MARKET OUTLOOK

FALL 2020

HOWE & RUSLING

ON OUR MINDS

Last quarter we started this Outlook with the following statement: “Our thoughts could not be more focused… the virus is running the show.” This Outlook could theoretically be a repeat story. COVID has changed life, and to this day, continues to influence everything we do and correspondingly how the markets perform.

That said, in an ever-changing world and in an odd way, it was good to see the markets jump around in September. Sure, that sounds crazy coming from an investment advisory firm, but September has a reputation for being a volatile month historically, so it was good to see as it was an orderly movement which gave hope to some traditional investment modeling theories returning. We will explain more in our Markets section of this Outlook.

Speaking of volatile months, it would be remiss if we did not immediately mention other notoriously known volatile months, especially those leading up to elections. October has one of the worst reputations (Black Monday being one example). However, from 1950-2019, the average return in October is +0.68% (and in this millennium, the average annual return is +1.03%). Conversely, November, the month everyone is talking about regarding the election, has the best return of any month over those 60 years, +1.42%. The point is that market axioms tend to be more market phobias than reality. Granted, many people have stakes in the ground for this upcoming election (as they do every election), but eventually the markets simply figure it out (more on this later in the Elections section).

As investors, we need to constantly assess the marketplace, watch for signals, and advise our clients. The most important advice is to not get caught up in the news, good or bad, but instead just have a plan. During this year’s meltdown, those with a plan, and those with belief in their advisors, were able to ride out the storm. Macro outlooks are one tool in the planning box, as they break down near-term signals and help to alleviate those axioms and phobias.

THE PAST GUIDES THE FUTURE

FIXED INCOME

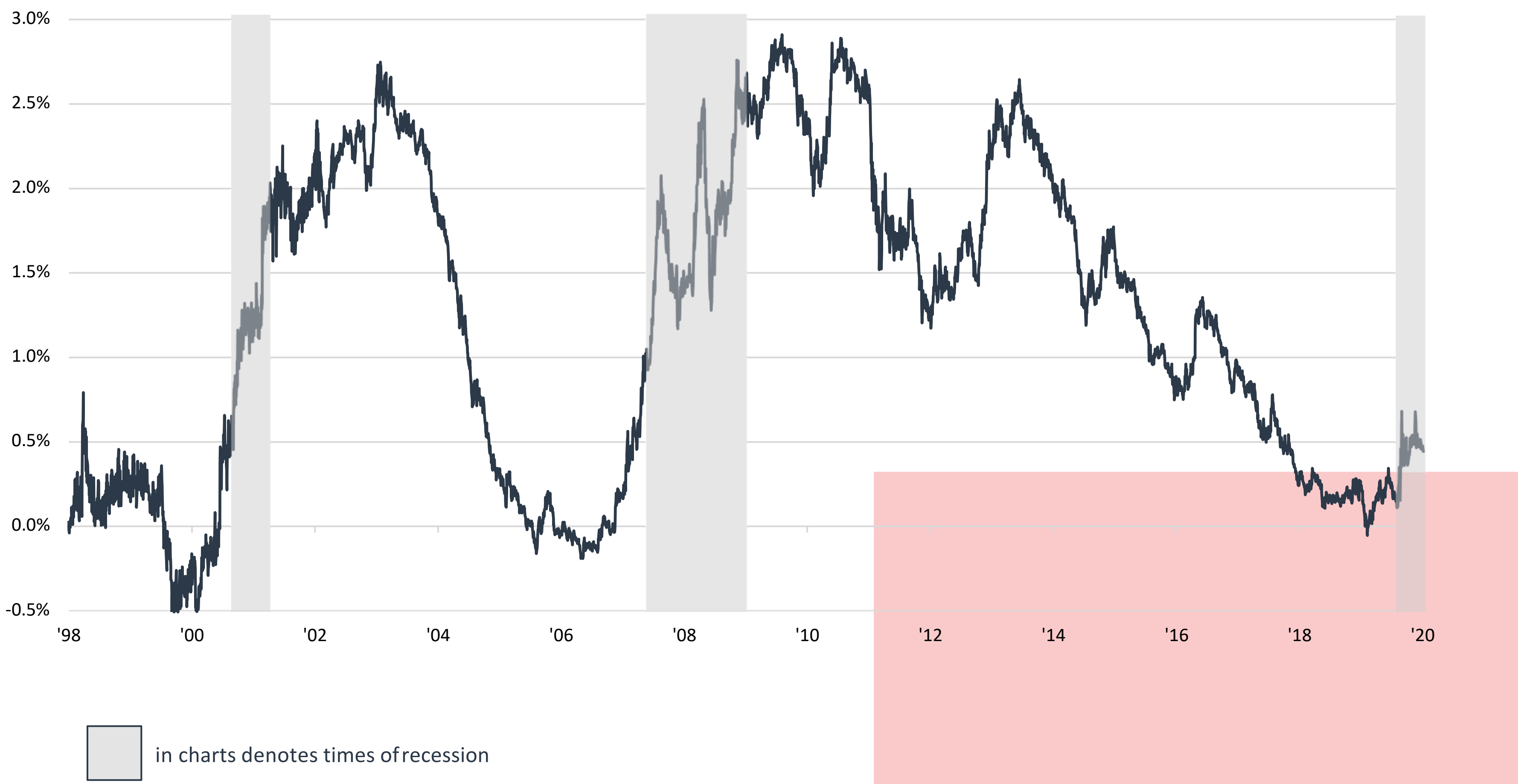
While every evening the Nightly News reports on the markets, they are essentially reporting the daily results of the symbolic portfolios of the Dow, S&P, and Nasdaq indexes. However, while not glamorous, the real market that economic forecasters tend to spend a fair amount of time laboring over is the bond market—the quintessential predictor of things to come.

