Current 3-6 Month Equity Market Outlook:
Following last month’s upgrade to neutral, we respond to our indicators and recent developments and move to overweight in stocks. Our allocations are now 70% stocks (10% overweight), 25% bonds (5% underweight) and 5% cash (5% underweight). We would look to use short-term pullbacks to add exposure.

Stock/Bond Relative Valuation -- Market Implied Long-Run Growth:
The Implied Growth Model was steady in October, holding near 2.2% and just above our fair value range of 1.5-2.0%. Relative valuation does not show stocks as cheap versus bonds, but as the economic outlook improves it should not act as a major headwind.

Small-Cap/Large-Cap Allocation:
We move to favoring small-caps over large-caps now, aligning with our model readings following signs that small-cap relative volatility has normalized and price action has shown a shift in investor behavior amid heavy style rotation.

Topical Macro and Policy: We look at US monetary and fiscal policy in the context of the US equity market, which gives a different perspective than absolute dollar figures or comparisons to GDP. Markets still depend on stimulus, but progress on vaccines may start to reduce that relationship. Investor optimism is elevated by many metrics, but not historically extreme, supporting the case for using tactical pullbacks to add to equity exposure.
Moving to overweight in stocks, use short-term pullbacks to add exposure

Stock prices have shown some unusual trading patterns recently in response to news and positioning, but the sideways trading range environment generally in place since June looks like it will be resolved positively.

With our Equity Risk Model remaining above the 60% level and improving further from last month’s reading, we take another step and move to overweight in stocks and slightly underweight in bonds and cash, and would recommend using any near-term pullbacks to make new buys. Our allocation is now 70% stocks (10% overweight), 25% bonds (5% underweight), 5% cash (5% underweight).

Unexpected news on November 9th of favorable results in Pfizer’s COVID-19 vaccine trials, along with prospects for other vaccines currently in development (e.g. Moderna), has raised the potential for at least some form of vaccine becoming available next year. While the logistics of providing vaccines to a sufficient proportion of the population to render COVID-19 a manageable problem remain uncertain, the market is likely to anticipate such developments sooner.

The potential downside right now is that the additional fiscal stimulus that many had expected earlier this year still looks unlikely to occur before the next Congress (and new President) begins in late January. The current trend in COVID-19 cases is very bad, making the winter potentially very dangerous. Without any additional stimulus, and the expiration of some of the existing support programs, this could bring renewed economic weakness in the current quarter and next quarter.

So far, corporate profits have held up significantly better than expected, as the huge initial stimulus that began in April continues to have an impact on activity along with partial re-openings of activity in many areas. As we discuss on page 6, earnings estimate revisions remain very strong in the US overall, and interest rates are likely to remain very low for some time. Our Implied Growth model (stock/bond relative valuation) is holding just above fair value, but if earnings do in fact recover next year, then the valuation picture could improve.

Overall, after a period of consolidation which may continue a little longer, stocks look to have better prospects to outperform bonds and cash, even if returns for all assets are more muted relative to history.
Indices are stable, but historic style volatility going on under the hood

While the major stock indices have been stable and moved back toward the upper end of their summer/fall trading range, there have recently been historic levels of rotation among investment styles and sectors going on under the surface.

After an earlier bout of heavy style rotation in late May/early June, early November brought another even more violent bout of rotation following unexpected news on COVID-19 vaccine trials. The result was that all major styles (factors) in US equities showed historic one-day gains or losses, as shown in the charts below. The left chart shows the daily returns to the five Dow Jones Thematic Market-Neutral style indices. They track hypothetical long-short (fully hedged, or market-neutral) portfolios based on commonly-used factors including price momentum, value, size (small-caps), quality, and anti-beta (low beta stocks).

