September 2020

After reading today's WSJ, one might wonder if the editor is suffering from split personality disorder, or just making sure all bets are covered. From the front page:

Stocks Defy the Pandemic In Bullish Quarter

Indexes close with big gains after stretch of volatility; risks ahead as U.S. election nears

By Gunjan Banerji

U.S. stocks turned in a second consecutive quarter of dramatic gains, continuing a historic stock-market recovery that few predicted in the depths of the March downturn.

The S&P 500 and Nasdaq Composite hit a string of records in the third quarter, a journey that has confounded many investors with its sheer velocity and strength. Despite a stretch of volatility that damped momentum in September, the S&P 500 and Dow Jones Industrial Average gained 8.5% and 7.6%, respectively, over the past three months.

The advances built on even bigger gains in the previous period, capping the best two-quarter performance since 2009. Both indexes are up more than 26% since the end of March. The Nasdaq Composite surged 11% in the third quarter and rose 45% over the past six months, its biggest two-quarter gain since 2000. ...

Still, there are plenty of potential challenges ahead for investors. Many are closely tracking the presidential election in November, wary that the result may not be known immediately. This has spurred bets on volatility through the end of the year in markets from derivatives to currencies and bonds.

“In the short term, both interest rates and risk sentiment have the potential to shift postelection, leading to sharp changes in equity prices,” Goldman Sachs analysts wrote in a note to clients. The firm expects the S&P 500 to hit 3600 by the end of the year, about a 7% jump from Wednesday’s close.

Despite the market’s gains since March, stocks are essentially back to where they started the year. The S&P 500 is up 4.1% for 2020, while the Dow industrials are down 2.7%. Only the tech-heavy Nasdaq Composite has clinched a meaningful gain for the year, up 24%. (Our MSCI ACWI AC benchmark was down 0.9% YTD.)

Among the big winners in the third quarter have been shares of home builders, which have benefited from an epic housing boom as the pandemic has created a historic shortage of homes for sale. Americans have been rushing to land more living space, anticipating they will continue working from home during the pandemic. ...

But shares of tech darlings and growth stocks stole the show again, and there have been exceptional moves by the U.S. stock market’s behemoths. Apple’s valuation crossed the $2 trillion mark, making the iPhone-maker bigger than entire global markets. The company’s shares soared 27% over the past three months.

And Tesla surged to a fresh high in August, gaining a market value of more than $400 billion. The shares have almost doubled in the third quarter.

Both stocks have been favorites among institutions, as well as individual investors, many of whom are new to trading stocks or have ramped up activity significantly this year. Some investors grew so optimistic about stocks like these that they turned to the derivatives markets to make aggressive bets on the market, fueling even greater gains at times.

Roadblocks emerged in the tail end of the quarter, pulling major indexes lower and crimping an epic run for the technology sector. The Nasdaq Composite fell into a correction territory—defined as at least a 10% drop from the recent high—just three sessions after hitting a record, the speediest-ever such fall. Although the index has since recovered some of the losses, the abrupt fall highlighted how fragile markets appear, and the uncertainty ahead. ...

Stock funds recently saw the biggest weekly outflows since 2018, according to Deutsche Bank. Meanwhile, traditionally safer investments like Treasurys and gold have done well, with gold prices jumping to an all-time high in July.

The yield on the 10-year U.S. Treasury note slipped in September to 0.677% as bond prices rose for the month, though yields ticked higher for the latest quarter.

Concerns remain that coronavirus infections could tick up in the colder months. For example, the daily share of people tested in New York City who are positive for Covid-19 recently hit 3.25% for the first time since June. Additionally, lawmakers so far haven't been able to agree on another stimulus bill for Americans.

The stock rally this quarter ignited greater debate about whether value stocks, those like cyclical companies with relatively low price-to-earnings ratios, would manage to soar past their faster-growing peers.

There has been a recent shift in market leadership between stocks that benefit from Americans' staying at home during the pandemic and those that would get a lift from a prolonged economic recovery, highlighting that much remains unknown about the path of the virus and economy.

But then this buried on page R2 of today's THIRD QUARTER **MARKETS REVIEW & OUTLOOK** section:

Value Stocks Beat Growth, in a Shift

BY CAITLIN MCCABE

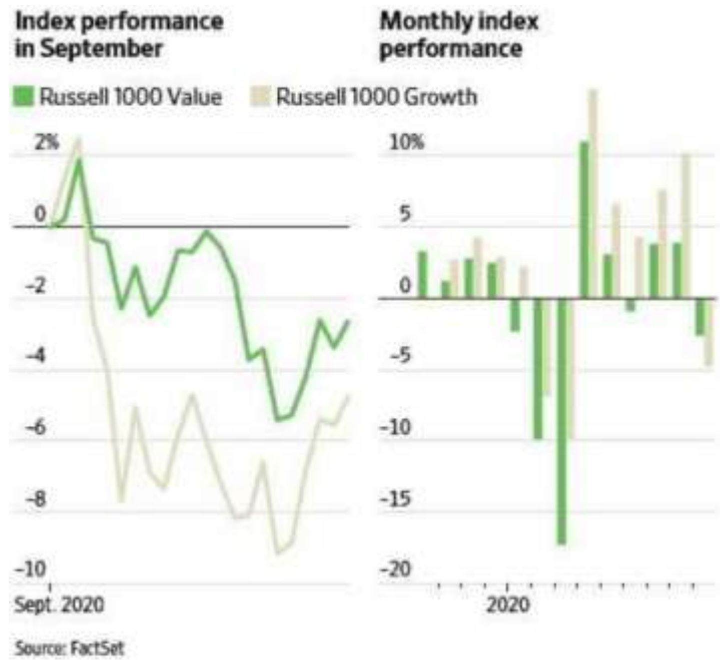
U.S. stocks just recorded their worst September performance in nearly a decade. For bargain-hunting investors who scooped up cheap stocks, however, the slump wasn't so bad.

Value stocks—often defined as companies whose shares trade at a low multiple of their book value, or net worth—outpaced growth stocks for the month as investors turned away from the fast-growing technology companies that had long powered the market higher. Instead, many investors looked for opportunities to scoop up shares in industries such as materials, transportation and utilities, many of which have been badly beaten down by the coronavirus pandemic this year.

The change in strategy pushed the Russell 1000 Growth Index down 4.8% for the month, ending its record 11-month winning streak over its value counterpart. The Russell 1000 Value Index, which measures the performance of large-cap value companies, fell just 2.6% in September. ...

Meanwhile, the S& P 500 fell 3.9% for the month, its steepest September loss since 2011. The index was dragged down by the recent pullback in megacap technology companies such as Amazon. Highflying momentum stocks like Tesla also pulled back. Shares of those companies lost 8.8% and 14%, respectively.

... A potential Democratic sweep of the White House and Congress might also offer a boost, as some analysts say they expect Democratic presidential candidate Joe Biden's corporate tax plan to more deeply impact some growth sectors, such as technology. Meanwhile, continued antitrust scrutiny of big tech companies from both presidential candidates could also weigh on the growth trade, market observers say.



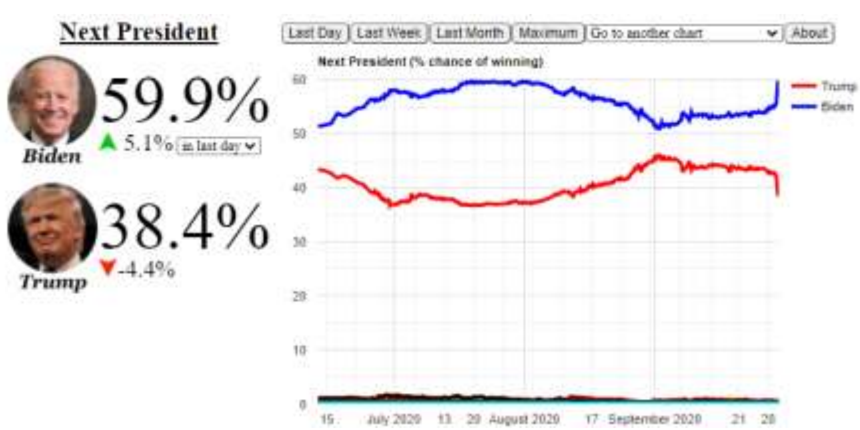
Even more, they say, as investors continue to look for gains in an environment with near-zero interest rates, many value stocks offer a promise of dividend yield. ...

Growth stocks, or those that offer higher-than-average profit growth, have largely driven U.S. stocks higher for more than a decade, led by megacap technology companies that have posted eye-popping gains. Even with its September outperformance, the Russell 1000 Value Index is still down 13% in 2020, compared with the 23% gain that the Russell 1000 Growth Index has posted.

Yet some investors and analysts argue that the recent out-performance of value stocks might be more enduring—and already, small signs of a shifting tide have emerged. A September Bank of America survey found a greater number of fund managers expect value to outperform growth over the next 12 months, a reversal from the month before. ...

In case you were in doubt about who loss Tuesday night's debate. From Bespoke yesterday:

The initial reaction to last night's debates in the betting markets was clearly in Biden's favor. Over at electionbettingodds.com, the odds for Biden to win the November election jumped back nearly to new highs after rising 4.9 percentage points in the last day to just under 60%. Trump's odds, conversely, dropped more than four points to below 40%.

