index returns.

A prominent factor for stocks rising is Fed actions to keep interest rates at all time low levels. Stock prices are inversely correlated with interest rates so, as interest rates go lower, the price that investors are willing to pay for a dollar of earnings (the Price Earnings (P/E) multiple) rises. Historically, P/E's have averaged around 15 times earnings, which makes the current P/E of 25 appear rich. Such an elevated metric is not unreasonable when the interest rate on a 10-year U.S. Treasury is one half of one percent (0.50%; 50 basis points).

The Fed continues to force investors to move out on the risk spectrum in order to receive meaningful returns. Until investors anticipate a change in Fed policies, risk assets will have the Fed at their back. We expect stock prices to grind higher with periodic pullbacks, and we sense that we may be in the initial stages, or near mid-field, of an asset melt-up. Prices in true markets are determined by supply and demand. In the past two decades the supply of publicly traded securities has greatly decreased while the amount of funds seeking stock investments has greatly increased. Note, for example, that there are over $5 trillion in money market funds earning basically zero. It seems reasonable to expect a portion of these funds to move to stocks as well as other sources of demand which will bid prices higher. The bottom line is that the time to get bearish is on the horizon, yet it may be too early for stock investors to reduce exposure to equities if these scenarios come to fruition in the months and years ahead.