Q3 Asset Management

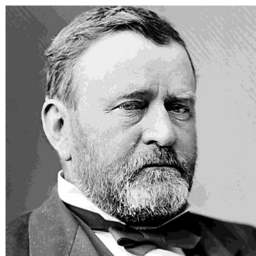
3rd Quarter 2020 Market Commentary ***October 15, 2020***

> "All that is gold does not glitter, not all those who wander are lost; the old that is strong does not wither, deep roots are not reached by the frost."
>
> *- J.R. Tolkien*

Summer of '69

After leading the Union Army as commanding General during the Civil War, Ulysses S. Grant was elected as the 18th President of the United States. It was the summer of 1869 and President Grant was focused on improving the U.S. economy through a reduction in the supply of greenbacks. Grant did this by using government gold to buy dollars from citizens, in turn creating a currency tied to the price of gold—the underlying premise behind "the gold standard."

Around this same time, businessmen Jay Gould and Jim Fisk would soon earn the reputation as two of Wall Street's biggest scoundrels. The two men hatched a plan to get close to Grant through his sister, who they befriended through a mutual acquaintance. The plan was to "corner" the gold market. They would buy large amounts of gold while at the same time convincing Grant to stop selling government gold - in turn increasing both the demand and value of the yellow metal and making themselves rich in the process.



President Grant—1870's

The plan seemed to be working. The two schemers bought up as much gold as they could and offered Assistant Treasurer, General Daniel Butterfield, a piece of the pie to tip them off should Grant decide at any point to sell government gold – in which case they would unload their stash prior to the sales. Not long thereafter, after much persuasion, Grant went public with his decision to stop selling government gold.

Gould and Fisk continued to increase their stake in the commodity, and the price quickly climbed. Over time, rumor spread about a sneaky group of speculators who were trying to drive up the price of gold, and as a result others joined in for the ride, expecting the price to continue higher. It was about this time that Grant caught wind of the scheme. Needless to say he was both embarrassed and irate. As a result, Grant secretly ordered his Treasury Secretary to sell a whopping $4 million in gold the following day, in turn flooding the market in hopes of driving the price down.

- *The "gold standard" is a monetary system where a country's currency has a value directly linked to gold.*
- *Britain stopped using the gold standard in 1931. The U.S. partially followed suit in 1933, and then entirely did so in 1973. There are currently no major governments using the gold standard.*
- *A "fiat currency" includes a monetary system where the value of a currency is not based on any physical commodity. Instead, the currency is allowed to fluctuate relative to other currencies.*

The news of Grants decision sent Wall Street into chaos and within minutes the price of gold fell from $160 to $133 an ounce. Grant did not realize the implications would in turn affect the stock market. Panic selling ensued, as stocks dropped 20% over the course of a week. The crash caused many of Wall Street's most venerable firms to declare bankruptcy.

Gould and Fisk somehow escaped prosecution. Gould would go on to control the Union Pacific Railway, but Fisk wasn't so lucky, as he was shot to death in 1872 after a dispute over a girl. While Grant was exonerated of any illicit involvement in the conspiracy, many historians say that Grant's image from that point on was tarnished. Hollywood made a movie of the ordeal, and while *The Toast of New York* was not one of Cary Grant's most famous films, the internet movie database gives it a 6.4 out of 10 – perhaps a rainy day film for those that appreciate biopics.

While some politicians seem to romanticize the notion of returning to the gold standard, the majority of economists believe that it is next to impossible. For one, not just the United States, but nearly the entire world, would have to sign on, as the interconnectedness of economies is much more pronounced than ever before.

In addition, a gold standard would severely limit the tools available for the government to offer stimulus or issue new debt. Given the fact the U.S. is over $25 trillion in the red, there is not nearly enough gold possessed by the U.S. government to back such obligations. Based on the dollars in circulation, gold would have to be re-priced at around $10,000 an ounce. So while the gold standard may sound logical to some, the possibility of returning to the gold standard given the rate that the U.S prints dollars is unlikely.

Quarterly Market Recap

Coming off the heels of two record quarters – the first seeing an unprecedented 30% drop in stocks, and the second a record fast recovery – relatively speaking the third quarter was less eventful. Volatility subsided as the markets balanced COVID fears with improved corporate earnings and bullish economic data. Of course, these are fluid situations and the upcoming election will add an element of the unknown. As we have pointed out in the past, the market abhors uncertainty, and increased market instability is almost a foregone conclusion.