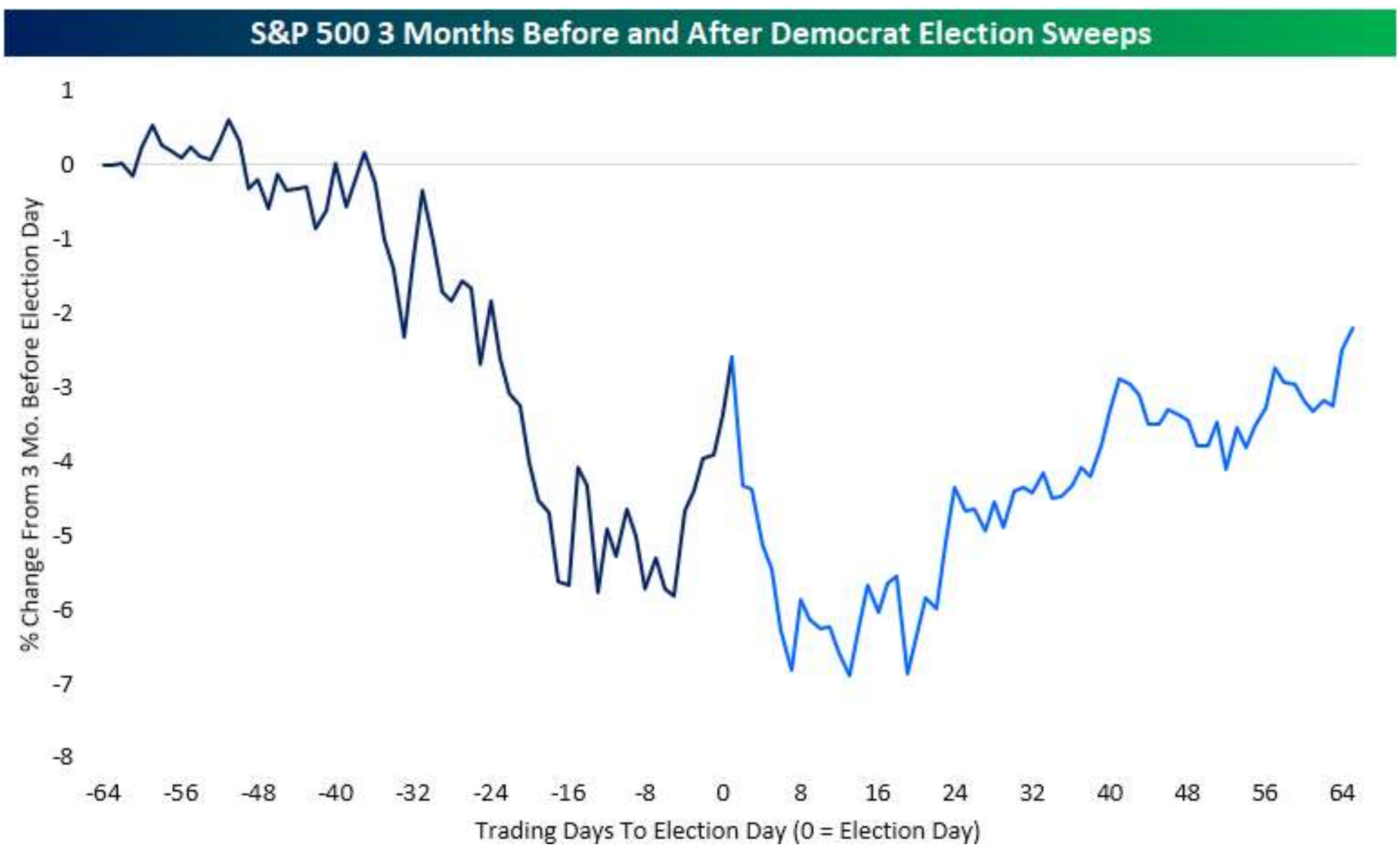


What Have Democratic Sweeps Meant for the S&P 500?

Wed, Sep 30, 2020

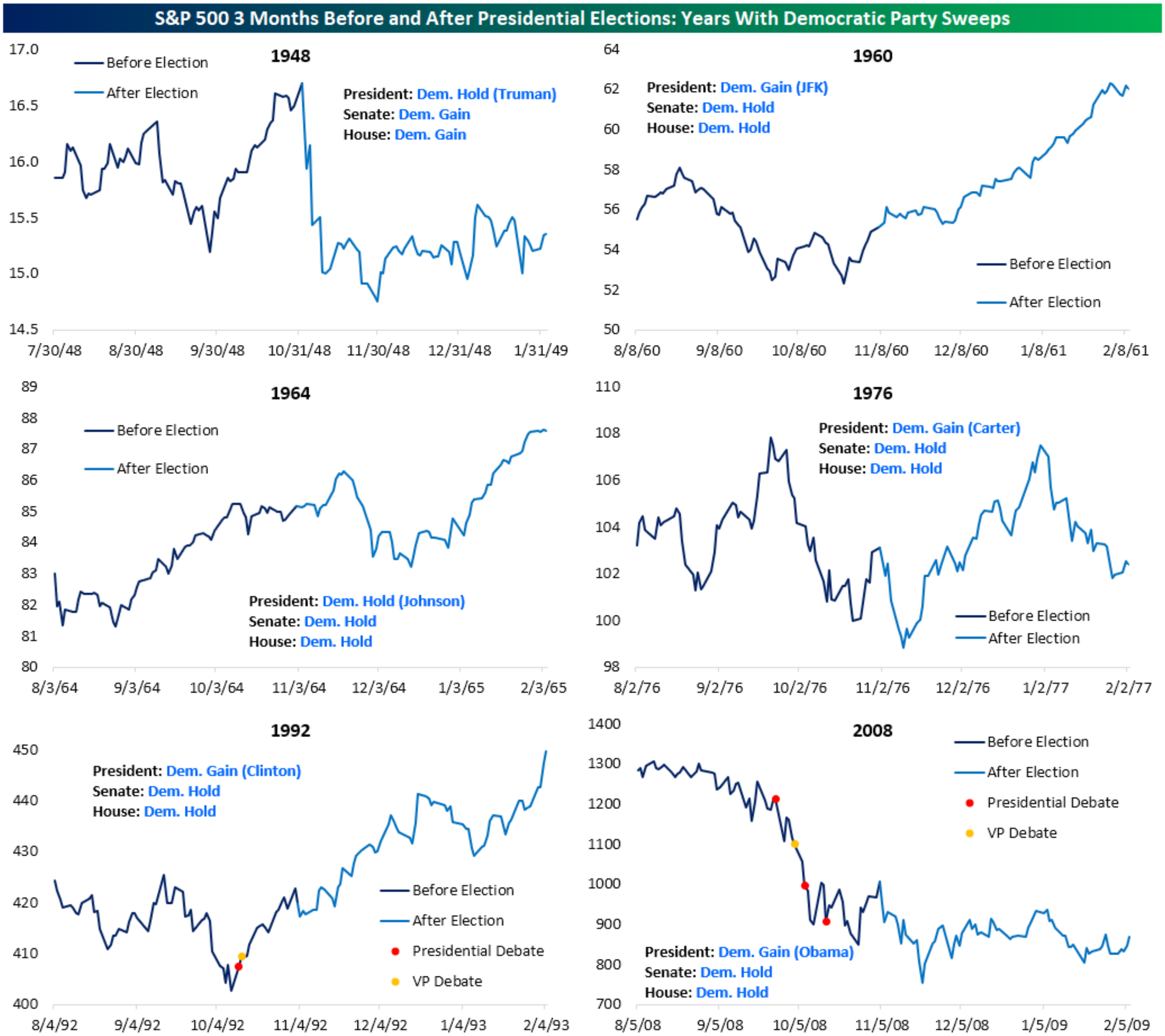
Headed into the first presidential debate Tuesday night, betting markets (ElectionBettingOdds.com) placed Democratic candidate Joe Biden as the slight favorite to take the White House in November. The debate resulted in Biden gaining another 5 percentage point chance of winning the Presidency. As of this morning, Biden's odds to win are at 59.8% versus Trump's odds of 38.9%. (We would be willing to place a very large bet on Biden at 60/40.) Additionally, Democrats are slight favorites to win control of the Senate (58.4% to 41.5%) and big favorites to maintain the House (82.8% to 17.1%). Given these odds, in the chart below we show the average performance of the S&P 500 from the three months before Election Day through three months after Election Day for all election years post-WWII that **resulted in a sweep of the executive and legislative branch by the Democrats**.

As shown, on average the S&P 500 has been on the decline in the weeks leading up to Election Day, though in the days just before the Election there has been a small rally that sharply reverses once the results come in. After the initial post-Election drop, the market has trended a bit higher, but by three months after the Election, it has only found itself around the same levels as Election Day; on average a 2.6% loss versus where the index stood three months prior.



The composite shown above is comprised of six different years: 1948, 1960, 1964, 1976, 1992, and 2008. While on average the S&P 500 has traded lower, it is not necessarily a sure-fire thing. For example, 1948 and 2008 were the only years that saw the S&P 500 trade and stay significantly lower in the wake of the election. In

1976, there was similarly a sell-off in the immediate aftermath of the election, but the index did make its way back up to the highs of that six-month time frame later on albeit no new high was put in place. Meanwhile, 1960, 1964, and 1992 all saw the S&P 500 run higher after the election even despite some periods of consolidation after initial moves higher. ...



From NYT:

Is the Stock Market Rooting for Trump or Biden?

Neither. Wall Street is not as partisan as you think.

By **Ruchir Sharma**

Sept. 21, 2020

For months the S&P 500 rose this year — despite a deadly pandemic, the resulting economic devastation and the rise of a Democratic Party increasingly sympathetic to democratic socialism. Then, this month, with Joe Biden doing well in the polls, stock prices finally stumbled.

If polls continue to point to a Biden victory in the 2020 presidential election, pundits will be tempted to see any further tremors in the stock market as expressing a concern about the economic priorities of a Democratic president. But the idea that the market favors a particular candidate or party, though widespread, is wrong.

My research, which reaches back to the 1860s, when the two-party political system began to dominate, shows that the market has no clear bias in favor of either party and that market volatility in the run-up to an election is perfectly normal.

The market is an economic barometer, not a political one. To be sure, its collective mind pays attention to presidential politics, but as just one of many factors that can influence the direction of the economy. The leader that the market listens to most carefully is the head of the Federal Reserve, not the president. When states started imposing lockdowns in March, the market suffered a drastic crash, but then the Fed and the Treasury rushed in with promises of trillions of dollars to keep businesses afloat, and the market bounced back.

This month's market tremors are best explained by growing concern about Congress's failure to pass a new spending bill and about the prospect of a contested election — not the prospect that Mr. Biden might win.

Indeed, the market seems to like a fresh face in the White House. Since the late 1860s, nine presidents have been elected to consecutive terms and have served at least five years. Eight of them saw higher market returns in their first term than in their second, often much higher. (Ronald Reagan was the exception.) First-term returns averaged 83 percent, second-term returns just 28 percent. This finding is consistent with research on the "second-term curse," which shows that underlying economic conditions tend to decline in a president's second term.

Likewise, there have been 16 elections since 1869 in which an incumbent finished a full term, and was fighting for a second. In general the markets do much better after an incumbent loses.

It's worth noting that underlying economic conditions, including G.D.P. growth and inflation, have tended to be more favorable under Democratic presidents, which can make it seem as if markets prefer a Democrat in the White House. Since 1869, the average market return over the course of a full presidential term was 68 percent under a Democratic president and 52 percent under a Republican.

But the connection between economic health and a Democrat in the White House is largely coincidental. Politicians can influence but not control the business cycle. Economic factors, not partisan bias, provide the best explanation for why markets have performed better under Democrats.

Another clear pattern, based on data going back to the 1920s, is that markets grow more volatile in the three months before an election. Whatever upset the market this month, the volatility started right on time, historically speaking.

All of this casts doubt on the widespread assumption that Wall Street is rooting for a Trump win. The related notion, that Wall Street is rooting against a Biden win because of his party's leftward drift, also does not jibe with what many leading investors are saying and writing.

These investors believe that despite Mr. Biden's left-leaning campaign rhetoric, he will govern more moderately when in office, raising taxes and regulation while decreasing tensions over immigration, global trade and China. That mix would have some effect on which economic sectors do best during a Biden presidency, but little effect on the market's overall direction.

More important, the market cares less about who leads the free world than who leads the Fed. Low interest rates make stocks look more attractive, so the Fed's policies in recent years have been turbocharging stock prices. The U.S. stock market is currently more expensive than at any time other than the dot-com bubble of 1999 to 2000, according to some measures.

What happens next in the market depends mainly on the direction of the economy and on interest rates. If over the coming months the economy keeps recovering but long-term interest rates start to rise rapidly, the market could actually decline — a mirror image of this year's market boom and economic bust.

Many traders, eager to see the market rally continue, are arguing that if Mr. Biden wins he will bring in leadership at the Fed that will be even more aggressive about keeping interest rates low. That's another reason Wall Street isn't too worried about who will be the next president, and more than anything else just wants the election to be over.

