COLORADO FINANCIAL MANAGEMENT®

Economic & Market Review

Written by Brad Bickham, CFA, CFP®
Partner & Chief Investment Officer

September 2020

As Of 09/08/2020	YTD	Last 12 Months	Last 5 Years
60/40 Balanced World Index (VSMGX)	3.1%	8.5%	7.9%
World Equity Index (ACWI)	0.7%	9.8%	9.8%
U.S. Large Cap Equities (S&P 500)	4.6%	14.1%	13.3%
U.S. Small Cap Equities (Russell 2000)	-8.9%	1.5%	6.8%
Nasdaq 100 (QQQ)	27.5%	42.0%	21.9%
Foreign Equities (ACWI-ex U.S.)	-5.5%	2.9%	5.4%
U.S. Bonds (AGG)	6.9%	6.5%	4.2%
Global Bond Index (BNDX)	5.0%	4.2%	n/a
Cash & Equivalents (VMFXX)	0.4%	1.0%	1.1%

Dear Clients and Friends,

It has been several weeks since we last wrote an update. In that time, the stock market has had an impressive rally. However, it has been a rally limited to a small number of companies. As shown in the table above, the Nasdaq 100 has far outperformed the other indexes. The Nasdaq 100 is skewed toward the FANMAG stocks (Facebook, Amazon, Netflix, Microsoft, Apple, Google). These six stocks are up an incredible 42.9% on average this year. In the last few days, we have seen a correction in these stocks (QQQ is down 10%), so some investors are asking: Is this rally over? Was it a bubble? What's next?

We've addressed some of these issues before, but we still get regular questions about the disconnect between the stock market and the economy. We will update you on our current thoughts.

Other issues we will explore in this letter:

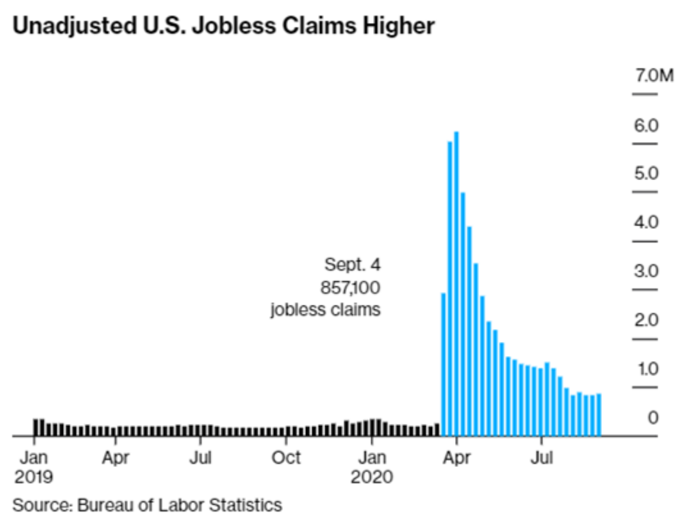
- The dollar has been falling since May. Is it finally time for international investments to outperform?
- Why are small caps underperforming?
- How is the economic recovery proceeding?
- The Fed has changed their approach to fighting inflation. What does it mean? Will inflation come back, and if so what should we do about it?
- Updated assumptions about the election.
- Gold has had a big run this year. What are our thoughts?

But as before, in order to understand where the economy is and where it is going, we have to first examine Covid-19 and its progress.

	Worldwide		United States	
	# of Cases	# of Deaths	# of Cases	# of Deaths
4/10	1.6 M	97 k	466 k	17 k
4/17	2.2 M	147 k	662 k	29 k
4/24	2.7 M	192 k	869 k	50 k
5/1	3.3 M	234 k	1.1 M	63 k
5/15	4.4 M	304 k	1.4 M	86 k
5/29	5.9 M	364 k	1.7 M	100 k
6/12	7.6 M	422 k	2.0 M	114 k
7/8	11.9M	545 k	3.0 M	132 k
9/8	27.9 M	905K	6.4M	191K

We really haven't made much progress in slowing this down. The monthly rate of change for new cases is 67% worldwide and 57% for the US. That is pretty much the same as it was in June. The monthly growth rate for deaths in the US has declined from 33% in June to 22% in September; but worldwide it remains at 33%. I've become somewhat numb to the figures on the virus, so I don't pay much attention on a daily basis anymore. Completing this table helped me focus on them. I cannot get much optimism from looking at these numbers.

