MALVERN CAPITAL MANAGEMENT

MCM

Third Quarter 2020 Review and Market Outlook

October 2020

Third Quarter 2020 Review

As far as the stock market goes, its price chart has displayed a "V" shaped recovery. The rebound of the S&P 500 Index to its previous highwater mark set on February 19th was again reached on August 12th. We had a one-month bear market and the Index recovered all of its losses in roughly four months. In the 3rd quarter 2020, the S&P 500 Index rallied 8.93% while the Nasdaq 100 Index rose another 12.62%. These returns were recorded despite a September sell-off trimming 3.74% from the S&P 500 Index's quarterly return. Equity investors shrugged off the news of recession and looked for the economy to bounce back quickly as parts of the economy re-opened and we saw a partial move back to normal. We are still a long way from being back to the pre-pandemic days but it seems that investors have adjusted to the reality of Covid-19.

The bond market also fared well during the quarter. High quality bonds had a total return of .62% as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. Lower quality or "junk" bonds also advanced by 4.60%. The Federal Reserve remains very accommodative which will help to prop up the bond market. It is still amazing to see the yield on the S&P 500 Index higher than the yield on the 10-year U.S. Treasury note. With the yield from stocks higher than the yield on bonds as of the end of the 3rd quarter, it is hard to imagine any significant and lasting sell-off in stocks. This yield differential may be one of the reasons the stock market has bounced back so quickly after the March sell-off.

Investors have their eyes on the upcoming election and are cognizant of possible further economic stimulus coming from Washington. We are still in a recession. Many people are hurting right now and many people are contracting the virus.

Index Performance

Category	Representative Index	3rd Qtr 2020	Y-T-D	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	8.22	-0.91	5.70	9.98	14.02	12.69
Broad US Large Companies	S&P 500 Index	8.93	5.57	15.15	12.28	14.15	13.74
US Small Cap Companies	Russell 2000 Index	4.93	-8.69	0.39	1.77	8.00	9.85
US Mid Cap Companies	Russell Mid Cap Index	7.46	-2.35	4.55	7.13	10.13	11.76
Largest 100 NASDAQ Companies	NASDAQ 100 Index	12.62	31.65	48.75	25.36	23.63	20.43
Developed International	MSCI EAFE Index	4.80	-7.09	0.49	0.62	5.26	4.62
Emerging Markets	FTSE All Emerging Markets	9.18	-2.09	9.42	2.92	8.83	2.49
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	0.62	6.79	6.98	5.24	4.18	3.64
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	4.60	0.62	3.25	4.21	6.79	6.47
Commodities	Bloomberg Commodity	9.07	-12.08	-8.20	-4.18	-3.09	-6.03
Total US Market (all cap stocks)	Russell 3000 Index	9.21	5.41	15.00	11.65	13.69	13.48
Real Estate Investment Trusts	Wilshire US REIT Index	1.25	-16.74	-17.69	0.45	3.65	8.00
Cash	US T-Bill 90 Day	0.03	0.34	0.73	1.54	1.12	0.59

** 3 year, 5 year and 10 year returns are annualized. All periods ending September 30, 2020.*
All returns include the reinvestment of dividends.