Ruchir Sharma is the chief global strategist at Morgan Stanley Investment Management, the author, most recently, of "The Ten Rules of Successful Nations" . ...

Our job is to make money for our clients. That doesn't mean that we are unaware of the economic suffering that so many are living through during this latest recession. While Trump claims that we are in a "V" shaped recovery, it is clearly "K" shaped. From this morning's The Finance 202:

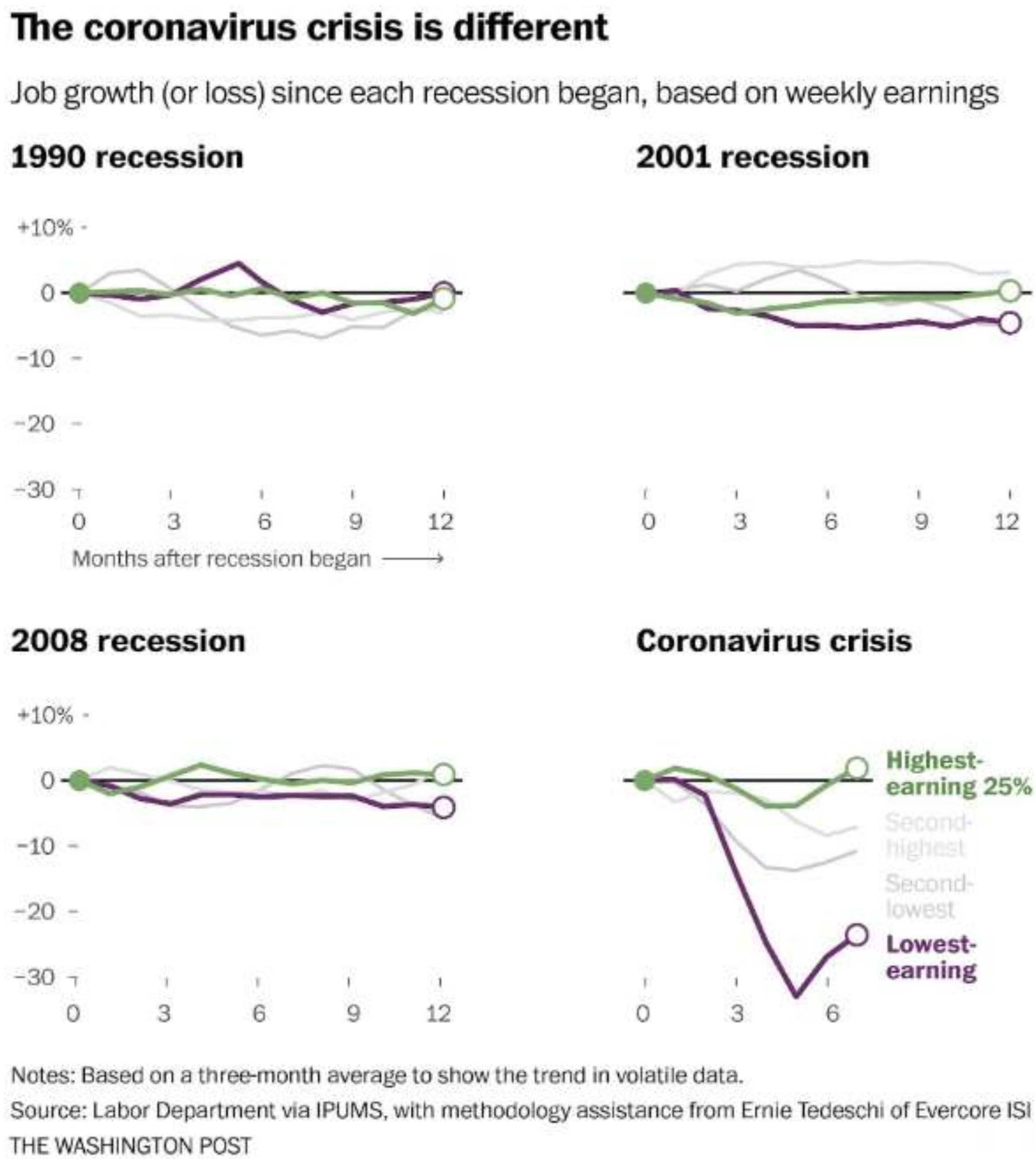
Yet as investors in publicly traded companies see gains, thousands of their workers are seeing pink slips. Just this week:

- **Disney announced it will fire 28,000 workers** across its U.S. theme-park division. Roughly two-thirds of them are part-time employees.
- **American Airlines will start furloughing 19,000 workers** immediately, blaming Washington's failure to reach an agreement on a relief package that could have included $25 billion in aid to airlines. It represented the leading edge of what could amount to 30,000 job losses in the industry.
- **Royal Dutch Shell said it will cut up to 9,000 jobs**, part of a wholesale corporate overhaul as it moves toward low-carbon energy.
- **Allstate is laying off 3,800 employees**, or about 8 percent of its workforce.
- **Dow Inc. said it will cut 6 percent from its global "workforce costs,"** without specifying a number of employees affected.

Across the economy, this recession is hitting poorer households harder than any in generations.

"While the nation overall has regained nearly half of the lost jobs, several key demographic groups have recovered more slowly, including mothers of school-age children, Black men, Black women, Hispanic men, Asian Americans, younger Americans (ages 25 to 34) and people without college degrees," a deep analysis of government employment data by Heather, Andrew Van Dam, Alyssa Fowers and Leslie Shapiro finds. ...

“No other recession in modern history has so pummeled society’s most vulnerable,” they write, noting that the Great Recession by contrast delivered pain across the income spectrum.



At the peak of the crisis, “low-wage jobs were lost at about eight times the rate of high-wage ones, The Post found,” per our colleagues. “The devastation was deepest among the lowest-paid, but middle-class jobs were not spared. A clear trend emerged: The less workers earned at their job, the more likely they were to lose it as businesses across the country closed.”

“By the end of the summer, the downturn was largely over for the wealthy — white-collar jobs had mostly rebounded, along with home values and stock prices. **The shift to remote work strongly favored more-educated workers, with as many as 6 in 10 college-educated employees working from home at the outset of the crisis, compared with about 1 in 7 who have only high school diplomas.”** ...

To make matters worse for those on the brink, potentially millions of them are now facing the prospect of “utility shut-offs and fast-growing debts they may never be able to repay,” Tony Romm reports. Only 21 states and the District of Columbia still have bans on utility shutoffs in place, which “leaves roughly 179 million Americans at risk of losing service even as the economy continues sputtering.”

From yesterday's Global Investment Strategy's **Fourth Quarter 2020 Strategy Outlook: A Post-Pandemic Regime Shift:**

I. Macroeconomic Outlook

Policy And The Pandemic Will Continue To Drive Markets

Going into the fourth quarter of 2020, we are tactically neutral on global equities but remain overweight stocks and other risk assets on a 12-month horizon.

As has been the case for much of the year, both the virus and the policy response to the pandemic will continue to be key drivers of market returns.

Coronavirus: Still Spreading Fast, But Less Deadly

On the virus front, the global number of daily new cases continues to trend higher, with the 7-day average reaching a record high of nearly 300,000 this week (**Chart 1**).

The number of daily new cases in the EU has risen above its April peak. Spain and France have been particularly hard hit. Canada is also seeing a pronounced rise in new cases.

In the US, the number of new cases peaked in July. However, the 7-day average has been creeping up since early September, raising the risk of a third wave.

On the positive side, mortality rates in most countries remain well below their spring levels.

There is no clear consensus as to why the virus has become less lethal. Better medical treatments, including the use of low-cost steroids, have certainly helped. A shift in the incidence of cases towards younger, healthier people has also lowered the overall mortality rate.

In addition, there is some evidence that the virus may be evolving to be more contagious but less deadly. It would not be surprising if that were the case. After all, a virus that kills its host will also kill itself.

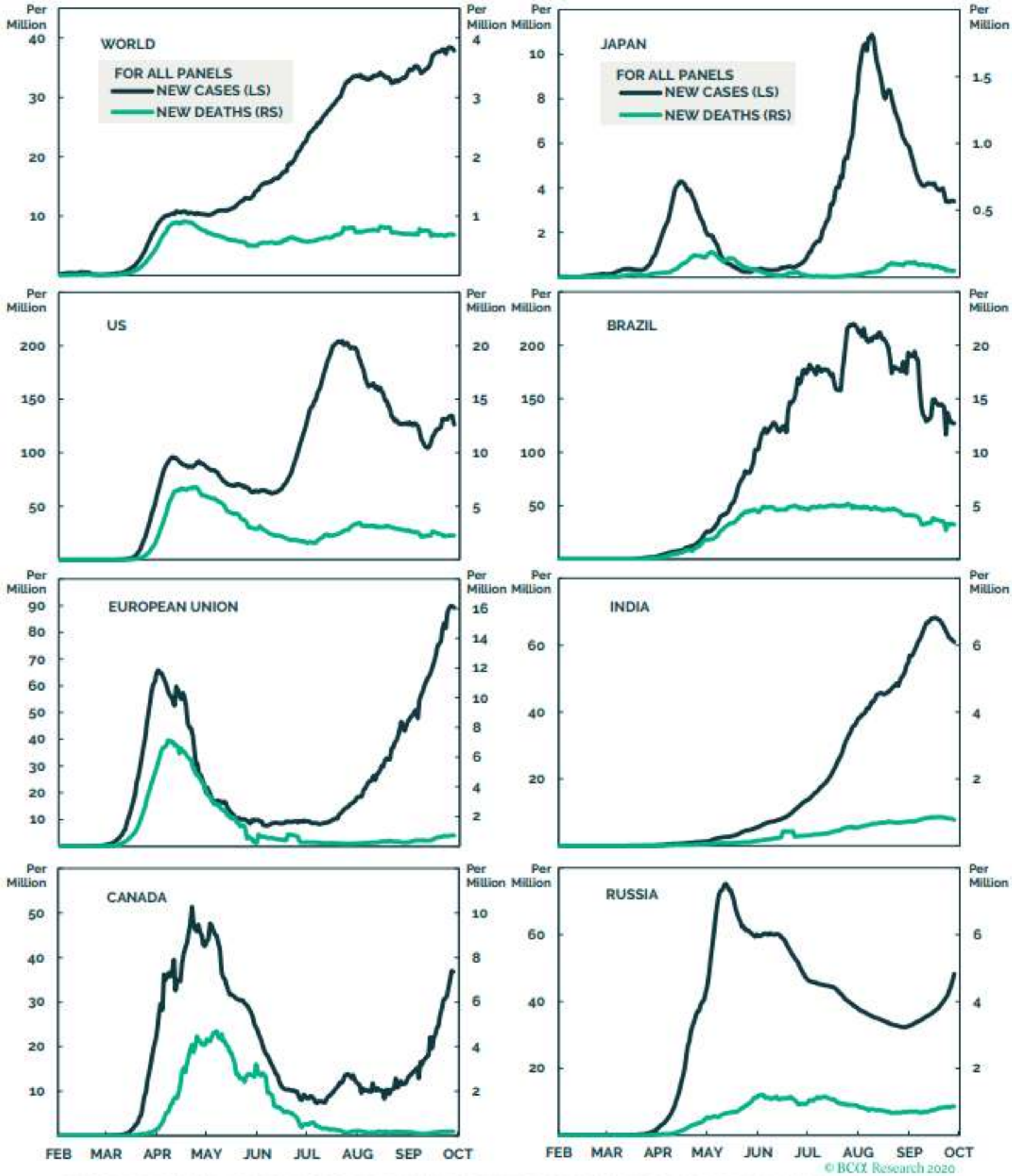
Lastly, pervasive mask wearing may be mitigating the severity of the disease by reducing the initial viral load that infected individuals receive. A smaller initial dose gives the immune system more time to launch an effective counterattack. ...

Waiting For A Vaccine

Despite the decline in mortality rates, there is still much that remains unknown about Covid-19, including the extent to which the disease will lead to long-term damage to the vascular and nervous systems. Thus, while governments are unlikely to impose the same sort of severe lockdown measures that they implemented in March, rising case counts will delay reopening plans, and in many cases, lead to the reintroduction of stricter social distancing rules.

CHART 1

Globally, The Number Of Daily New Cases Continues To Trend Higher



SOURCE: THE CENTER FOR SYSTEMS SCIENCE AND ENGINEERING (CSSE) AT JOHN HOPKINS UNIVERSITY AND THE EUROPEAN CENTRE FOR DISEASE PREVENTION AND CONTROL.
NOTE: SHOWN AS A 7-DAY MOVING AVERAGE.

This has already happened in a number of countries. The UK reinstated more stringent regulations over social gatherings last week, including ordering pubs and restaurants to close by 10pm. Spain has introduced tougher mobility restrictions in Madrid and surrounding municipalities. France ordered gyms and restaurants to close for two weeks. Canada has also tightened regulations, with the government of Quebec raising the alert level to maximum “red alert” in several regions of the province.

In the US, the share of the population living in states that were in the process of relaxing lockdown measures has risen above 50% for the first time since July. A third wave would almost certainly forestall the recent reopening trend.

Ultimately, a safe and effective vaccine will be necessary to defeat the virus. Fortunately, about half of experts polled by the Good Judgment Project expect a vaccine to become available by the first quarter of 2021. Only 2% expect there to be no vaccine available by April 2022, down from over 50% in May.

Premature Fiscal Tightening And The Risk of Second-Round Effects

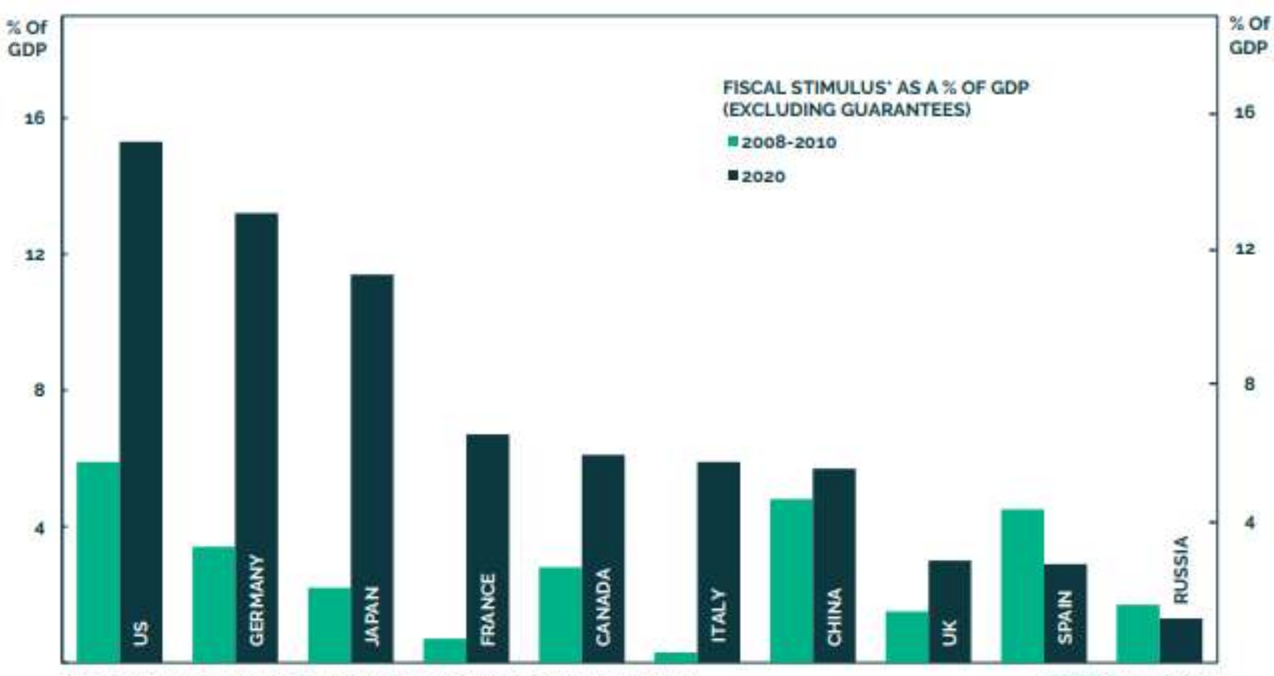
Even if a vaccine becomes available early next year, there is a danger that the global economy will have suffered enough damage over the intervening months to forestall a rapid recovery.

Whenever an economy suffers an adverse shock, a feedback loop can develop where rising joblessness leads to less spending, leading to even more joblessness.

Fiscal stimulus can short-circuit this vicious circle by providing households with adequate income to maintain spending.

Fiscal policy in the major economies turned expansionary within weeks of the onset of the pandemic (**Chart 4**). In the US, real personal income growth actually accelerated in the spring because transfers from the government more than offset the loss in wage and salary compensation.

CHART 4
Fiscal Policy Has Been Very Stimulative This Year



NOTE: LOAN GUARANTEES ARE EXCLUDED IF THERE IS A SPECIFIC AMOUNT IN THE NEWS.
* SOURCE: VARIOUS NEWS AND GOVERNMENT AGENCIES, BROOKINGS, THE IMF, AND BCA CALCULATIONS.

Starting in August, US fiscal policy turned less accommodative. ... regular weekly unemployment payments have fallen from around $25 billion to $8 billion since the end of July. At an annualized rate, this amounts to over 4% of GDP in fiscal tightening. While President Trump signed an executive order redirecting some of the money that had been earmarked for the Federal Emergency Management Agency (FEMA) to be given to unemployed workers, the available funding will run out within the next month or so. On top of that, the funds in the small business Paycheck Protection Program have been used up, while many state and local governments face a severe cash crunch.

US households saved a lot going into the autumn, so a sudden stop in spending is unlikely. Nevertheless, fissures in the economy are widening. Core retail sales contracted in August for the first time since April. Consumer expectations of future income growth remain weak.

Permanent job losses are rising faster than they did during the Great Recession (**Chart 8**). Both corporate bankruptcy and mortgage delinquency rates are moving up, while bank lending standards have tightened significantly (**Chart 9**).

CHART 8

Permanent Job Losses Are Rising Faster Than They Did During The Great Recession

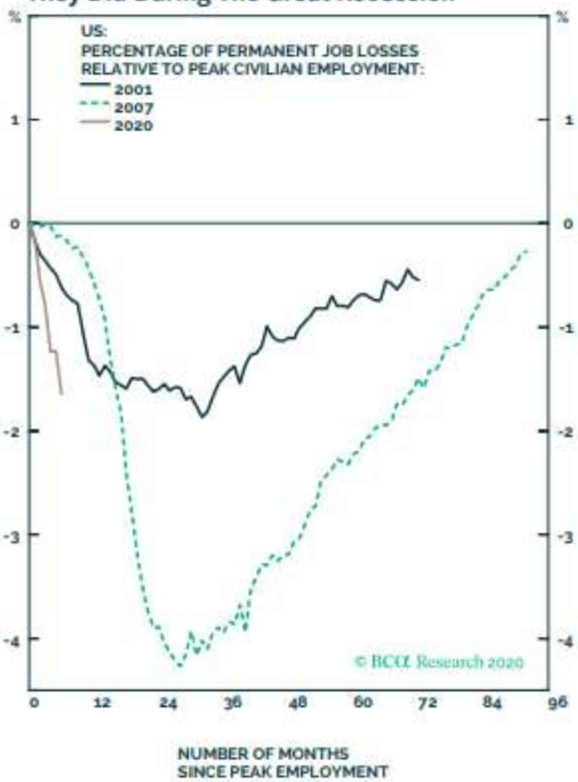
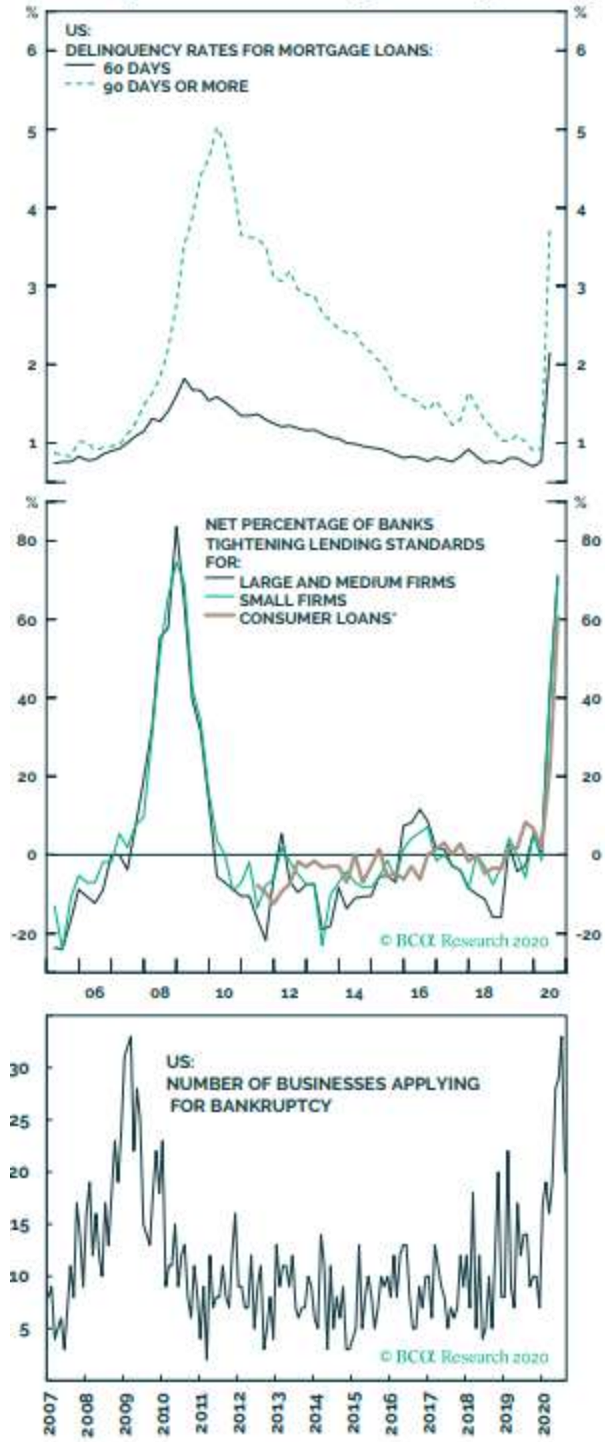


