Colorado Capital
MANAGEMENT

QUARTERLY MARKET UPDATE / OCTOBER 2020

Economic Outlook

Overview

After a record setting economic contraction in the second quarter, US GDP likely expanded at an unprecedented 20% to 30% annualized rate, or more, during the third quarter. These extremes were driven by the economy closing down in early spring due to the pandemic, and then reopening over the summer. As we enter the fourth quarter, the thundering economic rebound has shifted to a lukewarm recovery.

While the job market and retail sales are improving, unemployment remains high. A growing number of business layoffs and closures have dampened consumer confidence. Many households have also been affected by the conclusion in July of the massive federal aid program for small businesses and the unemployed. With Democrats and Republicans sharply divided, the possibility of additional government help before the November election seems very unlikely.

We suspect it will take until early 2022 for the economy to recover the ground it has lost, but the return to economic normalcy will depend heavily on the path of the pandemic and when an effective vaccine becomes widely available.

CCM Key Economic Indicators

Indicator	9.30.20	6.30.20	9.30.19
US Economy			
Quarterly GDP Growth	est. 35%	-31.4%	2.6%
Unemployment Rate	7.9%	11.1%	3.5%
U.S. CPI -Core (Inflation)	1.7%	1.2%	2.3%
Interest Rates			
Fed Funds Rate	0.00%	0.00%	2.00%
10-Year Treasury Rate	0.68%	0.73%	1.70%
Currency & Commodities			
Crude Oil (WTI)	$40.05	$ 39.27	$ 54.09
Gold Price	$ 1,883	$ 1,771	$ 1,488
Trade Weighted Dollar Index	116.7	120.0	117.4
Confidence			
Consumer Confidence Index	101.8	98.1	125.1
ISM Purchasing Managers Index	55.4	52.6	47.8
Stock Prices			
Dow Jones Industrial Average	27,782	25,813	26,917
S&P 500 Forward P/E Ratio	21.5	21.7	16.8

Labor Market

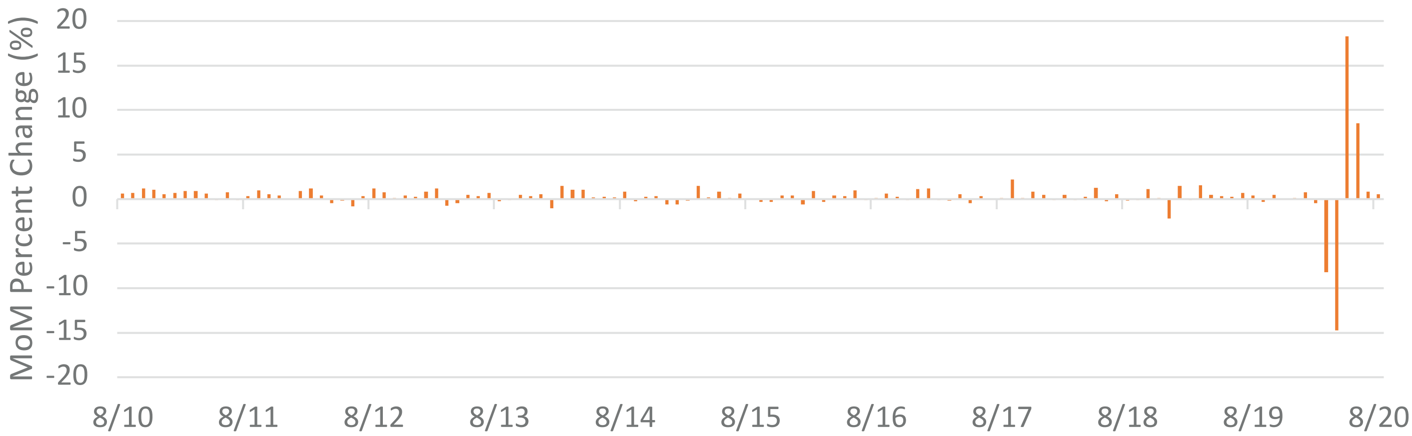
U.S. unemployment improved markedly during the quarter, falling from 11.1% to 7.9%. However, the pace of improvement appears to be slowing. Job postings rose sharply with the reopening of the economy in the second quarter, but have declined since late July. Initial and continuing jobless claims remain elevated, as more large firms announce layoffs and more small firms close permanently. Future hiring will likely be closely linked to the course of the pandemic, particularly if we see major new outbreaks this fall and winter.