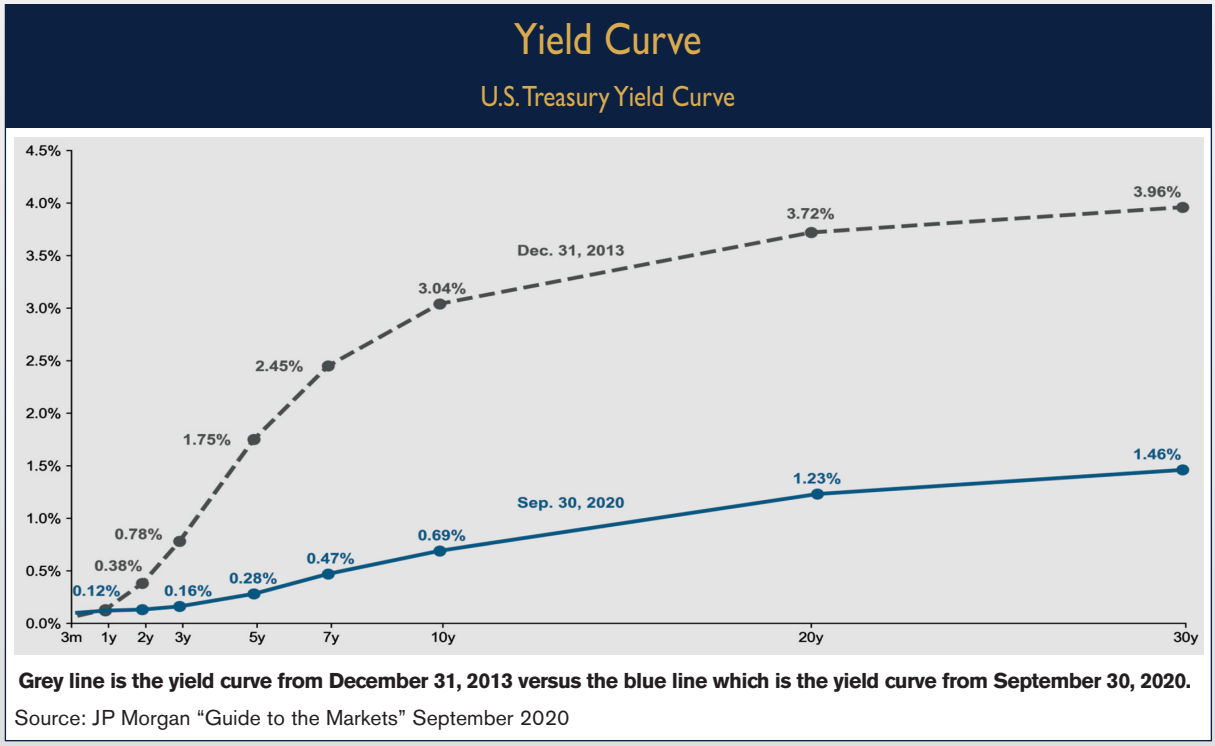
We are optimistic for the near future and we believe that equities will reflect that optimism through the remainder of this year. This has been a historic year so far, yet a year we are probably all eagerly looking forward to ending.

The Federal Reserve and Interest Rates

The Federal Reserve has said that it will not raise interest rates until no earlier than the year 2023. In its latest meeting ending on September 16th, it kept the Fed Funds rate at 0 - .25%. It stated that it was attempting to allow the inflation rate to reach its "long-run" target of 2% and would even allow it to rise above 2% temporarily until employment returns to maximum levels. Since the economic slowdown caused by the pandemic, too low of an inflation rate has been feared. The "lower for longer" interest rates are expected to help curb the currently high unemployment rate caused by the economic shutdown. The accommodative interest rate policy is in addition to its quantitative easing program in which the Fed is buying treasury and mortgage backed securities.

The Fed generally only has control over short-term interest rates although the quantitative easing programs it has employed indirectly affects longer-term interest rates as well. Nevertheless, longer-term interest rates are also at historically low levels.

The Fed's very cheap money can be expected to fuel the stock and bond markets. Further, stocks relative to bonds appears to be more attractive. The aforementioned yield differential between stocks and bonds is very positive for stocks. The Fed claims that the stock market ups and down have no bearing on interest rate decisions but it is certainly aware of the impact it is having on stock prices when it implements its policy measures.



Grey line is the yield curve from December 31, 2013 versus the blue line which is the yield curve from September 30, 2020.

Source: JP Morgan "Guide to the Markets" September 2020

The Election is Finally Upon Us

November 3rd, Americans go to the polls (if they have not voted earlier) to elect the next president of the United States. By and large, this election is a referendum on President Trump. It appears that beyond voters who identify as Democrats, the voters who will decide the election are either voting "for" Trump or voting "against" Trump; not necessarily voting "for" Biden. This is supported by polls measuring voter enthusiasm whereby supporters of Trump are very strongly for Trump and voters for Biden are less enthusiastic. A recent Pew poll (*Pew Research, August 13, 2020*) shows that 46% of Biden supporters strongly favored Biden while 66% of Trump supporters strongly supported Trump.

The implications of a Trump victory are that things will be status quo for the most part. In a second term Trump proposes changes to healthcare, and more progress with his dealings with China, but beyond that it is the same as usual. A Biden victory, along with the Democrats taking the senate and retaining control of the house, at the very least means higher taxes for the wealthy, higher corporate income taxes and increased regulations. These changes have the potential to affect the stock market and not necessarily in a positive way. For example, a higher corporate income tax rate suggests that stock prices may have to adjust downward to account for the tax effect on earnings. Biden, however, does promise he will fix the economy and lead us out of recession.

