Highland Capital
MANAGEMENT, LLC

QUARTERLY REVIEW

September 30, 2020

Economic Commentary

The third quarter of 2020 saw the market post a solid return of 8.9%, even after suffering the worst September in a decade (S&P corrected 10% from the highs reached on September 2nd). After a rough Q1 in the markets, the Q2 and Q3 of 2020 registered the best back to back two quarter performance for the S&P since 2009, with the S&P gaining over 31% since the end of March. NASDAQ has far and away been the biggest winner of 2020, with the index posting a gain of 25.3%. For the YTD the S&P has now gained 5.5%. The third quarter market action was positive with better sentiment as encouraging vaccine news, improving economic data, and the expectation of continuing government support helped to buoy the markets. We would attribute the downward move from the highs of September 2nd to a realization that another fiscal stimulus plan from congress could possibly be delayed until after the election, a resurgence of Covid cases in continental Europe and parts of the US, profit taking (primarily in the tech sector), and some flattening in the jobs data. In what has been the strangest year that any of us have lived through, market returns have been better than we would have expected. Credit is due to the quick actions taken by the Fed early in the pandemic to provide ample liquidity to markets (M2 money supply up 23% year over year), and to Congress for passing fiscal packages that provided aid to the unemployed and small business. The unemployment rate has declined from a high of 14.7% in April to 7.9% at present. Part of the recent drop is due to an unfavorable decline in the Labor Force Participation Rate to 61.4%. The easy part of the jobs recovery has been achieved. Lowering the unemployment rate from here will be tougher. Small business was the first to be impacted and layoffs occurred quickly. We are now in the midst of large companies (i.e. Disney, the airlines, Citigroup, etc..) starting to announce job cuts that will impact higher wage earners who will likely find it harder to find equivalent employment. The broader unemployment category U6 (includes those who are working part time, or who are not technically in labor force but would like to work) fell to 12.8% in September from 14.2% in August.

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Q3 2020 Equity Commentary

Third Quarter Market Recap: The S&P returned 8.9% in Q3, with some sector rotation from the previously top performing groups. Tech, which has consistently been the leader in 2020, was the fourth best performing group for the quarter gaining 12%. In a nod to an improving economy and perhaps the beginning of a new cycle, early cycle sectors performed best with Consumer Discretionary adding 15.1%, Materials 13.3, and Industrials 12.5%. FedEx was a top performer in Q3 delivering (pun intended) a return of 79%. Another transport stock, CSX railroad, was also a top performing Industrial name gaining over 11%. Homebuilder Lennar Corp within the Consumer Discretionary space added almost 33% as low interest rates continue to fuel the strong residential real estate market. Within Materials, improving copper prices (directly tied to better economic numbers) and higher gold prices led to Freeport McMoran gaining 35%. Lagging sectors for the quarter continued to be Energy (-19.7%), Real Estate (+1.9%), and Financials (+4.4%). Crude oil was up 2.4% in the quarter, but energy markets continue to worry about depressed demand due to Covid (primarily air travel), and the impacts that a second wave could have on demand. Real Estate is also a Covid casualty as the work from home concept has negative implications for commercial office real estate, and the accelerated shift to online purchasing continues to impact the retail segment. In 2020 we have experienced the fastest move from a bull market into a bear market (occurred in March), then subsequently the shortest bear market on record, and now likely the shortest recession. As such, we could start to see some shift in sector performance and would welcome that, but we would still expect Tech to remain solid, especially if the recovery is jagged. While growth stocks have continued to outperform value on a YTD basis, we did see a brief respite in that trend in September, with the Russell 1000 Growth index falling 4.8% for the month, while the Russell 1000 Value index fell by 2.6%. While growth has outperformed value for the better part of a decade, value does tend to outperform after a recession ends.