Consumer & Business Confidence

Both consumer and small business confidence rebounded significantly since April, but have recently leveled off and remain far below last year's peak levels. As gains in confidence have slowed, consumers have tightened their wallets, directly affecting consumer spending, in turn making it harder for businesses to justify adding to or even maintaining their current workforces. The ongoing need for social distance has shifted spending away from in-person services. As a result, the manufacturing sector has shown greater recent strength than the service sector, but lingering softness in sales, and an uncertain global outlook weigh on future business prospects.

Retail Sales

Retail and Food Services Sales



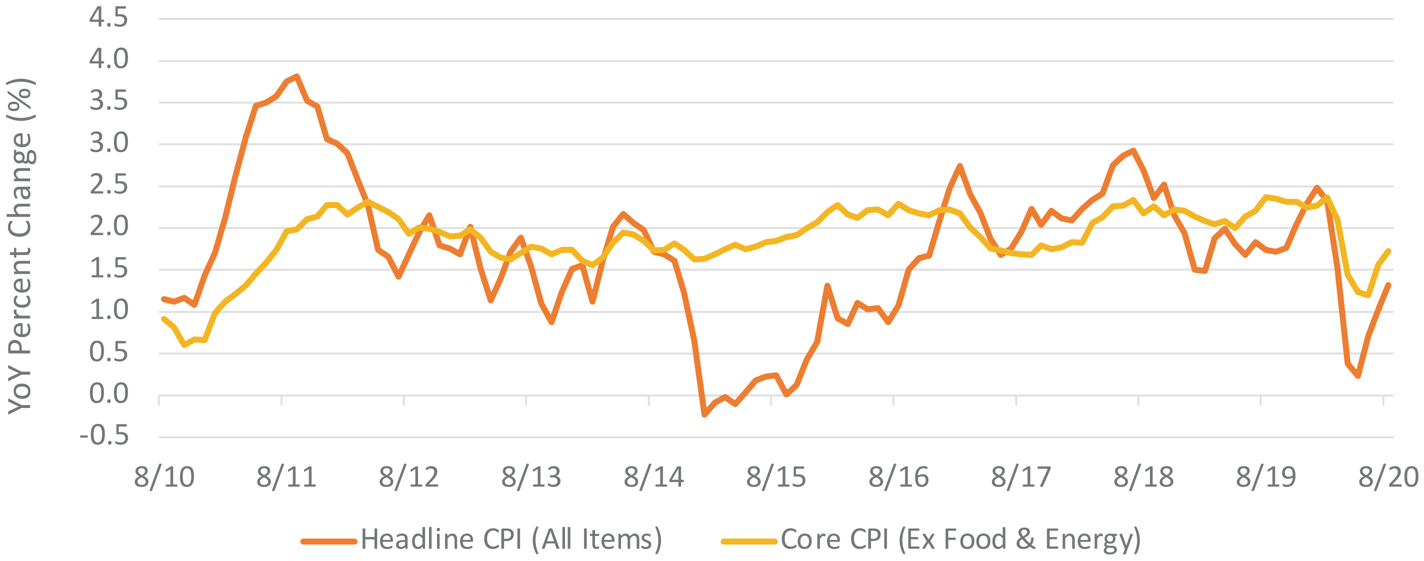
Source: U.S. Bureau of the Census

After plunging in March and April, and then skyrocketing in May and June, retail sales leveled off in July and August The marked slow-down in consumption reflects a return to historical norms, and also the end of the $600/week federal unemployment payments provided by the CARES Act, which stopped in late July. This drop off in payments threatens the finances of many households and represents a significant risk to consumer spending and the broader U.S. economic outlook.

Inflation & Interest Rates

Like many economic statistics, inflation fell sharply at the onset of the pandemic, had a big rebound, but still remains muted relative to historical norms. Prices for certain goods held up better than others, reflecting a shift in consumer habits and preferences amid the pandemic, as well as continued business disruptions and adaptations in many industries. The core CPI index increased 1.7% over the last 12 months, which is somewhat below the Federal Reserve's long-term target rate of 2%. In August, the Federal Reserve announced a new policy framework that abandoned the longtime strategy of pre-emptively lifting interest rates to head off higher inflation. It plans to keep U.S. interest rates at a record low for at least three more years. Short term interest rates should thus be anchored near zero through at least 2023, which could lead to higher rates of inflation.