CHART 9

Corporate Bankruptcy And Mortgage Delinquency Rates Are Moving Up ... While Bank Lending Standards Have Tightened Significantly

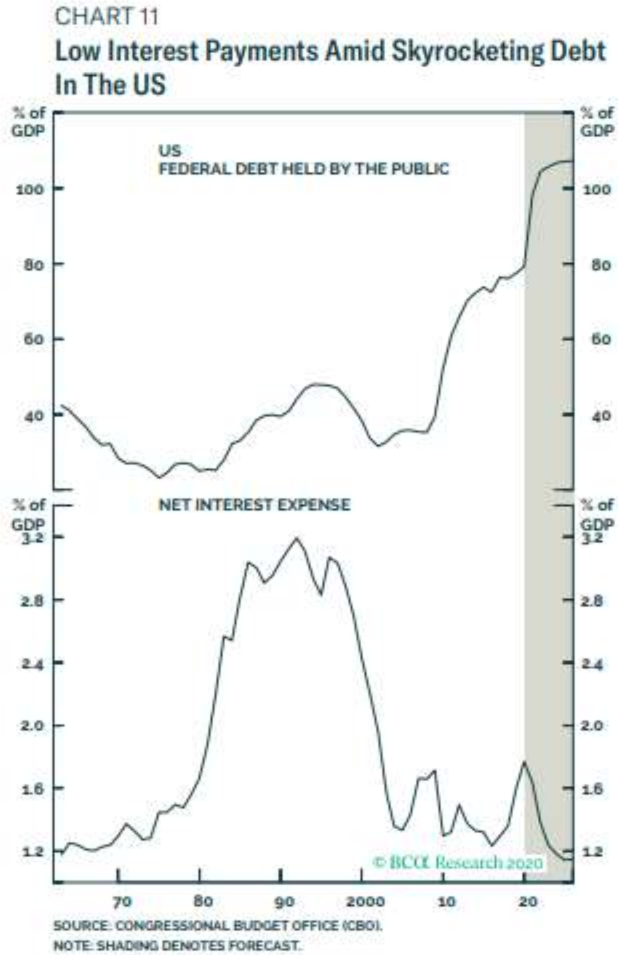


* EXCLUDES CREDIT CARDS AND AUTO LOANS.
NOTE: BLOOMBERG FINANCE L.P., MORTGAGE BANKERS ASSOCIATION, AND FEDERAL RESERVE (SENIOR LOAN OFFICER SURVEY) DATA.

Fiscal Stimulus Will Return

We ultimately expect US fiscal policy to turn accommodative again. There is no appetite for fiscal austerity. Both political parties are moving in a more populist direction, which usually signals larger budget deficits. Even among Republicans, more registered voters support extending emergency federal unemployment insurance payments than oppose it.

As long as interest rates stay low, there will be little market pressure to trim budget deficits. US real rates remain in negative territory. Despite a rising debt stock, the Congressional Budget Office expects net interest payments to decline towards 1% of GDP over the span of the next couple of years, thus reaching the lowest level in six decades (**Chart 11**).



Outside the US, there has been little movement towards tightening fiscal policy. The UK government unveiled last week a fresh round of economic and fiscal measures to help ease the burden on both employees, by subsidizing part-time work for example, and firms, by extending government-guaranteed loan programs. At the beginning of the month, the Macron government announced a 100 billion euro stimulus plan in France. Meanwhile, European leaders are moving forward on a euro area-wide 750 billion euro stimulus package that was announced this summer.

In Japan, the new Prime Minister Yoshihide Suga has indicated that he will pursue a third budget to fight the economic downturn, adding that "there is no limit to the amount of bonds the government can issue to support an economy battered by the coronavirus pandemic." The Japanese government now earns more interest than it pays because two-thirds of all Japanese debt bears negative yields. At least for now, a big debt burden is actually good for the Japanese government's finances!

China also continues to stimulate its economy. Jing Sima, BCA's chief China strategist, expects the broad-measure fiscal deficit to reach a record 8% of GDP this year and remain elevated into next year. The annual change in total social financing – a broad measure of Chinese credit formation – is expected to hit 35% of GDP, just shy of its GFC peak.

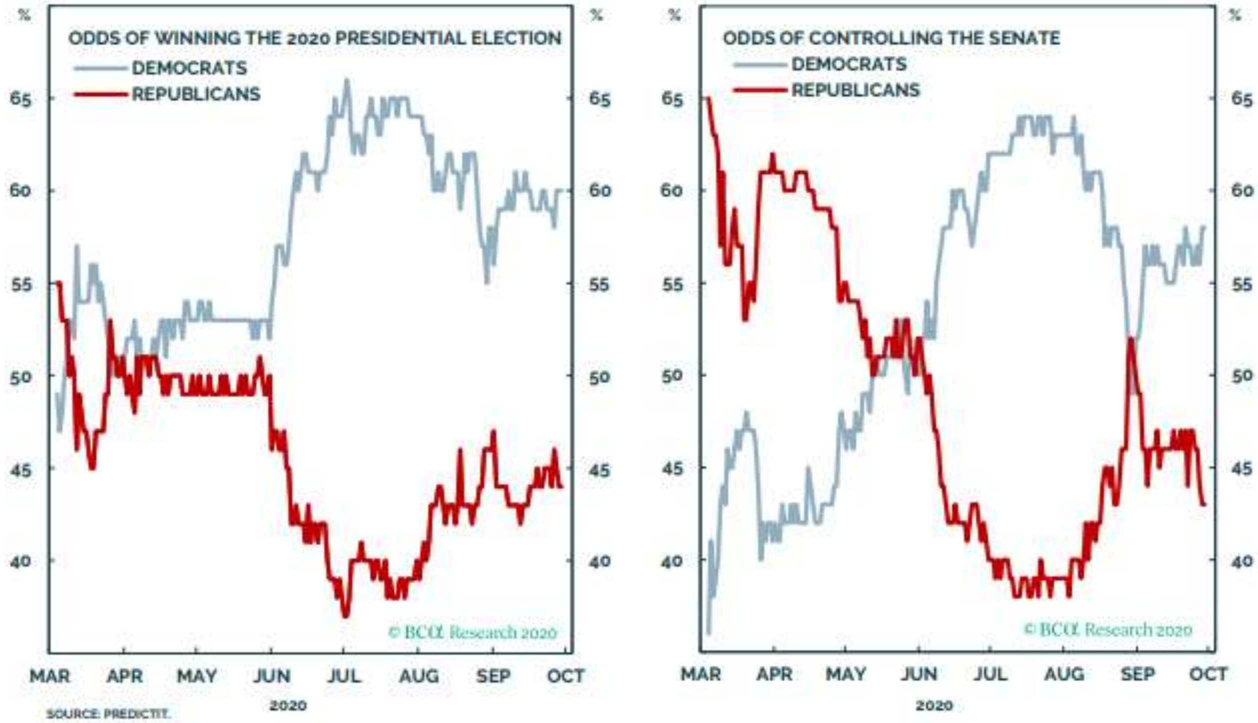
Not surprisingly, the Chinese economy is responding well to all this stimulus. Sales of floor space rose 40% year-over-year in August, driven by a close to 60% jump in Tier-1 cities. Excavator sales, a leading indicator for construction spending, are up 51% over last year's levels, while industrial profits have jumped 19%. A resurgent Chinese economy has historically been closely associated with rising global trade.

Biden Or Trump: How Will Financial Markets React?

Betting markets expect former Vice President Joe Biden to become president and for the Democrats to gain control of the Senate (**Chart 15**). A "blue wave" would produce more fiscal spending in the next few years. Recall that House Democrats passed a $3.5 trillion stimulus bill in May that was quickly rejected by Senate Republicans. More recently, Democratic leaders have suggested they would approve a stimulus deal in the range of $2-to-$2.5 trillion.

In addition to more pandemic-related stimulus, Joe Biden has also proposed a variety of longer-term spending initiatives. These include $2 trillion in infrastructure spending spread over four years, a $700 billion "Made in America" plan that would increase federal procurement of domestically produced goods and services, and new spending proposals worth about 1.7% of GDP per annum centered on health care, housing, education, and child and elder care.

CHART 15
Betting Markets Putting Their Money On The Democrats



As president, Joe Biden would likely take a less confrontational stance towards relations with China. While rolling back tariffs would not be an immediate priority for a Biden administration, it could happen later in 2021.

Less welcome for investors would be an increase in taxes. Joe Biden has proposed raising taxes by $4 trillion over ten years (about 1.5% of cumulative GDP). Slightly less than half of that consists of higher personal taxes on both regular income (for taxpayers earning more than $400,000 per year) and capital gains (for tax filers with over $1 million in income). The other half consists of increased business taxes, mainly in the form of a hike in the corporate tax rate from 21% to 28% and the introduction of a minimum 15% tax on the global book income of US-based companies.

Netting it out, a blue sweep in November would probably be neutral-to-slightly negative for equities. What about government bonds? Our guess is that Treasury yields would rise modestly in response to a blue wave, particularly at the longer end of the yield curve. Additional fiscal support would boost aggregate demand, implying that it would take less time for the economy to reach full employment. That said, interest rate expectations are unlikely to rise as sharply as they did in late 2016 following Donald Trump's victory. Back then, the Fed was primed to raise rates – it hiked rates nine times starting in December 2015, ultimately bringing the fed funds rate to 2.5% by end-2018. This time around, the Fed is firmly on hold, with the vast majority of FOMC members expecting policy rates to stay at rock-bottom levels until at least 2023.

The Fed's New Tune

In two important respects, the Fed's new Monetary Policy Framework (MPF) represents a sharp break with the past.

First, the MPF abandons the Fed's historic ... lifting rates whenever the unemployment rate declines towards its equilibrium level.

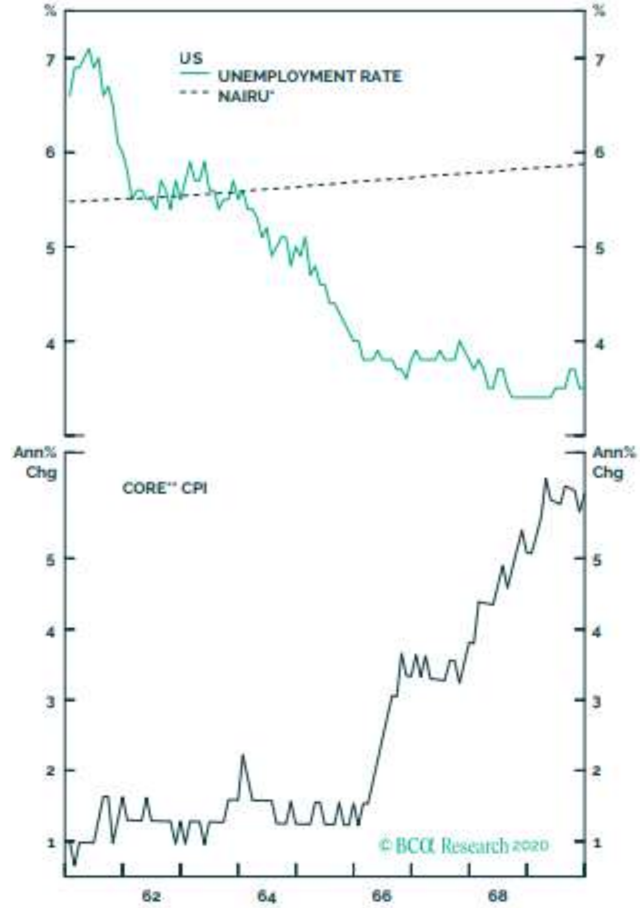
Second, the MPF eschews the “let bygones be bygones” approach of past monetary policymaking. Going forward, the Fed will try to maintain an average level of inflation of 2% over the course of the business cycle. This means that if inflation falls below 2%, the Fed will try to engineer a temporary inflation overshoot in order to bring the price level back up to its 2%-per-year upward trend. ...