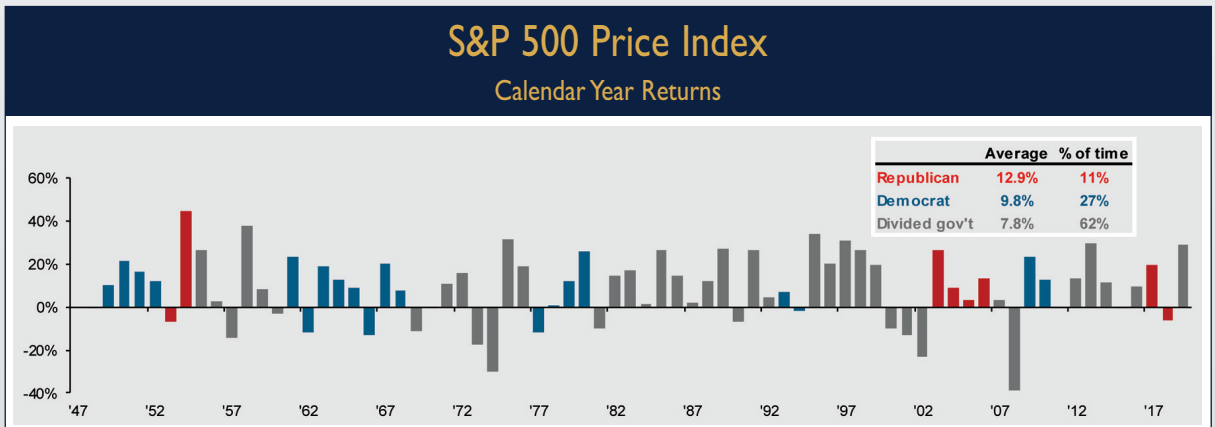
We are currently living in a very polarized country. Citizens are afraid to show their support for one candidate over another without fear that something could happen to them. Friendships and family relationships are in jeopardy because of one's support for one candidate versus another. The stakes are high with the results of this election. If it ends on November 3rd or sometime at a later date, it will be good to finally put it behind us.

There will be certain companies which will benefit from a Trump victory as there will be certain companies that benefit from a Biden victory. In the long run, the effect of who is president is not as important as how good corporate earnings are, the level of interest rates and the overall growth of the economy.

Over the past 70 years, when Republicans control the White House, House and Senate, the average return on the S&P 500 is 12.9%. When the Democrats control the White House, House and Senate, the average return is 9.8%. When we have divided government, the average annual return is 7.8%.

Regardless of which side of the aisle you sit on, please exercise your constitutional right to vote this November!!

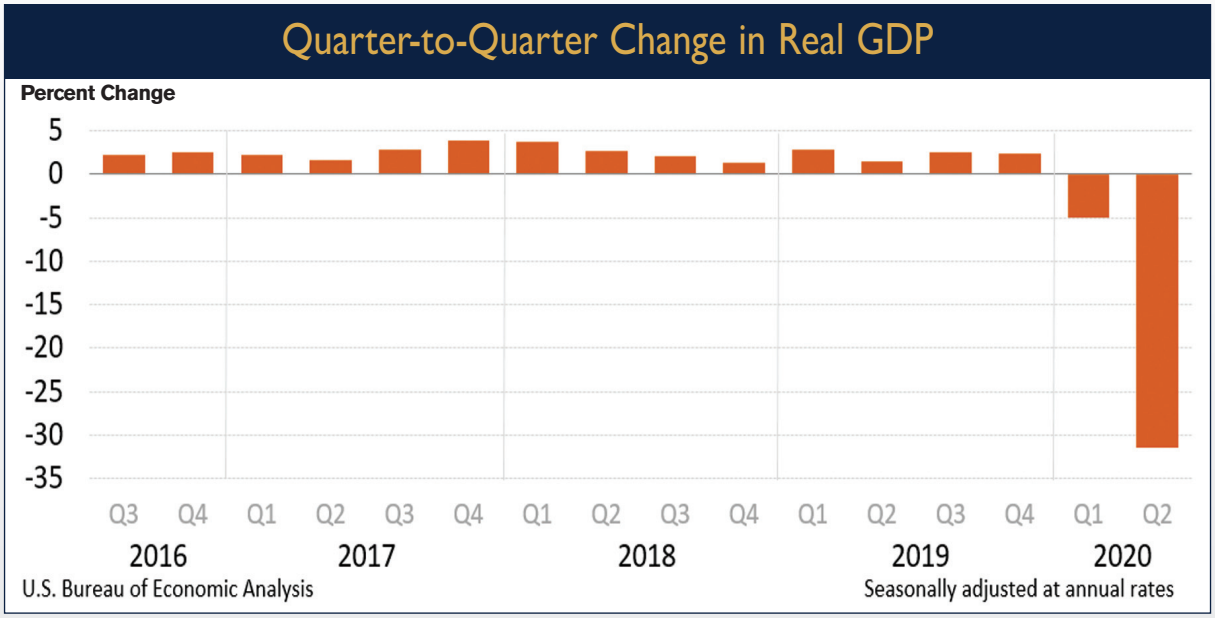
"Nobody will ever deprive the American people of the right to vote except the American people themselves and the only way they could do this is by not voting." – Franklin D. Roosevelt



