Bahl&Gaynor
Investment Counsel

A letter from the
Bahl & Gaynor Investment Committee

CELEBRATING 30 YEARS OF DEDICATED SERVICE
Bahl&Gaynor
1990–2020

In this issue:

Taking Stock of the Recovery

So very often and for good reason, investors associate the summer months with a quiet and meandering equity market profile; a period low on volatility, short on substantive developments and defined by little net progress.

Sand in unwelcome places, a cheeseburger and long, lazy days are all part of the summer mindset. However, summer 2020 was anything but standard fare. The COVID-19 pandemic remains front and center emotionally and economically, impacting day-to-day life for all (including the President and First Lady). While we are hopeful for an effective vaccine announcement in the weeks/months ahead, nothing can be certain. The final quarter of this year is expected to be action-packed, so please fasten your seatbelts as we may be experiencing turbulence ahead.

The global pandemic, vaccine developments, global economic recession recovery, China trade evolution, escalating geopolitical tensions and a contentious US election may come together to move global capital markets in either direction. This incomplete list of the bricks in the "wall of worry" are known to the investment community and are constantly being priced and re-priced into the capital markets based upon perceived outcomes. Entire industries and their players are devoted to predicting these outcomes and finding the proverbial needle of insight in a haystack of noise.

To the degree American consumers become more mobile and able to live with the pandemic's challenges, markets are likely to gradually return to prior norms. We look forward to restoring the days when securities were valued for their long-standing measures of competitive strength, profit generation and balance sheet flexibility. While we are hopeful of a return to capital market rationality, in the balance of this letter we will visit a number of key issues whose normalization will support long-term economic and market sustainability.

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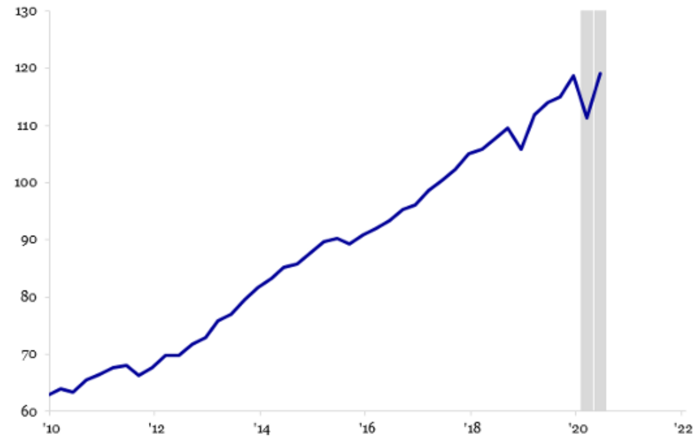
Consumers

Even without 3Q2020 Congressional approval of a fourth stimulus package, government data suggests stabilization of overall consumer economic wellbeing. While additional progress and momentum is needed, the unemployment rate (7.9% in September) and weekly unemployment claims data continue to trend downward even as many small businesses and travel/consumer entertainment industries report limited progress. Unlike prior recession recovery periods, it appears the purchase of goods is stronger than the purchase of services, consistent with the nature of the pandemic. Employment improvement coupled with aggressive Federal Reserve interest rate actions and fiscal stimulus have been a powerful combination, driving a recovery in consumer spending while consumer credit card debt remains lower than pre-pandemic levels. Reflecting the uneven nature of this recession's recovery, a rebound in the capital markets, elevated residential real estate values and savings rates resulted in an all-time high consumer net worth during 2Q2020 *(pictured at right)*. It is expected 3Q2020 data will bring yet another new high. While consumer momentum may fade in 4Q2020, positive vaccine developments and an increasing number of service industry jobs could combine to provide a 2021 economic trajectory above current expectations.

