COLONIAL TRUST *Quarterly*

4TH QUARTER | 2020

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LEADERSHIP

H. Walter Barre
Barry D. Wynn
Bert D. Barre, CFA
Camp R. Wynn, CFA
Jamison W. Hinds, JD
Brad Humphries, CFP®, ChFC, CLU, CLTC
Carolyn L. West
Karen H. Longhurst, CTFA
Ansley J. Mitcham
W. Charlton Wieters
Pamela G. McCauley
James C. Fiske, CFP®
Reid E. Thompson, AIF®

LOCATIONS

Spartanburg Office
359 S. Pine Street
Spartanburg, SC 29302
(864) 582-3356

Greenville Office
101 E. Washington St., Ste 200
Greenville, SC 29602
(864) 370-0737

Columbia Office
6 Calendar Ct, Suite 1
Columbia, SC 29206
(803) 782-7646

Charleston Office
578 East Bay Street, Suite B
Charleston, SC 29403
(843) 577-0444

ColonialTrust.com

A Team Built For Solutions And Stability

Over the past several years we have used the cover of this newsletter to highlight one of the many valuable members of our team. We still have some important colleagues to highlight, but first we wanted to pause and make sure that all of our clients understand the depth of the team we have built and their ability to add value to your experience.

Many of our clients work with only a couple of us, but Colonial Trust now consists of 23 full-time professionals across the state. Over the past 10 years we have very deliberately built a broad team with varied backgrounds, ages, and skill sets to better serve our clients. Each client has different needs depending on their asset mix, family dynamics, service needs, and stage in life. No matter the situation, we believe we can bring the resources to bear that meet your needs. We have trust officers with CTFA designations, investment managers with CFAs, financial planners that hold their CFP, legal experience in our General Counsel, an accredited corporate retirement plan specialist and a certified caseworker focused on special needs and elder care clients. We are also very proud of our service team with extensive financial services backgrounds and long tenures at the firm.

In addition to the broad level of advice and service enable by this model, our clients also benefit from strong relationship continuity as part of a broad succession plan. Our intentional team building has allowed us to navigate a handful of retirements in recent years. Most recently Barbara Weatherford who helped open our Greenville office in 1996 transitioned from part to full retirement in September. Barbara was extremely loyal to the firm and to her clients and we congratulate her on her retirement; she will be sorely missed. Nevertheless, we believe that our clients will see a smooth transition because of the additions of Lori Cash and Gina Grooms to the Greenville office over the past few years. Similarly, our Spartanburg, Columbia and Charleston offices have had recent retirements with no disruption in client service because of our proactive planning and cross training.

Maintaining a comprehensive teamwork approach allows us to navigate changes and provide continuity to our long-term relationships, which is a high priority at Colonial Trust. For this team approach to continue to succeed, all of our clients need to be familiar with more than just their lead advisor. To help strengthen this team environment, we plan to be more intentional about introducing additional people to your service experience. Diversification is a prudent component of our investment philosophy and needs to be in our service model as well. Everyone at Colonial Trust looks forward to getting to know more of our clients even better and hope you will always let us know if there is anything we can do to better serve you.

Review of the Quarter

Equity strength from the second quarter continued into the first two months of the third quarter. August was the best month for markets since 1984 and the market reached all-time highs on September 2nd. Over the last 70 years, September has been the market's worst month, and when coupled with a strong August and an election year, underperformance in September is more pronounced. The 3.6% sell-off in September brought the quarter's return to 8.9%. The Nasdaq returned 11.2% for the quarter, as the market continues to be led by technology stocks. International equities were positive for the quarter, with the MSCI EFAE index returning 4.9% and the MSCI Emerging Markets index returning 9.7%.

Consumer discretionary stocks were the strongest sector, up 15.0%, followed by industrials, materials, and technology – all up more than 11%. Technology was a top performing sector through August, but a 5.4% selloff in September moved it to fourth place. The strength in industrials, materials, and parts of consumer discretionary was a rotation into stocks which were left behind in the tech focused rally since late March. This broadening of market leadership is a healthy development, as the market value of AAPL, MSFT, GOOG, FB, and AMZN became over 26% of the S&P 500 in August. Each of these stocks hit all-time highs in late August or early September before falling an average of 13% from those highs.

The bond market as measured by the US Aggregate Bond Index returned 0.6%. Returns came largely from yield as the benchmark 10yr treasury yield was essentially unchanged, finishing the quarter yielding 0.64%. Aggressive Fed policy and investors starved of yield have kept rates at historically low levels and the Fed has signaled its expectation that rates will remain low for several years.

In our last newsletter, we attempted to explain the divergent paths of Main Street and Wall Street. Depending on the measure examined, this divergence has lessened or worsened during the quarter. The economy improved in the third quarter, although the improvement was not evenly distributed. We will spend the remainder of this letter outlining the current economic situation and the market's expectations going into the fourth quarter.