A Bias Towards Higher Inflation

Despite the advantages of the Fed’s new approach, it faces a number of hurdles, some practical and some political.

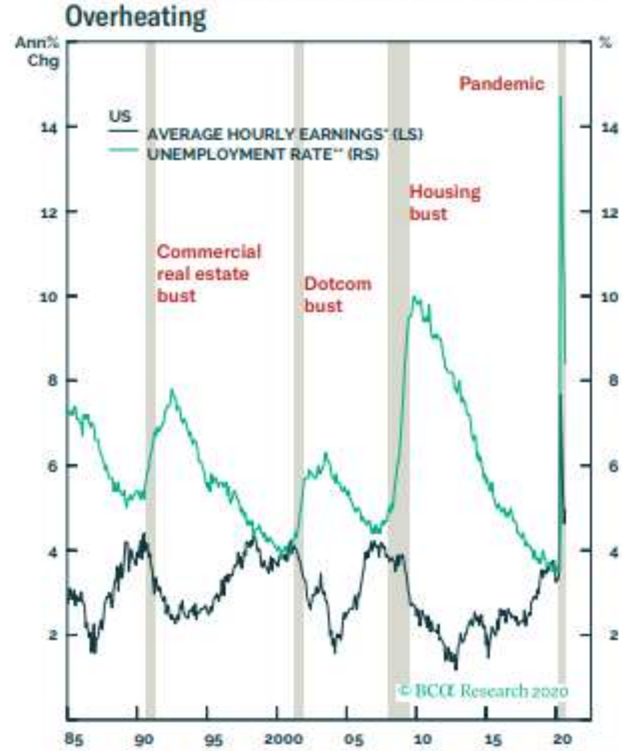
... inflation could remain stubbornly dormant as slack slowly disappears, only to rocket higher once full employment has been reached. Since changes in monetary policy only affect the economy with a lag, the central bank could find itself woefully behind the curve, scrambling to contain rising inflation. This is precisely what happened during the 1960s (**Chart 17**).

CHART 17
Inflation Started Accelerating Quickly Only When Unemployment Reached Very Low Levels In The 1960s



Over the past three decades, something always happened that kept the US economy from overheating (**Chart 18**). The unemployment rate reached a 50-year low in 2019. Inflation may have moved higher this year had it not been for the fact that the global economy was clotheslined by the pandemic. In 2007, the economy was heating up only to be sandbagged by the housing bust. In 2000, the bursting of the dotcom bubble helped reverse incipient inflationary pressures. But just because the economy did not have a chance to overheat at any time over the past 30 years does not mean it cannot happen in the future.

CHART 18
Something Has Always Happened To Preempt Overheating



* TOTAL PRIVATE NONFARM OF PRODUCTION AND NONSUPERVISORY EMPLOYEES.
** AGES 25-54.
SHADING DENOTES NBER-DESIGNATED RECESSIONS.

The Political Economy Of Higher Inflation

On the political side, average inflation targeting assumes that central banks will be just as willing to tolerate inflation undershoots as overshoots. This could be a faulty assumption. Generating an inflation overshoot requires that interest rates be kept low enough to enable unemployment to fall below its full employment level. That is likely to be politically popular.

Generating an inflation undershoot, in contrast, requires restrictive monetary policy and rising unemployment. More joblessness would not sit well with workers. High interest rates could also damage the stock market and depress home prices, while forcing debt-saddled governments to shift more spending from social programs to bondholders. None of that will be politically popular.

If central banks are quick to allow inflation overshoots but slow to engineer inflation undershoots, the result could be structurally higher inflation. Markets are not pricing in such an outcome.

II. Financial Markets

Global Asset Allocation: Despite Near-Term Dangers, Overweight Equities On A 12-Month Horizon

An acceleration in the number of COVID19 cases and the rising probability that the US Congress will fail to pass a stimulus bill before the November election could push equities and other risk assets lower in the near term. Investors should maintain somewhat larger than normal cash positions in the short run that can be deployed if stocks resume their correction.

Provided that progress continues to be made towards developing a vaccine and US fiscal policy eventually turns stimulative again, stocks will regain their footing, rising about 15% from current levels over a 12-month horizon.

Negative real bond yields will continue to support stocks. The 30-year TIPS yield has fallen by over 90 basis points in 2020. Even if one assumes that it will take the rest of the decade for S&P 500 earnings to return to their pre-pandemic trend, the deep drop in the risk-free component of the discount rate has still raised the present value of future S&P 500 cash flows by nearly 20% since the start of the year.

Thanks to these exceptionally low real bond yields ... The TINA mantra reverberates throughout the investment world: There Is No Alternative to stocks. (The relevant recommendations that followed were largely shared in our 9/20/20 Worth Sharing - Patience, which is posted on HCM's website.)

The End Game

What will end the bull market in stocks? As is often the case, the answer is tighter monetary policy. The good news is tight money is not an imminent risk. The Fed will not hike rates at least until 2023, and it will take even longer than that for interest rates to rise elsewhere in the world. The bad news is that the day of reckoning will eventually arrive and when it does, bond yields will soar and stocks will tumble. ...

From Morningstar:

Can You Predict the Next Downturn?

The longer the time period, the stronger the pattern.

John Rekenthaler

Sep 24, 2020

A reader asked:

"Looking at current 10-year returns gives me a sinking feeling in the pit of my stomach which I have experienced twice before, during the tech bubble and the financial crisis. Is there any data regarding

significantly higher 10-year returns being negatively correlated with lower subsequent 10-year returns (like the tech boom followed by the 'lost decade')?"

My initial answer is that there is a loose inverse relationship between past and future 10-year returns, but so loose that one cannot make money off that information. This column provides the figures to defend--or refute--that assertion. In addition to showing the results of 10-year returns, I also examine five- and 20-year periods.

The data series begins in 1926, not because that year was particularly memorable for equities, but instead because it commences Ibbotson's Stocks, Bonds, Bills, and Inflation database (which is owned by Morningstar). The returns, from Ibbotson's Large Stock Index, are monthly and real, meaning that they adjust for the effects of inflation. (Using nominal returns would be grievously misleading, given how greatly the rate of inflation has fluctuated.)

Each of the three following charts contains three lines:

Blue represents the average annualized return for the past rolling time period. Thus, for the five-year chart, the 11% amount that is shown above the year 1931 represents stocks' annualized gain from the years 1926 through 1930.

(I was surprised that the 1926-30 results were so resoundingly positive, but despite the lore surrounding October 1929's Black Thursday, the worst Great Depression stock-market returns came later, in 1931 and 1937.)

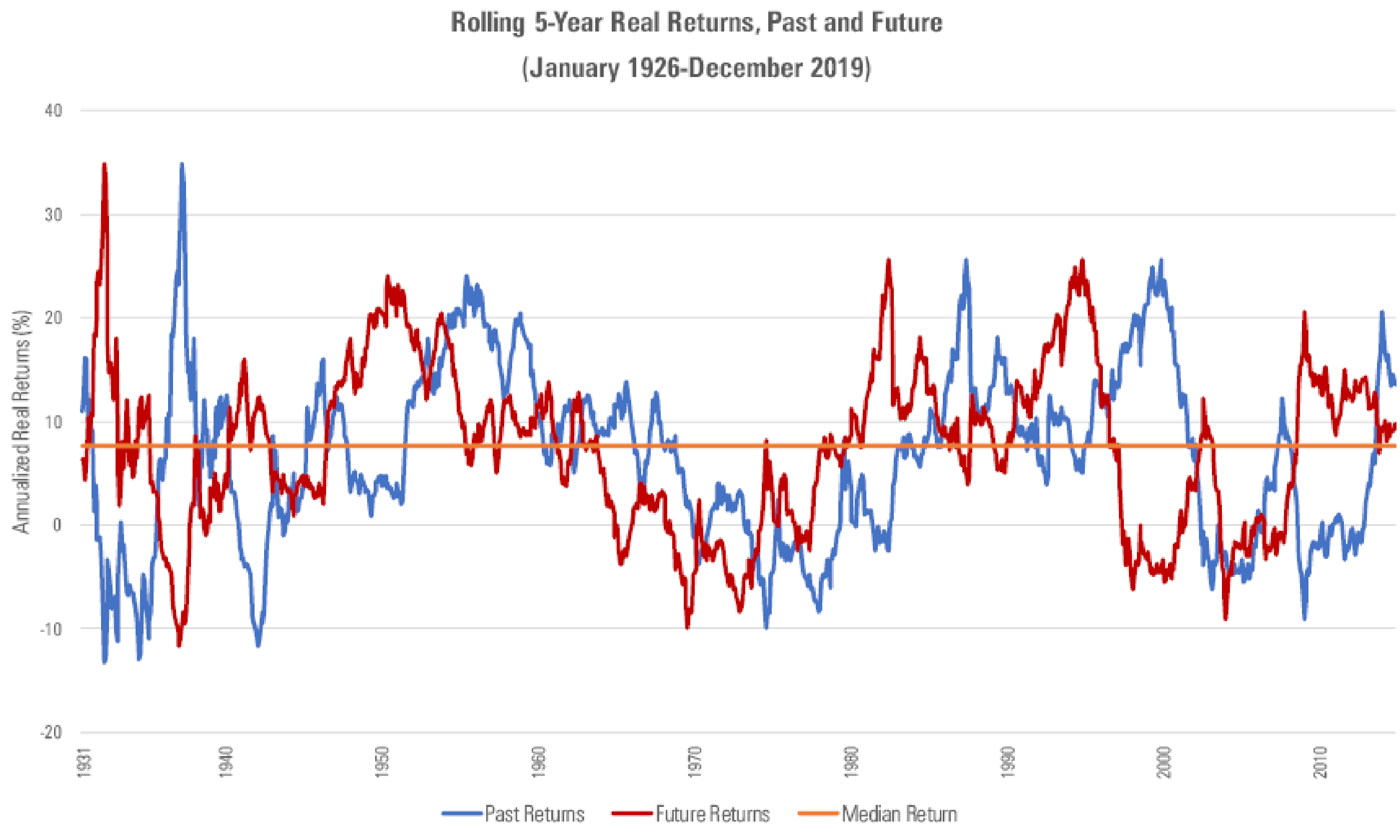
Red represents the average annualized return for the future rolling returns. Thus, for the five-year chart, the 6.35% amount that is shown above the year 1931 represents stocks' annualized gain from the years 1931 through 1935.

