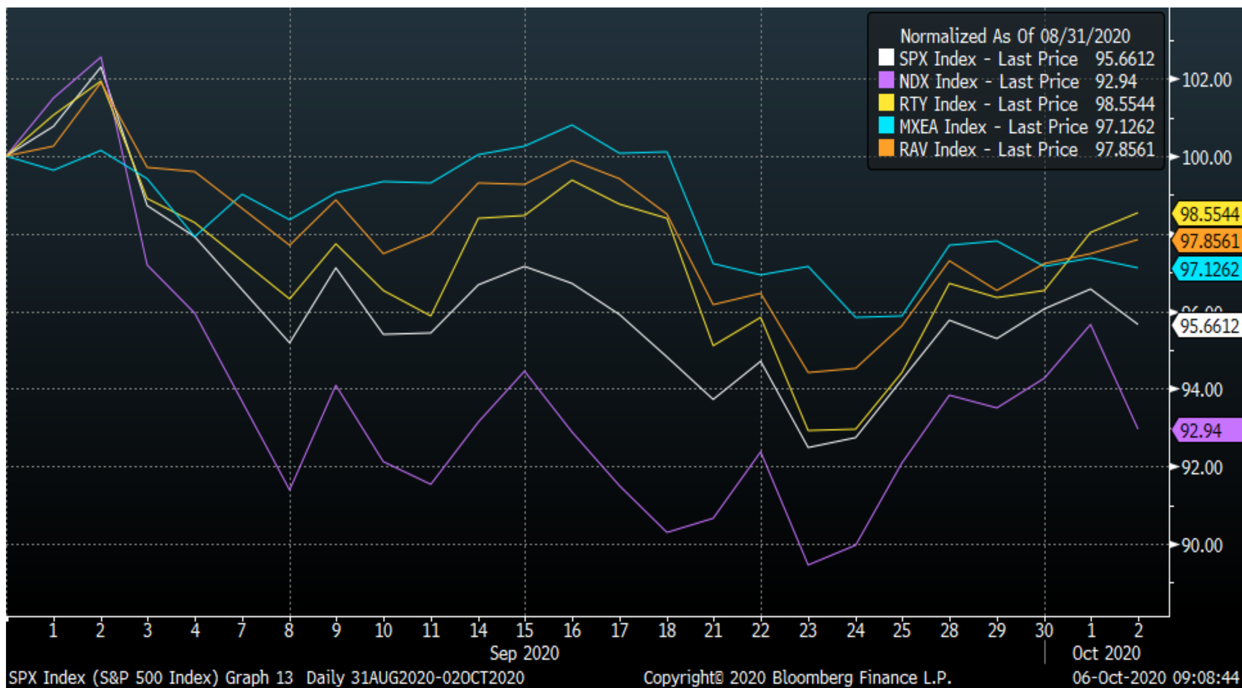
FROM THE DESK OF ERIK OROS

OCTOBER 2020

In September's letter, we emphasized the dramatic excesses, commonplace across both equity and fixed income markets, fueled by a rush of liquidity provided by central banks globally. This narrative has come into focus as markets wobbled over the course of September, producing volatility unseen since the depths on the pandemic. While risks remain elevated, excess still endures, and catalysts loom on the horizon, our conviction in steadfast, disciplined allocation remains critical.

As we concluded an exuberant third quarter of 2020, many of the speculative indulgences (SPACs, stock splits, high flying tech mega-caps) saw their momentum reverse. While many have ventured to nail down the so-called "pin" that caused the forceful correction witnessed at the start of the month, the condition is more reflective of the symptoms of excessive and irrational valuation. That being said, among many catalysts for the sell off, participants pointed to the conclusion of stock splits enacted by AAPL and TSLA, renewed concern around a second wave of infections, the shenanigans uncovered at SPAC poster child Nikola Corp, along with an SEC investigation into SPACs generally. The transcendent Nasdaq 100 experienced a correction of over 10% in three short weeks, though staging a modest recovery as we neared quarter end. Beleaguered value, international, and small cap stocks outperformed.

