"Contested Election"

Market Commentary – January 2021

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 33.4% in the third quarter of 2020. This is higher than 33.1% for the advance and second estimates. On December 16, the Federal Reserve revised its economic projections that were last released in September 2020. It now sees GDP growth of -2.4% in 2020, 4.2% in 2021, 3.2% in 2022, 2.4% in 2023, and 1.8% in the "longer run" (beyond 2023). Note that in June 2020, the Fed projected 2020 GDP to contract by -6.5%, so a contraction of -2.4% is much shallower than feared only six months ago ("V-shaped" recovery).

The Federal Reserve continues its historic monetary policy easing to mitigate the economic effects of COVID-19. In its regularly scheduled announcement on December 16, the Federal Open Market Committee (FOMC) projected the federal funds rate will remain at 0% to 0.25% through 2023. Moreover, the balance sheet ballooned to $7.45 trillion in assets on December 28 and it should grow by $120 billion per month going forward (bullish for stock prices). The next FOMC announcement will be on January 27.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) during 2021 is $166.63, which implies a price-to-earnings (P/E) ratio of 22.5 with the S&P 500 at 3,756. The earnings yield (E/P) of 4.44% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.93%. As the S&P 500 index pushed to new highs in December, it could use a short-term consolidation. Note that the spread between growth and value has not yet converged. In 2020, the Nasdaq 100 rose 47.6% and the S&P 500 Large Cap Value index fell -1.5% (both without dividends), for a spread of 49.1%. While excellent opportunities remain for value stocks across all capitalizations, the strategic role of cash in a portfolio should not be forgotten.

A constitutional process to determine the *true* President-Elect is about to unfold in a way that has not happened since the contested election of 1876…and perhaps ever. Electoral votes are being contested by Republican State Legislatures in 7 states (AZ, GA, MI, NV, NM, PA, and WI) due to evidence of election fraud. On January 6, 2021, the 12th Amendment to the U.S. Constitution will drive the process (along with Title 3 U.S. Code §15 and the Electoral Count Act of 1887). The President of the Senate (Vice President Pence) shall open the electoral votes in front of the Senate and House of Representatives in alphabetical order by state. If any disputes cannot be resolved by Congress, the process may get messy. There are conflicting theories on whether the original "certified" Democrat electoral slates would be counted (if so, Biden wins) or whether Pence would have the authority to decide which electors to accept/reject. If Pence rejects *both* electoral slates for the contested states, then it is possible that neither Biden nor Trump would win 270 electoral votes. In this case, the House of Representatives (HR) would select the President, with each state getting only one vote. In the new 117th Congress HR, Republicans control 27 states, Democrats control 20 states, and 3 states are tied. If Representatives vote along party lines, Trump would win re-election. If enough Republicans vote for Biden, however, then Biden would become President-Elect.

Everyone has their personal political views, but as investors, we need to ask how this process may affect the stock market. Based on the last four years, President Trump loves the stock market and the stock market loves him back. His policies of lower taxes and lower regulations have been bullish. He seems ready to launch a war against "big tech", though, which could pop the technology stock bubble and cause collateral damage to the major indexes (watch out, index investors). A Biden presidency may cause more stagnant economic growth (similar to the Obama years) due to higher taxes and regulations. If the increases are moderate, however, stocks should react favorably (albeit less so than under Trump). With vaccines being distributed, the COVID-19 pandemic should resolve under either president. A negative scenario for the stock market would be the failure of the Constitution to deliver a peaceful transfer of power.