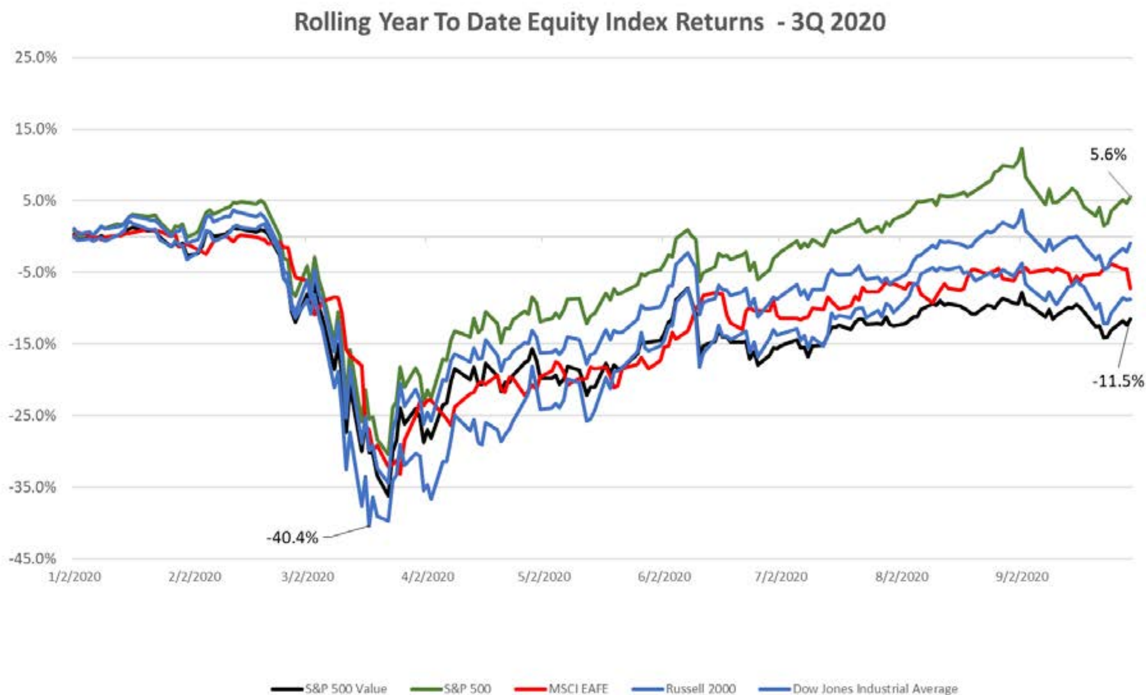
October 23, 2020

Dear Turtle Creek Client,

The U.S. economy extended its surprising recovery throughout the 3rd quarter, validating year-to-date stock market gains and raising expectations that a best-case "V-Shaped" economic recovery might be at hand. Central Banks also reiterated their commitment to unprecedented monetary accommodation during the quarter, committing to years of historic stimulus measures if needed to ensure a full economic recovery.

Investors have expressed continued skepticism regarding the U.S. stock market's brisk recovery from its late-March lows, noting a number of risks including the ongoing expansion of the COVID-19 virus, the upcoming November elections, and the longer-term dangers related to historic deficit spending. These concerns are legitimate and could fuel future bouts of market volatility. We believe they are outweighed by the minimal or even zero returns on competing assets classes like bonds and cash and the sheer scale of the government's efforts to sustain an economic recovery. We continue to view your stock allocation as the driver of portfolio returns for the near future and believe staying invested and taking advantage of any market dislocation remains the best strategy.

