Q3 Asset Management

4th Quarter 2020 Market Commentary ***January 15, 2021***

> "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.R. Tolkien*

"Lights, Camera, Action"

2003's The Lord of the Rings: The Return of the King made cinema history in a number of ways when it won the Best Picture at the 2004 Academy Awards. It had the 3rd longest run time at 201 minutes, it was the only final installment of a trilogy to win, it had the highest box office take of over $1.1B, and it won 11 total Academy Awards tying Titanic and Ben-Hur for the most Oscars won.

While the movie will rightfully go down in cinematic history for all of its achievements, there is a lesser-known honor that it also holds: it is the last movie to win Best Picture that was also the top-grossing movie of the year. This may, or may not, come as a surprise to moviegoers. Casual film fans may assume that if a movie won Best Picture then surely it must have also been a box office smash.

Such is not the case, however. In 2009, for example, The Hurt Locker took home the prized Oscar while only grossing $17M at the box office. Four additional Best Picture winners since then are in the top-10 of lowest grossing movies which won the top award. These include Moonlight (2016, $29M), Birdman (2014, $44M), Spotlight (2015, $47M) and The Artist (2011, $50M).

This disconnect began to concern the members of the Academy especially after three consecutive years of winning movies performing relatively dismally at the box office. With the surge in popularity of comic book-based superhero movies, coupled with the opinion that these films were not considered "Oscar-worthy," members of the movie Academy were worried that there was a widening chasm between what they considered achievement and what the actual moviegoing public wanted to see.

In order to remedy this perceived problem, in 2018, the Academy announced a proposal to establish a new category reflecting outstanding achievements in "popular" film. Few details were announced at the time, but the implication was the category was intended for blockbuster movies which had achieved mainstream appeal.

Reaction to the proposal was swift and overwhelmingly negative. Movie critics and journalists viewed it simply as pandering to mainstream audiences in the hopes of increasing television ratings. In response, the Academy quietly shelved the idea stating they would "examine and seek additional input regarding the new category". In other words, it is unlikely they will float that idea anytime soon.

With the 93rd Academy Awards set to air in April of this year, all bets are off in terms of box office as the COVID pandemic all but shut down traditional movie watching during 2020. Instead, movies will be tallied using streaming metrics and downloads which will make comparisons to previous years very difficult indeed. Nevertheless, the money says that the top streamed movie will probably not be the top winner come award night.

So, what are the takeaways from this example? Primarily that there are logical reasons for disconnects – we are often just blind to them. While many Best Pictures did extremely well at the box office, Forrest Gump and Titanic for example, there has never been an explicit link between mainstream popularity and critical accolades – they are two different things, each affected by unique factors. Mainstream popularity may hinge on the draw of the leading actor, for example, whereas critical response may be focused on the story or the

cinematography. These components may not always align.

In the realm of economics, such a disconnect often exists between the performance of the stock market and the health of the economy. We have witnessed this throughout the past year. Intuitively it would seem to be almost obvious that they should move in tandem, but there are a number of factors which affect the stock market, not all of which are reflected in the economy and vice-versa.

In April, if you watch the broadcast of the Oscars, just keep in mind your favorite movies of 2020 may not be amongst the ones represented in the slate for Best Picture. But until you and I are invited to the Academy, and offered a vote, we'll just have to remember that movies are meant to entertain us, and if they succeed – it was well worth the cost of admission.

Quarterly Market Recap

The first two quarters of 2020 displayed historic market behavior, the fastest bear market drop in the 1st quarter and the fastest bear recovery in the 2nd. The past six months were relatively free of downside volatility as there were increased signs that a COVID vaccine would be happening sooner than originally expected. Talks of additional government stimulus also helped quell the fears of investors.

With the Presidential election in November, and everything that tends to go along with that, many expected a tumultuous time in the markets. Surprisingly, even with contested election results, the market seemed to largely shrug this off and continue along as if nothing happened. Some interpret this as a strong sign of a healthy market, one that cannot be "bullied" by external forces. Others, however, point out that it may be a sign of complacency – which often occurs at market extremes.