Inflation (Consumer Price Index)



Source: U.S Bureau of Labor Statistics

Commodity Prices and Trade Weighted Dollar

The pandemic related slowdown in economic activity is expected to reduce oil consumption for the year by about 10%. The sudden drop in demand led to oversupply and a first quarter crash in the oil market. Prices have since leveled off, albeit at about 2/3 of the level from a year ago. In the current environment of high political and economic uncertainty and low interest rates, gold prices have taken off. Reaching $1,883 at quarter end, the price of an ounce of gold was up over $100 for the quarter and close to $400 for the year. The U.S. dollar, viewed as a safe haven at the onset of the pandemic, fell approximately 3% in value last quarter as the U.S. was more adversely impacted by the Coronavirus than most other nations.

Outlook

After the reopening of the economy in the third quarter pushed economic growth to record highs, the question now turns to how much growth will slow in the fourth quarter. While both manufacturing and service companies reported solid growth in September, Coronavirus infection rates remain high in the U.S., and mounting uncertainty over the presidential election could further push down business optimism.

The path ahead continues to be highly uncertain. A full recovery is likely to come only when people are confident that it is safe to re-engage in a broad range of activities, and most importantly, when they are back at work. The case for a rapid return to the pre-pandemic economy rests on businesses quickly hiring back workers laid off in the spring. And indeed, since April, the number of people on temporary layoff has plummeted by two-thirds, or about 12 million. But the longer the pandemic drags on, the more businesses in the most vulnerable sectors will close forever. Since February, more than two million people have permanently lost their jobs, and their numbers seem certain to grow.

With pandemic-related uncertainty remaining elevated, near-term risks to the economy still appear tilted to the downside. As such, continued government support will be essential in limiting financial stress to households and businesses and in determining the pace of the recovery. Considering stalled negotiations around the next stimulus package in Washington, consumption growth is at risk of tapering off in the coming months.

It is going to be a long and bumpy road back to economic normalcy, with some industries recovering much more rapidly than others. Barring another round of economic shutdowns, GDP is expected to regain its pre-recession level by the first quarter of 2022. While the rapid development of a vaccine could accelerate this timetable, a major second wave of the virus would of course slow the recovery.

Market Commentary

Overview

After experiencing the largest economic contraction ever in the second quarter of 2020, the economy began a robust recovery. The shape of the recovery has been the subject of much debate. During the early days of the pandemic, there was hopeful talk about a “V” shaped recovery. More recently, economists have pointed to a “K” shaped recovery with middle and upper-class workers suffering less and recovering more quickly than individuals holding lower-paying jobs.

In addition to the reopening of the economy, financial markets also received a boost from the government’s aggressive fiscal and monetary response to the COVID-19 pandemic. Given this environment, the S&P 500 rose 8.9% during the third quarter. Overseas, the MSCI EAFE International Index gained 4.8%, and the MSCI Emerging Markets Index increased by 9.6%. Fixed income markets produced modest positive returns, with the The Barclays U.S. Aggregate Bond Index gaining 0.62%.

Domestic Equity Review

Despite the ongoing pandemic, U.S. equity markets continued to rebound during the first two months of the quarter. By early September, the tech-heavy Nasdaq Composite was up nearly 20% and had reached an all-time high.