We see that the returns for November 9th were literally off the charts for most of them based on data since 2002, as investors reversed bets in dramatic fashion on the assumption that a new post-COVID environment was potentially now more likely. As shown in the right chart below, most of the dramatic moves reversed the trends that had been in place for most of the last year. Momentum arguably had the biggest move relative to its history, showing a -14% decline in one day, after having been the best performing of the five factors in the year through November 6th. Value stocks, small-caps, lower quality and higher beta stocks all outperformed, reflecting assumptions of an improving cyclical outlook as well as positioning risk after extended periods of underperformance. While we would hesitate to chase such movements in the short-run and expect some normalization back toward the earlier trends, the case has improved further for a more balanced style view (as we have done in our sector allocations in recent months) and giving a bit more weight to the potential upside for the economic outlook.

Exhibit 2: All major investment styles showed historically extreme movements on Monday, November 9th. Most of them reversed trends in place for much of the past year, indicating positioning risk unwinding and revised economic views.

Source: Mill Street Research, Factset, Bloomberg
Our Implied Growth Model was little changed in October, holding at a reading of 2.2%. This remains just above our expected fair value range of 1.5-2.0% and broadly in line with recent years' readings.

Despite the historically unusual economic and market conditions this year, our model has been remarkably stable and has not reached extreme readings (either direction). This is mostly because the movements in corporate bond yields (credit spreads) have moved similarly to stock prices recently, while the model's use of cyclically-adjusted earnings (10-year average) has done its job in muting the sharp movements in short-term earnings data.

The broad patterns that have been in place for some time remain: stocks look expensive relative to history, but not as extreme as in the 1999-2000 bubble period, and our cyclically-adjusted earnings yield has been fairly stable over the last two years. Bonds have become much more expensive than stocks relative to their own historical norms, so the yield spread between stocks and bonds has widened in favor of stocks.

That wider spread has largely compensated for the higher risk in equities due to the weaker and more volatile economic backdrop. So lower bond yields have offset higher economic risk and kept our model's overall reading relatively stable for several years now.

While we would prefer to see the Implied Growth model reading be lower to increase our confidence in overweighting stocks versus bonds, the unusual conditions right now suggest that the model is within its “margin of error” versus our fair value range. If there is further evidence of a viable vaccine arriving next year, markets will likely maintain a more positive near-term growth outlook even as the Fed keeps bond yields down.

At the same time, one of our earlier concerns about the earnings component of the model has eased somewhat. Last year we highlighted the wide gap between current S&P 500 earnings (in real terms) and the 10-year average used in the model, suggesting earnings were very high versus their longer-term trend. With earnings now having fallen and the 10-year average still rising, the gap between current earnings and the long-run average has essentially closed. If earnings do recover next year as the consensus expects, the valuation backdrop for stocks will be more constructive.

Source: Mill Street Research, Factset, Bloomberg
Our Small-cap/Large-cap Model has been favoring small-caps over large-caps for several months now, but relative returns (at least in the US) had not corroborated. Recently, there are more signs that small-caps are at least holding their own and could show more persistent outperformance. This is particularly true if some additional fiscal stimulus is forthcoming early next year.

Our model reverted slightly from last month, but remains clearly in favor of small-caps with four of the six indicators supporting small-cap outperformance, one neutral, and one now favoring large-caps (the volatile VIX indicator).

We remain concerned about the relative fundamental weakness in US small-caps compared to large-caps, and COVID-19 has in many ways favored large companies that can access capital and have sufficient diversification to make it through tough times. However, if cyclical support is sufficiently strong, and the prospects for a vaccine that would allow more small companies to benefit have grown, then the argument for small-caps becomes stronger.

With the prospect of some additional fiscal support, continued low rates, and potentially more "normal" economic activity next year, we now align our recommendation with our model and overweight small-caps in the US.

Two other factors also help make the case for tilting toward small-caps now. One is that, as we have noted here previously, small-caps outside the US are already outperforming, leaving US small-caps as the outlier. This suggests that cyclical forces globally are supportive for small-caps, but some special factors in the US have prevented outperformance so far.

