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CHILDRESS INVESTMENT MANAGEMENT
QUARTERLY ECONOMIC REPORT
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The financial markets put in a strong performance during the 3rd quarter of 2020. After a drop of –35% in the S&P 500 index from the middle of February to the bottom on April 23rd, the market rallied to the high made in February before the Corona Virus outbreak.

Significant events of this quarter were:

- ***The U.S. economy is predicted to grow by 35.2% during the third quarter of 2020.***
- ***FED continues to keep short-term interest rates at 0% due to Covid.***
- ***3.8 million jobs were added in the third quarter.***
- ***U.S. Government was not able to approve a second round of Economic Aid to businesses and consumers.***

The third quarter of 2020 witnessed an increase in jobs after the dramatic job losses that occurred in the second quarter due to the Covid shutdowns. The U.S. economy added 1.8 million jobs in July, 1.4 million in August and slowed down to 661,000 new jobs added in September. (Source: U.S. Labor department).

The unemployment rate in the third quarter dropped from 10.2% in July to 7.9% in September. This was a large improvement as many furloughed workers were brought back to their companies. Of note, there were layoffs of 45,000 employees in the airline industry that started on October 1st due to Congress not approving a second round of aid to the airlines. There are also many furloughed employees in the leisure/hospitality industry that have yet to find out if they will be brought back by their employers

In terms of employment trends, it will be critical as we head into the Winter months to watch if Covid cases increase or can be contained at the lower levels we have seen this Summer. Many restaurants will not be able to offer outdoor dining during Winter and I know a restaurant owner in New York who made the decision to shut down his restaurant this week until March. He said he could not handle the large losses during the Winter months with New York City's 25% indoor capacity restrictions. There will be many other restaurant owners making this same decision all over the country. Many of these restaurants will not open in the Spring but instead be forced to close due to financial failure.

A big impact on the job market and economy will occur when an effective vaccine reaches the market. There are now two large late stage vaccine trials. One is from Pfizer with late October trial results to be released. The other is from Moderna and results are scheduled for November. The critical factor will be if the vaccines are more than 50% effective to be approved by the FDA. Hopefully, the effective rate is better than 60% to give the public more confidence.

Importantly, we need to factor in vaccine production time and people getting the vaccine shot. This will not reach an effective scale of stopping the spread of the virus until probably the Spring or Summer of 2021. For Wall Street and investors this is a big deal, as when the market went into a tail spin in March, no one new if there would be a vaccine or how long it would take to produce one. The imminence of a vaccine should provide support to the stock market if the numbers of Covid infections were to rise sharply this Winter.

Once an effective vaccine reaches the market, industries devastated by the virus will begin a recovery. The airline industry is currently losing $6 Billion per month and air traffic is still down 60% from pre-pandemic levels. Airline stocks should recover rapidly once an effective vaccine is produced as it will restore consumer confidence to fly again. Restaurants, hotels, cruise ships, office buildings and malls will also greatly benefit from an effective vaccine.

The residential housing market has done well in 2020. This is unusual considering we are now in a recession. With interest rates so low for home mortgages many consumers are buying second homes and some are coming off the sidelines to purchase their first home. It is a great time for people with secure jobs to purchase real estate but horrible for the unemployed in Covid impacted industries. Inventory of homes for sale has dropped to around 1.5% versus the recent rate of 2% in the past few years. This lack of inventory is pushing up prices in most areas of the country.

There are cracks building in the real estate market as 3.5 million home owners are in the government mortgage forbearance program. **This program started with the outbreak of Covid and allows homeowners to skip payments for up to one year.** This program ends in 2021 and the question remains how many of these homeowners will be forced to sell their home due to not being able to make their monthly payments. Many of these forbearance home owners will sell their homes and take the cash out to get them through until they find another job. One positive for people forced to sell is that there is now $10 Trillion in home equity for all homes in the U.S. versus $4 Trillion in 2010. This reflects how well home prices have done in the past 10 years. But home prices may come under pressure in 2021 as the Government aid programs end for real estate.

Unlike residential real estate, commercial real estate has been negatively impacted by Covid. Owners of office buildings, city retail spaces and malls are all under pressure due to tenants not making rent payments. Making matters worse are failed businesses that create empty commercial spaces that no one wants to rent in this environment. Restaurant failures have been well documented and this has resulted in many commercial property owners not being paid in this situation. This is a very big problem in New York City right now and other big cities with high rent commercial spaces. Many tenants are also trying to negotiate lower rental terms, some with success but others taken to court by their property owners.

The extent of the economic damage being done in commercial real estate is hard to track but again this situation could dramatically improve with a successful Covid vaccine. Banks make big loans into the commercial real estate sector and they will be making comments about this space during earnings reports in mid-October. This sector has to be watched closely by investors in terms of gauging how our economy is doing. If negative trends were to continue in this commercial real estate industry, banks may pull back further on lending which hurts the entire economy.

The Presidential election is around the corner and will impact the financial markets. I hope we do not have a contested election as this is not what our country needs with all the issues we are currently facing. Biden has laid out his tax strategy and here are the highlights of his plan:

- Individuals and households making more than $400,000 per year will see a sharp rise in their tax rate. The higher tax rate kicks in for all income over the $400,000 level.
- Corporate tax rate to go from current 21% rate to 28%.
- Top capital gains rate to go to 39.6% from current rate of 24%,

If you are a very high income person, i.e. a professional athlete or corporate executive, these tax rate increases will be significant. **But these individuals only make up 1% of the U.S. population.** I have no economic issues with these increases on the very wealthy and it would not impact our economy negatively. **But I do not agree on the corporate tax increase to 28%**. Due to our being in a global economy with the average tax rate for countries across the world at around 20%, we may lose foreign investment due to this higher tax rate. As an example, if you are a European auto manufacturer looking to build a plant in North America, you may choose Mexico or Canada if the tax rate is lower.

We also have a huge problem with large corporations keeping money permanently overseas to avoid our higher corporate tax rate. Currently, Microsoft, Apple and Amazon have hundreds of Billions sitting in European banks. Some of this money came back after we lowered our tax rate in 2017. Look for this money to stay overseas if we raise the corporate tax rate to 28%.

Due to the $2.8 Trillion in aid given this year for Covid relief, this will take us to a debt level equal to 101% of our country's annual Gross Domestic Product. Economists have long used the 100% debt to GDP of a country as a red flag of when to watch a country's debt to see if borrowing has gotten out of control. As with an individual or company, when debt gets out of hand your income winds up going to paying interest and not allowing for profits or investment. I hope we get this spending under control in the next year, as borrowing and printing money is not the solution.

BULL CASE

The Bullish stock market case is as follows:

- FED has cut short-term rates to 0%.
- Strong balance sheets at many large corporations.
- Very strong tech cycle for many technology companies, which is producing strong earnings and sales.
- Stock valuations are attractive in many non-tech sectors.
- Massive economic stimulus by the Federal Government with enhanced jobless benefits and loans to distressed industries.

BEAR CASE

Bear Case:

- Covid Virus has proven hard to contain and vaccine is still not available.
- Trade issues with China.
- High unemployment in the U.S.
- Budget issues with State and local governments.
- Possible rise in taxes.
- Commercial real estate problems.

The bear case versus bull case is now in the neutral camp for the U.S. financial markets. My upgrade is mainly due to a vaccine probably coming soon. We continue to face a host of economic and political problems, both domestically and internationally. The U.S. economy has fallen into a recession and determining the recovery is much more difficult than usual. In the current financial market, my continued focus will be on U.S. economic growth, Europe, China and the Presidential Election.

The residential real estate market is benefiting from a 30 year fixed rate mortgage that dropped from 4% to 2.70% in the past year! Home prices are a huge driver of consumer spending and if this market can hold pricing this portends well for our economy going into 2021. If home prices come under pressure than an economic recovery will not be possible in the next year. There are many factors that could trip up the economy in the next six months and I will be watching economic matters very carefully.

After the large increase in stock prices during the third quarter of 2020, this quarter should see a pullback in stock market prices in the U.S. Importantly, the financial markets have settled down since the FED assured investors they would be accommodative if the economy were to weaken further. I am now patiently waiting for economic developments, especially with Covid trends and developments for an effective vaccine.

Bonds were up during the quarter due to interest rates dropping after the FED cut rates. Corporate bonds still have appeal. In closing, the coming months will be more volatile for stocks than during the past ten years. This is due to the increased uncertainty caused by the Corona Virus, the Presidential election and the resulting economic events occurring in the world.

ASSET ALLOCATION

The current client allocations are as follows:

- **Growth Accounts: 52% in U.S. stocks, 4% International stocks, 1% Gold, 28% in bonds and 15% in cash.**
- **Retirement accounts: 48% U.S. stocks, 3% International stocks, 1% Gold, 28% bonds and 20% cash.**
- **Conservative Accounts: 40% U.S stocks, 3% International Stocks, 37% bonds, and 20% cash.**

U.S. stock allocations were held steady during the period of July to September. Foreign stock holdings were held steady. I continue to favor U.S. company stocks over foreign stocks.

INVESTMENT REVIEW
OPENING AN ACCOUNT

If you have any comments or questions concerning this report, please contact Frank Childress at (425) 985-2621. Or via e-mail at: childressinvtmgt@msn.com. Feedback and comments are welcomed.

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