S&P 500, Nasdaq Composite, Russell 2000, Russell 3000 Value, and MSCI EAFE



*Past performance does not guarantee future results.

Given the relative, though modest, rotation we saw over the month, the question of its endurance and the outlook for both the value and size factors has been top of mind for investors. High level, it was very clear that the outlook on a going forward basis post-pandemic was highly favorable for larger companies with robust balance sheets and the ability to borrow cheaply. The same can be said for growth companies whose secular tailwinds have likely accelerated due to the pandemic.

Secular growth companies can be more highly valued when cyclical growth is hard to find. That being said, there is a question as to what extent this effect has been priced into markets.

The charts below show the 5- and 20-year relative performance of the IWF (Russell 1000 Growth) vs. IWM (Russell 2000 Value). The level of outperformance of large cap growth vs small cap value is staggering. Just in the past year, IWF is up 41.44% and IWN is down 13.4%. Clearly there has been a violent rotation away from small cap and value stocks. Whether the modest reversal of this trend we witnessed in September is the start of something larger remains to be seen, but it seems like there is potentially much greater "value" in the small/value stocks. With the potential for a vaccine forthcoming, it is likely that investor focus will shift toward these more economically sensitive companies and sectors.

Russell 1000 Growth vs. Russell 2000 Value

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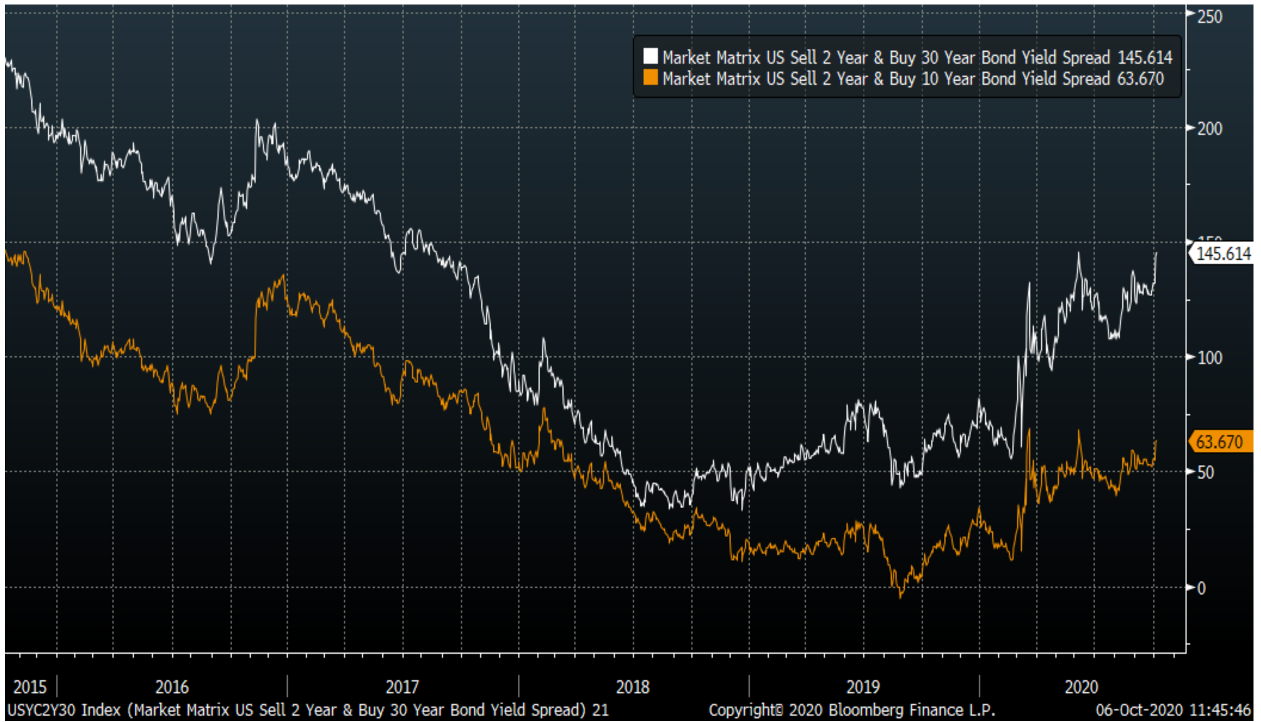
Some indications of the cause of this rotation might be found in fixed income markets. There has been a notable steepening of the yield curve over the past few weeks as the prospect of increased stimulus measures has come into focus. With the election upcoming, the market is likely discounting the possibility of a so-called blue wave, a scenario likely to lead to very large fiscal stimulus. In such a scenario, investors are likely to focus on more cyclical growth companies found in value sectors. Nevertheless, this trend bears monitoring for our fixed income allocations where we remain cautious of duration risk and the potential for inflation to cause acceleration of such trends.