Household & Nonprofit Organizations: Net Worth
(EoP, NSA, Tril. $)

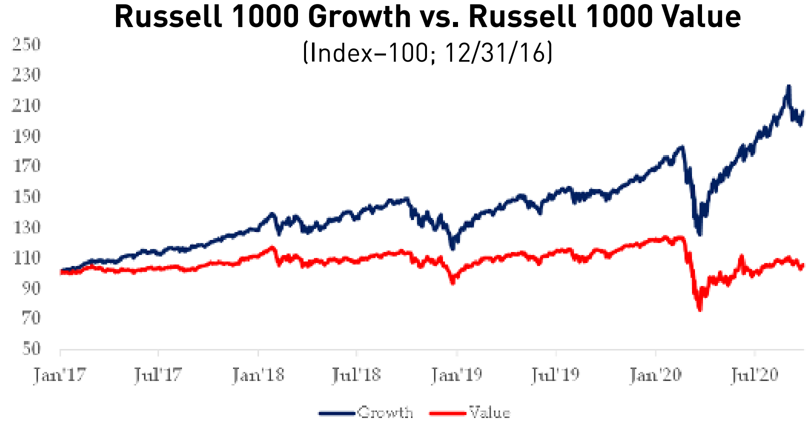


Source: Strategas, 2020.

Growth versus Value in 2020

Few topics in investment management attract more attention than the massive performance gap between "growth" and "value" equities *(pictured below)*. Sluggish macroeconomic growth since emerging from the Great Financial Crisis has been more favorable to growth equities, such as technology stocks. These stocks tend to report stronger and more consistent financial results relative to companies that are more economically sensitive which often reside in the value category. Additionally, consumer and business purchases during the sudden work-from-home/ shop-from-home pivot only served to accelerate technology adoption, further favoring these growth securities. Finally, low inflation and interest rates lifted growth stock valuations by valuing projected cash flows at a lower discount rate, yielding greater present value. The combination of these influences has potentially pushed the growth security contingent beyond reasonable and practical valuation limits. While years in the making, the 2020 global economic lockdown only accelerated the growth and value equity performance gap to a peak disparity in August. Insofar as a durable economic recovery may serve to reverse at least some of the incremental benefit the pandemic has brought to growth securities, this trend of secular growth outperformance would appear ripe for a reversal.

Russell 1000 Growth vs. Russell 1000 Value
(Index–100; 12/31/16)



Source: Strategas, 2020.

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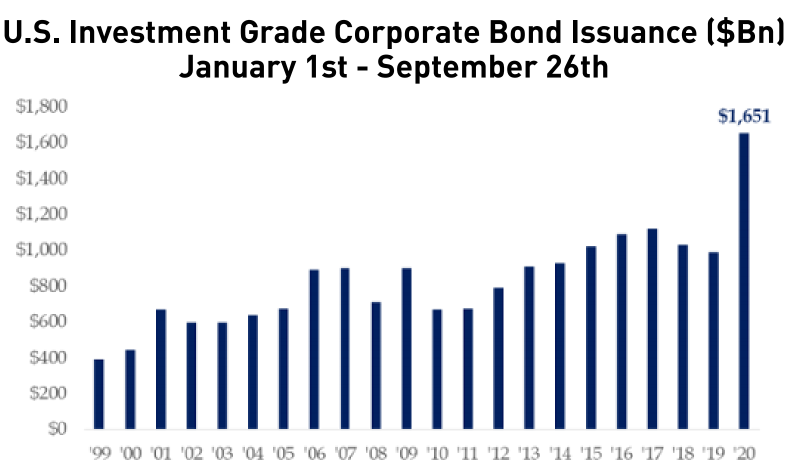
Is September's Value Rotation the Start of Something Much Bigger?

Indeed, beginning in September, the preference for large capitalization growth and momentum equities over value stocks took a sudden pause. Exact reasons for this shift in investor sentiment, beyond extreme valuation levels, are uncertain. It is possible anticipation of a vaccine breakthrough and statements by the Federal Reserve suggesting higher inflation in the years ahead are catalysts for a shift toward economically levered value securities. While confined to September and too early to be definitive, it appears a rotation of investor capital is underway favoring companies likely to see an acceleration in top and bottom line growth. This, as the global economy continues to heal in the quarters ahead. Popular large capitalization momentum growth equities have dramatically outperformed other areas of the markets since the pandemic reached US shores in late February. Should this global economic normalization persist, a rotation from momentum growth to more economically sensitive equities could prove to be durable and long lasting.

