Traub Capital Management
Quarterly Outlook Q4 2020

Another Bumpy Ride

Last quarter was another bumpy ride in the equity markets, but it did produce a good gain. The S&P 500 started the quarter at 3100. It headed up for a 15% gain, reaching a high of 3580 on September 2, then fell almost 10%, in the first "correction" since the March rally began, only to recover a good chunk of the correction to finish at 3363 and including dividends, it produced an upward gain of 9% for the quarter. That said, it sure does not feel like we just completed a quarter where the S&P 500 set a new all-time high and finished with a 9% return. It feels more like a time span resting on pins and needles, just waiting for the wind to push everything over the brink- maybe because we finished the quarter with a September sell off from the highs as the markets frequently do in September.

Or maybe it's because the average stock continues to lag the S&P 500, as that index continues to be driven by the big tech stocks, led by Facebook, Apple, Amazon, Microsoft, and Alphabet (Google). Mid-cap stocks (the S&P 400) only returned 4.8%, while small-caps stocks (the S&P 600) returned even less, at 3.2% for Q3. The average stock in the S&P 1500, i.e. equal weighted, returned 4.5%.

And year-to-date we have a similar story. Although the S&P 500 has returned about 5 ½% this year, the other indices and markets are generally down. Mid-cap stocks have fallen 9% while small-cap stocks are off 15%. Across the broad US market, the average stock in the S&P 1500 is down 10% this year.

We did see some moderation in the market's volatility index (VIX) from the first and second quarters, but the volatility experienced in Q3 was more like a "normal" market and quite unlike what was a quiet period from 2012 through 2019 with historically low volatility.

As we have mentioned on several occasions, there is never an "all clear" signal for equity markets. Stocks trade on people's expectations of prices to be realized in the future and once everyone feels completely comfortable, there is nowhere to go but down. Clearly, not everyone is feeling comfortable today, so that is actually a good omen.

Many market participants believe that the stock markets have recovered from the March lows too far, too fast, and are out of sync with reality. We disagree, because "reality" for the markets is not what the economy is experiencing today, but rather the market "reality" is what is expected in the future – typically 6 to 24 months into the future. The balance of this report peers in to that future to see if the market values today reflect what we should expect in the general economy about two years from now.

COVID-19 Review

Let's start with COVID-19. COVID-19 is a serious and frequently deadly infection caused by a virus that has mutated into a form very toxic to humans and sufficiently unlike any previous virus in its family to be quite resistant to any medications that mankind has so far developed.

In this country, there are over 7 million confirmed cases and over 200,000 deaths directly attributable to the viral infection so far this year. For the 12-month period starting last March, the projected fatalities are upwards of 400,000 people. This 400,000 compares to about 600,000 annual victims of all the various cancers.

COVID-19 is a serious issue. However, it is no longer an unknown and it is unknowns and shocks that significantly move markets and frequently move them quickly. As we have detailed in past reviews, there are five known action items that can be taken to stem the spread of the infection – masks, social distancing, widespread testing, contact tracing and limiting the assembly of large groups of people, particularly indoors and most particularly in indoor settings with poor ventilation. Taking these measures is not pleasant and the necessary measures are resisted as we have seen on numerous occasions – at least resisted to the point that infections reach about 300 per day per million people in any given group.

Once the steps mentioned above are implemented, infections fall and they remain low in spite of measured economic reopening. Examples abound, including most of China, all of South Korea and numerous areas of the US including the Northeast, plus more recently many other states. Now, as a country, we see that reopening the economy, particularly without implementing all of the five steps noted above can and will produce increases in infection. We, as a country can also do more and we can be more diligent, but we know that more diligent efforts with the five known steps will continue to quell the spread of the infection.