(Once again, I was surprised. Stocks profited during the heart of the Great Depression? Yes they did, at times, although that red line soon plunges. Not only did Wall Street periodically rally, but the nation underwent steep deflation, thereby boosting the real value of equities.)

Orange represents the median return for the rolling time periods.

Interpreting the pictures is therefore straightforward. If, for a given date, the blue and red lines land on opposite sides of the orange line, then past returns were an inverse indicator of future results. High past returns led to low future returns, or vice versa. If, on the other hand, the blue and red lines place on the same side of the orange line, then the signal failed. Strong begat strong, or weak begat weak.

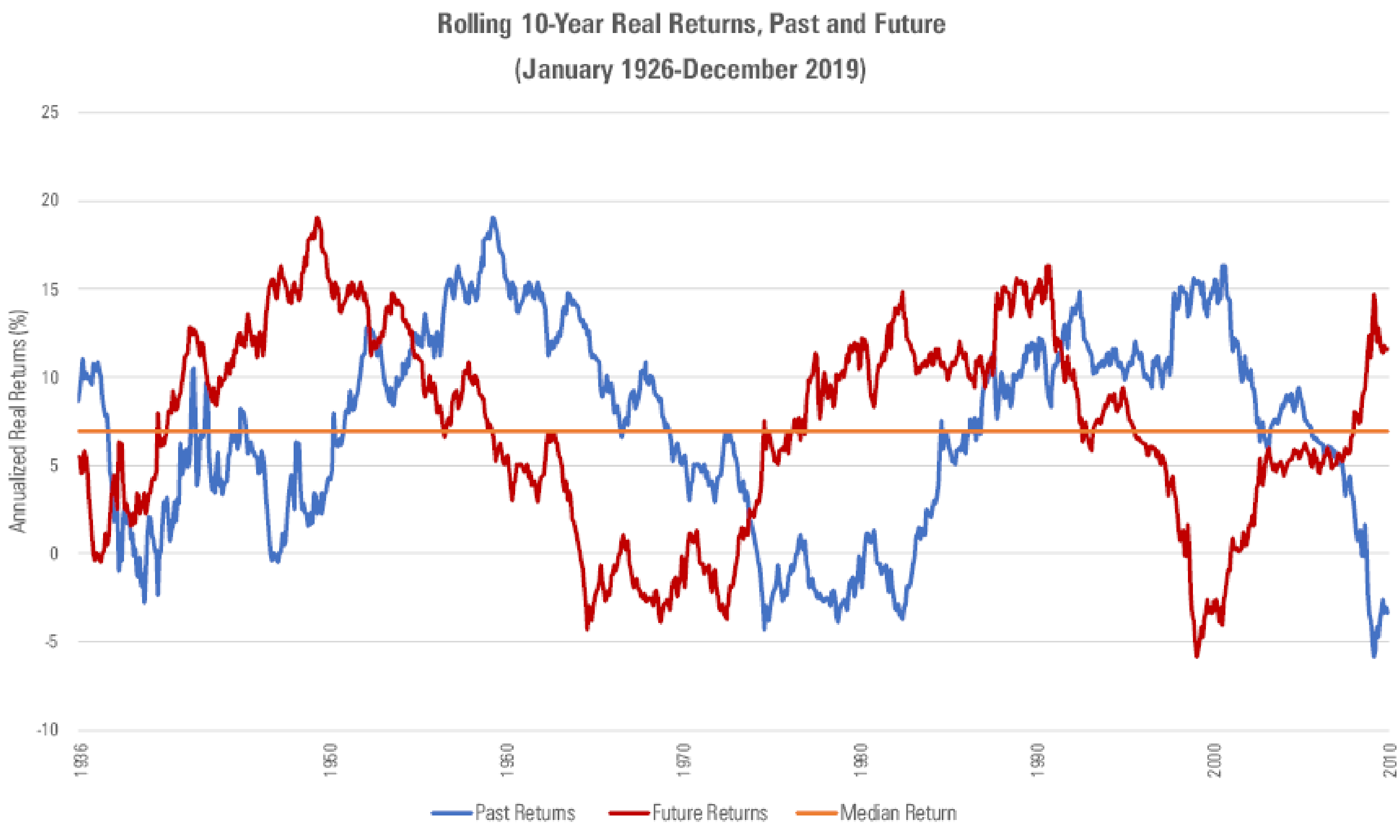
5 Years



Source: Morningstar Direct.

What a mess! There's no point in attempting to analyze the splatter of these tea leaves. (Pity the poor investor who attempts to construct a market-timing barometer based on those totals.) The negligible correlation statistic of negative 0.09 confirms the uselessness of five-year equity returns. Knowing what happened to U.S. stocks over the previous five years sheds little insight, if any, about what will occur during the next half-decade.

10 Years



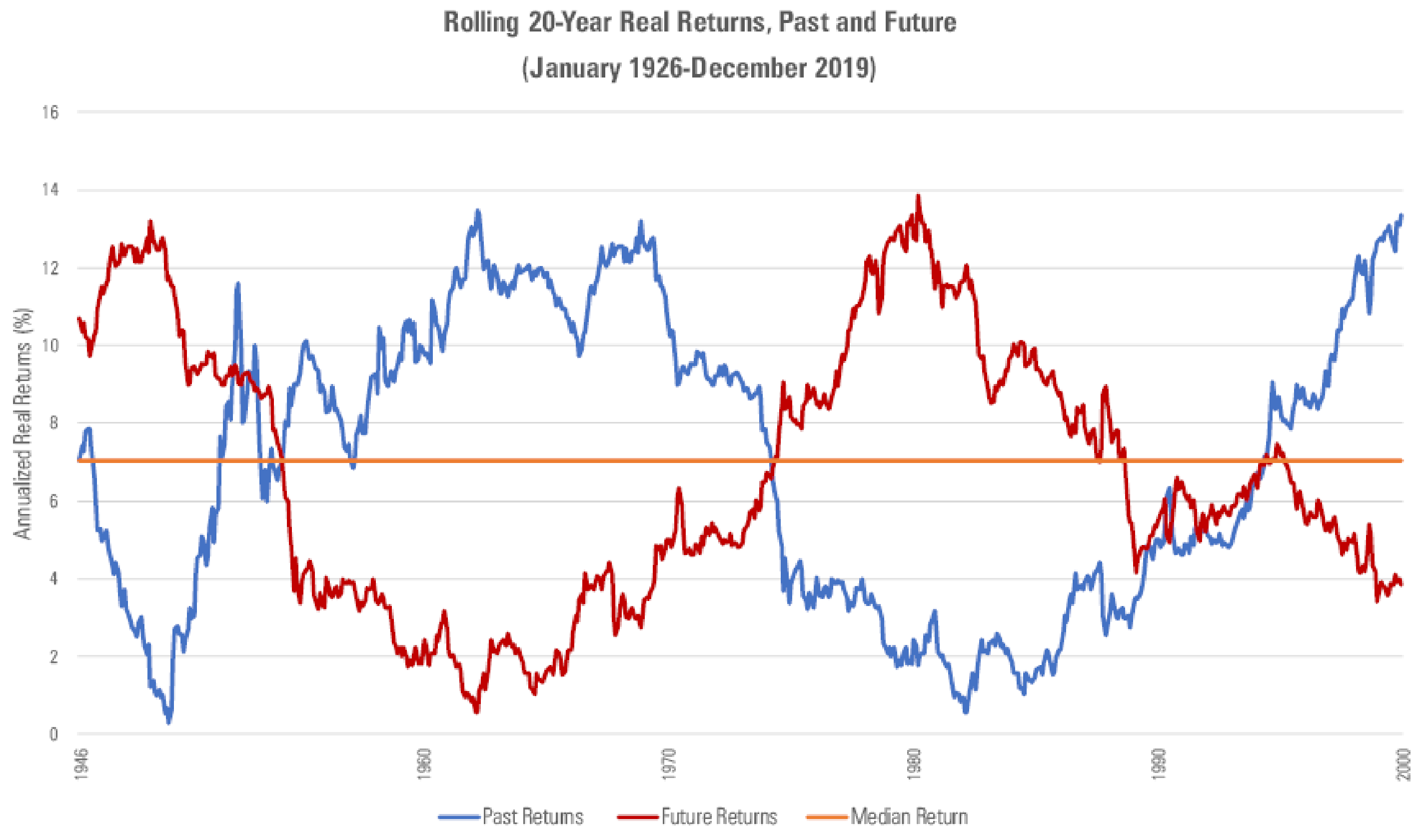
Source: Morningstar Direct.

This is better. Early 10-year losses were followed by the highest 10-year gains of the entire period. Later, just past the halfway mark, a similar pattern occurred, with bottom-basement performance succeeded by above-average future results. Then--as the reader lamented--the highs of the 1990s' tech boom presaged the lows of the "lost decade."

However, the blue and red lines do land on the same side of the orange line one third of the time, which is too often for a long-term signal. Batting .667 is great when making small bets, as with constructing a portfolio, but it is insufficient when making a single 10-year commitment. Given the length of time that the wager requires, there won't be enough betting opportunities to ensure that the law of large numbers will work in the investor's favor.

The correlation is negative 0.25, high enough to be suggestive but not so high as to be practically useful. My response to the reader stands.

20 Years



Source: Morningstar Direct.

And now for something completely different. One could not hope for a clearer picture than what occurs with the 20-year chart. When blue is up, red is down, and the converse. There are only brief stretches when the two lines appear on the same side of the median, and in those instances the returns are close to normal, so the signal doesn't flash brightly. The graph looks so clean that one suspects that its author erred. (The thought did initially cross my mind.)

This portrait is dominated by five events:

1. The depression/war years (weak results)
2. The 1950s/1960s (strong)
3. The 1970s oil crisis (weak)
4. The 1980s/1990s (strong)
5. The 2000s (weak, in fact considerably worse than the 1930s)

Consequently, these results not only lack statistical significance, because the 648 monthly observations so thoroughly overlap, but they also fail common sense. That buoyant economies generate optimistic stock valuations, which eventually decline as the economic news worsens, makes sense. But that such events have occurred on a seemingly regular cycle is surely accidental. The pattern's apparent inevitability is a mirage, based on a tiny sample size.

That said, I suspect the 20-year numbers offer a fair guide to the future, if not as accurately as their negative 0.84 correlation suggests. (Now that's a correlation!) Secular economic changes do tend to occur gradually, and investor emotions can overshoot the mark. Although the letter of this finding need not be observed, its spirit deserves some respect.

Which implies good news for the U.S. stock market, as entering 2020 the real 20-year return on equities was a modest 3.85%, well below the historic norm. These days, it has become commonplace to bemoan high stock prices. Perhaps the skeptics will prove to be correct. But 20-year return measure foresees a happier outcome.