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Stock Market Index				
Market/Index	**2019 Close**	**As of September 30**	**Quarterly Change**	**YTD Change**
DJIA	28,538.44	27,781.70	8.22%	-0.91%
Nasdaq	8,972.60	11,167.51	11.23%	25.40%
S&P 500	3,230.78	3,340.47	8.93%	5.57%
Russell 2000 (Small Cap)	1,668.47	1,507.69	4.93%	-8.70%

What can we expect in the months ahead? As much as we hate to admit it, the virus will continue to dictate the trajectory of the economic recovery. We would rule out any kind of national "lock down" going forward as the consequences are too severe, but a resurgence of Covid could certainly impact consumer habits in areas experiencing an outbreak. We expect a slow grind forward with the economy continuing to recover, but at a much more subdued pace after a sharp bounce in Q3 GDP (Atlanta Fed projects 32%). For the next few quarters we expect GDP in the 3 – 5% range. Whether or not another stimulus package is passed before or after the election, we do see this as something that the economy needs. The recent slowdown in new job creation emphasizes that point. We would anticipate another $1.5 - $2 trillion package will be necessary to provide additional unemployment benefits, aid to state and local governments, and some form of housing assistance for those in mortgage forbearance programs due to job loss. The job of central bankers and policy makers has been to provide a bridge to span the gap of lost income until an effective vaccine can allow normal activities to resume. We expect that by late spring or early summer of 2021 we could reach that point, or at least be within shouting distance. The added debt burden that has been incurred as a result of stimulus could have longer term impacts on the US dollar and inflation. The dollar is down 5% YTD, and down almost 6% over the past three months. A weaker dollar is inflationary for the US consumer, but is also an advantage for larger US companies that sell products internationally, as the weaker dollar makes their goods more price competitive. The election adds another layer of uncertainty regarding potential policy changes impacting regulation, taxes, climate, trade, infrastructure, and antitrust. Seasonality is not great historically in the third quarter, with the market on average gaining 1.4%, and with the uncertainty of an election looming, volatility should increase.

Is there further upside likely? We suspect gains from these levels will be minimal. The market in our opinion has already priced in good progress on the vaccine front, the Fed has been more than generous, and valuations are mildly stretched. Further stimulus is needed, and while its not certain, the market has probably priced in to some degree that Congress will act. The next driver for the market will need to be a recovery in earnings, and that is hopefully more visible as we move deeper into 2021. It will probably take until 2022 to recapture the aggregate earnings level achieved in 2019.

Valuation: The market continues to exhibit valuation levels that are above the historical averages, with the current multiple at 20.9X forward 12 month earnings, versus the five year average of 17.2X and the 10 year average of 15.4X. With weak earnings, most investors have been relying on easy monetary policy and fiscal stimulus to bridge the "covid gap," and get the market back to a positive earnings trajectory in 2021. In effect, 2020 has been viewed as a throw away year for earnings, and company target prices have been forecasted based on normalized earnings in 2021 and 2022. To put valuation in some historical perspective, during the "Nifty Fifty" era of the early '70's the top 50 names had a median valuation multiple of 41.1X earnings. The more recent "Tech Bubble" at the end of the 90's had a median multiple of 33.6X earnings. In comparison, today's top 50 names have a multiple of 30.3X earnings. So while there are similarities to the late 90's with technology being the rage, and initial public offerings being highly anticipated and well received even when companies have limited prospects for profits in the foreseeable future, today's valuation levels have not quite reached the same lofty levels. Today's valuations are also supported by the lowest interest rates on record which increase the present value of future cash flows. However, it seems as though the market has been forgiving in allowing that the economy will recover and get back on track in 2021. As mentioned in previous notes, there is a wide disparity between the market and the economy at present. If the timing of the anticipated recovery falters, and if unemployment remains stubbornly high, then earnings will not recover as anticipated, and the market would likely see valuations compress. For the Q3 of 2021 earnings are expected to decline by 21.2%, and the fourth quarter is expected to see a decline of 12.7%. Full year 2020 earnings should be down 18%. We should finally see a positive earnings quarter in Q1 of 2021 with earnings rising 12.8%, and if the recovery materializes, 2021 eps will grow by 26% over the weak comparison of 2020.

The pandemic is not over, but if we put things into a baseball analogy we would guess that we are now in the middle innings. Scientists and doctors know much more today than they did in January, and progress is being made. There are still challenges to meet with the seasonal flu and winter coming, but we are hopeful that by this time next year we can speak of the pandemic in the past tense. We hope that you will all continue to stay well, and encourage you to reach out with any questions you might have regarding your portfolios. We thank you for your trust and confidence.

Fixed Income Commentary

The Federal Reserve has kept the same playbook since the economy was forced to shut down earlier this year. The Fed has signaled to market participants ultra-accommodation until a vaccine is in place and growth/inflation resume to pre-COVID levels. On September 16th, the Federal Reserve delivered another dovish message to the market. The Fed left interest rates on hold and stated short term rates would be near zero for the next several years. We can continue to expect accommodation from the Federal Reserve, until the average rate of inflation is well in excess of 2%. The Fed will continue buying Treasuries and mortgages in order to make sure the market is functioning properly. The housing market has benefited from low rates, as the 30 year fixed mortgage index set an all-time low in September. It appears the Fed is ready to ramp up asset purchases should the economy slow, or inflation remains well below the target of 2%. For the time being, it appears the Fed has ruled out negative interest rates except under the most extreme circumstances. Additionally, the Federal Reserve is getting pressure from Congress to address income inequality. Certain members on the Fed have recently acknowledged increasing short term interest rates might harm lower wage workers disproportionally. The forceful language and continued expansion of asset purchases has driven Treasury volatility to the lowest level on record (a metric with over 33 years' worth of data). Global central bankers are also making sure cheap money is available for the foreseeable future. The Bank of England is even considering cutting interest rates below zero as the country faces uncertainty from government restrictions caused by the pandemic. Similar to the Federal Reserve, ECB President Christine Lagarde made the case for changing ECB policy to allow inflation to run above 2%. The last time the ECB raised rates was in 2011 (in response to a bout of energy inflation).

Corporate credit risk slightly underperformed Treasuries in September as the market appears concerned about: the next Supreme court judge, the timing of another fiscal package from Congress and the ongoing talk of a potential contested election. The third quarter generated another positive rate of return for the bond market after interest rates traded in a narrow range during the last three months. The vast majority of the gains came in July (both August and September generated negative total return). Credit spreads and investment grade have benefited from consistent inflows from mutual funds (24 straight weeks as of September 28th).

The 10-year Treasury ended the quarter yielding 0.69%, a small increase of 3 basis points since June 30th. The Bloomberg Barclays Aggregate increased 0.62% during the quarter bringing year-to-date performance to 6.79%. The Bloomberg Barclays Intermediate US Gov/Credit index increased 0.61% during the quarter bringing year-to-date performance to 5.92%. The trailing 12-month global default rate edged up to 6.4% at the end of August, from 6.2% in July. The latest reading marked the highest default rate in a decade. The second quarter of 2020 was the second highest number of defaults in a single quarter behind only the first quarter of 2009. 53% of the defaults were comprised from two sectors (Consumer/Service and Energy).

The municipal bond market has been resilient during the 3rd quarter, but we have begun to see weakness in segments of the revenue bond market backed by sales and income taxes as unemployment levels remain elevated. The Bloomberg Barclays Municipal bond Index increased 1.23% during the quarter bringing the year-to-date performance to 3.33%. With the aid of the Fed's bond buying vehicles, it has helped stabilize the market by providing liquidity to illiquid parts of the market. As congress continues to negotiate another stimulus package, the municipal market is keeping a close eye on the negotiations as aid for local and state governments are at the forefront of the negotiations.

As of early September, corporate bond issuance has already surpassed the previous annual record set in 2017. The new issue market has remained healthy after the volatility experienced in March. Companies have responded to the economic uncertainty by building liquidity to shore up balance sheets in light of expected material revenue declines. Companies have also reduced cash outlays as a revenue offset. Buybacks and dividends of US large companies are down this year, stock buybacks are down 21% year over year as of the first half of 2020. Additionally, capital expenditures are down 7% year over year. As a consequence, gross and net leverage is up for companies this year. Companies hardest hit by the pandemic have been pushed to secure bond deals pledged against their assets (i.e. planes, routes, ships, etc.). Similar to the Treasury market, the corporate bond market has acted surprisingly calm over the past several months and trading in a very tight range. Corporate issuance is expected to slow down after the Presidential election.

The risk to interest rates going forward will obviously be driven by the level of accommodation supplied by the Federal Reserve. Should the Federal Reserve reduce monthly asset purchases the market should expect heightened volatility and a path to marginally higher interest rates. US interest rates continue to face competitive pressure as international buyers are confronted with negative interest rates. The path to higher rates will not happen until we have an adopted COVID vaccine, sustained global growth and hints of inflation picking up.

We are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us. Stay safe and well.