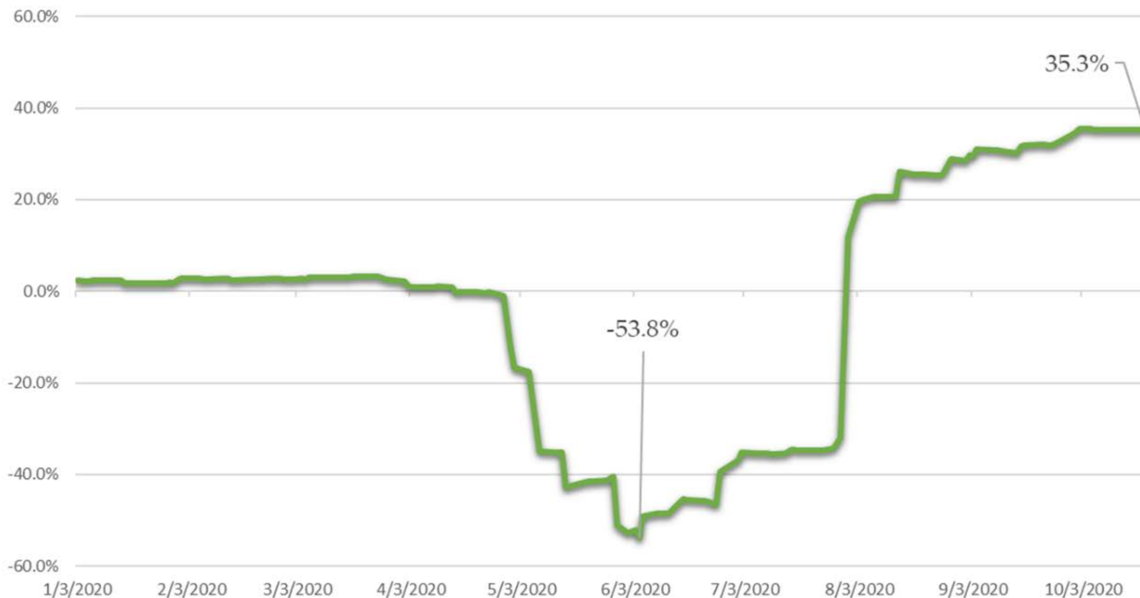


Source: Bloomberg

Tracking the Economic Recovery

The surprise bottoming and nascent recovery in U.S. economic activity late in the in the second quarter evolved to a more consistent and broad-based expansion throughout the summer. U.S. consumer spending continued to grow after its sharp May snap-back albeit at more modest pace. Weekly new jobless claims declined consistently from a late March peak of nearly 7 million to 845K by the end of the quarter. The unemployment rate fell from a peak of nearly 15% to less than 8% in September. Manufacturing orders jumped and consumer confidence improved.

All these data-points signal that the economy should "officially" return to growth when the Bureau of Economic Analysis releases its third quarter GDP statistics at the end of October. We have noted that the fast-moving nature of this recession and apparent recovery has made the traditional government data-gathering process almost useless. Real time indicators such as the Atlanta Fed GDP Now Index have already confirmed the economy's return to growth.



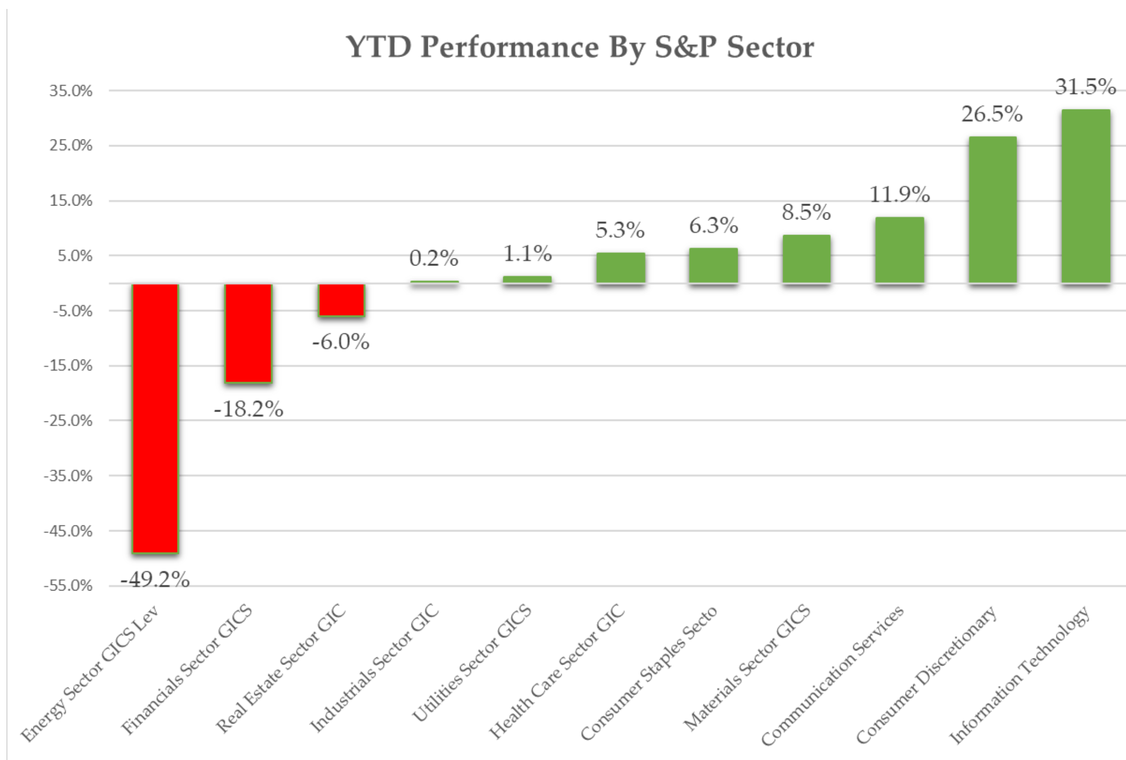
Source: Bloomberg

These encouraging trends are just a first step, as most economic data-points remain well below the pre-COVID peaks of January and February and multiple risks remain to the economy fully returning to a healthy state. The government's timely, massive stimulus has played a large role in sustaining household spending and keeping small businesses afloat. More will be required, and congressional delay could slow economic progress. The timing and efficacy of any COVID vaccine remains uncertain and the virus continues to expand after a brief summer lull in cases. Additionally, the November election portends a wide range of outcomes for the tax code, the regulatory environment, global trade, government spending, our health care system, and a host of other issues.