Source: JP Morgan "Guide to the Markets" September 2020

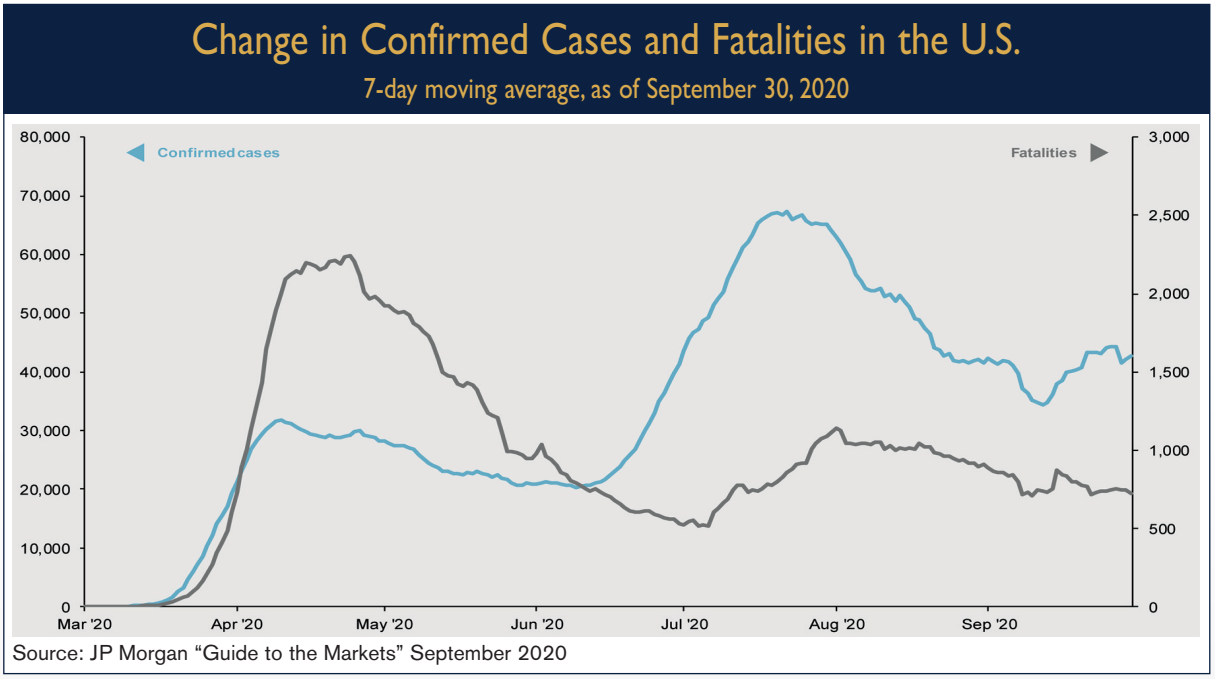
The Economy

As reported by the Bureau of Economic Analysis, real Gross Domestic Product (GDP) growth for the 2nd quarter of 2020 came in at an annual rate of -31.4%. Real GDP growth for the 1st quarter of 2020 was -5%. A recession is defined as two consecutive quarters of negative GDP growth. We are officially in a recession. In anticipation of the fall in GDP growth when the economy first closed back in March, stocks had initially sold off sharply. But stocks have since rebounded as investors are expecting a "V" shaped recovery in the economy. Investors expect that when the economy re-opens, it will do so quickly and that demand will still be there for goods and services unlike typical recessions where it takes time for demand and consumer confidence to return. The economy has been re-opening gradually and many economists expect that GDP growth for the 3rd quarter of 2020 will show a huge increase. The first read of GDP for the 3rd quarter will be released on October 29th. A large increase in growth will certainly give investors more confidence but a disappointing read could result in stocks selling off, at least initially.



The unemployment rate has dropped significantly since its peak in April. The unemployment rate in April was 14.7%. As of the September jobs report, it had fallen to 7.9%. An improving jobs market is necessary for consumer confidence to increase which is needed for the "V" shaped recovery to take place. The unemployment rate's decline is contingent on the continued re-opening of the economy while the re-opening is contingent on improvement in the Covid virus. Fortunately, the Covid numbers are improving.

Any set-back in economic growth or the unemployment situation may suggest that we see a "W" shaped recovery versus a "V" shaped recovery. All eyes will continue to be on the first read of the 3rd quarter GDP number as well as weekly unemployment claims and monthly jobs reports.



Corporate Earnings – The Real Driver of Stock Prices

According to the Bureau of Economic Analysis, corporate profits fell 10.3% in the 2nd quarter 2020 following a drop of 12% in the 1st quarter of this year. Comparing the 2nd quarter of 2020 to the 2nd quarter of 2019, the year-over-year 2nd quarter profits declined by 19.3%. This is a backward-looking view of corporate earnings. Investors look forward. They are asking the question, despite these drops in earnings, where are earnings expected to go?