The fourth quarter ushered in a change in leadership politically and in the markets. A newly elected President will govern us for the next four years, and new leadership was established in the investing arena, as small-caps, value and international issues had their day in the sun. Whether or not these areas of the market continue to outperform remains to be seen, but the rotation into these asset classes seems to imply we might be on the cusp of a sea change in the stock market.

- US stocks added to a strong third quarter by tacking on additional gains over the last three months. The S&P 500 gained 12.1% and the Dow Jones Industrial Average rose 10.7%. Value-based stocks outperformed growth issues, during the quarter, for the first time in over a year. This rotation began in the third quarter and accelerated into the fourth quarter as "work-at-home" stocks began to lose some of their luster due to continued vaccine hopes.
- The major equity sectors experienced above-average returns with all eleven S&P 500 sectors gaining ground. Leading the way were Energy (XLE) and Financials (XLF) rising 28.3% and 23.1%. Real Estate (XLRE) and Consumer Staples (XLP) had the smallest gains, rising 5.0% and 6.1%. Notably, the two strongest sectors in the 4th quarter are both defensive in nature, and have struggled for over a year. In fact, even with the strong showing of these two, they both are still negative over the one-year period. Energy down 32.5% and Real Estate off 2.1%.
- International equity markets continue to outpace their US-based counterparts. Performance was headed up by the Latin America (ILF) markets gaining an impressive 40.7%, but still down over 11% for 2020. Europe (IEV) and Pacific (IPAC) regions both were up 15.3% and Emerging Markets (EEM) rose 18.4% for the period. The gains for the quarter were driven by many of these regions' ability to navigate their way through the COVID pandemic with a minimum of disruption to their economies.
- The fixed income market, to no surprise, continued to underperform equities for the quarter. Of course, it does offer the relative safety of bond investing along with lower volatility. Bond yields began to climb during the period which led to losses in US Treasury issues. Long-term government bonds (TLT) lost 3.0% for the quarter. Winners were High Yields (HYG) and Corporate Bonds (LQD) rising 5.8% and 3.4%.

- Not to be left out, alternative asset classes also had a respectable quarter. Gold (IAU) after its record run in the summer months eked out a small gain of 0.8%. Oil (USO) continued its strong run adding on 16.7% for the quarter. Incredibly, even after these gains, oil finished 2020 down more than 65%.

As Goes January...

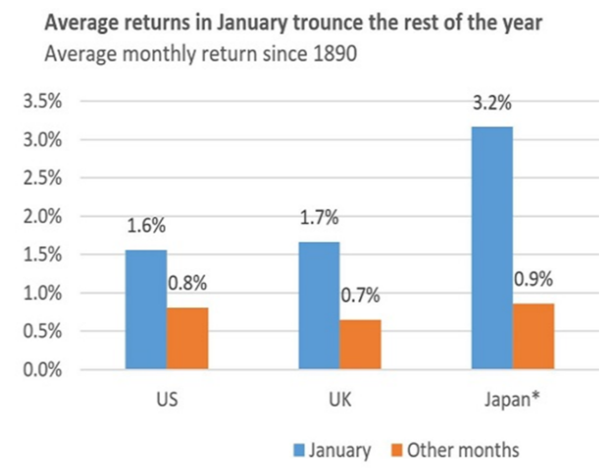
January in the markets is not entirely different than January in our everyday lives, a time for new beginnings and a time to look ahead to see what the year will bring. Just as we try to envision what the year will have in store for our personal lives, market watchers have been doing a similar thing for decades.

Perhaps in no other endeavor is predicting the future more germane than it is for the investment industry. Naturally, the ability to do so is difficult – to say the least. Nevertheless, it does not stop people from trying. One of the more common practices is to look closely at the market during the beginning of a new year. Again, investment professionals are really no different than the rest of us, they want to be prepared for times to come, and act accordingly.