Consider this: what entity comes riding in to save the day when the economy collapses? The Federal Reserve. What does the Federal Reserve principally do? In simple terms, it monitors and controls interest rates, which is the main component of a bond. Outside of initial Fed changes, interest rates move up and down freely in the market based on perceived economic data. While the Dow, S&P, and Nasdaq are extremely important, the financial strength of all the companies that make up each of these three indexes is directly correlated to interest rates. Companies issue bonds to raise money (in addition to traditional borrowing from banks), and just like a bank loan, when interest rates rise, they eventually must pay investors more in terms of annual bond interest. These higher rates eventually limit expansion as more revenue is used to service (or pay down) debt versus investing in new revenue-generating assets such as more efficient machines or the purchase of another company. Less growth translates into less employment… and the dominos fall from there. Hence, watching the bond market is a critical macroeconomic tool.

As case in point of the impact of interest rates, and insight into the future, let's consider the spread (or difference) between the 10-Year and 2-Year U.S. Treasury bonds. Of recent, the 10-Year Treasury has been yielding around 0.65% and the 2-Year Treasury around 0.11% (and people wonder why savings rates are so low). Using this data, the spread is 0.54%, and while not great, it is positive, and the overall trend is positive. (This data is illustrated in the chart on the following page).

The important takeaway is that this spread is a critical economic indicator. When spreads shrink, or the 10-Year yield comes very close to the 2-Year, or even inverts (meaning the 2-Year yield is greater than the 10-Year), it signals trouble for the future, as who wants to take a bet on the future when the return on long-term bonds is less than that of short-term bonds? With recessions shown in shaded gray areas, you can see that every time this spread drops below zero, a recession soon comes into play. As stated, the spread has been widening (increasing), and therefore we consider this to be market-favorable in the near term. However, with “lower for longer” long-term rates (which I will get into more in a minute), there is little room for error.

10-YEAR TREASURY MINUS 2-YEAR TREASURY YIELD SPREAD (%)



INFLATION & UNEMPLOYMENT

While we simplified the role of the Fed in discussing interest rates and bonds, the Federal Reserve's official dual mandate is that of price stability and maximizing employment. Inflation control is the price stability component, and monitoring unemployment acts as the method of maximizing employment. Inflation is the Fed's Public Enemy #1 and low unemployment has been Public Enemy #2. While most people instinctively think low unemployment is a great economic trait, historically, having everyone working will lead to inflation, which is the start of the end for a functioning economy. With more people working, there is more money in the system. More money means more buying power which means more demand for likely less supply—hence prices rising (inflation!). This was classic Federal Reserve policy until recently.

In August, the Fed announced, somewhat shockingly, that low unemployment was not quite the contributor to inflation as once feared and, as such, said it was taking a less stringent view and letting it run a bit. The Fed signaled it was more concerned with average inflation over time, versus a hard and fast, stick-in-the-mud practice of raising rates when inflation hit 2% (or the employment rate was "full" at roughly 4% or less unemployment). Therefore, rates could stay lower for longer. The below chart gives insight into the Fed's projections and how it does not see either inflation or employment being a concern, hence having years to play out.