Economically, things look better, but we are not out of the woods by any means. Initial filings for jobless claims have fallen from over 6 million to 884,000, but it has been steady at that level for a few weeks. In other words, it has stopped improving. Continuing claims is at 12.9 million. Before the pandemic, initial claims were at 212,000 and continuing claims at 1.7 million.



One can come to a more optimistic view by slicing the economy into different sections. Sectors such as manufacturing and construction, where face to face interaction is less essential, are rebounding strongly. Consumer service sectors, which require face to face interaction, are recovering more sluggishly but are adapting to the pandemic via low cost mitigation measures such as face masks. And, there is growing optimism that a vaccine will be approved by then end of 2020 and available in the first quarter of next year. 2021 economic growth should rebound smartly with growth faster than 5% and some analysts expecting growth as high as 7%.

Governmental response

The Federal government has bungled nearly every aspect of this crisis and appears ready to do so again by not passing another stimulus bill. Today (September 10th) the Senate failed to pass a bill and the two sides are far apart from a compromise. The economy is likely to suffer over the next few months as people on unemployment lose the extra money from the Federal government. There are bound to be increased delinquencies between landlords and tenants. Many small real estate owners are likely to default on their loans. Will their renters become homeless? State and local governments are going to have to cut back on spending and personnel; and public transportation services such as Amtrak and RTD will be forced into dismissals and service cutbacks. Because states have balanced budgets required in their constitutions, it is only the Federal government that can help during periods like this. When we talk about borrowing trillions of dollars, the numbers are daunting; but the alternative is actually worse.

Stock market

So once again we return to the question of why the stock market is doing so well (despite a correction over the last few days), when the economy is doing so poorly. Let's go back to a few of those FANMAG companies and look at their fundamentals:

Revenue 12 Months ending:	Facebook	Amazon	Netflix	Microsoft	Apple	Google
June 2020	73.9B	321.8B	22.6B	143.0B	273.9B	176.4B
March 2020	72.2B	296.2B	21.4B	138.7B	268.0B	177.1B
Dec 2019	69.7B	280.5B	20.2B	134.3B	260.2B	172.1B
Sept 2019	65.6B	265.5B	18.9B	129.8B	259.0B	161.3B

Do those look like recessionary numbers to you? Most of these companies increased revenues by $10 billion or more. Amazon by over $50 billion! Investors have rewarded these companies because of their recession proof businesses. Has it gone too far? Here's a look at their P/E ratios vs. the last five years:

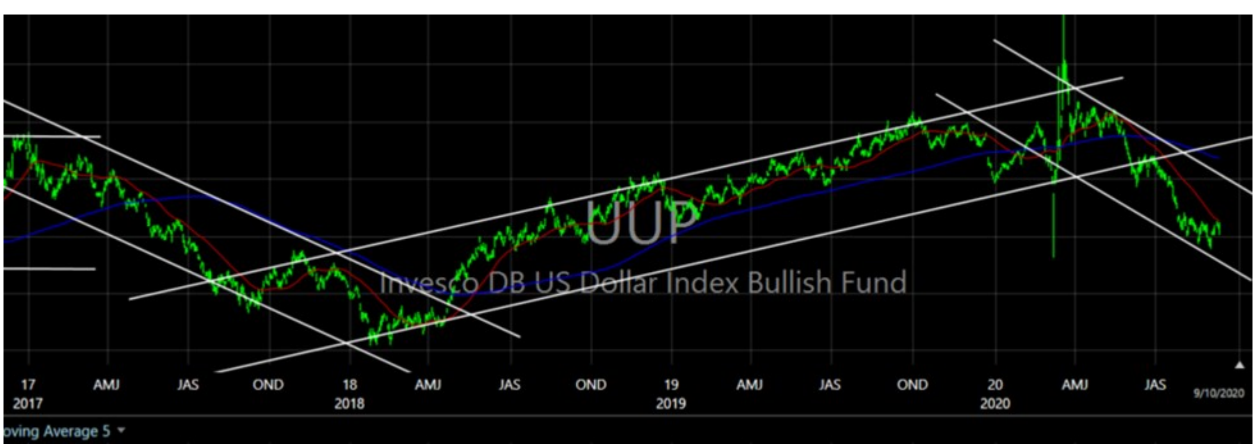
Company	Current P/E	5 Year Avg.
Facebook	32.9	41.4
Amazon	123	211
Netflix	80	201
Microsoft	35.8	34.0
Apple	34.6	17.3
Google	33.7	34.1

In most cases the stocks are trading at similar valuations to their averages. Apple is the exception. Amazon and Netflix are outliers in their valuations because investors have been willing to look through current earnings in anticipation of better profit margins in the future. They invest a disproportionate amount in their businesses to maintain their growth. The bottom line is the fundamentals of these companies are strong, and their valuations (while high) are in line with their historical averages.

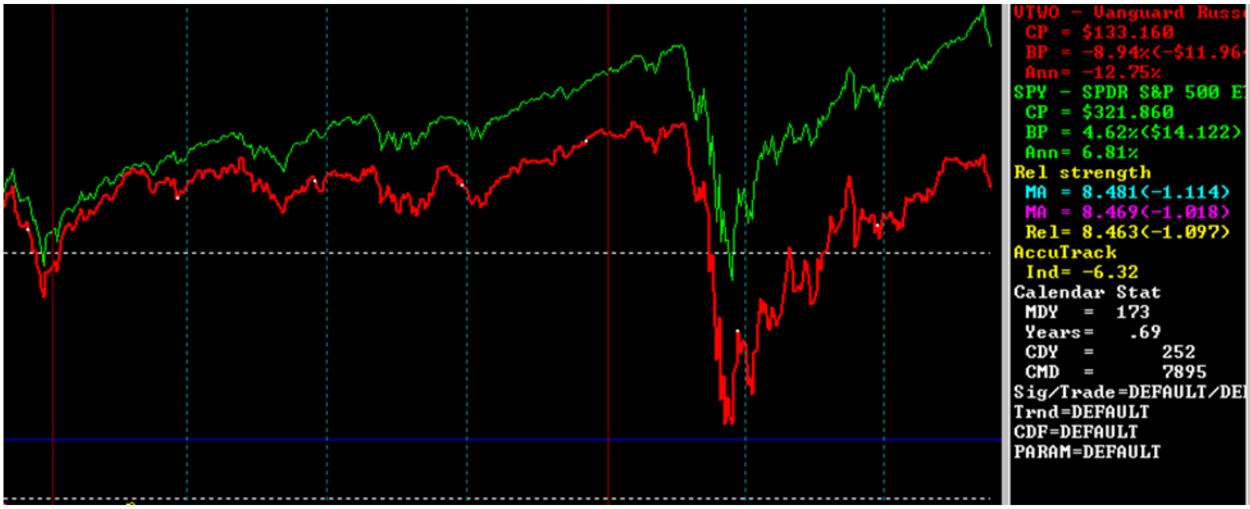
Valuation

It is also important to understand that valuations are affected by the level of interest rates. While equities are expensive, relative to bonds they have rarely been as attractive. A corporate bond today yields about 2%. That is a Price/Earnings ratio of 50x. According to Standard & Poors, the S&P 500 is currently trading at 21.3x estimated earnings for 2021.

US Dollar

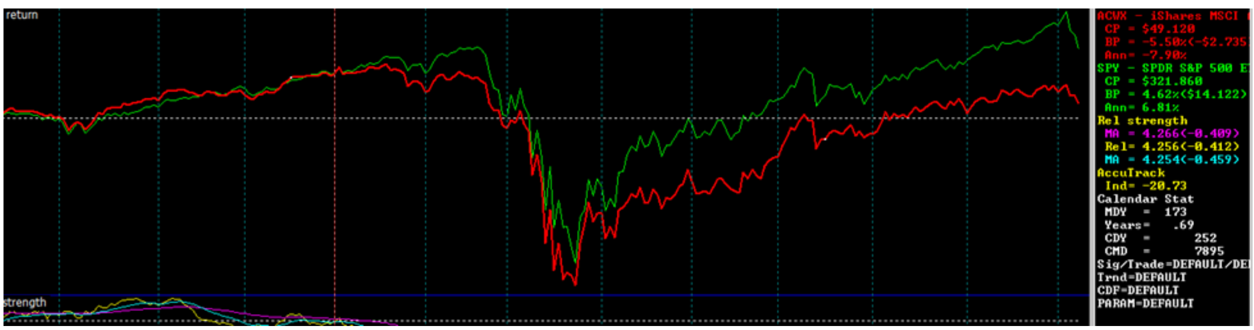


The strength or weakness in the dollar can have far reaching implications. Since Americans aren't allowed to travel to other countries, it has little impact on our travel budgets, but it does help our multinational exporting companies. This may be one of the reasons that large cap companies have outperformed small caps. Another reason is probably due to stronger balance sheets. Regardless, there seems little evidence the trend will change as shown in this chart:



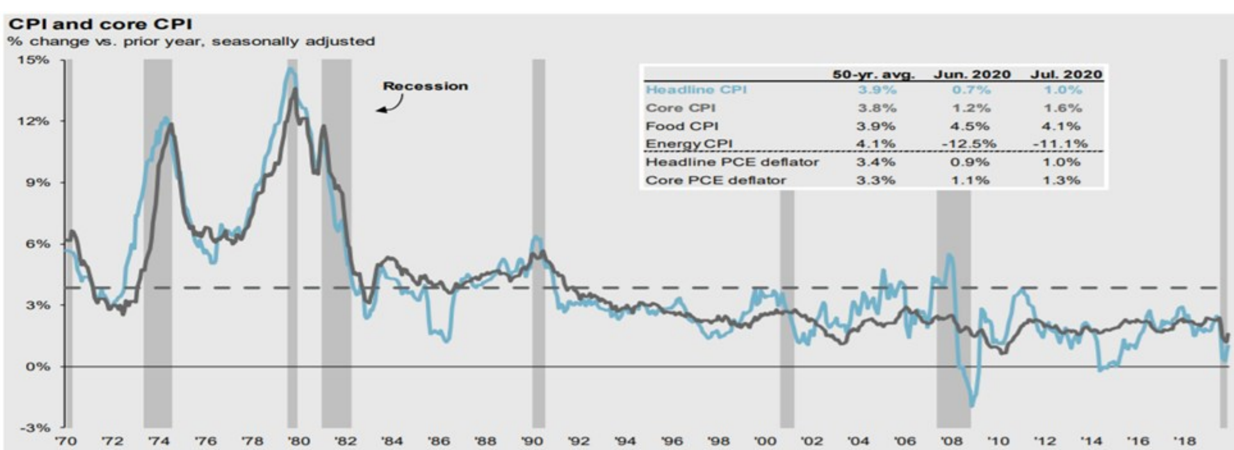
The red line is the Russell 2000, an index of small cap stocks, and the green line is the S&P 500.

Similarly, international stocks usually outperform when the dollar is falling; but not this time. At least not yet. The chart compares the MSCI All Country World – ex US index to the S&P 500.



Inflation

A concern we have begun hearing from clients is whether there may be a return of inflation. As we have said before, over the next few years we see almost no risk of inflation because of the excess supply of almost everything; but the huge amount of policy stimulus from the government could push up inflation in future years. Also, the Federal Reserve has indicated a willingness to accept higher inflation. What is most likely?



	50-yr. avg.	Jun. 2020	Jul. 2020
Headline CPI	3.9%	0.7%	1.0%
Core CPI	3.8%	1.2%	1.6%
Food CPI	3.9%	4.5%	4.1%
Energy CPI	4.1%	-12.5%	-11.1%
Headline PCE deflator	3.4%	0.9%	1.0%
Core PCE deflator	3.3%	1.1%	1.3%

The link between money growth, demand, and inflation is not automatic. Companies and households will likely be cautious for some time. Over the next few years, however, demand will increase and that could fuel inflation. The extent will depend in large part on the strength of workers' bargaining power as labor costs are the biggest factor in broad based inflation. Government policies could influence the outcome, and the pendulum does appear poised to swing toward labor. At this point, we tend to agree with analysts who predict a modest increase in inflation of 2-3%. Nothing like the great inflation of the late 1960s and 1970s, which was accidental and uniquely driven by labor unions, a spike in oil prices, and policy mistakes. None of those seem likely to repeat.