Historically, the stock market tends to exhibit lower volatility in the summer months as many traders take time off or otherwise step away from the market. July and August witnessed the equity markets continuing their run-up from the depths of the COVID crisis. After stocks became overextended toward the end of the summer, we saw a pullback in September.

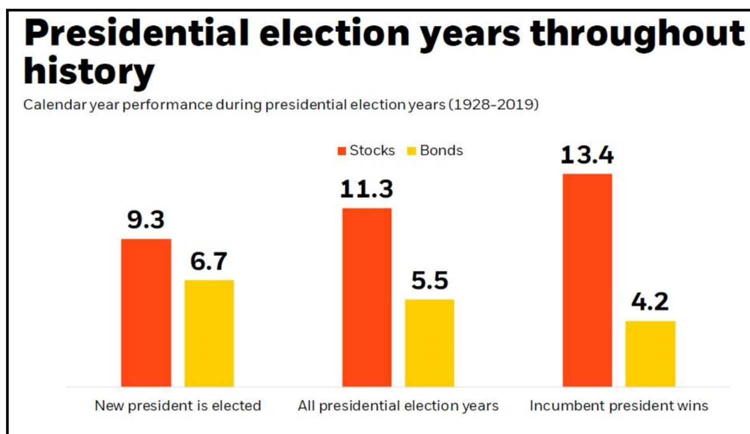
As we move into the autumn months, and election season, historically the market begins to heat up. Even without a pandemic, social strife, and the uncertainty of a hotly contested election, the months of October and November have tended to bring about larger than typical moves in the market. Perhaps counterintuitively, it is possible that we see the opposite - as so many market participants are anticipating a rough ride. Only time will tell.

- US stocks added to a strong second quarter by tacking on additional gains over the last three months. The iShares Moderate Allocation Fund advanced 3.6% for the quarter. The S&P 500 added 9.0% and the Dow Jones Industrial Average rose 8.2%. Small caps, as has been the case the last several quarters, lagged, rising 5.0%. Once again, large cap, and growth stocks led the way, particularly tech-based “mega-caps” such as Amazon, Microsoft, and Facebook.
- Major equity sectors experienced above-average returns for the quarter, with the exception of Energy (XLE) losing 19.5% and Real Estate (XLRE) gaining just 1.9%. Furthermore, those two sectors have negative 1-year returns in addition to Utilities (XLU) and Financials (XLF) losing 5.0% and 11.8% over the course of the last 12 months. Winners for the quarter include Consumer Discretionary (XLY) and Materials (XLB) rising 15.3% and 13.5%.
- After consecutive quarters of relative outperformance, international equity markets had mixed results for the most recent three-month period. Leading the way were Emerging Markets (EEM) and Pacific Basin (IPAC) rising 10.3% and 6.9%. Latin America (ILF) fell 2.4% as that region continues to struggle - down more than 35% YTD. Even the two “winners” for the quarter, Emerging and Pacific, are still looking to recover with returns of 0.1% and -1.9% YTD.
- The fixed income market continues to exhibit lower volatility as investors look to equities for enhanced returns. Bond asset classes were moderately tilted to the upside with High Yields (HYG) gaining 4.1% and Municipals (MUB) adding 1.0%. Long-term Government Treasuries (TLT) lost 0.1% and the Aggregate bond market (AGG) rose just 0.4%.
- Alternative asset classes had a decent quarter buoyed by a record high in gold during July and early August. For the quarter, Gold (IAU) added 5.9% and Commodities (PDBC) rose 5.6%. Oil (OIL) rose 4.1% continuing its comeback from the springtime lows, though still off more than 30% for the year.

Election Jitters?

There is no escaping the fact that we are fully immersed in election season. Yards and street corners are festooned with political signs of all sizes and colors – from both political parties. And good luck with not seeing a television ad every few minutes, often the same one over and over. It's enough to make your head spin.

Voting is a bedrock of our democracy. And even amidst the COVID pandemic, it has been forecasted that a record turnout is likely. No matter which side of the political spectrum one falls, Presidential elections have an immeasurable effect on all of our lives, and this one is no different. Just one effect is the economy, and more specifically the stock market.



If you watch any of the financial news networks you will be bombarded with various charts, tables, and graphics illustrating all manner of outcomes and "what-ifs." How does the market perform when the incumbent wins? What about a sweep of all three legislative branches? How can the weather affect the election? Mail-in voting vs. in-person voting, and on and on.

