Morris Capital Advisors, LLC

Investment Commentary
September 30, 2020

A Disconnect

I play ice hockey early in the morning a couple of days a week with a group of players of a similar age. The rink 4 group is a mix of professionals, contractors, and business owners. We sometimes head to the DK Diner for a short stack after our sessions. Recently, the discussion turned to the new popularity of work-from-home and the potential negative impact this might have on the commercial real estate market. The concern expressed was that a decline in demand for commercial real estate could result in a "second wave" of economic stress on our weakened economy.

While the discussion centered on the disconnect between the risks represented by this structural change in our workforce and the highly leveraged commercial real estate industry, it really points to a larger disconnect between the recent performance of our financial markets and economic impact of the Covid business shutdowns. It is a classic example of the divergence between the realities of the "main street" economy and the performance of the "wall street" markets.

After declining 35% in just 6 weeks when Covid hit, the S&P 500 index climbed from the lows to an all-time high in just 126 trading days. The move was led by the mega-cap tech names; Facebook, Apple, Amazon, Netflix, Microsoft, and Google, collectively known as the FAANMG's. Those stocks were up 42.5% on a price basis year-to-date on 9/30 compared to just 4.1% for the S&P 500. That means that the stocks above were up 42.5% while the remaining 494 companies in the S&P 500 were down 3.6% collectively. The dominance of these growth names pushed valuations to levels not seen since the dot com days. While stocks may look "cheap" given the low interest rate levels, they do not seem to be cheap on the basis of earnings and growth expectations, especially considering that earnings per share are expected to be down 20% this year and not expected to be back to pre-recession levels until 2022 at the earliest.

Massive shutdowns of non-essential businesses caused real Gross Domestic Product (GDP) to drop at a 31.4% annual rate during the second quarter, the biggest drop since the 1930's, but GDP for the third quarter is expected to rebound 33.4%. At a quick glance this looks like good news since the rebound is greater than the decline, but when combined, the net result is actually a decline of approximately 8.5% over those two quarters. News on the labor market is also disappointing. Over 40 million jobs were lost due to the lockdowns, but only 25 million were created in the rebound. The unemployment rate is over 11%, a number that would be 15% higher if adjusted for the vast number of people who have just stopped looking for work. Of additional concern is that the number of "permanently" unemployed people in the unemployment rate above account for one third of the total. If this group continues to remain unemployed on a permanent basis, it could result in long-term structural damage to the economy. Compounding this labor market crisis is that upwards of 30% of the workforce were employed by travel, leisure, hospitality, and restaurant businesses that are struggling to reopen, or facing the prospect of bankruptcies.

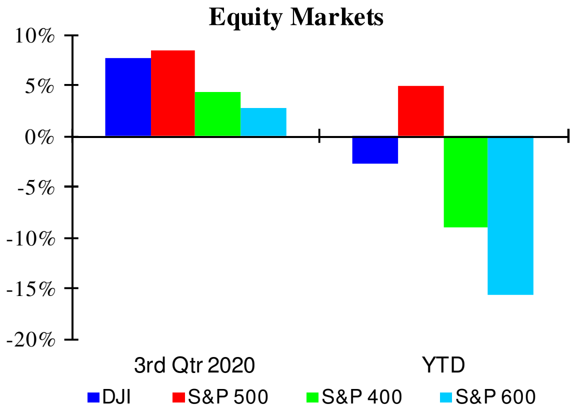
The dislocation between our economy and financial markets is explained simply by massive policy interventions by the Federal Reserve and our Federal government. In the Great Financial Crisis the Fed bought US Treasury and mortgage backed securities directly in the open market, a policy referred to as Quantitative Easing (QE). Those purchases expanded the Fed balance sheet from $1 trillion to $3.5 trillion. With Covid and the economic shutdowns, the Fed ramped up their policy interventions, adding corporate bonds and junk bond ETF's to their purchases, expanding their balance sheet to over $7 trillion in just a few months while promising to continue buying $120 billion per month of the securities above for the foreseeable future. The Federal government, meanwhile, spent more than $2.7 trillion in stimulus, and could add another $2+ trillion. Taken together this stimulus represents almost 40% of US GDP in 2019. All of this borrowing has pushed US debt to GDP from 68% in 2008 to more that 136% as of June 2020. The financial markets are the beneficiaries of the debt fueled liquidity, hence the main street/wall street divergence, but without a rebound in the "main street" economy the financial markets will become dependent on liquidity injections that cannot go on forever. We cannot predict when that might happen so we will continue to invest in a manner that can provide some reasonable investment return while managing the risk associated with the impact of the policy measures that dominate the markets at this time.

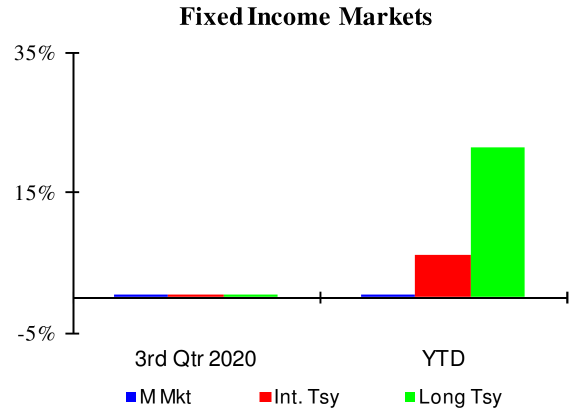
Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
September 30, 2020





The stock market continued to rebound during the 3rd Quarter, building on gains achieved since the market bottom in late March. Stocks were supported by signs of economic recovery and a belief among investors that the worst of the Covid crisis and the economic impact of widespread shutdowns were behind us. The promise of additional fiscal stimulus, and highly accommodative Fed policy also contributed to the move.

A closer look at stock market returns, however, illustrates that some sectors of the stock market performed substantially better than others. Large-cap names outperformed the mid and small-cap sectors of the market, and growth names once again outperformed value names. This growth vs. value divergence was most pronounced in the large-cap sector where the market performance was driven by a small group of mega-cap growth names.

At quarter end the year-to-date returns for most equity categories remained negative, with small-cap indices registering double digit declines. Returns in the large-cap indices turned positive year-to-date, while returns for the large-cap growth indices registered strong double-digit year-to-date returns.

Returns in the bond market were modestly positive during the quarter as longer term maturities generated minimal coupon income. Intermediate term US Treasury yields remained near record lows, held in check by weak economic activity, quantitative easing, and a global low-yield environment. Real yields remained negative as inflationary measures exceeded the nominal yield on intermediate term securities.

Credit spreads tightened during the quarter, but remained elevated relative to their long-term averages. Massive central bank accommodation, including the outright purchase of high yield exchange traded funds (ETF), pressured both rates and spreads, pushing bond yields in high-quality debt categories down their lowest levels on record. Market expectations for inflation as represented by breakeven rates on inflation protected securities climbed from decade lows but remain near the bottom end of their historical range.