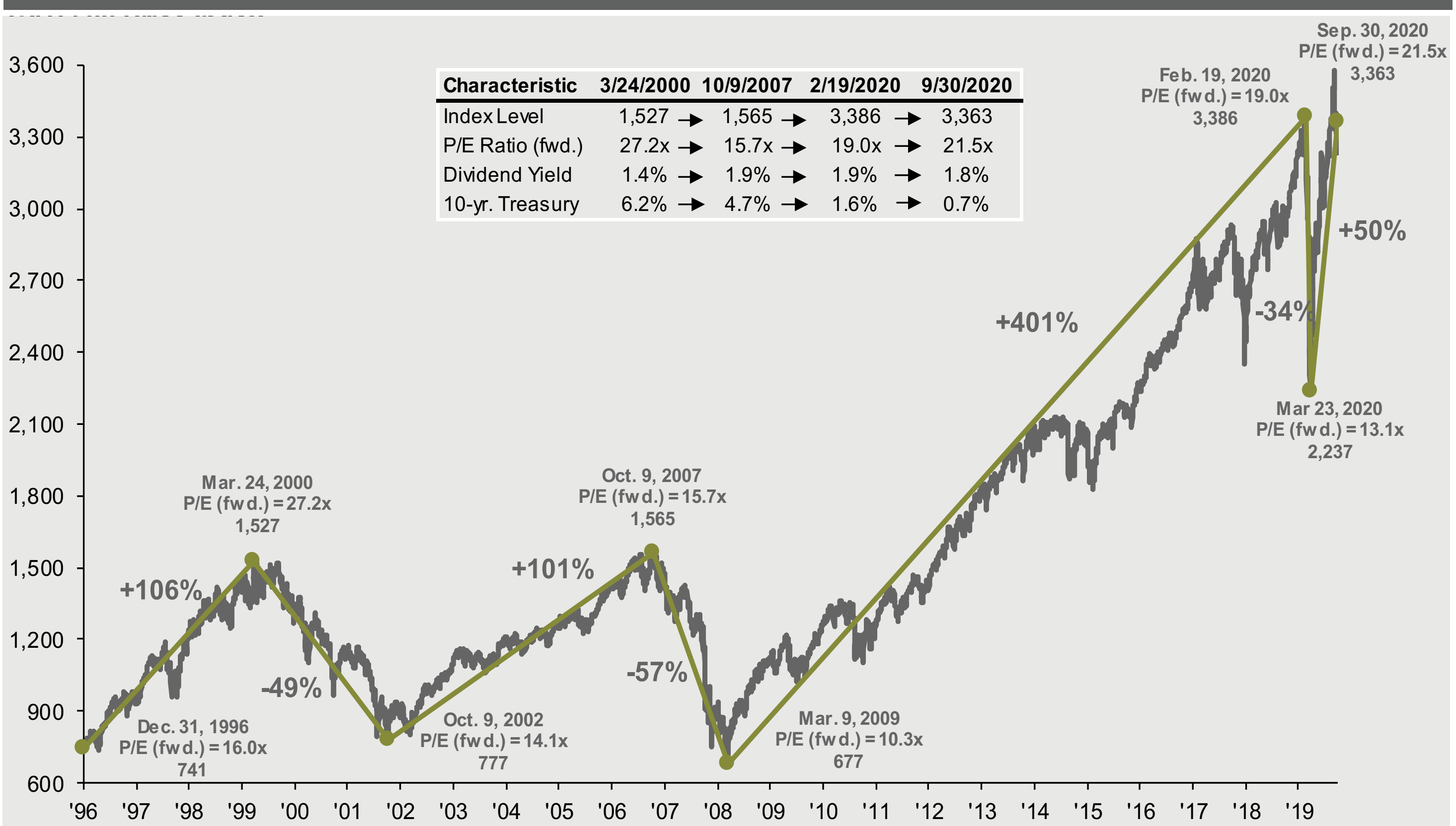
However, markets reversed course in the final month of the quarter as the daily numbers of new COVID infections continued to grow, and it appeared that that a vaccine would likely not be available until the summer of 2021. Additionally, a vacancy in the Supreme Court ramped up the already contentious political climate and made a deal for additional fiscal stimulus less likely, or at least delayed.

The possibility of a contested election is another source of uncertainty.

Throughout the quarter, the rising stock market has been at least partially driven by the federal government's aggressive efforts to ensure that the capital markets remain liquid and investors stay confident. The Federal Reserve's balance sheet now stands at more than $7 trillion, or about 80% higher than this time last year.

The continued rally in the U.S. stock market has stretched valuations (see chart below). At quarter end, the S&P 500 index was trading at 21.5 times projected future earnings, which is well above its 25-year average of 16.5 times earnings.

S&P 500 Price Index



Characteristic	3/24/2000	10/9/2007	2/19/2020	9/30/2020
Index Level	1,527 →	1,565 →	3,386 →	3,363
P/E Ratio (fwd.)	27.2x →	15.7x →	19.0x →	21.5x
Dividend Yield	1.4% →	1.9% →	1.9% →	1.8%
10-yr. Treasury	6.2% →	4.7% →	1.6% →	0.7%

Source: JP Morgan Guide to the Markets

International Equity Review

Overseas, investor optimism rebounded with less vigor than in the U.S., especially in Europe where the economy contracted even more severely during the COVID-19 shutdowns. Additionally, a new spike in cases in Europe is fanning fears of a second wave of the pandemic. While it is probable that governments will be better prepared for a recurrence, the effects on consumer confidence and economic activity could be severe. As in the U.S., central bank accommodation and government stimulus have played an important role in stabilizing international economies. Emerging markets fared particularly well during the quarter, rising close to 10%.

Fixed Income

The overall environment was largely "risk-on" during the quarter, meaning investors sought out riskier assets. High yield bonds were the strongest performing sector, gaining 4.6%, while international bonds outpaced domestic issues due to a decline in the dollar. The US aggregate bond index gained 0.62%.

Looking forward, the fixed income environment remains challenging with yields on 10-year Treasuries ending the quarter around 0.68%. Given the Fed's commitment to a "lower for longer" rate policy, the yield on the 10-year Treasury is expected to remain below 1.0% for the foreseeable future. With interest rates so low, the outlook for bond returns is modest at best.

