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2020 FALL INVESTMENT OUTLOOK

Stocks have entered the fall months and are in true seasonal form as volatility has returned and a downside price correction has commenced following a record month of August, which saw many indices reach all-time highs. Throw in the fourth year of a Presidential cycle, when returns have been negative for the months of September and October on average going back to 1928, then it is not a surprise that equities have much to digest in terms of seasonality as well as economic, policy, and health outcomes.

August was truly a blowout month with the tech-laden Nasdaq gaining 9.6%, its best monthly performance since 2000. The S&P 500 and the Dow Industrials turned in their best August since the 1980s. Evidence emerged in early September that rampant bullish participation by both institutional and retail players in the options market, where investors can speculate on short term price movements of both individual equities and indices, added fuel to the upward momentum in stocks throughout the summer and especially in August as Wall Street was forced to hedge its books to accommodate such activity. Such speculative trading led to the narrow NYSE FANG+ Index gaining an incredible 21% for the month. At the same time, various measures of valuation reached levels not seen since the late '90s bubble and sentiment gauges were at extremes that made the rally look overdone. Thus, it was not a surprise to see such risk taking abate and prices correct in recent weeks.

The amount of cash in money market funds and bank deposits is near all-time highs and such liquidity has driven a resurgence in both IPO activity and a proliferation of riskier Wall Street instruments following the shortest bear market ever. The IPO of tech company Snowflake shows the lack of discipline by investors prior to the recent stock market selloff. The stock traded as high as $319 per share on its first day of public trading on September 16th, more than 2.6x its IPO price of $120 per share, before declining 32% since then. The market has also seen a surge in special purpose acquisition companies (SPACs) or so-called "blank check" funds which raise public money to eventually reverse merge with a private enterprise, enabling a quicker route to public markets. SPAC sponsors have raised a record $33 billion so far in 2020 and outpaced traditional IPOs in July and August. Such risk taking helped offset headwinds from corporations where share repurchases fell to a 9-year low and insiders sold more stock in a single month during the month of August in nearly five years as markets were making all-time highs.

With the Federal Reserve extending its commitment to keeping its policy rate near 0% for many years, headline interest rates remained trapped in a narrow range over the summer. The nominal 10-year Treasury currently yields just 0.66% while the 2-year note offers a measly 0.13%. However, underneath the surface the bond market showed a rising expectation for inflation in recent months in response to such a policy commitment with so-called inflation-linked TIPS rallying, pushing real yields lower. The trend price of gold continues to benefit from such a relationship alongside equities. Homeowners and corporations have taken advantage of such low rates to refinance mortgages and debt while savers have been tempted to consider riskier alternatives for returns. The federal government has seen its own interest burden fall despite rising deficits and debt, giving it the ability to further boost the economy until a successful vaccine arrives. But the acrimony in Washington is only rising, further strained by the recent Supreme Court vacancy and a contentious Presidential election.

Equity Markets – 9/23/20

	Index Price Level	2020 YTD Total Return
Dow 30 Industrials	27,763	-4.5%
S&P 500	3,237	+1.6%
NASDAQ Composite	10,633	+19.3%
MSCI All Country World Index ex-USA	279	-7.5%

Outlook

The U.S. economy is snapping back in the third quarter of 2020 with just one week remaining. Various indicators point to a sharp recovery in growth following the biggest ever quarterly plunge of -31.7% in the second quarter. The latest Atlanta Fed GDPNow model forecasts 32% annualized growth in the quarter on the heels of a recovery in the labor market and the reopening of the economy following the spring lockdowns.