The other condition that makes us more inclined to give small-caps more weight is that the "volatility penalty" for owning small-caps has declined sharply. As shown in the bottom chart at right, the difference in rolling three-month realized volatility between the Russell 2000 (small-caps) and Russell 1000 (large-caps) grew extremely wide starting in March, and has only now returned to its pre-COVID level showing small-caps only mildly more volatile than large-caps. Thus the relative risk of owning small-caps has declined. Any outperformance by small-caps going forward is therefore more likely to hold up when adjusting for risk.

Exhibit 4: Small-cap/Large-cap Model eases slightly but remains in favor of small-caps. As relative risk in small-caps eases, we shift our allocation in line with the model.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Reading</th>
<th>Last Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings Growth</td>
<td>Small-Caps</td>
<td>30-Sep-2020</td>
</tr>
<tr>
<td>Consumer Confidence</td>
<td>Small-Caps</td>
<td>31-Mar-2020</td>
</tr>
<tr>
<td>Rate/Credit Indicator</td>
<td>Small-Caps</td>
<td>31-Mar-2020</td>
</tr>
<tr>
<td>Stock/Bond Yield Spread</td>
<td>Small-Caps</td>
<td>31-May-2019</td>
</tr>
<tr>
<td>Equity Market Oscillator</td>
<td>Neutral</td>
<td>31-Mar-2020</td>
</tr>
<tr>
<td>VIX Index</td>
<td>Large-Caps</td>
<td>31-Oct-2020</td>
</tr>
</tbody>
</table>

Net % Favoring Small-Caps 50%
Q3 earnings reports drive earnings revisions higher, led by the US

While overshadowed by the headlines surrounding the US election and vaccine developments, corporate earnings reports for Q3 have come in much better than expected.

Factset reports that with 92% of the S&P 500 now having reported Q3 EPS, 84% of them have beaten expectations for EPS and 77% have beaten sales expectations. These are very high figures relative to historical norms. The magnitude of the beats was also large.

On the other side of the Atlantic, we see that with 78% of the index constituents reporting, a solid but less spectacular 62% of Stoxx 600 companies have beaten EPS expectations.

These results have led to analysts raising EPS figures for 2020 and, to a somewhat lesser extent, for 2021. The strongest revisions readings are still in the US, where our broad, equal-weighted US revisions metrics are re-accelerating and holding at cycle highs.

Turning to the actual aggregate estimates for EPS, we see that the traditional forward 12-month bottom-up index EPS figures for the S&P 500 (from Factset) continues to march higher, now approaching the $167 estimate for 2021 as 2020 nears a close. If this trend continues, forward EPS could rise alongside or slightly faster than stock prices, helping mitigate valuation concerns.

A similar but less dramatic picture is found in Europe. The aggregate bottom-up estimates for the Stoxx 600 index for the next 12 months are also rising, and accelerating slightly recently. However, the level of expected earnings remains far below the pre-COVID level of estimates, suggesting a longer road back to "normal" earnings in Europe than in the US.

If earnings estimates are steady to higher, and interest rates are stable at extremely low levels, then stock prices are likely to grind higher (with a lot of back and forth along the way) and outperform low-yielding bonds and cash. As discussed on the following page, the risks to profit growth associated with a drop-off in policy support remain a concern, but earnings have thus far held up much better than initially feared.

Source: Mill Street Research, Factset, Bloomberg
Putting US fiscal and monetary stimulus in context of the equity market

There can be little doubt that fiscal and monetary policy support has been critical for the overall US (and global) economy and the stock market. Corporate profits would almost certainly be much lower were it not for the trillions of dollars of new spending and asset purchases by Congress and the Fed. The magnitude of policy activities is often simply described in dollar terms, or put in the context of US GDP or other macroeconomic measures, but for equity market analysis it also makes sense to view them relative to the size of the equity market itself.

This is because the equity market is a forward-looking measure of the capitalized future profits accruing to equity holders, and the equity market has grown substantially relative to GDP as profits have likewise grown relative to GDP, and the valuation placed on those profits has expanded.

The biggest benefit to the economy and markets comes when both fiscal and monetary policy are expansionary, meaning large or growing US federal deficits and, in recent years, a growing Fed balance sheet (due to asset purchases, or QE).

The chart below shows two series, both scaled relative to the total US equity market value represented by the Russell 3000 index. On top is the rolling 12-month US federal deficit as the broadest measure of fiscal policy. On the bottom is the Fed’s balance sheet (total assets). We see that the magnitude of the recent policy movements has been quite large relative to the equity market, but not extreme compared to the period after 2008. This is because the equity market is much larger now than it was back then: the current value of $35 trillion is roughly twice the peak level in 2007, and more than three times the value at the 2008-09 lows.

The Fed has indicated it will continue to buy $120 billion of bonds (Treasuries and MBS) per month, which would help keep monetary support accommodative but not extreme relative to the current balance sheet size (~$7 trillion). There is much greater debate about the path of US fiscal policy, and the risk is that federal spending is scaled back too quickly and a key support removed. Markets will likely do best if the two lines in the chart below stay steady or rise somewhat, while declines in either or both would act as headwinds to the economy and markets, at least until COVID-19’s impact is fully behind us.

Exhibit 6: Fiscal and monetary support looks somewhat different when scaled relative to the size of the equity market. Markets likely need and expect ongoing support in this context.

Source: Mill Street Research, Factset, Bloomberg
Sentiment is optimistic but not extreme, supports the case for buying pullbacks

As we shift to overweight in equities, we also highlight the potential benefits of tactically waiting for near-term pullbacks to buy. One key reason for this is that investor sentiment measures show relatively high optimism toward stocks, and this often raises the risk of "chasing" the market higher in these conditions.

The top chart at right is arguably the least worrisome from an overall sentiment standpoint. It plots the average level of bullishness toward stocks and bonds based on data from Consensus Inc. and Market Vane (both of which survey newsletter writers, strategists, and other market watchers and investors). The average level of bullishness toward stocks has been holding steady within the range it has spent much of the last two years in (except during Q2 of this year), lately hovering near 60%. That is elevated but notably below the peak levels of 76% seen in early 2018 (after the corporate tax cuts of that year went into effect).

We also see that bullishness on bonds (Treasuries) has declined as bond prices have pulled back and the economic outlook has shifted. If sentiment for bonds were to reach very negative levels, we would be concerned about a reversal (i.e., a shift from stocks to bonds), but for now the readings are fairly neutral on these metrics.

The corresponding readings on equity bullishness from Investors Intelligence are somewhat more concerning near-term. The spread between outright bulls and outright bears (ignoring the "correction" camp) is back near the upper end of its range and signaling high optimism. Pullbacks in stocks of even a week or two have often quickly led to retreats in the proportion of bulls and set up better tactical opportunities. Like the data in the top chart, sentiment is not at the extremes found at the early 2018 peak, after which stocks did poorly and riskier stocks lagged lower-risk stocks.

Finally, we update the 20-day average CBOE equity put/call volume ratio in the bottom chart at right. It remains quite low in its historical context, signaling a continued strong demand for calls over puts among equity options traders and hence high optimism. Currently about 51%, it is not quite as extreme as it was in early September, but well below levels seen before the middle of this year. Overall, sentiment is not wildly extreme but suggests pullbacks will still occur and offer better opportunities for new buying.

Source: Mill Street Research, Factset, Bloomberg, Investors Intelligence, Consensus, Market Vane
Hypothetical Performance Tracking

The charts and tables below show indicative hypothetical tracking results for the allocation recommendations published in this report. See important disclosures below.

GLOBAL ASSET ALLOCATION (STOCKS/BONDS/CASH)

Global Asset Allocation Recommendation Performance

Global Asset Allocation Summary Statistics

<table>
<thead>
<tr>
<th>01 January 2019 - 13 November 2020</th>
<th>Recommended Portfolio</th>
<th>Benchmark Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ann. Return (%)</td>
<td>13.21</td>
<td>17.71</td>
</tr>
<tr>
<td>Ann. Volatility (%)</td>
<td>12.50</td>
<td>13.09</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.93</td>
<td>1.23</td>
</tr>
</tbody>
</table>

Results assume allocation to the ACWI index (ETF ticker ACWI), US long-term Treasury bonds (ETF ticker TLT) and US cash-like holdings (ETF ticker SHV) relative to a benchmark of 60% stocks, 30% bonds, 10% cash, as published for the date range indicated. Always use caution in interpreting results for short time periods.