At the beginning of 2020, analysts at the Standard & Poor's Corporation projected earnings on the S&P 500 Index to be $175.52 per share. The estimate came before Covid-19 hit anyone's radar. At the end of June, 2020 those same analysts had reduced their estimates for full year 2020 to $109.05 per share. At the end of September, they have been able to slightly increase those estimates for earnings to $113.84 per share. Not a big increase, but it is an increase rather than an additional decrease. Back in June, the analysts had not projected that we would see earnings increase until the 1st quarter 2021. The analysts currently project gradually increasing earnings throughout 2021. A lot of this optimism no doubt is assuming a full reopening of the economy next year. Such an assumption may still be a bit hopeful as the pandemic is still with us and a vaccine has yet to be approved. We will be monitoring the progress toward full reopening of the economy as we proceed through this year into next year.

Market Valuation

The equity markets appear to be overvalued at this time. At the end of September 2020, the price of the S&P 500 Index was 3363.00. The estimated earnings per share in the 3rd quarter was $117.51. The trailing price-to-earnings (P/E) ratio of the index was 28.62. The forward P/E ratio was 21.72. Both ratios indicate an expensive stock market. The analysts at Standard & Poor's Corporation do project growth in earnings over the next 12 months. They project earnings of $164.28 for the full year of 2021. This shows significant growth in earnings and is assuming a sharp rebound in the economy as well as the re-opening of many businesses that have closed or slowed down operations.

As for the earnings, one concern would be the operating margins on those earnings. The current operating margin on the S&P 500 Index's earnings is 8.49% (for the 2nd quarter 2020). It had dipped as low as 5.86% in the 1st quarter of 2020. For comparison purposes, the operating margins every quarter since 2017 have exceeded 10% and were as high as 12.13% for the 3rd quarter of 2018.

Another concern would be the impact of higher corporate income taxes. It does not seem that the earnings estimates are fully pricing in the possibility of higher corporate income tax rates next year as promised by Biden should he win the White House. Higher tax rates will affect the earnings per share of companies and the market will likely need to adjust for those lower estimates.