FEDERAL OPEN MARKET COMMITTEE (FOMC) SUMMARY OF ECONOMIC PROJECTIONS

SEPTEMBER 2020 RELEASE

	2020	2021	2022	2023
	1.20	**1.75**	**1.80**	**1.95**
2019 (September) projections	1.90	2.00	2.00	NA
	1.50	**1.80**	**1.90**	**2.00**
2019 (September) projections	1.90	2.00	2.00	NA
Unemployment	**7.60**	**5.50**	**4.60**	**4.00**
2019 (September) projections	3.70	3.80	3.90	NA
Federal Funds Rate	**0.10**	**0.10**	**0.10**	**0.10**
2019 (September) projections	1.90	2.10	2.40	NA
Gross Domestic Product	**-3.50**	**4.15**	**2.90**	**2.70**
2019 (September) projections	2.00	1.90	1.80	NA

PCE = Personal Consumption Expenditures

While inflation is not a concern for the coming years according to the Fed, our view is inflation will slightly raise its head, likely in the near to mid term, given several factors. First, this recovery is not a traditional recovery, and purchase patterns have changed given the lockdown. With global shutdowns, supply for many goods does not keep up with demand, which therefore pressures prices. Good examples of this are lumber and copper, which are key input products in building. During the lockdown, production (and shipping) stoppages limited their supply, which consequently raised prices. Extend this manufacturing and shipping stoppage across a broad range of products, including processed food, and it takes time to recreate supply (as at the same time consumers are still buying online, cutting into existing supply). These pressures are real. Add to this the talk of a second wave of COVID infections, and necessity goods are starting to feel supply pressure (again). Hence, there are plenty of economic catalysts to cause isolated inflation.

Even with stimulus, not everyone will benefit. Fortunately, and unfortunately, there is a higher level of savings in the system. The fortunate news is these extra savings could help those who are unemployed continue to hold on. The unfortunate news is it means they will be injecting funds into the economy which could put pressure on prices (but the spending of the savings will also support others who are working, so this is a never-ending game of dominos). Therefore, while we are not forecasting runaway inflation in the near term, we are cautiously watching pockets of the economy.

Employment/unemployment has been a very real issue to individuals, businesses, and therefore the economy at large. Furthermore, while the Fed projects unemployment shrinking over time, the present reality is the daily struggles of the millions who are unemployed. Workers in the food & beverage, entertainment, travel, and retail industries watched their employers shut down totally during the lockdown and are still watching their employers severely cut hours, locations, or start to fold entirely. Regardless of any stimulus, these employees are in trades that cannot "work from home." We continue to monitor this closely, as higher levels of unemployed workers will stress the system and could turn the slowly evolving recovery backwards.

GROSS DOMESTIC PRODUCT AND RETAIL SALES

Two critical indicators for growth are the value of goods produced as well as the consumption of those goods. As can be seen in the prior chart of the FOMC's projections, GDP is forecasted to end calendar year 2020 at -3.5%, with a somewhat robust rebound in 2021 of 4.15%, and then a leveling off in 2022 of 2.90% and 2.70% in 2023. This is encouraging news, for back in June, the FOMC was projecting GDP for 2020 to be -6.5%. Despite shutdowns, the economy is coming back, aside from the previously mentioned struggling industries.

As we review retail sales, which includes the hard-hit food services sector, activity leveled off a bit in Q3, principally due to increased virus outbreaks in the South and Southwest (showed in the below chart, highlighted for July and August 2020 results).

U.S. CENSUS BUREAU
RETAIL TRADE AND FOOD SERVICES:
U.S. TOTAL SEASONALLY ADJUSTED SALES
(MONTHLY % CHANGE)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2015	-0.6	-0.2	1.5	0.2	0.8	0.2	0.6	0	-0.3	-0.3	0.4	0.4
2016	-0.6	0.9	-0.3	0.4	0.4	1	-0.1	0.1	0.6	0.3	-0.1	1.1
2017	1.2	-0.1	-0.2	0.6	-0.4	0.3	0.1	0.1	2.2	0.1	0.8	0.5
2018	-0.1	0.4	0	0.2	1.3	-0.2	0.5	-0.2	-0.1	1.1	0.1	-2.1
2019	1.5	-0.1	1.6	0.5	0.4	0.3	0.7	0.4	-0.3	0.5	0	0.1
2020	0.8	-0.4	-8.2	-14.7	18.3	8.6	0.9	0.6	NA	NA	NA	NA

This slowing of sorts came after strong returns in May and June when most states had started their re-opening phases. Granted, March and April were horrendous retail trade months, as we were in lockdown (and we are still climbing out of that hole). However, with fears in June and early July of a possible second lockdown (given a rise in cases), Corporate America decided to undertake its own "protection", mainly to its bottom-line, somewhat regardless of whatever was happening with COVID response policies at the state or local municipality level. Most large, retail-focused firms implemented virus mitigation strategies that included nationwide policies such as required masks, limiting the numbers of shoppers, and in some cases, temperature testing. It is our belief that if there is any new mass-scale outbreak again, Corporate America will continue to employ whatever strategy is necessary to keep cash flow alive, therefore protecting its bottom line to some degree.

Furthermore, starting in mid to late October, we believe there will be some publicly traded firms that surprise to the upside with their Q3 earnings results. This upside earnings surprise could be from a combination of entering into the third quarter with muted or no guidance regarding anticipated quarterly results, as well as analysts expecting the worst, making expectations easy to beat. However, we are still in a recession, and latest data indicates capital orders are weakening. Therefore, this enforces the slower recovery theory. As mentioned at the onset, given September's market action, this health crisis has fully morphed into a somewhat classic economic crisis (barring the continued virus unknowns).

Speaking of the virus, and the economy with GDP and sales, we might as well mention here that we don't believe any industry can fully recover until a vaccine is on the table. While the vaccine has seemingly turned into a game of political hot potato, analysis was done by the former Center for Economic Activity Chair Tomas Philipson that this virus is costing the economy $15 billion daily. He further calculated that the best stimulus would be a vaccine—as in, if the vaccine is available by mid-January 2021 versus mid-June 2021, it would save $1.8 trillion, ironically a number similar to those being tossed around for stimulus packages. Philipson also proposed getting the elderly and essential workers vaccinated immediately, as this would allow most of the economy to get back to normal without fear of passing the virus onto the vulnerable, and it wouldn't require a mass rush to get everyone vaccinated right away. It is an interesting macro perspective, if nothing else.

MARKET INFLUENCES

As we stated in last quarter's Outlook, the market is a forward-looking indicator. We saw the S&P index start its recovery on March 23, months before Americans were venturing outside. Granted, this is a market-cap weighted index[1], but the equal weight index[2] is showing a similar trend, and both are showing recovery from the depths of the pandemic fear. The interesting fact is the S&P dipped below its 50-day moving average in late September, which many consider an important threshold and technical indictor (typically when the S&P drops below the 50-day moving average, a pullback occurs). While this is important, interpretation of the data needs review. Fifty days in the market is equivalent to two calendar months of trading. However, when stock prices fall or rise rapidly, the 50-day average can be a bit distorting. However, the 200-day moving average is a good reference point in times of sudden turbulence. The 200-day average equates to about eight months of average pricing, which eases out the bumps. Like the 50-day, when the market drops below this moving average, it is usually a signal. While the markets are above the 200-day, we are carefully monitoring it given the easing of the market recovery in September—but we feel comfortable with the trend.

S&P 500 INDEX WITH 50 &200-DAY MOVING AVERAGES

[1,2] Investors should understand that not all reporting of results is the same. In a market-cap weighted index, which is what is typically used on news reports and all performance statistical data, the larger the company, typically the higher weight, or percentage of the average the firm has in the results of the index. Using the S&P 500 as an example, in a market-cap weighted index each company is not 1/500th of the index, as one might commonly think. This equal split would be the Equal Weight index, which is rarely, if ever, used in reporting.

We wanted to highlight the diversity of sector performance, principally attributable to the pandemic. The takeaway is that two sectors have done exceptionally well this year and two sectors have struggled, which gives us some macro perspective moving forward. The winner has been the technology sector, as technology has come to the aid of many with remote work, shopping, and communication. The digital transformation was in progress pre-pandemic, but most economists had anticipated a 5-10 year conversion timeline. This instead came in two months, and now the “New Economy” is here to stay. Consumer discretionary has also done well, somewhat surprisingly, as with mass unemployment, discretionary spending is typically a second thought. That said, Amazon is part of the consumer discretionary sector, so just looking at the raw numbers is deceiving. Of the 18.28% return for the sector through the third quarter, Amazon contributed nearly 15%, given its high market-cap weight influence on the index. In light of the transition mentioned above regarding online (digital) presence of retailers, those who were ahead of the timeline benefited, and those who were behind suffered. In fact, through the quarter, only one-third of the firms in the discretionary sector had a positive return. However, with stimulus checks in hand, added funds from the CARES Act, lack of spending in energy (not traveling), and a good share of people under the belief their jobs were still secure once the pandemic ended, selected discretionary spending was seemingly an enjoyed luxury during a very depressing time. As always, though, it is important to do the work beneath the surface.

SECTOR PERFORMANCE
(JANUARY - SEPTEMBER 2020)

Energy has underperformed for obvious reasons, with a good portion attributable to grounded airlines, a milder winter, zero travel to work for many months, and diminished summer travel due to travel restrictions. Also a very large factor was supply and price manipulation by the Russians and Saudi Arabians at the start of the pandemic which decimated the sector. The financial sector has suffered as well, as it usually does, when interest rates are pushed to zero. Banks make money on net interest margin, and when rates are low, the spread is much narrower.

While sector analysis can drive investing purchase decisions, inherently many sectors can be grouped into two style boxes: value and growth. The pandemic has punished value, with the S&P 500 value index still down double digits. Traditional value sectors are energy, financials, heath care, utilities, and industrials/materials. Conversely, the S&P growth index is up over double digits this year with technology leading the way. That said, the returns of sectors are driven by economics. During the early part of the pandemic, tech stocks obviously took hold, and as former CEO of Google Eric Schmidt mentioned in an August interview, "They got us through a pandemic." However, as the recovery broadens, cyclicals (value) should come back into play which is typical of any recession recovery. The market-cap indexes took off faster (weighted heavily in tech names), but a traditional recovery is forthcoming with time (and a vaccine leading the way).

THE ELECTIONS AND THE ECONOMY

With less than a month until the elections, many pundits have called this the most important election of our lifetime. It is easy to see how many people in our country have been divided since November 2016, and now with the rise in protests over policing practices and racial inequality, that divide is widening further. As investment advisors, we must take a step back and focus on our primary objective: surveying the political, social, and economic landscapes and determining how portfolios could be affected.

While we just recently created a StreetSmarts video on the "what ifs" of the election (found on our website, in case you missed it), three facts exist. First, the biggest political/economic risk of the election is not what you are hearing in the press; it is politicians deciding to implement another national shutdown. With the fall season here now, and cases starting to rise again, health care officials are sounding the alarm of concern and challenging party candidates' promise to get COVID under control. While this might solicit some votes, unlike early spring, hospitals are not overwhelmed, focused restrictions do work, and politicians know lockdowns have unbelievable economic cost.

The second fact is companies are in the business of making a profit and returning value to their shareholders. Therefore, after anticipated volatility leading up to the election, and perhaps days or weeks thereafter, the fact is that whichever party wins, companies will adjust to any new rules, or taxes, and find a way to return value to shareholders. Furthermore, while promises are grandiose on the campaign trail, we do not expect rapid implementation of new laws or taxes given the stress the economy is presently under due to COVID and the recession.

Finally, and this gets no press, but from a macro perceptive, investing is about time, not timing. Hence, removing human bias toward recent events (elections included), goals should be the driving force of any portfolio, and proper risk allocation is essential. The adage of "this, too, shall pass" applies to events like elections, especially in a time when a vaccine might be approved. It is easy to get out of the market, but the real question is when to get back in. That guessing game is perhaps the biggest risk of all, and one we would certainly avoid taking on.

OUR VISION

Our vision first and foremost is one of hope. This health crisis has been an awakening in many regards across economic, social, and political spectrums, and our hope is everyone has learned something about their ways of doing business or interacting with others so that we can be better tomorrow. We all have changed, but above all, we have all learned we have no control over the future.

As we have detailed throughout this outlook, the next quarter is likely to have a mixture of positive news coupled with challenging headwinds. One could easily cry uncle and retreat, especially as cases rise again, but we believe opportunity is around the corner. As stated, the New Economy has started in full vigor, sadly accelerated by the pandemic. Stalwart retail giants like Macy's, who self-admittedly was struggling pre-pandemic from its brick and mortar retail anchor stores, and then had all its stores closed in the lockdown, was forced to overhaul and enhance its online presence, or let the parade forever leave town without it. Macy's says it is seeing favorable results and it has likewise committed to cutting 100 of its 500 locations (presumably good for the company's bottom line but bad for employees given anticipated layoffs). While we are not here to assess the survival of Macy's, the message is simply that change is afoot. The same is true for many retail storefront operators who had tried to eke out revenue from fading walk-in traffic locations for years, but learned these past few months that consumers still spend money, just in different ways. The New Economy is now, and those who adapt quickly have a better chance of surviving and eventually thriving.

While the economy is still fragile, and the pandemic and election will continue to introduce volatility, we are remaining neutral in our allocations—not fearing the unknown, but not overly exposing portfolios to risk. The time will come for adjustments, but with a vaccine imminent and perhaps some targeted fiscal aid, it is important to take a stand on both sides of the risk spectrum, as those invested should be rewarded. We likewise believe a fully diversified allocation to every sector is critical, as this is not the time to place bets given so many moving parts.

end.

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