Low Interest Rates Constructive for Recovery

Interest rates remain extremely low across the yield curve, and the combination of low inflation and a clearly voiced accommodative monetary policy on the part of the Fed is likely to keep interest rates low for the foreseeable future. Low rates significantly cut borrowing costs for both companies and indebted consumers. As such, debt capital market activity has been heightened in 2020, particularly starting in March as rates began to drop. Year-to-date through late September, investment grade debt issuance is 67% above 2019 totals as seen in the chart below.

The US housing market has historically been a linchpin of the US economy. This market is further supported by all-time-low 30-year mortgage rates just below 3% during the summer months. Housing inventory remains tight with 27% fewer homes on the market in June versus a year ago, lifting prices and contributing to consumer net worth in many parts of the US. Mortgage purchase applications were 17% higher in June versus the prior year while refinancing activity was 200% higher as measured against year-ago levels during the April-June time frame. Clearly, lower interest rates have been a constructive influence for companies and consumers as the domestic economy continues to recover.



Source: Strategas, 2020.

A Return to Normalcy

Economic uncertainty and volatility represented the only consistent investor theme during the pandemic. This dynamic remains intact. The dialogue describing the contours of a post-COVID global economy is now underway. We expect, as the global economy normalizes, capital markets will also return to long-standing, traditional valuation metrics given safe, sustainable sources of yield are scarce and reliable and growing income streams are now more valuable. As we emerge from this black swan event, we know that income growth, downside protection and total return over a market cycle will remain central objectives for investors in the future.

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Financial Planning Update

Don't Delay: Four 2020 Tax Strategies to Consider

Before we exit 2020, there are tax-advantageous maneuvers we would encourage you to make for a better 2021 and beyond. Now is the time to talk with your tax advisor about these moves so you are acting with a prepared plan to make best of current opportunities:

Roth IRA Conversions

With historically lower tax rates, now might be a good time to consider a Roth IRA conversion. A Roth IRA conversion consists of transferring your tax-deferred traditional IRA into a Roth IRA. The newly converted Roth IRA will then grow tax-free, meaning future capital appreciation and distributions will be free of taxation.

When you make the conversion, the transferred funds will be taxed as ordinary income. However, current low tax rates may offer a more compelling conversion now versus future taxed distributions. This consideration depends your asset levels and current tax bracket and should be discussed with your tax advisor to see if it works for you.

Tax Loss Harvesting

With the average stock return in the S&P 500 still negative year-to-date, some holdings in your portfolio may carry unrealized losses. Realizing these capital losses could be valuable in reducing your overall tax liability. Selling an investment at a net capital loss can be used to reduce realized taxable capital gains. Excess capital losses can offset up to $3,000 ($1,500 married filing separately) of ordinary income, anything over this amount can be carried forward and utilized in future tax years.

Charitable Giving

The recently enacted CARES Act allows you to make fully deductible cash donations to qualified public charities if you itemize. If you choose a standard deduction instead, the deduction cap is $300 per individual ($600 married filing jointly). Donor Advised Funds, while not included in the CARES Act, are still eligible for cash donations to be deducted up to 60% of taxable income. Individuals who itemize and wish to donate highly appreciated assets, such as stocks or mutual funds, are still able to donate (equal to the market value of the securities) up to 30% of their income. Furthermore, securities donated to qualified charities incur no capital gains taxes.

Gift & Estate Tax Exemption

Under the 2017 Tax Cuts and Jobs Act, the lifetime federal gift and estate tax exemptions doubled to $11.58 million per individual (more than $23 million for a couple). In 2026, these exemption limits will revert to 2017 limits ($5.45 million for individuals, adjusted for inflation). When assets are gifted assets, they are removed from the donor's taxable estate and future appreciation in those specific assets are free from further gift and estate taxes. We encourage continual conversations with your tax professional around lifetime exemptions to ensure gifting intentions are being maximized under current tax law.

At Bahl and Gaynor, we have been successful for our clients by focusing on the things we can control. We encourage you to take charge of your finances and be your most tax-efficient self. Contact your Portfolio Manager to see how we can aid in your Tax Advisor conversations to build a comprehensive tax strategy.

Disclosure:

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