"The Tide Is Not Lifting All Boats"

Market Commentary – September 2020

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The second estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. decreased at an annual rate of -31.7% in the second quarter of 2020. This is higher than the advance estimate of -32.9%. The components of the 2020 Q2 GDP number are: consumer spending -24.76 percentage points, investment -8.66 percentage points, net exports +0.90 percentage point, and government spending +0.82 percentage point. The sum of these numbers equals -31.70%. The historic nature of the Great Cessation cannot be overstated. After unemployment skyrocketed from 3.5% in February to 14.7% in April, it has already fallen to 10.2% as of July. Amazingly, the recession that began in February may already be over, although that call has not yet been officially made by the National Bureau of Economic Research.

The Federal Reserve surprised financial markets on August 27 with a change in its fight against inflation: rather than target 2% inflation, it now "seeks to achieve inflation that averages 2% over time". This is a subtle but important difference. By targeting an *average* inflation rate of 2% over time, the Fed will allow inflation to run "moderately above 2% for some time". In typical Fed fashion, they left room for interpretation with their statement. Financial markets interpret this, however, as the Fed's willingness to keep monetary policy accommodative for longer than expected by historical standards. With the federal funds rate at a range of 0% to 0.25% through at least 2022, future rate cuts or hikes are unlikely. All eyes will be on the Fed's balance sheet, which was $7.0 trillion as of August 26 (after jumping from $4.2 trillion in February and peaking near $7.2 trillion by June). The next Fed announcement on monetary policy is scheduled for September 16.

Love him or hate him, President Trump is helpful for rising stock prices. Lower taxes and regulations, which are core beliefs of President Trump's policies, are generally celebrated on Wall Street. A Joe Biden presidency, especially if accompanied by Democrats keeping control of the House of Representatives and winning control of the Senate, would likely result in higher taxes and regulations. With the S&P 500 and Nasdaq rising to new highs, a victory by President Trump on November 3, 2020 is being priced in. If this is true, a sell-off could be brewing after the election, regardless of who wins.

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 $164.02, which implies a price-to-earnings (P/E) ratio of 21.3 with the S&P 500 at 3,500. The earnings yield (E/P) of 4.69% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.69%. The S&P 500's P/E is being skewed by the technology bubble: AAPL ($2.2 trillion market cap, 33.3 P/E), AMZN ($1.7T, 78.2), MSFT ($1.7T, 30.7), GOOGL/GOOG ($1.1T, 28.8), and FB ($0.8T, 28.9). There are much cheaper stocks available to buy!

While the S&P 500 uptrend continues, breadth is drastically skewed. The S&P 500 broke through the old all-time closing high of 3,386 from February 2020, hitting a new all-time closing high of 3,508. The tide is not lifting all boats, however. The trends we have pointed out in market commentaries from recent months have stretched even further. In 2020 year-to-date, the Nasdaq 100 is up 38.7% (without dividends). In comparison, the value indexes lag (S&P 500 Large Cap Value -11.0%, S&P 500 Mid Cap Value -17.1%, and S&P 600 Small Cap Value -19.7%). The market-cap weighted S&P 500 is up 8.3% (without dividends), while the equal-weighted S&P 500 is down -3.7%. This is a spread of 12.0% for the same 500 companies! Since January 1, 2017, the Nasdaq 100 is up 149% versus the Russell 2000 Value down -12%. We can point out the existence of this bubble, but we cannot say when it will burst. When it does burst, however, it will likely be a violent move to the downside. Since the Fed is remaining accommodative, our hypothesis is that money will flow out of the mega-cap technology stocks and into the unloved value stocks. We have positioned our portfolios accordingly, quietly accumulating stocks that are on sale.