Analyzing Stock Market Performance

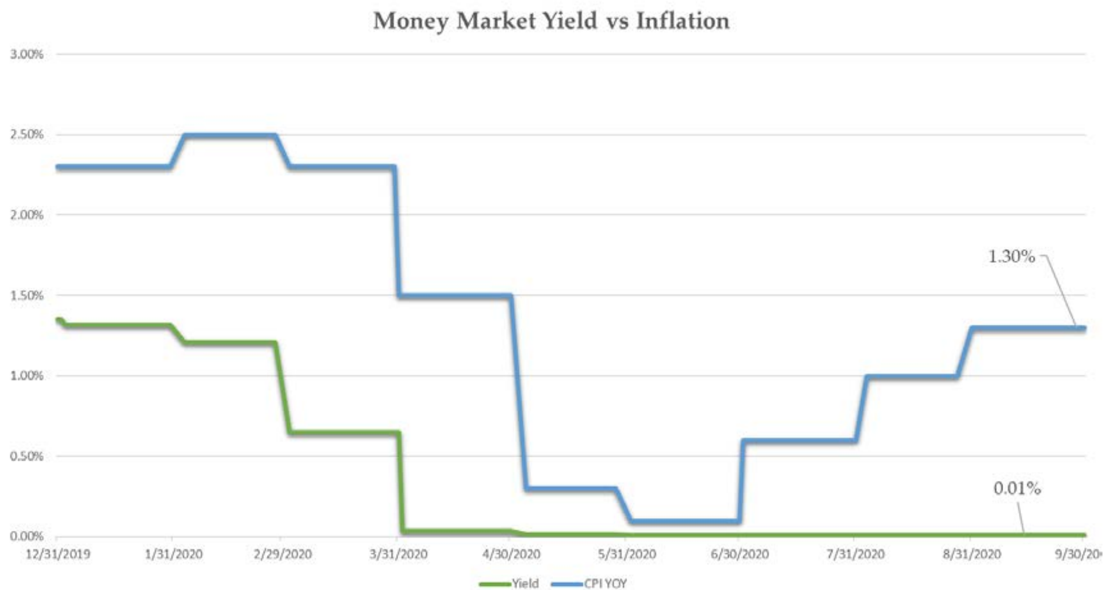
Because of these lingering uncertainties, the historically unusual nature of the recent stock market recovery persisted through the latest quarter. Stock performance continues to be driven by small group of mega-cap technology, communications and consumer companies which in our view represents a defensive stance on the part of investors who normally would be embracing other opportunities.

Stock market recoveries in the wake of recessions have followed a somewhat consistent pattern, with smaller capitalization companies outperforming their larger cap peers and value and cyclical stocks leading over quality, growth, and defensive investments. The opposite of this pattern has played out since the market found its lows in late March. Investors continue to prefer the predictability of large, competitively advantaged, and highly profitable firms whose growth relies on secular rather than cyclical factors.



Fixed Income and Cash

Bond investments continue to feature historically low yields and unattractive compensation for credit risk. Money market funds saw their yields vanish earlier in the year due to the Federal Reserve's implementation of a zero-level Fed Funds rate. This lack of return on a key asset class was justifiable for a short-time due to the specter of deflation and the incredible economic uncertainty related to the COVID shutdowns. As the economy has shifted to a recovery stance, inflation has once again accelerated. The near-zero yield on your cash holdings during a period of inflation implies a decline in the value of those funds. Given these conditions, we have where appropriate increased exposure to short-term investment grade bonds in order to maintain appropriate yield on your fixed income and cash allocation.