Similar to today, stocks were very expensive at the end of 1999 at the height of the technology boom and dotcom bubble and we know how that ended. The S&P 500 Index dropped three consecutive years from 2000 to 2002. Growth stocks suffered the biggest losses. The P/E Ratio on the S&P 500 Index in December 1999 was 28.43 versus the current P/E ratio at 28.62. One huge difference, however, between the years 1999 and 2020 is interest rates. Today the Fed Funds rate is 0 - .25%. The Week ending December 24, 1999 the Fed Funds rate was 5.46%. Today the prime rate is 3.25%. The prime rate that same week in 1999 was 8.50%. Also, today the yield on the 10-year U.S. Treasury note is 0.68% (September 30, 2020). It was 6.39% the week ending December 24, 1999.

Maybe we can justify stocks being expensive and becoming more expensive when we consider the value and current yields on bonds as the equity alternative. Also, given the substantial monetary and fiscal liquidity and stimulus provided by the Federal Reserve and the government, stocks can possibly validate their current levels. We still remain cautiously optimistic for further equity gains over the near future.

Value versus Growth Stocks

With the exception of a few short periods of excess return for value versus growth stocks, growth stocks have outperformed value stocks since December of 2006. A growth stock is a stock that tends to trade based on expected earnings growth whereas a value stock trades at or near its intrinsic value. Value stocks are generally companies that are more mature while growth stocks are less mature. There are also many companies that are considered a "blend" between value and growth. Apple is a good example of this. We will often see Apple owned by both value and growth mutual funds.

When does value do better than growth or vice versa? Value stocks tend to do better in the recovery stage of an economic cycle. We are coming out of a recession right now which would argue in favor of value stocks over growth stocks. Growth stocks do better in the expansion stage of the economic cycle.

Value stocks are perceived to be less risky than growth stocks, but this is just a perception. In the March sell-off we saw value stocks fall at a greater magnitude than growth stocks did as growth stocks held up very well. If we look historically, value stocks have out-performed growth stocks since 1926.

Growth stocks did extremely well in the late 1990's. By late 1999 valuations appeared to be quite extreme. Some investors believe there are a lot of parallels between the late 1990's and now. In the year 2000, we saw a sudden and sharp reversal where growth stocks sold off, (in particular technology and dotcom stocks) and value stocks carried the day. The following seven years saw value outperform growth.

At present, growth stocks appear to be over-valued and extremely rich compared to value stocks. The price-to-earnings ratio of the Ishares Russell 1000 Growth ETF is currently 32.20 versus the Ishares Russell 1000 Value ETF at 18.16. The price-to-book Ratio of the growth index is 10.12 versus 1.74 for the value index. Momentum has been with growth stocks and the relative return differential has expanded. Perhaps we

are about to see a “reversion to the mean” suggesting that value performance at least keeps up with growth. At this time, we suggest that clients’ portfolios should have a neutral weighting between value and growth, moving away from the over-weighting in growth stocks.

Conclusion

The stock market has rebounded significantly since its low in March. We experienced one of the shortest bear markets in history. The Federal Reserve has been very accommodative and is expected to keep the Fed Funds rate at 0 - .25% at least until 2023. Although Fed Chairman Jay Powell says that the stock market does not influence Fed policy, the Fed’s actions have been very good for stocks especially through the entire pandemic crisis.

It is an election year and the election is fast upon us. Depending on who wins, there will be winners and losers. A Trump victory may be good for the wealthy and corporations who will retain their lower tax rates. In turn, the markets should continue to do well. A continued lower corporate tax rate is good for stock prices. A Biden victory may not be seen as good for the wealthy as they will pay higher taxes. Corporations may pay high taxes as well. A Biden victory and a control of both houses by the Democrats could result in significant headwinds for the markets, at least in the near term.

The economy is looking for the “V” shaped recovery but may have to settle for a “W” shaped recovery. Unemployment is still a problem in this country during the Covid-19 crisis, but it has greatly improved over the past few months. There is still a long way to go to reach the 3.5% unemployment rate recorded pre-Covid-19.

Corporate profits have fallen dramatically through the crisis but earnings are starting to improve. Analysts are increasing earnings estimates as parts of the economy have re-opened. The market does appear to be on the expensive side right now. But given the low level of interest rates, increased liquidity and stimulus, perhaps that leaves us with some justification for the higher stock prices.

Growth stocks have vastly out-performed value stocks in recent years. Valuations on growth stocks are seen as extreme suggesting that a shift toward value stocks may be coming. We recommend trimming any over-weighting toward growth and take on a neutral weighting between growth and value stocks.

We are living in unusual yet historic times right now. Optimism and caution are both needed. As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer