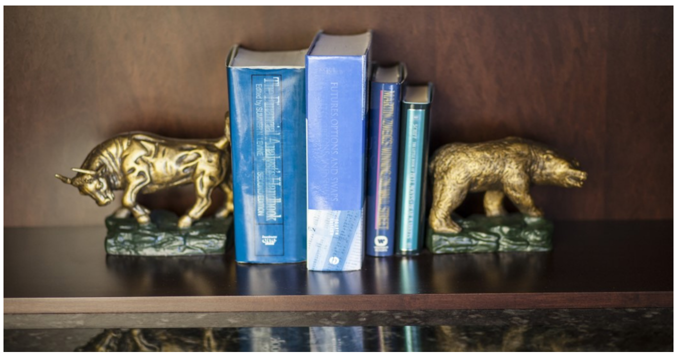
Wallington ASSET MANAGEMENT
INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2020: THIRD QUARTER — **127TH EDITION**



"You can disagree without being disagreeable."

~Ruth Bader Ginsburg

"The Federal Reserve...is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up."

~1955 Fed Chair William McChesney Martin, Jr.

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	3Q20 Total Return (%)	2020 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	8.9	5.6	21.7	3.7	1.7
DJIA	8.2	-0.9	20.3	4.2	2.2
NASDAQ	11.2	25.3	32.3	5.7	0.8
Russell 1000 Growth	13.2	24.3	30.5	11.7	0.8
Russell 1000 Value	5.6	-11.6	17.2	2.1	2.6
Russell 2000	4.9	-8.7	36.6	1.9	1.6
International*					
MSCI EAFE	4.9	-6.7	17.3	1.6	2.9
MSCI Emerging Markets	9.7	-0.9	14.7	1.8	2.1
MSCI United Kingdom	-0.2	-23.4	14.4	1.4	4.1
MSCI France	2.9	-13.0	18.0	1.5	3.4
MSCI Germany	8.4	0.7	16.8	1.6	2.6
MSCI Japan	7.1	-0.3	18.1	1.3	2.3

Fixed Income		
Indices**	3Q20 Total Return (%)	2020 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	0.3	3.1
U.S. Corp - Gov (3-5 Years)	0.6	5.9
U.S. Corp - Gov (10+ Years)	1.2	14.3
U.S. Treasuries Master	0.2	9.2
U.S. Corporates Master	1.7	6.6
U.S. Municipals Master	1.2	3.2
U.S. High Yield Master	4.7	-0.3
International*		
Developed Markets Sov Bond	2.6	6.8

Commodities		
Resource	3Q20 Total Return (%)	2020 Total Return (%)
Precious Metals		
Gold	5.3	24.2
Silver	33.0	31.5
Industrial Metals		
Copper	11.6	8.4
Aluminum	8.4	-3.5
Energy		
Brent Crude Oil	-3.2	-40.5
WTI Crude Oil	2.0	-34.5
Natural Gas	44.3	15.4

Key Rates				
Rates	9/30/2020	6/30/2020	12/31/2019	9/30/2019
U.S. Target Fed Funds Rate	0.25	0.25	1.75	2.00
2-Year U.S. Treasury	0.13	0.16	1.58	1.63
10-Year U.S. Treasury	0.69	0.66	1.92	1.68
30-Year U.S. Treasury	1.46	1.41	2.39	2.12
10-Year German Bund	-0.53	-0.48	-0.19	-0.58
10-Year Japanese Bond	0.02	0.02	-0.02	-0.23
30-Year Fixed Mortgage	2.89	3.16	3.72	3.61

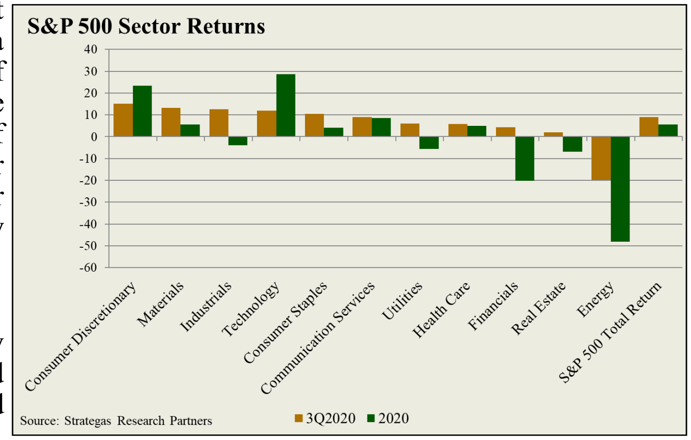
Currencies				
Indices/ Exchange Rates	9/30/2020	6/30/2020	12/31/2019	9/30/2019
ICE U.S. Dollar Index	93.89	97.39	96.39	99.38
USD per EUR	1.17	1.12	1.12	1.09
USD per GBP	1.29	1.24	1.32	1.23
JPY per USD	105.53	107.89	108.68	108.08
CAD per USD	1.34	1.36	1.30	1.32

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

After notching an all-time high on September 2, the Standard & Poor's 500 index (S&P 500) nearly reached correction territory over the next three weeks, declining 9.6% through its September 23 close. The -3.8% return for the month was the worst September market performance since 2011. Still, the index provided a total return (price appreciation plus dividends) of 8.9% in the third quarter, bringing its year-to-date (YTD) return to 5.6%. The best performing sector of the S&P 500 for the third quarter was Consumer Discretionary, up 15.1%. The Energy Sector continued its prolonged struggle, posting the only negative return for the quarter at -19.7%.



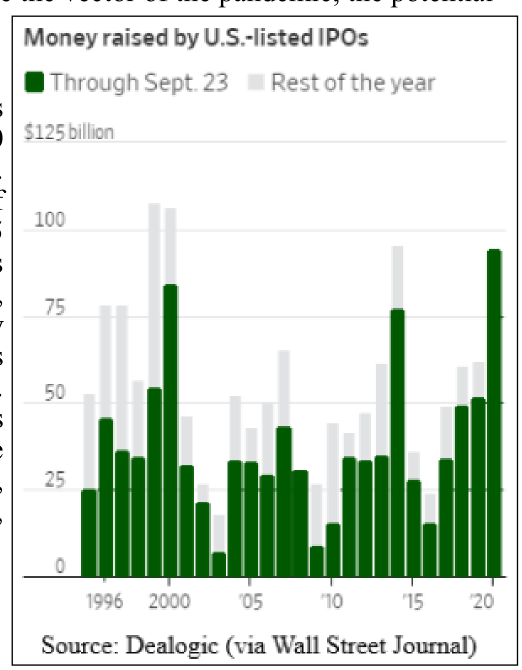
Source: Strategas Research Partners

Small company stocks underperformed large company stocks with the Russell 2000 up 4.9% for the third quarter. International indices were mixed. Developed markets lagged U.S. stocks with the MSCI Europe, Australasia, and Far East (EAFE) Index returning 4.9%, but the MSCI Emerging Markets Index outperformed, up 9.7% for the quarter. On a YTD basis, large cap domestic stocks remain in the lead. Emerging Markets stocks are off slightly at -0.9%, while the EAFE Index and Russell 2000 have returned -6.7% and -8.7% respectively.

September's volatility spike in the S&P 500 marked the first protracted stretch in a year where value stocks have outperformed growth stocks. Since the February peak, however, value stocks have not recovered (down 12.6%) while growth stocks have led the way (up 13.8%). Of note, growth stocks beat value stocks handily both during the COVID decline in February-March and in the ensuing rebound, continuing their decade-plus trend of significant outperformance. Much of the outperformance can be traced to their sustainability of revenue and earnings growth coupled with a low interest rate environment which causes investors to discount the future cash flows of these companies at a very low rate in their models.

Analysts are predicting companies in the S&P 500 will post another decline in earnings this quarter as a result of the pandemic. Their estimates of a 21% decline will likely not materialize, however, based upon recent announcements and strategists becoming less negative on earnings in September. This would be consistent with the second quarter when earnings fell 31% versus analyst estimates of a 43% drop. While the unprecedented uncertainty brought on by COVID continues to erode earnings predictability, fourth quarter earnings guidance will be one of the items at the forefront of investors' minds as companies continue to reshuffle operations and workforces. Other key considerations will be the vector of the pandemic, the potential for vaccines and treatments, and the election.

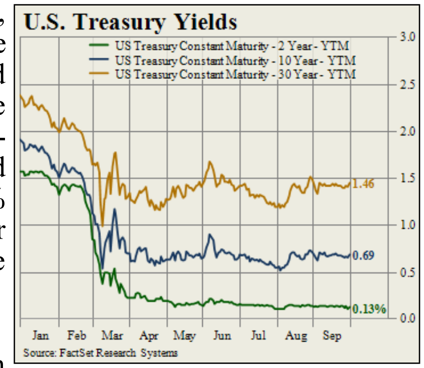
More than $95 billion has been raised YTD in initial public offerings (IPOs). If this pace continues, IPOs in 2020 will surpass the $110 billion record set in 1999 and 2000 during the technology bubble. While it may surpass 1999 and 2000 in market value, the number of companies that have entered the IPO market this year is just 235 compared to 439 at its peak two decades ago. Many companies entering the IPO market this year are also larger, more established, and more sector-diverse than the flood of young technology companies then. Of note, special purpose acquisition companies (SPACs) have comprised nearly half of the IPO market this year. SPACs, also called blank check companies, are shell corporations with no operations which are formed to raise money for the purpose of undertaking later mergers or acquisitions. Through September, 21% of the IPO money raised has gone to technology companies, 17% to healthcare companies, and 47% to SPACs.



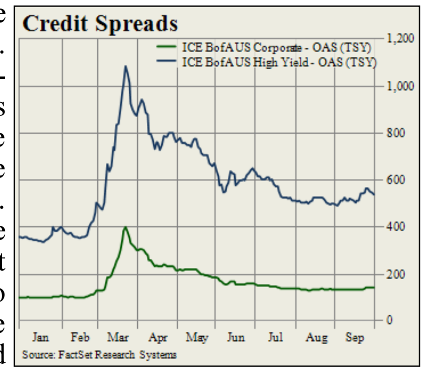
Source: Dealogic (via Wall Street Journal)

FIXED INCOME

U.S. Treasuries (USTs) provided lackluster performance in the third quarter, returning only 0.2% in aggregate as measured by BofA-ML indices. The yield curve (the spectrum of UST yields across varying maturities) remained stable with 10-year UST yields beginning the quarter at 0.66%, ending the quarter at 0.69%, and never surpassing March's low or June's post-contraction high. 30-year UST yields, which are typically more volatile and sensitive to news flow, held a similar pattern, starting the quarter at 1.41% and finishing only marginally higher at 1.46%. Even after the lackluster quarter, USTs in aggregate have returned 9.2% this year, outperforming the S&P 500, Russell 2000, and broad-based international equities markets.



A major cause of the stability in the yield curve and UST returns has been the Federal Reserve's (Fed's) signaling on interest rates. Most Federal Open Market Committee (FOMC) members expect the fed funds rate to remain unchanged through at least 2022, anchoring short-term interest rates. The inability to earn much interest income on short-term, safe government-backed bonds has been pushing investors to take on more risk. One means of accomplishing this objective has been to assume more interest-rate risk by investing in longer-dated bonds. Another has been for investors to increase the credit risk in their portfolios. This caused credit spreads, the interest rate differential between corporate and government debt, to continue to contract through the third quarter despite an uncertain economic outlook. As a result, both investment grade and high-yield debt outperformed for the quarter, returning 1.7% and 4.7% respectively. The outperformance was not enough for either category to overcome their lagging performance relative to USTs earlier in the year. On a YTD basis, investment grade bonds have generated a 6.6% return while the performance of high-yield bonds remained slightly negative at -0.3%.

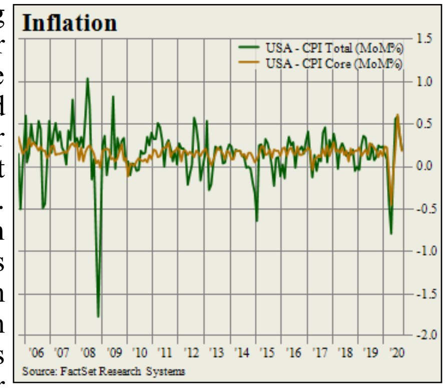


Although high-yield credit spreads have continued to contract as the equity market has rebounded, concerns remain about companies with tenuous financial positions defaulting on their debt. Principal Global Investors performed a study recently on "zombie companies," or companies which could not cover their interest costs with last year's pretax earnings. They found the number of companies in this financial position increased from 10% to 18% over the course of a year. Often, a firm's creditors would prefer to refinance debt at lower rates as opposed to restructuring, even without a clear road to profitability. Fitch projects a 7% high-yield default rate for 2020 and an increase to 10% in 2021. With the increase in zombie companies and projected default rates, an investor could assume that the high yield market, in general, is overvalued since credit spreads remain near their long-term averages. A counteracting measure has been a record amount of "fallen angels," or companies which were considered investment grade but were downgraded to a high-yield rating. This has helped bolster the quality of the upper end of the high yield space: "BB" rated bonds.

As companies have sought to survive the recession, traditional financing mechanisms have evolved in order to raise capital. Carnival Cruise Lines, for example, was able to issue debt secured by assets such as their ships in the spring of this year. While this debt, which matures in 2023, still comes with a hefty yield-to-maturity of over 6%, unsecured debt previously issued by the company also due in 2023 is yielding in excess of 12%. Companies have also been raising capital under SEC Rule 144A in order to issue debt quickly and with fewer regulatory requirements. These securities are only offered to Qualified Institutional Buyers, or institutions with more than $100 million in investable assets, and allow for less regulatory protection for the investors. Therefore, this has been a desirable approach for many high-yield companies, but it has come at the expense of smaller investors who are still searching for yield in a low interest rate environment.

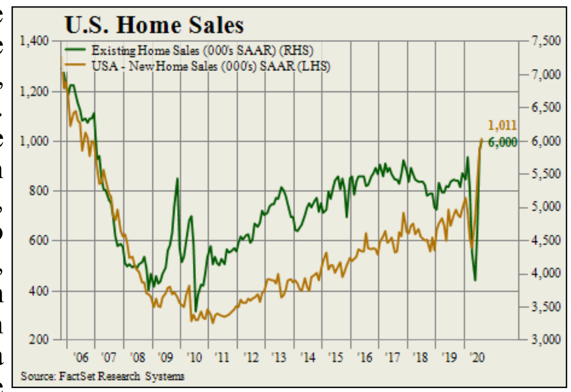
In August, Vanguard announced the phase-out of their Vanguard Prime Money Market Fund. Prime funds can invest in a wider range of securities than government money market funds, and therefore come with higher expenses and more risk of "breaking the buck," or being worth less than $1/ share. In the current low interest rate environment, the additional universe of securities available to prime funds has not enabled them to offer a discernible yield boost relative to higher-quality government funds, even after waiving large portions of their fees. Sponsoring firms such as Vanguard have discontinued these products since they offer higher theoretical risks, lower profitability than in the past, a higher regulatory burden, and little return enhancement for investors.

ECONOMICS



It has been difficult to determine whether households are experiencing inflation or deflation. The Consumer Price Index (CPI) was up 2.3% over the 12 months ending in February 2020 but subsequently, for the first time ever, fell for three consecutive months: March (-0.4%), April (-0.8%), and May (-0.1%). The monthly drop in April was the largest since December 2008. CPI then increased in June (+0.6%), July (+0.6%), and August (+0.4%); the June and July increases were the largest since January 1991. In the 12 months ending in August, CPI increased 1.3%. Core CPI, which excludes volatile food and energy components, increased 1.7% over this same 12-month period. In the last three months, CPI has increased at an annual rate of 5.8%. Massive shifts in consumer demand combined with supply chain disruptions have caused a bifurcation in inflation across goods and services. Year-over-year inflation through August is up for sports vehicles including bicycles (+5.7%), medical care (+5.3%), and food at home (+4.6%), while it is down for hotels (-13.1%), apparel (-5.9%), and airline fares (-23.2%). Apparently, men and women are not dressing up for their in-home Zoom meetings.

The housing market was on a tear in the third quarter as sales of existing homes surged 24.7% in July from the prior month, the strongest monthly gain ever recorded going back to 1968. Sales increased another 2.4% in August to an annual rate of 6 million which is 10.5% above August 2019 levels. Home buyers have returned in force since last spring's lockdowns motivated by ultra-low mortgage rates, the need for more space, and leaving cities for the suburbs. Strong demand and a shortage of homes have pushed the median existing home price to record highs. In July, the median existing home price surpassed $300,000 for the first time ever, and in August prices increased 11.4% over the prior year to $310,600. According to the National Association of Realtors, there were 1.3 million single-family existing homes for sale in July, the lowest number for any July dating back to 1982. In mid-September, the for-sale inventory was down 29.4% from a year earlier. New home sales have also surged to an annual rate of 1 million, the highest level since 2006, even though the cost of building a new single-family home has increased significantly due to rising lumber and other building material prices.



According to the Fed, *total* household net worth, assets minus liabilities, rose to a record $119 trillion at the end of the second quarter, up 6.8% from the first quarter. The first quarter wiped out more than $7 trillion of wealth mainly due to the fall in stock prices. The $7.6 trillion second quarter increase in net worth, the largest in several decades, was primarily due to rising stock prices ($5.7 trillion), rising home prices ($458 billion), and increased savings ($768 billion). Another Fed survey was published showing *median* household net worth rose 18% to $121,700 from 2016 to 2019. Reversing earlier trends, the median net worth rose 37% for the lowest earners and 40% for the second-lowest group during this time period. However, the highest and second-highest earnings groups median net worth surprisingly declined 8% and 9%, respectively. The Census Bureau also reported that median household income increased 6.8% to a record $68,703, the largest increase since 1952. All income classes and ethnic groups shared in the higher income levels.

U.S. federal debt has been rising at an unprecedented rate. At the end of August 2020, U.S. debt held by the public topped $20.8 trillion and total debt was $26.7 trillion. The difference of $5.9 trillion is debt held internally by U.S. agencies such as the Social Security and Disability Trust Funds and federal retirement programs. Public debt was equivalent to 79% of U.S. GDP in 2019 and is estimated to eclipse 100% this year. The Congressional Budget Office (CBO) recently forecast it will reach 195% of GDP by 2050. With historically low bond yields, the cost of servicing the debt is manageable now but obviously could be a problem if interest rates rise. The CBO recently forecast average annual real GDP growth to be 1.6% from 2020 to 2050, down from its prior forecast of 1.9%. The debt/GDP ratio was 102% at the end of World War II, but strong economic growth was able to reduce the ratio to 35% in the 1990s. If the CBO forecast on economic growth is correct, a reduction in the debt/GDP ratio will not happen in the foreseeable future meaning there will be a huge amount of debt overhanging the federal government and taxpayers.

The Fed – Lower for Longer

U.S. households were doing well at the end of 2019, then the coronavirus pandemic hit sending the U.S. and the global economy into a sharp recession. The U.S. economy contracted at a record rate in the second quarter. According to a report from the Commerce Department, U.S. gross domestic product (GDP) – the value of all goods and services produced across the economy – fell at a seasonally-adjusted annual rate of 31.4%. Framed a little differently, GDP dropped 9.1% from the prior quarter. These were the steepest declines since GDP record-keeping began in 1947. In the first quarter, GDP fell at an annual rate of 5.0%. On a combined basis, the U.S. has suffered the worst economic decline since the 1930s due to the pandemic.

The first and second quarter contractions occurred as states imposed lockdowns, social distancing, and other initiatives in March and April to contain the coronavirus pandemic. The second-quarter decline in GDP reflected a deep drop in consumer and business spending; consumer spending fell at a 34.6% annual rate, with sharp decreases in spending on services such as bars, restaurants, events, and travel where it is much more difficult to socially distance. Digital services fared much better. In past recessions, spending on goods, not services, bore the brunt of the declines in consumer spending, but in this recession the roles have reversed. This is significant because money spent on services accounts for nearly 70% of all consumer spending. Further, consumption is the largest driver of economic growth in the U.S. making up more than two-thirds of GDP. Business spending fell at a 27% annual rate and both exports and imports plummeted. The only positives in the GDP reports were increased spending by the federal government, as it paid out money for fiscal stimulus and supplemental unemployment benefits.

In May and June, as many restrictions were lifted allowing economic growth to resume, the economy started what some economists thought would be a V-shaped recovery. However, broad-based economic growth moderated in the third quarter. Industrial production – manufacturing, mining, and utility output – only increased 0.4% in August, down from 3.0% in July and still 7.3% below February levels. IHS Markit reported that the U.S. composite purchasing managers index (PMI) – a measure of activity in the private business sector – was still expanding in September but at a slightly slower pace than August. New orders for durable goods rose 0.4% in August from July, well short of July's monthly gain of 11.7%. Job growth totaling 7.5 million in May and June fell to 1.8 million in July, 1.5 million in August, and 661,000 in September. Even though the unemployment rate fell from its peak of 14.7% in April to 7.9% in September, unemployment remains in a deep hole. In September, the number of unemployed workers was still at approximately 11.4 million after falling from a peak of more than 22 million in April, and those considered permanently unemployed increased to 35%, well above prior months. The labor participation rate fell to 61.4% as thousands of workers stopped looking for a job. Further, personal consumption expenditures increased 1% in August, substantially below the increases seen in May and June. The personal savings rate remained elevated at 14.1%, but it was down from a peak of 33.6% in the second quarter as consumers used their savings for spending on goods and services. Third-quarter GDP figures will look impressive but only because of the dramatic decline in the second quarter. With this slowdown in growth, economists have been revising their expectations of a V-shaped recovery to what many believe will now more closely resemble a Nike Swoosh. According to Fed estimates, the economy will not reach pre-pandemic levels until 2022.

Even though economic growth slowed as the third quarter progressed, the economic outlook at the end of September appeared much better than 90 days earlier. In June, the Fed's median prediction for GDP in 2020 was a decline of 6.5%; 90 days later it is "only" a decline of 3.7%. The forecast in June for the year-end unemployment rate was 9.3% but that forecast now stands at 7.6%. While still significantly worse than pre-pandemic levels, many foreign economies are in poorer shape. The composite PMI for the Eurozone showed their service sector declined in September. Service activity also declined in Japan and Australia, highlighting the problem of kickstarting a service-based economy. The Organization of Economically Developed Countries (OECD) forecasts 34 of its 35 members will have negative GDP growth in 2020. The only exception is China which is forecast to have economic growth of 1-2%, its slowest in decades. This global recession is arguably much worse than what was experienced in 2008-2009.

The outlook for the economy has improved, but there is still concern over the possibility the U.S. will experience a double dip – a decline in quarterly GDP following a temporary rebound. In general, the more severe the recession, the longer the recovery, and the higher the likelihood of a double dip. The double dip could be for one quarter or it could develop into another recession which would then likely result in a W-shaped recovery. To help the economy, the Fed made two important strategic changes in setting a new framework for monetary policy which were announced at the annual Jackson Hole symposium in August. These strategic changes do not alter the mandates of the Federal Reserve Act to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Rather, they change how the Fed attempts to achieve these goals. The mandate never called for preventing employment from going too high (or unemployment too low), but most economists thought low unemployment would set off wage inflation. In other words, when economic growth was high and unemployment low, central bankers and economists worried that workers would demand pay raises over and above inflation and improvements in productivity. Firms would pass these higher wages on to consumers by increasing prices and thus inflation. To prevent this cycle from becoming too engrained, central banks would be forced to raise interest rates, thereby slowing the economy and subduing wage pressure. Conversely, during periods of high unemployment, spending would decline, putting downward pressure on wages and inflation prompting central banks to cut interest rates to kickstart the economy.

The perceived negative relationship between unemployment and inflation is referred to as the Phillips Curve and has been one of the most important policy-making tools used by central bankers. However, over the last two decades, a historically strong labor market did not trigger a significant rise in inflation. As the unemployment rate moved to a historical low of 3.5%, inflation remained muted. Wage growth was subdued because of workers' weaker bargaining power due to globalization, technology, and a greater emphasis on a service-based economy with less unionization than in manufacturing. Under the new framework adopted in August, the Fed would not have raised interest rates nine times from the end of 2015 to the end of 2018. Essentially, there is now no natural rate of unemployment below which the Fed would feel compelled to increase interest rates. The Fed has abandoned the idea that low unemployment stokes inflation, and thus the once highly favored Phillips Curve has been set aside, at least for now.

The second strategic policy change by the Fed in August was the adoption of a flexible average inflation target. Since 2011, the Fed had a specific 2% inflation target (not an average) which was rarely met. The Fed's preferred measure of inflation, the personal consumption expenditure price index, had exceeded 2% in only 14 months out of the 104-month period. Under the new more flexible policy, the Fed seeks to achieve inflation that averages 2% over time. Following periods when inflation has persistently run below 2%, the new policy allows the Fed to tolerate inflation moderately above 2% to compensate for the prior inflation shortfall. A catch-up strategy means that the failure to hit 2% for most of the past decade could be used to justify inflation moderately above 2% for a considerable period of time over the next decade.

These new policy changes acknowledge that the Fed's interest rate increases in 2015-2018 were at odds with the economic reality of slow economic growth, global disinflationary pressures, and labor market slack even at historically low unemployment rates. The new dovish stance acknowledges the Fed is willing to take on more inflation risk to boost economic and job growth. This was reflected in their September meeting when the Fed signaled near-zero interest rates through the end of 2023 even if the economic recovery quickens. The Fed said it would maintain rates near zero until it sees evidence of a tight labor market, inflation reaches 2%, and "is on track to moderately exceed 2% for some time." Thus, the Fed has set a higher bar for raising interest rates for the foreseeable future. Historically, investors expected the Fed to "take away the punchbowl" when the party – economic growth – was still going on. Now there is no set formula guiding the Fed, but more flexibility, which means greater investor uncertainty and more risk. Inflationary expectations will undoubtedly play a role in Fed decision making going forward.

In addition to the strategic policy changes, the Fed took the unusual step of recommending increased fiscal spending to stimulate the economy. This signifies the difficulty of overcoming the current recession, one caused by a natural disaster that has devastated the service sector. The U.S. does not have much experience dealing with a service-driven recession. Unless the silver bullet – thought to be an effective vaccine – arrives fairly soon, the pandemic has the potential to leave psychological scars on the economy, complicating the policy responses to it. Fiscal policy is probably the most effective tool to lessen this psychological damage, which means it is time for both sides of the political aisle in Washington, D.C. to come to the need of the American people; doing so, though, in a manner that will not bankrupt future generations. It is a tough balancing act, but the time has long passed to quit playing politics. Lives are at stake. Hopefully by the time this newsletter has been published and read, progress will have been made and political-based ambitions will have been subordinated not only to the lives of the electorate, but also to the lives beyond our borders, as the U.S. economy is so important to the global economy.