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Follow-ups

From the front page of September 16th's WSJ:

How Stocks Defied The Pandemic

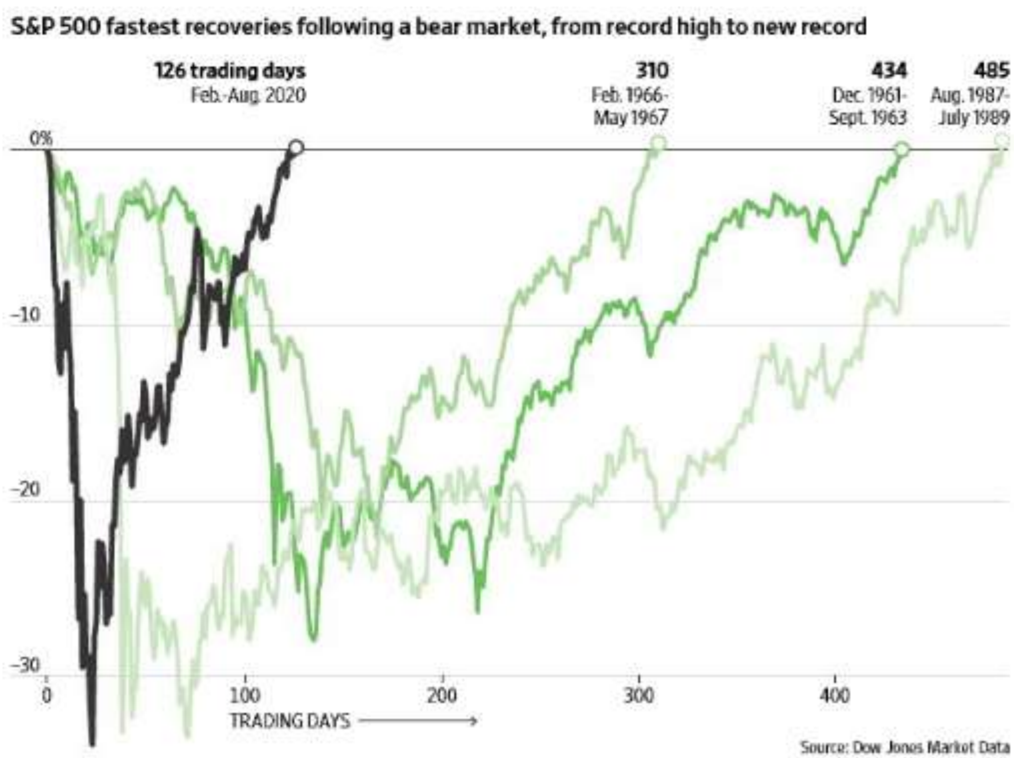
A record round trip was fueled by the Fed, tech shares and a lot of exuberance

BY GUNJAN BANERJI

The Dow Jones Industrial Average's wild round trip is nearly complete.

The venerable stock index, despite a recent hiccup, has nearly recovered all the losses suffered during the coronavirus pandemic, an epic journey during one of the most catastrophic economic collapses in U.S. history.

The Dow and the bench- mark S& P 500 plunged about 35% within six weeks this spring—the fastest-ever fall from record levels into a bear market—as the economy shut down and the virus spread across the country. Since then, U.S. stocks have been on a winning streak that is unprecedented in the modern era of financial markets.



The Dow is near Feb. 12's all-time high, while the S& P 500 recently staged its most robust five-month rally in more than 80 years.

The S& P 500's journey from record high to a bear market—defined as a drop of 20% or more—to a new record took just 126 trading days, the fastest- ever climb. In previous downturns going back to 1928, it took an average of more than 1,500 sessions for the index to return to record levels, equivalent to about six years.

This year's tumultuous ride is even more striking against the backdrop of the recession and pandemic gripping the U.S. Millions of Americans remain unemployed, corporate profits have collapsed at the steepest rate in a decade and the pandemic hasn't been contained.

Despite a two-week rout fueled by shares of technology companies, U.S. stocks sharply rebounded to start the week. ...

Here's what's driving the historic rally:

1. Stimulus from the Fed and Congress

A key factor differentiating this crisis is the response of the Federal Reserve and U.S. government, which was speedier and mightier than ever before. The Fed cut interest rates to near-zero and outlined plans to lend billions of dollars across markets. The U.S. government sent more than 150 million stimulus checks to Americans and backed around half a trillion dollars in loans to small businesses.

The response, alongside lessons learned from the financial crisis of 2008, helped spark the stock market's rebound. Many investors say history has taught them it isn't wise to bet against the Fed. Wading into the market during swoons big and small has been profitable over the past 10 years.

That helped make the market's recovery almost as jarring as the crash. ...

The Fed also appeared to absorb some lessons from the last crisis. Moving early and aggressively is important, Patrick Harker, president of the Federal Reserve Bank of Philadelphia, said in March.

The Fed's intervention had another unintentional effect: As it bought corporate and Treasury bonds, yields tumbled, making stocks even more attractive.

The real yield on Treasurys slipped to negative levels as bond prices rallied, meaning investors who park money in government bonds can expect to lose money when adjusted for inflation. The dwindling returns pushed investors into stocks, a scramble so familiar it has its own acronym: TINA, or There Is No Alternative.

2. Expectations of a strong recovery

Underpinning the rally is an unwavering faith that the U.S. economy will bounce back once the pandemic is under control.

Many believe the worst has passed. Manufacturing activity accelerated in August, hiring has increased for four straight months and consumer spending picked up after a sharp drop.

Analysts say the skid in corporate profits has likely bottomed, too. Earnings among companies in the S& P 500 declined 32% in the latest quarter, the deepest drop since 2009, according to FactSet. They are expected to continue falling through the year, but at a more modest pace. Next year, analysts expect earnings to surpass pre-pandemic levels.

Meanwhile, private-sector economists expect annual gross domestic product to bounce back next year at a rate rarely seen in the past 70 years, according to the Leuthold Group, a research firm.

"Everything about this crisis has been outsized and has moved at warp speed," Jim Paulsen, chief investment strategist at Leuthold, wrote in an August client note. "If the economy continues its recovery and real GDP growth is anywhere close to the current consensus view, the stock-market bull may just be getting warmed up."

Goldman Sachs analysts recently said they expect the S& P 500 to hit 3600 by the end of 2020, a 5.8% increase from Tuesday's close. Bank of America analysts said they can envision a "melt-up" in which stocks continue to advance .

3. The dominance of the tech giants

The gap between the stock market's winners and losers is stark and growing. Tech behemoths have benefited from societal changes forced by the pandemic and are increasingly influential in the market.

One of them, Apple, is bigger than entire global markets. Apple shares have skyrocketed 57% in 2020 and were recently worth more than all of the small companies in the Russell 2000 index combined, or the FTSE 100 index, which tracks the biggest companies listed on the London Stock Exchange. Meanwhile, companies in industries battered by the pandemic have seen their sway in the stock market wane.

The five largest companies in the S& P 500—today that is Apple, Amazon, Microsoft, Google parent Alphabet and Facebook—recently made up about 23% of the index, the highest concentration in at least 30 years, according to Goldman Sachs analysts. Apple, the biggest company in the U.S. stock market, has contributed more than half of the index's 4.8% total return this year, according to S& P Dow Jones Indices data through Friday.

Investors are betting that influence will grow as Americans continue working from home, and shopping and streaming movies online. Amazon shares have jumped 71% in 2020, Facebook 33%, Microsoft 32% and Alphabet 15%.

One way to gauge the outsize influence of those stocks: A version of the S& P 500 that gives every stock an equal weighting is still down 4.4% in 2020, while the standard benchmark has climbed 5.3%. Within the S& P 500, the energy, financials, utilities, real-estate and industrial segments are still in the red.

The group's heft can leave the broader market vulnerable to big declines. The tech giants pulled the market lower last week as concerns grew about whether they had risen in value too far, too fast.

In one sign of the energy sector's diminishing influence, Exxon Mobil was recently dropped from the Dow industrials, ending a tenure that dated to 1928. Energy now makes up less than 3% of the Dow and S& P 500.

"The stock market is comprised of the biggest and strongest companies…. It is not representative of the entire economy," hedge-fund billionaire William Ackman, founder of Pershing Square Capital Management LP, wrote in a recent letter to shareholders.

4. The return of individual investors

It is impossible to ignore the stampede of individual investors entering the stock market. During the first six months of the year, they made up roughly 20% of market activity, nearly double the level from 2010, according to Bloomberg Intelligence. It has never been easier to trade.

Novices stuck at home during the pandemic opened brokerage accounts, enticed by rock-bottom commissions and the chance to profit from stocks' gyrations. The market moves have also brought in younger investors trying their hand at stock or options trading.

These newbie investors are trading tips on Facebook groups and swarming discussion forums on Reddit. They are following stock-market influencers on social media platform TikTok and chatting with other young traders round the clock on the messaging platform Discord.

"When I talk to people with gray hair, they all feel nervous about this market," said Zhiwei Ren, a portfolio manager at Penn Mutual Asset Management. "It is a very dangerous market. For retail investors, it's the best market."

Many of these investors, alongside institutional players, have piled into stocks they view as beneficiaries of the pandemic, or those that they think can reshape industries.

Sports-betting operator DraftKings has rallied 351% while human-spaceflight company Virgin Galactic Holdings has jumped 53%. Individual investors also flocked to shares of Eastman Kodak after a disclosure of a possible $765 million government loan to make drug ingredients at U.S. factories. That helped drive them up as much as 614% before they lost most of those gains.

And, of course, there is Tesla which has gained 438% this year, making it the most valuable auto maker in the world, the eighth-largest company in the U.S. stock market and one of the most hotly debated companies.

Interest—in trading and Tesla—has swelled. As of June, posts tied to #stockmarket garnered 250 million views on TikTok. By September, that figure swelled to about 420 million views. One popular post: "How To Invest in the 'Next Tesla.' "

5. Momentum trading

In many ways, Tesla epitomizes today's market, in which retail and institutional investors have chased companies promising high growth. The car maker has become synonymous with 2020's hot momentum trade—piling into stocks that have climbed the fastest and furthest. Few stocks can match the velocity with which Tesla has soared.

Data from Société Générale SA as of June show that individual investors tend to prefer stocks that have risen the most over the past three months. Traders using the Robinhood Markets brokerage increased their holdings of such shares dramatically since March, outpacing investments in companies with the worst price performance. Investors have also piled into exchange-traded funds tracking the momentum trade. And like the broader market, Tesla has been painfully difficult to bet against. Few saw its dramatic rise coming, and the ascent continues to alarm, and burn, many investors who sought to profit from its demise.

Technical dynamics help explain the stock's mind-boggling gains, since bearish wagers on the company have inadvertently fueled Tesla's rise, and derivatives bets tied to its advance have helped intensify the rally.

Many investors aren't just buying small dips in the stock market or individual shares like Tesla. They are looking for turbocharged trades that profit when individual stocks quickly rise and, at times, borrowing money to bet big.

Stock-options volumes jumped to a record this year, and trades that pay out if stocks continue to soar have been popular. These derivatives, known as call and put contracts, allow investors to put down a small amount of cash for a potentially quick and outsize return if their bets prove correct. Although they can magnify profits, they are extremely risky.

These trades are increasingly influential on the stock market itself. Mammoth options bets by big investor SoftBank Group helped drive the market's recent roller coaster, along with trades from individual investors.

Barclays research shows that stocks benefiting from the highest increase in options trading over the past year have outperformed the market. In addition to Tesla, these stocks include Amazon, Apple, Microsoft, Shopify, among others. ...