With a consequential earnings season set to begin just prior to the election, we are mindful that expectations have increased meaningfully heading into such reports. Combined with elevated earnings multiples, such a set up could potentially result in significant disappointment and volatility. While economic activity has certainly recovered meaningfully from the depths of the first and second quarters, signs of deceleration give the sense of increased risk heading into these reports.

US Treasury Curve Spreads



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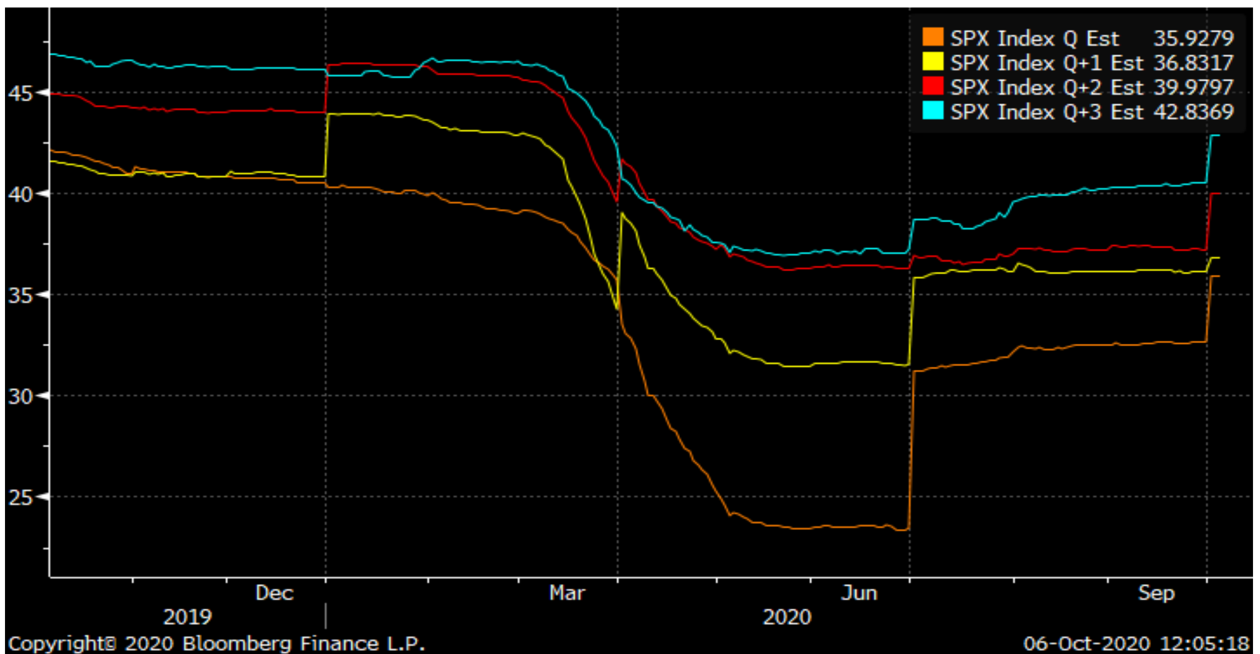
S&P Quarterly Earnings Expectations



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As we approach the election in November, heading into an historically volatile month of October, we remain cautious and diligent around our deployment of fresh capital. We remain focused on providing unique opportunities to our clients that are distinctively positioned to capitalize on the bountiful dislocations in markets that are sure to come as we conclude 2020.

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