Manufacturers experienced a V-shaped recovery as the economy began to reopen. Industrial production fell 16.7% from February through April and has rebounded 11.4%. It remains below the February level but has regained more than half of the lost output. The ISM Purchasing Managers Index (PMI) fell deeply into contraction territory in April and has rebounded from 41.5 to 55.4 in September. We believe there are two factors driving this rebound. Manufacturers can implement procedures to limit COVID spread by requiring masks and distancing, allowing them to restart production more safely. Additionally, the shutdowns yielded tight inventory levels for manufactured goods, forcing an uptick in production to meet demand. In 2Q, inventories fell \$286.4bn, led by a \$213.3bn drop in auto inventory due to shutdowns. Auto sales fell 49% from February to April and have rebounded 90% from the low through September, leading to higher production to restock inventories. It appears the slope of the V-shape in manufacturing moderated in September but is moving in the right direction.

The strongest part of the economy is housing, driven by record low mortgage rates and deurbanization. New and existing home sales are at their highest levels since 2006. Housing starts and permits have rebounded sharply and matched their multi-year highs of January. The National Assoc. of Home Builder's sentiment index reached 83 in September, the highest reading in its 35yr history. Homebuyers typically purchase new furniture, appliances, and home good which increases housing's impact. The housing trend is not confined to home purchases, as consumers are upgrading their existing homes and yards after staring at the same four walls for months in quarantine. Low rates and low housing inventory will likely support the housing market going into 4Q.

The pandemic has changed how we spend our discretionary dollars. The 90% increase in auto sales in five months is due to low rates, movement to the suburbs, and avoidance of crowded public transportation. But cars are just one big ticket item seeing strong demand. The National Marine Manufacturers Association reported power boat sales for May and June were up 30% over 2019. Thor, an RV maker, reported a 186.4% increase in its backlog and 50% of its customers were first time RV buyers. A report from NPD Group, a market research firm, reported bike sales in April were up nearly 100%, with bikes under \$200 up 203%. These are but a few examples of pockets of strength resulting from changes in consumer behavior. Dollars that would normally go to travel or dining are being repurposed to activities considered safe by consumers. The long-term implications of this are difficult to quantify and we don't expect bike sales to increase at a 100% rate for years. We could see more dollars spent enjoying these purchases for years to come, or we could see a lot of boats, bikes, and RVs on eBay in a few years.

Economic weakness remains for small businesses and companies in retail, travel, and hospitality. Yelp has reported 163,735 businesses on its platform were closed in August, with 60% of those closed permanently. The hardest hit areas were restaurants, small retail, beauty, and bars. Businesses on Yelp's platform are overwhelmingly small businesses and the closures are heaviest in locales with slow reopenings or reliance on tourism. These small businesses don't have the access to capital and scale to manage through the pandemic like larger companies. Airline travel remains impaired, with TSA checkpoints down 68% year-over-year in the last week of September. Lodging revenue per room in the US was down 51.6% and estimates of spending at amusement parks and movie theaters were down 56% and 85%, over the same period. Virus fears have reduced demand for companies in these industries and lack of capital makes the pain more acute for the small and mid-size operators.

The employment situation remains challenged. The non-farm payroll reports show 11.4 million jobs gained since April. The unemployment rate peaked at 14.7% in April and was 7.9% in September but remains elevated. Employment in leisure and hospitality remains 2.3 million below the levels in February and professional and business services are down 1.4 million over the same period. Homebase, a payroll provider, tracks employees and hours worked, which are down 24.8% and 25.5%, respectively in August versus a year ago. The rebound in employment was quicker than economists expected in the spring; however, the pace of the rebound has slowed. Weekly initial unemployment claims fell from 6,867,000 to 1,408,000 in the second quarter. Over the third quarter, claims fell to 837,000 as the pace of improvement slowed. The high level of small business failures means many of these jobs are not coming back and workers will have to be retrained. This will keep the unemployment rate elevated, with the average Wall Street estimate for the unemployment rate for 4Q21 of 6.2%.

Near and longer term expectations for economic growth balance these areas of strength and weakness. Wall Street economists forecast 3Q GDP growth of 25.1% and the Atlanta Fed GDPNowcast has that number at 32.0%, after a 31.4% reduction in 2Q. GDP growth in 4Q is estimated to be 5.0%, putting the full year GDP down 4.8%. The strength is the second half is projected to continue in 2021 with estimates of 3.8% growth, before slowing to 2.9% in 2022. If achieved, the economy would eclipse its 2019 level in mid-2022.

Given the uncertainties about the path of the virus, the election, and other risks, it is difficult to predict with accuracy where the economy will be at year-end, much less 2022. The economic data in the third quarter gives us confidence in a strong bounce back, possibly in the 30% range. We expect this growth to continue into the fourth quarter and 2021; however, the pace will depend on the virus and governmental response. While we can't know with precision when the economy will return to pre-pandemic levels, it is clear to us it will take a year or longer. The recession in 2020 will be the sharpest and shortest on record. The snapback in 3Q will likely be the sharpest initial recovery on record, but we are going to still have a portion of our economy in recession for many quarters to come. The recovery for the remainder of our economy will be a mixture of an average recovery or accelerated growth, especially in areas of digitization and technology.

As we go to press, Congress has yet to pass more stimulus. We expect a bill to pass and possibly more in 2021 without a widely available vaccine in the first half of the year. Fiscal stimulus will continue to serve as a bridge for those impacted by the virus, as monetary policy has for markets. The challenges of businesses and individuals impacted by the virus will weigh on economic growth in 2021, but we don't consider the weight sufficient to forestall the current expansion, particularly with more fiscal stimulus. We also expect the acceleration of many of the underlying pre-COVID trend around online shopping, and remote work, and remote nearly everything to continue. We are learning new behaviors, many of which will build muscle memory with some pre-COVID routines never to return. Our new normal will bring back behaviors we miss, like eating out and travel, while condemning things we disliked to the dustbin, like unwanted trips to the mall and long commutes to work each day. We believe the economy will continue to move through this difficult time and a different future awaits than what we expected in January 2020.

The markets are a discounting mechanism, which looks through the current situation in anticipation of the future. Looking at equity returns from March 23rd to quarter end (51.7% for the S&P 500), it could be argued the markets may be too optimistic about the future. Of course, this was after a 33.8% drawdown from February 19th to March 23rd. Like the economy, the performance in the market has been uneven among companies. The large five stocks mentioned above have been the winners in this market, due to their strong balance sheets, scale, and near monopolies in industries that excel in this environment. It is inarguable many companies have strengthened their competitive position during this crisis. This explains the divergent path of these stocks with much of the market. The market got frothy in August, particularly for these large cap tech firms, which caused the revaluation in September. The pullback lowered the average forward P/E's for these five stocks from 42x to 37x.

These five firms are 1% of the companies in the S&P 500 with 24% of the value of the index. Their valuations are rich at 37x forward earnings, heavily skewed by AMZN, compared to the S&P at 23.0x. The forward valuation for the other 495 stocks based is closer to 18x. Additionally, while the S&P 500 has returned 5.6% for the year, the S&P 500 without those five companies is slightly negative. While there are companies in the index whose business models are impaired by the virus, there are plenty of companies that are positioned to benefit from the continued reopening of the economy. Diversification across a broad category of assets seems imprudent when five stocks are leading the market; however, the benefits of diversification are evident over a market cycle.

Valuing stocks on the last year of earnings is currently difficult because the first two quarters of this year were abysmal with S&P earnings down 48.7% and 33.3%, respectively. Looking out a year has the same problem as earnings are projected to fall 19.5% and 9.4% in 3Q and 4Q. In FY21 we will anniversary the recession and COVID lockdown and estimates are 44.3% earnings growth off the low levels. The valuation of the market is more realistic at 20.5x FY21 normalized earnings. Achieving this level of earnings growth is dependent on vaccines and therapeutics being available soon. Even if this is delayed a few months, much of the economy has learned how to operate safely in this environment and we believe we will see earnings increase off this low base in 2021, albeit with the winners and losers we mentioned above.

We expect the equity markets to continue to benefit from dovish Fed policy. The Fed has signaled they don't expect to raise interest rates until 2023 and will continue to provide liquidity through asset purchases. This policy will keep rates low across the yield curve, which is supportive for equities – in particular companies with secular growth prospects and those with growing dividends.

We believe the economy is trending in a better direction and with more than 150 coronavirus vaccines in development, we expect several viable candidates to be delivered later this year or early 2021. Distribution will be a herculean effort, but the entire world will be working on this. The elimination of the virus will not be a light switch, but more of a process that will take time to achieve resolution. But we will have a resolution and the equity markets expect 2021 to be better than 2020 – in our opinion it could not be worse.

Over the next quarter we expect to see more market volatility. 2020 has brought more twists and turns than we can remember and just when we think we have seen all the surprises it can bring we are hit with another. In the next three months we know we will see Trump deal with a COVID diagnosis, an election, haggling over a stimulus package, Amy Coney Barrett's SCOTUS hearings, and the pandemic. Many of these events could have short and long term economic and market impacts. The election could impact tax policy, with Biden's tax plan calling for higher corporate income and capital gains taxes. The path of the virus is critical for the next few quarters, while tax policy will be important for the next several years. The presidential election is important, but control over the Senate is equally important. A blue wave through the Presidency and both houses of Congress would allow Biden to implement more sweeping reform. From a market standpoint, the changes to tax policy would be the most significant change. Currently, Real Clear Politics has eight toss-up races, including seven GOP held seats and one DEM seat, including North and South Carolina. Questions remain as to whether Biden would raise taxes as the economy continues to deal with the pandemic. We are watching these items closely to evaluate their impact on markets and determine how to allocate capital as the facts on the ground change.

We look forward to getting to the post-COVID world and especially more face to face meetings with clients without masks. We are also excited about the investment opportunities that will arise from the disruption created by this pandemic. The world will be better on the other side of this as the march of progress and humanity has been setback before but has always moved toward better times. We expect 2020 to be a difficult setback on our march to a better world. As we enter the fourth quarter, we want to wish our clients and friends a Happy Thanksgiving and Happy Holiday later this year. We hope you are able to be with family, either virtually or safely in person. Please reach out to us if you have any concerns or questions about the markets or your situation.