Sometimes more data is not better, as without context it loses all meaning. Presidential elections certainly have an effect on the economy, and by extension the stock market, but it is important to look at the bigger picture. Often, effects attributed to an election are merely a continuation of the environment preceding the election. To be sure, short-term volatility does arise in the weeks bookending the election but after the dust settles, the weeks and months after voting day are typically reflective of the overall economic landscape that existed earlier in the year.

More often than not, the largest contributor to pre-election turmoil is simply uncertainty. The market dislikes that which is not known. This is illustrated by the fact that when a new president is elected (as opposed to the incumbent), the stock market underperforms by roughly 4%, on average, over the next year. However, not surprisingly, the more cautions bond market performs over 50% better.

It should be noted, though, that a balanced portfolio (50% stocks, 50% bonds) is largely unaffected. 8.0% for a new president, and 8.8% for the status quo. So what to make of this?

One popular takeaway is to simply step back and stick with the investment plan that was mapped out previous to election season. Making short-term decisions based on emotions rarely turns out well. A few weeks in October and November should not dictate your longer-term investment processes.

Further, it may be tempting to reallocate your investments in the final days leading up to the election, or a few days afterwards if the market exhibits extreme moves. However, these can often be "head fakes," catching unwary investors off guard as the markets suddenly bob and weave leaving the best laid plans in tatters.

For example, the 2016 election showed how predictions can go awry and how quickly the market can incorporate new information and recover. On the night of the 2016 election, as more states began reporting and a Trump victory became increasingly likely, stock market futures sank rapidly (a new president, so more "uncertainty"). The S&P 500 fell more than 5% in premarket trading, triggering a halt in trading. By the time the market closed the day after the election, the index was up over 1%.

When all is said and done, the market historically has looked beyond the election and ultimately relied on underlying economic fundamentals. Of course, in 2020 with the continued specter of COVID, the "fundamentals" themselves are in doubt. More than likely, over the next six months stocks will be influenced more so by the progress on a COVID vaccine than the results of the presidential election.

The Road Ahead

For all the noise of late, the resilience of the stock market serves as a reminder of perhaps the single most important catalyst for stocks as we move forward: stimulus. Trillions of dollars have been thrown at the stock market, both directly and indirectly, over the course of the last six months. A steady dose of "continued stimulus" comments from various members of Congress and the administration, Democrats and Republicans alike, has kept sellers at bay. While each party may differ in regard to the size of the next round of "helicopter money," both sides are talking in the trillions. Sometimes it's not about which side "wins" but rather the market's reaction to an event.

As we often point out, the stock market dislikes uncertainty. Regardless of the outcome of the election, or the trajectory of the virus, the stock market seems content with the fact that no matter what happens, as long as there is continued stimulus, stocks will have a wind at their back.

Calling back to our opening piece in this letter, we believe the "gold standard" of investment management is the ability to adapt to changing markets. Here at Q3, we preach the gospel of "staying the course." This does not mean blindly buying and holding your investments and "hoping" they go up. Rather, it means having a systematic plan – investment strategies that maintain the ability to react in both good times and bad. Your investments with Q3 are all actively managed, in a time-tested, rules-based approach void of human emotion. Precisely what is needed given what may transpire in the following weeks and months.

As always, we appreciate your continued trust in Q3. If you have any questions or concerns, please do not hesitate to contact either your Representative or Q3 directly.

All the best,

Bradford Giaimo - Principal

Adam Quiring - Principal

Bruce Greig - Director of Research

Our Form ADV Brochure was updated on March 18th and there were no material changes since our last update. If you would like a copy of the Brochure please contact our office at info@q3tactical.com or 248-566-1122 x 102 and we will send you one. Additionally, a copy can be downloaded at the following URL: https://q3tactical.com/pdf/Q3_ADV.pdf. Beginning July 1, 2020, Q3 provides investors with our "Form CRS." As a reminder to clients, we ask that you contact either Q3 or your Representative if your investment objectives, suitability considerations or investment time frame has changed. If you would like to update your suitability questionnaire, a copy can be obtained by going to www.q3tactical.com/pdf/questionnaire. Once complete, it can be faxed to us at 888-439-2572. If you would like to impose reasonable restrictions on the management of your account, or modify existing restrictions, you may do so by providing such restrictions to Q3 in writing, via fax (888-439-2572) or mail (2175 Cole Street Birmingham, MI 48009).

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