Gold has had a strong rally this year for a couple of reasons. The primary driver of gold prices is the 'real yield', which is the difference between inflation and nominal yields. As nominal yields have fallen to near zero, the 'real yield' has gone negative. There is a clear historical inverse relationship between real yields and gold prices. Since nominal yields are unlikely to fall further (they are near zero now), real yields can only get more negative if inflation rises. As described above, that is unlikely over the next couple of years; but it is also true inflation is unlikely to fall. Our conclusion, therefore, is that gold is unlikely to repeat its recent performance, but is also unlikely to fall until nominal interest rates begin rising, which may be a year or more away.

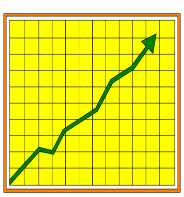
Election

Finally, just a few words about the election. While we have our own personal views about the candidates, we try hard to be a neutral observer when writing this letter or advising clients. The important truth is the President doesn't make that much difference to your investment returns. There is not a direct link between economic cycles and presidential cycles. It's true that regulations, trade policy, and taxes have an effect; but so do wars and pandemics, which cannot be anticipated. And, there is a time lag between changes in policy and their economic effect. History does not prove that the economy or stock market does better under one party or the other.

This is an emotional election, and many people are going to be upset with either outcome. Try and remember that regardless of the election result what will drive investment returns over the longer term is the economy, earnings, interest rates, and valuation. A President has little impact over these factors. In 2021 the economy and earnings are going to be better, interest rates are likely to be little changed, and while valuation seems a little stretched – relative to bonds, stocks still look attractive.

As always, thank you for your confidence and don't hesitate to call or email us if you have any questions or we can do anything to help you with your financial affairs.

Happy returns,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

And Your Entire Colorado Financial Mgmt. Team

Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).
- **Barclays Capital 1-3 Month U.S. Treasury Bill Index:** The Barclays Capital 1-3 Month US Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

Other Indices

- **Invesco QQQ:** is an ETF based on the Nasdaq-100 Index. The Fund will, under most circumstances, consist of all of stocks in the Index. The Index includes 100 of the largest domestic and international nonfinancial companies listed on the Nasdaq Stock Market based on market capitalization.
- **Invesco DB US Dollar Index Bullish (Fund):** seeks to track changes, whether positive or negative, in the level of the Deutsche Bank Long USD Currency Portfolio Index - Excess Return (DB Long USD Currency Portfolio Index ER or Index) plus the interest income from the Fund's holdings of primarily US Treasury securities and money market income less the Fund's expenses. The Fund is designed for investors who want a cost effective and convenient way to track the value of the U.S. dollar relative to a basket of the six major world currencies - the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc (collectively, the "Basket Currencies"). The Index is a rules-based index composed solely of long U.S. Dollar Index futures contracts that trade on the ICE futures exchange (USDX® futures contracts). The USDX® futures contract is designed to replicate the performance of being long the U.S. dollar against the Basket Currencies.
- **Russell 2000® Index:** The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set
- **Vanguard Federal Money Market Fund:** invests at least 99.5% of its total assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities or cash (collectively, government securities). As government agency securities, the fund's holdings have very high credit quality, although most are not backed by the full faith and credit of the U.S. government. The average maturity typically ranges from 30–60 days, and the fund maintains a dollar-weighted average maturity of 60 days or less, and a dollar-weighted average life of 120 days or less.
- **Vanguard LifeStrategy Moderate Growth Fund:** holds 60% of its assets in stocks, a portion of which is allocated to international stocks, and 40% in bonds, a portion of which is allocated to international bonds. Specifically, the fund invests in four other Vanguard funds: 36% Total Stock Market Index Fund; 28% Total Bond Market II Index Fund; 24% Total International Stock Index Fund; and 12% Vanguard Total International Bond Index Fund.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

References to specific investments should not be construed as a recommendation by Colorado Financial Management to buy or sell securities.

Past performance is not an indication of future results, and as is the case with all investment advisors that concentrate on equity investments, future performance may result in a loss. Portfolio holdings and weightings are subject to change at any time due to ongoing portfolio management. Portfolio returns given are after trading costs but not after fees. Returns do not reflect the holding of cash in the account, if any. This report is for informational purposes only.

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COLORADO
FINANCIAL
MANAGEMENT®

303-443-2433 www.colofinancial.com

Boulder	Denver	Loveland
4840 Pearl East Circle, Suite 300E	3033 E First Ave, Suite 408	4848 Thompson Pkwy, Suite 320
Boulder, CO 80301	Denver, CO 80206	Johnstown, CO 80534