If the there is a Democratic sweep of the fall elections, we would expect to see an increase in taxes and regulations on corporations. Although there would also likely be more government stimulus spending, investors could view this as a “risk-off” environment. In this scenario, increased demand for high-quality bonds could push interest rates lower. It could also lead to investors moving away from high yield (riskier) bonds, which already face significant headwinds from potential defaults, downgrades, and bankruptcies.

U.S. Outlook

In the U.S., supportive monetary and fiscal policies, the potential of a COVID-19 vaccine, and favorable fundamentals anchored by modest inflation are among factors supportive of domestic equities. The early recovery phase of the business cycle, typically characterized by low inflation and interest rates, usually favors equities over bonds. But after the dramatic rebound from the March 23rd lows, an equity market pullback would not be surprising. Volatility is expected to remain elevated into the new year for as long as the duration and impact of COVID-19 remain unclear.

Uncertainties also surround the U.S. election, particularly with respect to tax policy, government regulation, and the re-escalation of U.S.-China trade tensions. A victory by President Trump would likely benefit domestic equities as tax hikes would be averted while a Biden administration would probably benefit international stocks as trade policy may be less contentious. A contested election has the potential to destabilize markets.

In terms of market capitalization and style, the markets may be poised for a rotation away from growth leadership toward more cyclical value stocks. This outlook is supported by where we are in the business cycle and by the extreme pricing variation between value and growth stocks. Shares of small-cap companies may also enjoy a strong recovery as the economy emerges from recession.

If the post-coronavirus economic recovery favors undervalued cyclical value stocks over expensive technology and growth stocks, developed international equities should perform well. This is because most major foreign stock indexes are overweight cyclical value stocks relative to the U.S.

International Outlook

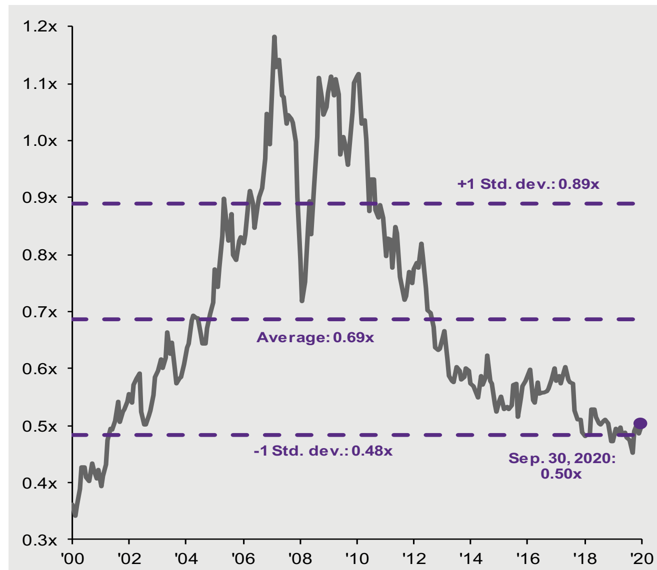
In Europe, economic indicators have rebounded through the September quarter following the easing of lockdowns. COVID-19 infections have been rising, but hospitalization and death rates remain low. The prospect of nationwide shutdowns appears unlikely. In Japan, the economy continues to lag the recovery of other major regions. The Japanese economy may remain a laggard in the recovery, due to constrained monetary policy and deflationary dynamics. In the UK, Brexit dominates the outlook, and the risk of a hard exit is high.

In emerging markets, uncertainties surrounding global trade policies will likely remain a headwind until investors get clarity about the state of trade negotiations after the U.S. election. However, the MSCI Emerging Markets index, with its relatively attractive valuations (see chart) and its exposure to cyclically sensitive sectors, has the potential to outperform when economic activity picks up.

China's early exit from lockdown measures as well as stimulus support should also benefit this asset class. It is becoming clear that the lifting of lockdowns and government stimulus are the most important elements in determining how economies recover from the current health crisis.

Unfortunately, the pandemic has caused almost all developing countries to experience a deterioration of budget balances and rising debt-to-GDP ratios. This weaker fiscal position makes emerging markets more vulnerable and contributes to their lower valuations.

Emerging Markets vs. S&P 500
Relative Price-to-Book Ratio
Trailing 12-Month Data



Source: JP Morgan Guide to the Markets

Sources: Capital Market Consultants, JP Morgan, Department of Commerce, Department of Labor, Morningstar, Bloomberg,, Institute for Supply Management, National Federation of Independent Business

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