Not only is January the start to a new year, but it has also been historically one of the more volatile months for stocks. Perhaps these reasons are why so many people try to extrapolate longer-term predictions from the performance of just this one month. Following are just a few of the indicators and "effects" that have been identified in the markets:

"The January Effect"

The term refers to the buying of stocks in January -- often for a perceived discount. In December, investors often sell for tax purposes or just to make some quick holiday cash. This sell-off is thought to create stock market "discounts" in January. Any effects from this phenomenon are noticed mostly in small-cap stocks, as they are easier to move given their smaller market footprint. The chart below shows that the month of January indeed outperforms over the average month, and not just in the US.



Global Financial Data. Through 12.2019. Japan data from 1921.

This anomaly was first noted in 1942 by the investment banker, Sidney Wachtel. But it was not until the 1980s that it really came to the forefront. During this time, many academic papers did a deep dive into this phenomenon attempting to explain its existence. Generally, the consensus was that January, indeed, did seem to deliver outsized returns and could be largely explained by tax management. Simply put, investors sold their losses in December to offset any gain they might have, then bought back similar positions in the following January.

"First Five Days Rule"

If the S&P 500 finishes higher in the first five days of the year, as it has in 2021, there is an 85% chance the market will end the year higher and with an average gain of about 13%. Many of the causes and explanation of this rule are similar to those of the "January Effect" cited above.

Of course, looking at just a handful of days cannot fully account for the subsequent 200+ market days of the year, but it does have a strong track record. An element of "self-fulfilling prophecy" may exist, in that investors are aware of this phenomenon and begin buying in anticipation of it – thereby perpetuating the effect.

"As Goes January, So Goes the Year"

As a natural progression to the above effects, it may come as no surprise that market researchers have identified that market performance in January tends to be an accurate predictor of the rest of the year. Simply put, the idea is that if the S&P 500 index ends January higher than it started, the rest of the year will follow suit. This "prediction" has been correct 34 out of 38 times since 1950. A strong beginning to the year may mean investors are more encouraged to get invested in the subsequent months.

The Road Ahead

Last quarter we wrote: "Without a doubt the news in the following weeks will be dominated by two items - the presidential election and the Coronavirus." To no one's surprise, this was certainly the case. In both instances, though, the market generally responded positively. The gains in the 4th quarter came as a surprise to some given the level of uncertainty surrounding the election coupled with the challenge of a nationwide vaccine distribution effort.

We believe this points to the fact that the market, to some extent, will "do what it wants to do." Meaning, it is not wise to assume that the market will react to news in a rational manner. As we discussed at the beginning of this letter, the concept of a "disconnect" comes into play again. The market seems to be decoupled from the events occurring around it. In addition, there are literally hundreds of factors that drive the performance of stocks. Some would argue millions – each investor has a certain pull; however small it may be. Because of this, it is just not possible to base investment decisions of off headline news even if you think the news should affect the stock market.

This conundrum is further compounded when investors begin to let their own emotions enter into the investment decision making process. Human emotion has been shown, time and time again, to be one of the single largest impediments to reaching one's investment goals. This is precisely the reason why we rely on objective, quantifiable rules to guide all of our investment decisions. There are simply too many external factors which generate "noise" and not a meaningful "signal." Separating the noise from the signal is the hallmark of algorithmic-based investing.

With the new year ahead, we are often asked "what will the market do in 2021?" To which we generally answer by giving our thoughts on high level trends that we see unfolding. But ultimately, nobody really knows, and frankly - we are largely indifferent. This is not the same as not caring, or not having an opinion. Rather, it is a recognition of what we know and what we do not know. More precisely, what we can control and what we cannot.

We are concerned with what can be controlled, namely the design and implementation of our investment strategies. When we research our ideas, one of the most important steps undertaken is to compile historical data on methodology associated with each model. We gather as much data as possible, attempting to cover any market eventuality. Again, we do not profess to see into the future, but rather we incorporate historical patterns and tendencies into our strategies to give them the ability to adapt to any possible market environment.

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,

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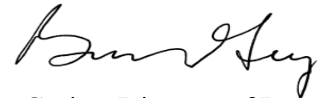
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Our Form ADV Brochure was last updated on March 18th, 2020. If you would like a copy of the Brochure please contact our office at info@q3tactical.com or 248-566-1122 x 102 and we will send you one. Additionally, a copy can be downloaded at the following 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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