Over the past four months the labor market has recovered about half of the 22.1 million jobs lost during the months of March and April. Federal and state governments have provided extraordinary income support throughout the pandemic, driven by passage of the CARES Act in late March. Such one-time cash payments and increased unemployment benefits pushed personal income above the pre-pandemic trend, supporting consumption and enabling households to meet financial obligations. While foodservice sales have lagged due to dining restrictions and restaurant closures, trend growth in retail sales ex-foodservice has returned to pre-pandemic levels much faster than most economists expected, especially considering the savings rate has averaged over 20% since March. Some of this spending was likely pulled forward as households furnished home offices and purchased electronics to work at home. However, with government support now waning and the passage of a new stimulus bill uncertain, consumer spending could stall to finish the year.

The housing market has snapped back during the third quarter recovery and is likely to contribute to GDP at a much greater rate during the new expansion compared to the previous one. There are anecdotal stories of households moving deeper into the suburbs from urban areas, a trend that is supported by recent data and is likely to continue in the quarters ahead. Mortgage rates are at generational lows with the latest Freddie Mac 30-year fixed rate averaging 2.94%. Existing home sales and permits for single family residential construction are at highs last seen in 2007. Homebuilder confidence is back to late ‘90s levels.

Despite the sharp recovery in some parts of the economy, other sectors are likely to be a drag for some time. Small businesses have been crushed by the pandemic and continue to permanently shutter despite the large aid package in March from Washington. Up to 4 million could be forced to close this year alone, which is approximately 13% of the 30.7 million small businesses that operate nationwide, according to the Small Business Administration. Commercial real estate demand also continues to collapse as restaurants and retailers close their doors and businesses reduce office space at a rate not seen for several decades. Corporate bankruptcies are already at 2009 levels and are likely to accelerate. Such headwinds are why many economists do not expect the U.S. to return to pre-crisis GDP levels until at least mid-2022.

Large multinational corporations essentially have unfettered access to the public bond market as demonstrated by the more than $1.2 trillion in corporate bonds sold since March. However, smaller enterprises only have access to bank debt or private capital. As Peter Atwater from the research firm Financial Insights succinctly states, “capital markets access has become a determiner of life or death for business.” U.S. banks are tightening lending standards at the greatest rate over the past 30 years other than during the 2008 financial crisis. Such a metric has been a leading indicator of economic activity historically, which means the current recovery could downshift by the end of the year without some help. Unfortunately, the Federal Reserve’s own Main Street Lending Program has thus far failed to unclog the credit spigots for small business with just $1.4 billion of loans issued relative to the $600 billion mandated for the program. The central bank and regulators will need to update guidance and become more lenient with lenders if origination is to pick up.

A significant amount of spare capacity is likely to exist in the economy in the coming years in terms of excess labor and capital, which should keep a lid on any near-term inflation. Also, during the previous expansion the Federal Reserve consistently undershot its 2.0% inflation target throughout the cycle despite enormous liquidity injections. Thus, the central bank recently modified its policy to now target an *average* inflation rate, meaning it is inclined to let inflation run higher than 2% for some time before hiking interest rates in the future. At its most recent meeting FOMC members signaled in their projections that rates would remain at near-zero levels through 2023.

Such policy has implications for decision making across the investment landscape. The price of gold and gold mining stocks should continue to benefit from low interest rates as long as inflation expectations are stable or rising. Growth stocks have outperformed the S&P 500 index by a wide margin on a relative basis during the current stock market recovery as real interest rates declined while value-oriented names and so-called dividend aristocrats have underperformed. However, with valuations stretched in crowded sectors like large cap technology, investors could find dividend stocks more appealing again on a relative basis like 2016 and 2012-13 when interest rates were previously trapped at lows. Gradually shifting the asset allocation to favor a slightly higher level of equities of distinctive competence companies (purchased at an appropriate valuation) while reducing exposure to fixed income as bonds mature may also help investors position for persistently low rates and income headwinds in the near term but rising inflation down the road.

Near-zero interest rates and a rising fiscal deficit have put pressure on the U.S. dollar. After peaking in late March, the dollar has declined about 10% against major currencies to a 28-month low. As the U.S. economy recovers from the recession the trade deficit is also likely to widen (despite the trade deal with China) as underlying demand recovers and imports pickup. Such twin deficits historically have a close relationship with the medium-term direction of the currency. Short of a revival of fiscal discipline out of Washington, these rising twin deficits could maintain downward pressure on the dollar. Such a decline would make it easier for the Federal Reserve to eventually achieve its inflation target as imported inflation would have a greater impact on overall price pressures. A weak dollar also favors companies that have more sales and profits outside the U.S.

The recent pickup in stock market volatility is likely to continue with the U.S. presidential election less than six weeks away. According to RealClear Politics, the betting markets put the current odds of a Biden victory at 53.1%, down from 61.0% at the end of July. Biden also leads the RealClear Politics polling average of the top battleground states at 48.7% vs. 44.8% for President Trump. A second Trump administration would likely accelerate the deglobalization of trade that is already underway and the continued shift away from multilateralism and international institutions. Politics in Washington, DC would become even more rancorous and bitter over the next four years.

A Biden administration could be somewhat investor unfriendly, introducing even higher levels of fiscal spending on various domestic programs at a time when deficits are the widest since WWII. Such proposed increases in spending would be financed by higher taxes on the wealthiest citizens earning more than $400,000 as well as an increase in the corporate tax rate to 28% from the current 21%. The proposed increase in the corporate rate would be a headwind to stock prices, lowering S&P 500 earnings by $20 or 12% in year one, according to Goldman Sachs. Biden has also proposed increasing the capital gains tax rate to 39.6% for the highest earners from a current 23.8%, the largest increase in history. While higher taxes will be necessary to close the widening fiscal deficit, it is also important for the government to structure taxes so that the economy can continue to grow. Turning campaign proposals into actual legislation also requires the Democrats to capture the Senate from the Republicans, who currently hold a 53-47 majority. RealClear Politics polling shows the race for the Senate to essentially be a dead heat.

The death of Supreme Court Justice Ruth Bader Ginsburg and the Republican party's intention of filling that vacancy prior to the election has only raised the level of acrimony in the nation's capital at a time when leadership should be coming together to see the country through to the other side of the pandemic. Additional fiscal stimulus to aid both households and businesses is unlikely to pass prior to the election and could even slip into 2021, raising the level of uncertainty and giving investors a reason to doubt whether or not the economy can be successfully reflated by its leaders.

A more durable economic recovery and further stock market gains will ultimately depend upon the approval of safe vaccines and therapeutics that enable the public to return to a more normal lifestyle. According to the New York Times, researchers are testing 40 vaccines in clinical trials in humans and at least 92 preclinical vaccines are under active investigation in animals. At a Senate Appropriations Subcommittee hearing on September 23rd, Dr. Anthony Fauci shared that there is growing optimism for a successful vaccine to be discovered before year-end and that 50-100 million doses could be available in the November-December timeframe with potentially 700 million doses by April. Such scientific success could eventually benefit more diversified portfolios and lead to broadening leadership in the stock market by sectors that historically have been associated with a cyclical recovery but have lagged since the March bottom such as industrials, energy, and financials. While the headline S&P 500 Index is essentially flat in price for the year, driven by the narrow leadership of large cap tech, the average stock in the index has underperformed and is down 9.2%.

Investment Conclusion

The decline in stock prices during September has only rolled back the incredible August rally in many equities, leaving valuation still unappealing with the market trading at 20x *next year's* earnings. Excess liquidity from central bank support is likely to keep multiples for both individual stocks and indices above long-term averages in the near term. In the meantime, we continue to expand our research list and find some select opportunities in individual names given our long-term horizon. Bonds continue to be broadly unattractive, offering negative returns on an inflation-adjusted basis, although our credit research has uncovered some corporate bonds that offer a satisfactory return relative to money market rates for those accounts with excess cash. If the recent price correction in stocks continues throughout the fall months given the uncertainty around several variables we discussed above, then having some extra cash for incremental investment should allow investors to take advantage of the opportunities that are likely to develop.

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