US SMALL-CAP/LARGE-CAP ALLOCATION

US Small vs Large-Cap Allocation Summary Statistics

<table>
<thead>
<tr>
<th>13 April 2016 - 13 November 2020</th>
<th>Recommended Portfolio</th>
<th>Benchmark Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ann. Return (%)</td>
<td>15.47</td>
<td>12.79</td>
</tr>
<tr>
<td>Ann. Volatility (%)</td>
<td>19.66</td>
<td>20.52</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.72</td>
<td>0.56</td>
</tr>
</tbody>
</table>

Results assume 100% investment in large-caps (Russell 1000, ETF ticker IWB) or small-caps (Russell 2000, ETF ticker IWM) or the 50/50 large/small benchmark as published for the date range indicated.

Note: Results shown here do not reflect any actual trading and are for informational purposes only. They do not include important considerations such as transactions costs, taxes, fees or other expenses. Past performance is no guarantee of future results.

Source: Mill Street Research, Factset, Bloomberg
Indicator Appendix

The charts below show all of the component indicators of the Global Equity Risk Model (eight indicators) and Small-cap/Large-cap Model (six indicators) for reference.

GLOBAL EQUITY RISK MODEL

Global Equity Volatility Indicator

MSCI ACWI Index Total Return USD

Global Risk Appetite Indicator

MSCI ACWI Index Total Return USD

Global Momentum Indicator

MSCI ACWI Index Total Return USD

Global VIX Divergence Indicator

MSCI ACWI Index Total Return USD

Source: Mill Street Research, Factset, Bloomberg
Indicator Appendix

GLOBAL EQUITY RISK MODEL (CONTINUED)

Global Credit Risk Indicator

MSCI ACWI Index Total Return USD

Global Baa Corp. Bond Option Adjusted Spread

Global Credit Risk Indicator

Dec-17 Jul-18 Feb-19 Sep-19 Apr-20

Nov 13 2020 = 99.4

Fed Expectations Indicator

MSCI ACWI Index Total Return USD

US Treasury 2-year/3-month Yield Spread

Fed Expectations Indicator

Dec-17 Jul-18 Feb-19 Sep-19 Apr-20

Nov 13 2020 = 53.8

Global Real Yield Indicator

MSCI ACWI Index Total Return USD

Est. Global Real 10-year Yield: US, UK, Germany

Weighted Average of US, UK and Germany Estimated Real 10-year Government Bond Yields

Global Real Yield Indicator

Dec-17 Jul-18 Feb-19 Sep-19 Apr-20

Nov 13 2020 = 66.5

Global Metals Indicator

MSCI ACWI Index Total Return USD

GSCI Industrial/Precious Metals Relative Price

Global Metals Indicator

Dec-17 Jul-18 Feb-19 Sep-19 Apr-20

Nov 13 2020 = 37.8

Source: Mill Street Research, Factset, Bloomberg
Indicator Appendix

SMALL-CAP/LARGE-CAP MODEL

Source: Mill Street Research, Factset, Bloomberg
Indicator Appendix

SMALL-CAP/LARGE-CAP MODEL (CONTINUED)

**Equity Market Oscillator**
- Russell 2000 / Russell 1000 Relative Return
- Russell 1000 smoothed 12-month % change (inverted scale)

Favor small-caps if % change < 5%
Favor large-caps if % change > 15%
Oct 31, 2020 = 14%


**VIX Indicator**
- Russell 2000 / Russell 1000 Relative Return
- VIX Volatility Index (inverted scale)
- VIX % from 6-month average (inverted scale)

Favor small-caps if VIX % change < 5%
Favor large-caps if VIX % change > 5%
Oct 31, 2020 = 31.7


Source: Mill Street Research, Factset, Bloomberg
Important Disclosures and Certifications

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