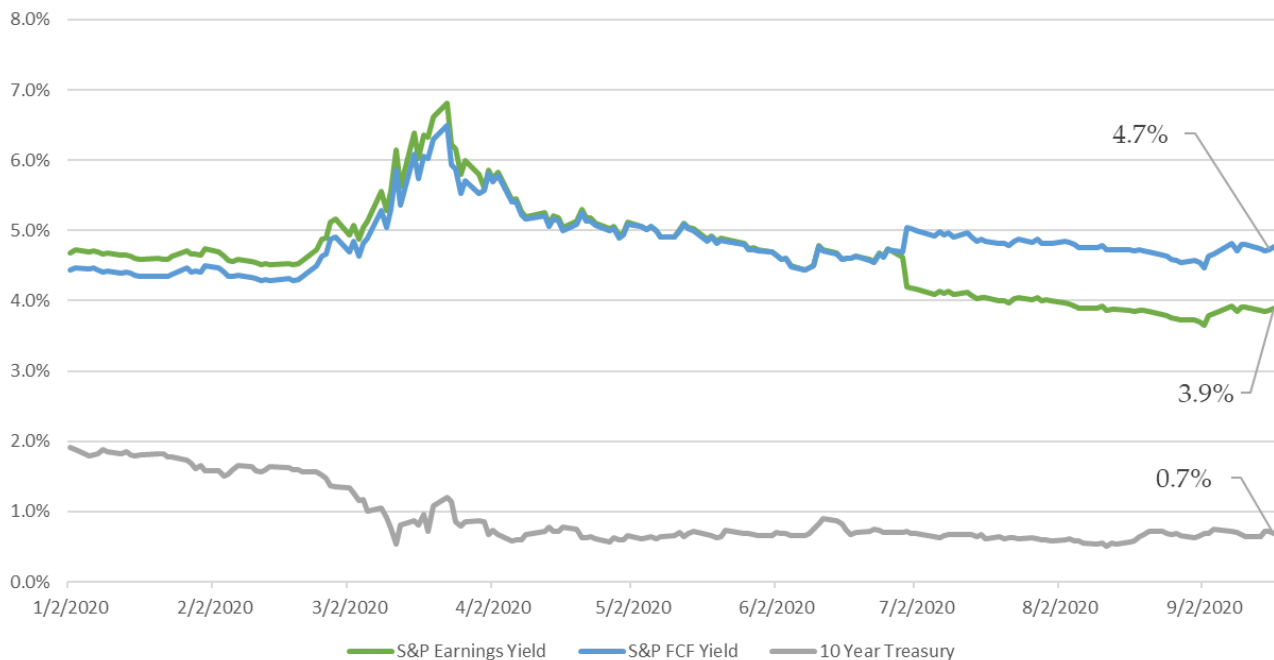
<u>Alternate Views on Market Valuation</u>

One of the most consistent investor concerns has been the elevated valuations currently embedded in stock prices. The S&P 500 traded at a P/E multiple of 25x its expected earnings at the end of the quarter, a noticeable premium to long-run averages. The P/E multiple is just one gauge for stock valuations however and analyzing other techniques should give investors more comfort.

Warren Buffett's famous 1999 Sun Valley speech accurately criticized stock market valuations in the run up to the Dot.com bubble. He noted that "interest rates are to finance as gravity is to physics." Low rates imply higher prices and vice-versa. At that time, bond rates handily surpassed the meager dividend or cash flow yields offered by speculative companies. Extraordinary growth was needed in earnings per share to justify market prices at that time. Given the profitless nature of most technology ventures, Buffett viewed that future growth as improbable. His framework captures a finance terms known as the "equity risk premium", or the perceived reward stock investors are being paid for risk as compared to safe investments like bonds or cash. He rightly noted the very bad terms being offered to investors at that moment.

Buffett's framework has been turned on its head during 2020. Corporate dividends, free cash flow, and earnings yields significantly outstrip meager treasury yields. They do so during a time of depressed revenue and profits that should improve in the months and years ahead. Technology leaders of today are a far cry from the speculative franchises of the late 1990s. They feature impressive and stable profit margins and growing competitive advantages that should allow them sustained and above average profits over the near future. Finally, the Federal Reserves vow to maintain near-zero rates for years if necessary.

This economic backdrop points to a much more rationale basis for the valuations currently being paid for stocks. Even at premium multiples, stock investors are being offered fair to attractive compensation vis a vis the meager rates on potentially risky corporate debt or the negative outcomes currently on offer for cash holdings.



Portfolio Strategy

Considering the above points, we encourage investors to balance legitimate short-term concerns with the long-term reward currently embedded in the stock market. While stocks could admittedly encounter volatility for any of the reasons listed above, we would view any such sell-off opportunistically and add to quality investments as they present themselves.

Fixed income and cash remain an important source of liquidity but their role as a portfolio diversifier and source of returns is much less appealing. In the case of bonds, we continue to find the reward for corporate credit risk to be unattractive. The now negative returns embedded in cash holdings should be balanced against the safe funding of near-term withdrawal needs.

Looking out longer-term, we believe the extraordinary level of government stimulus, an eventual solution to the COVID pandemic, and the resolution of the upcoming elections are catalysts for a sustained beginning of a new economic cycle. In that phase, the current interest rate regime will likely shift and other risk considerations will present themselves. Until then, we urge you to stay the course.

As always, please call or write with any questions.

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA