CHEVY CHASE TRUST
INVESTMENT ADVISORS

Investment Update—October 2020

This is a quarterly update of economic conditions and investment strategy.

The Great Market/Economy Divide

Stock markets around the world continued to rise in the third quarter. In the U.S., the S&P 500 delivered an 8.49% total return for the quarter and 5.6% year-to-date. Despite the pandemic-related fall-off in February and March, the S&P 500 recently hit an all-time high, with valuations expanding to unusually rich levels.

What explains the rally? Governments around the world have been spending heavily to offset the shuttering of economic activity. The Federal Reserve and other central banks have slashed interest rates to near zero or lower and injected massive liquidity to support markets and stimulate economies. These actions dwarf any previous programs initiated to address an economic or health crisis. Partly as a result, the U.S. economy has rebounded from its worst-ever quarterly drop. However, we are still operating well below pre-pandemic levels in many, if not most, sectors.

Given the unusual nature of this crisis, economic weakness is very unevenly distributed. Much of the economy's losses are coming from private small businesses and a few concentrated industries, including travel and leisure, energy, restaurants and brick and mortar retail. Profitability in many of these sectors is challenging even in the best of times, due in large part to their labor intensity. As a result, their combined contribution to S&P earnings is smaller than their contribution to GDP, and their contribution to GDP is smaller than their impact on employment. Thus, it is not surprising that employment has fallen more than GDP or that S&P earnings have been more resilient than either GDP or employment data imply.

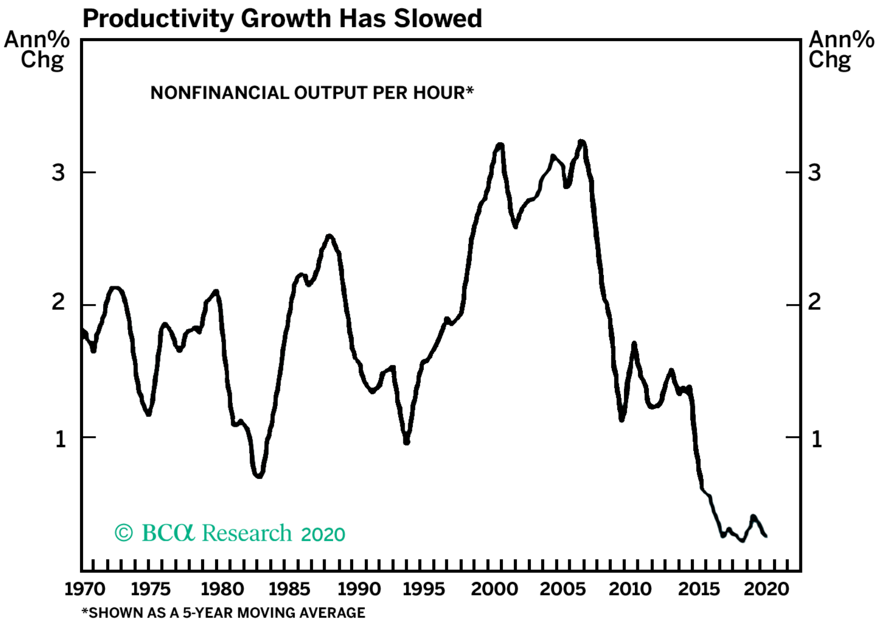
We do not think the economy is nearly as strong as equity market performance suggests. Unprecedented fiscal and monetary actions are important contributors to the current disconnect between economic and market performance. Cutting interest rates drives up the valuation of stocks. The stimulative impact on economic growth takes longer. While it's not unusual for economic and market performance to diverge for periods of time, ultimately, the market and macroeconomic backdrop must re-converge. The question is, will GDP rise to meet the market or will the market fall to match GDP?

What's ahead?

The economic outlook remains unusually difficult to predict. Americans are once again going to stores, albeit armed with masks and sanitizer, and dining at restaurants, or at least those with outdoor seating. But Covid-19 is not under control in the U.S., and cold weather may increase its spread. In Europe, a second spike in infections has caused some countries to reimpose partial shutdowns. Parts of the U.S. may do the same if infection rates rise. The economic momentum of late summer is already slowing.

The longer-term economic outlook was less than inspiring even before the virus struck, because the two main drivers of real economic growth--demographics and productivity—were weak. The demographic story is straightforward and essentially locked in place. Due to a falling birth rate, the working-age population will rise at a meager 0.2% per year for the next ten years, compared with over 1% per year in the 1980s, 1990s and 2000s.

Productivity is harder to measure and its trends less obvious. Nevertheless, growth in output per labor hour in the non-financial corporate sector has slowed markedly for more than decade after a tech-driven spurt in the late 1990s (see chart). Low levels of business investment, the recent retreat from globalization, increased government involvement in the economy and friction caused by pandemic-related protocols are other potential drags on productivity.



With real economic growth likely to remain tepid, the wildcard becomes inflation. Many economists argue that inflation is dead, noting that central banks have failed for ten years to increase inflation to their targets of 2% to 3%. The Fed doesn't go that far, but it deems deflation a greater risk than inflation. Financial crises are often deflationary. The 2008 housing and credit crisis is a case in point.

Other economists think inflation is a significant risk, noting that the 2008 crisis differs from the 2020 crisis in four important ways that make it a poor indicator of future price trends.

- **Causes of crisis.** While the 2008 crisis was precipitated by excesses in the financial sector that led to widespread bank failures, the 2020 crisis was precipitated by the policy response to the pandemic, which, like war times, involves supply-chain dislocations and misallocated resources. Financial crises have often been deflationary, or at least disinflationary, while wars have been inflationary.
- **Trade and wage trends.** The 2008 crisis accelerated globalization. World leaders came together in a shared response. China fast-forwarded its infrastructure spending to support the global economy, effectively connecting 500 million workers to the global labor market, putting downward pressure on wages in developed countries. The recent crisis, by contrast, has been marked by a decline in global trade likely to push wages up in many countries when the pandemic subsides.
- **Oil prices.** Before 2008, expectations that oil prices would reach new highs triggered huge investments in the energy sector, leading to a sustained decline in oil prices. As a result, oil prices were low before the 2020 crisis and have fallen further since. The oil and gas industry is now being starved of capital, which may lead to shortages and higher future prices.
- **Fiscal policy.** Perhaps the most important difference between now and the post-2008 period lies in fiscal spending. After an initial spending spree in late 2008 and 2009, most governments embraced belt tightening. U.S. federal spending flatlined for six years. The U.K. embraced austerity, and most governments across Europe sought to slash annual deficits to the 3% target in the Maastricht Treaty. In China, Xi Jinping's anti-corruption drive led to local governments reining in spending. While many central banks around the world maintained easy monetary policies, fiscal policies were anything but easy. By contrast, since the pandemic struck, governments have been borrowing heavily to support people and companies hurt by the economic shutdown. The era of fiscal austerity is over, at least for a while. While deficit spending can stimulate an economic recovery, it tends to be inflationary in the medium to longer term.

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We don't expect inflation to emerge near-term; the economy's too weak for that. We expect near zero interest rates and additional fiscal spending to support financial markets for the foreseeable future. Disconnects between underlying economic fundamentals and equity market performance can turn into bubbles that last far longer and rise much higher than investors expect. Nonetheless, recent events make future inflation more likely. History suggests that when inflation rises above 2%, interest rates will rise and equity multiples contract. Said another way, markets will fall to meet the economy.

A Concentrated Rally

For years, technology and interactive media firms have been among the biggest beneficiaries of low inflation and low interest rates. Just five tech-related stocks--Apple, Microsoft, Amazon, Google and Facebook—account for more than half of the $11 trillion gain in the S&P 500's market cap since 2015. The trend accelerated during the current crisis. Year-to-date, performance of these stocks account for more than 100% of the S&P gain. Given their large weighting and strong performance, they have increased the entire Index return by 8.5%, while the other 495 stocks collectively lost 2.9%. They are now the five largest stocks by market capitalization in the S&P 500.

There are good reasons for these stocks' market leadership:

- The current crisis has fueled their growth by making on-line activity a larger share of everyday life;
- Massive scale, technological advantages, and network effects provide greater protection from competition than was available to leading companies of the past; and
- With intellectual property the main input of their products and services, they can boost output at low marginal costs.

But even leading companies' shares can become overvalued. Indeed, they are more likely to become overvalued than others. Historical examples include the Nifty Fifty in the 1960s, oil companies in the 1970s, Japanese equities in the late 1980s, tech and telecom in the late 1990s, and U.S. residential real estate in the mid to late 2000s.

Trends don't last forever. Sectors that appear to be noncyclical often turn out to be more cyclical than investors anticipate. The latest fad loses its appeal. Remember the Palm Pilot and Blackberry? Someday, the iPhone may be old-hat too. As one character in Michael Lewis's *The Big Short* said: "It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so."

While we admire these five big companies and hold some of them in client portfolios, we think their valuations are high. And since these five companies represent 23% of the S&P 500's market cap, though only 1% of its constituents, their eventual fall might drag the market down.

The last time the largest stocks in the S&P 500 made up such a large share of the index's market cap was near the end of the tech bubble. After the March 2000 high, the Index fell for three years--and seven of the nine largest-cap tech stocks (Cisco, Nortel, Intel, Lucent, Oracle, Sun and Hewlett Packard) have yet to regain their peak market cap. IBM and Microsoft were the two exceptions, but their investors had to wait a very long time to recoup their declines. IBM surpassed its bubble high in 2012, Microsoft, in 2017.

Portfolio Positioning

In the third quarter, we trimmed overall equity exposure modestly, and within equities, reduced exposure to the U.S. and the technology sector, in particular. In retrospect, some of these moves were premature. Nonetheless, we think these actions were prudent, even if early.

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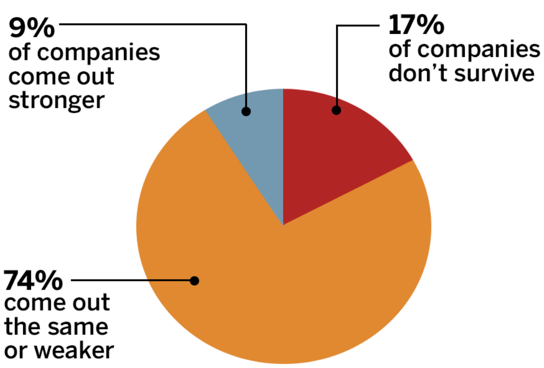
We expect to continue overweighting healthcare and increasing non-U.S. exposure. We also expect to further reduce large-cap technology. If Democrats win the Presidency and gain control of the Senate, the capital gains tax rate may increase materially next year, which could put downward pressure on highly appreciated tech stocks in early 2021.

We also expect to increase exposure to companies that benefit from inflation, particularly Japanese industrials and both U.S. and emerging-market materials firms. Given the valuations of many of these companies, we think the risk/reward is favorable.

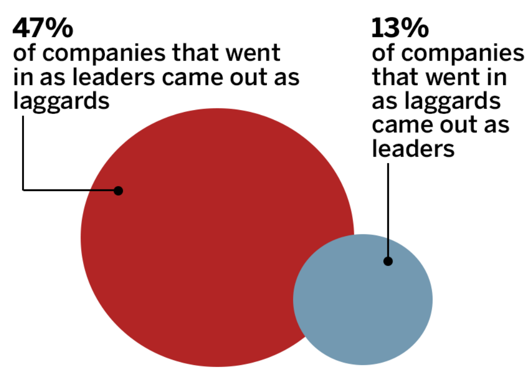
We have increased portfolio exposure to companies we view as long-term, but often indirect, beneficiaries of the crisis. Recessions tend to reshuffle the deck and only a few companies emerge as winners, as the chart below shows.

ONLY A FEW COMPANIES EMERGE FROM RECESSIONS AS WINNERS



SOURCE: "ROARING OUT OF RECESSION" BY RANJAY GULATI, NITIN NOHRIA, AND FRANZ WOHLGEZOGEN

AN INDUSTRY'S COMPETITIVE ORDER CHANGES MOST IN TIMES OF TURMOIL



SOURCE: MCKINSEY

Nike is one likely long-term beneficiary. Its revenue from online sales soared from 8% of total revenue for fiscal year 2019 to 30% in its most recent quarterly report, three years ahead of plan. Selling directly over the Internet improves margins by cutting out middlemen, such as Foot Locker and Kohl's. We think many customers who were previously reluctant to buy online may become accustomed to the convenience of having sneakers delivered to their front door. If so, this margin-enhancing trend should continue after the pandemic ends.

Estée Lauder may benefit from the same phenomena. Cosmetic companies have long sought to sell directly, but customers were reluctant to stop shopping for makeup and face creams at their favorite department store, even though most high-end cosmetic sales are repeat purchases. People seldom change face creams, or where they buy them. Covid-19 forced change. Consumers stuck at home learned that the Internet was a simple, efficient way to reorder. While the pandemic may depress sales in the short-term, because people apply make-up less often when they stay at home, eliminating the middleman should improve profitability for years to come.

The pandemic-induced surge in internet sales is also causing companies to rethink supply chains and business practices that evolved over decades. For example, using ultra-high radio frequency identification (RFID) quickly became a necessity for many firms seeking to manage inventory more fluidly across physical stores and rapidly grow online operations. We are invested in companies that make and help implement this technology, as well as companies on the leading edge of adopting it for supply-chain management.

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Crises lead to change. We do not subscribe to the theory that everyone will work from home forever and in-person business meetings are a thing of the past. We think companies benefitting from what may turn out to be temporary behavioral changes may find it hard to beat this year's strong results and will face competition from new entrants to their markets. For example, Microsoft Teams is vying to catch Zoom Video Conferencing's early dominance in video conferencing. Often, the obvious short-term beneficiaries of a crisis aren't the long-term winners. Rather, companies with the infrastructure and management foresight to alter their operations to meet the moment and create sustainable competitive advantages will come out on top. Our research is seeking to identify these long-term winners.

Fixed Income

Despite the volatility in equity markets and uneven economic backdrop, bond prices were remarkably stable during the third quarter. U.S. 10-Year Treasury yields started the quarter at 0.66% and ended the quarter at 0.68%, and remained in a relatively narrow range of 0.51% to 0.75% throughout the quarter. Such low yields virtually guarantee negative real returns. Nonetheless, in aggregate, money is still flowing into fixed-income markets.

In the near term, we expect short- and long-term interest rates to remain very low. However, once the pandemic ends, the enormous increase in money supply may lead to inflation and higher rates.

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