We also have learned how to stem the fatality rate from the infection. Earlier this year, in this country, the fatality rate among those infected was running about 10%. It is now down to about 2.5% - a very significant reduction in a very short time. Better tools, like Abbott's new $5 test with results in 15 minutes and with Abbott producing about 1 million a day, coupled with better medications to treat the infection have and will continue to vastly reduce demand on hospital resources. These tools give every indication of lower infection rates and lower fatality rates going forward.

During August and September, fifteen percent of the population of the United States was tested for COVID-19, some on multiple occasions. Our testing is running roughly one million per day. Infection rates are under 6% and it is generally considered to be sufficient testing. We do not have the testing capability to test every vulnerable segment of the population on anything like a daily frequency. Abbott can make 1 million tests a day, which is roughly the number of tests we are currently running at much greater expense and with much longer result turn around. However, there are roughly 20 million college students in the country, 60 million students in primary and secondary education, 17 million healthcare workers and that is just a start for people at risk. So we are not going to test our way out of the crisis and this is also known.

We also know that there are huge efforts worldwide aimed at producing an effective vaccine. There are presently 11 vaccine candidates in large-scale trials. These trials typically use a sample size of about 40,000 people, half of which have a vaccine administered and half get a placebo injection. A successful trial would be to reduce the rate of COVID-19 infection by half. It takes time to gather this data. In the last two months, 0.7% of the US population tested positive for COVID-19. In a trial of 40,000 people with 20,000 getting the vaccine, a 0.7% infection rate is 140 people in a two-month period. A 50% reduction is 70 people. A 20,000 sample might be good enough to have a reasonable measure of side effects, but 70 people is a very small number to conclude that a particular vaccine should be administered to everyone in the world, and that is after two months of elapsed trial time.

With 11 large-scale trials underway, the odds favor having a successful vaccine, but it takes time to run the trials and it is not likely that a vaccine will be widely available to all of the US population before mid-2021.

We do not know exactly which vaccine (or vaccines) will prove most effective and exactly when it, or they, can be available in large quantities, but the overall efforts on the endeavor have moved the vaccine from an unknown into a likely known quantity within the 6 to 24 month window into the future that the market is foreseeing.

The unknown is the extent to which the economy can reopen without triggering an exponential takeoff in infections. This concept is explored below.

Reopening the Economy

Let's start with the labor markets. The US economy added an unprecedented number of jobs this summer. The August labor report was a bit under consensus, but most observers fail to realize that the softness was due entirely to softness in the education sector. Normally this sector adds roughly 200,000 positions in August in anticipation of going back to school. This year, the normal addition for education evaporated with the coronavirus. The balance of the economy continued to add jobs and the unemployment rate continues to fall, now at 7.9% down from 14.5% in April.

Next is the personal savings rate, which has declined from 33.7% in April to 14.1% in August. American consumers are putting these savings to work, particularly in the housing market and in the purchase of motor vehicles (not to mention in the stock market.) These sectors showed very surprising strength.

Next is interest rates and inflation. Both remain very low. The Fed has pledged to keep interest rates low across all maturity dates. The interest rates on Fed Funds, 3 month treasuries and 2 year treasuries are at record lows at <0.1%, 0.1% and 0.14% respectively. From there, the yield curve has a positive slope up to a rate of 1.45% for 30 year Treasuries. Inflation is well under 1.5% and could remain under the Fed's 2% goal through 2021. However, with all the pent up demand, and some virus related logistical issues that companies, particularly manufacturing and construction companies, are facing which are restricting supply, it is certainly feasible we move above a 2% inflation rate next year. This is a risk where we have concerns and have positioned the portfolio to reflect this.

In the reopening economy, activity is very strong in the construction, manufacturing and technology sectors. It is also strong in the financial sector. Mortgage applications are up over 20% since this time last year. Vehicle sales in September were reported at an annualized rate of 15.7 million – up from 8.5 million in April and comparable to an average of 16.8 million in 2019.

This level of economic activity should continue. Travel, lodging and restaurants will struggle as is well known, but recovery of this sector should be noticeable with the availability of a coronavirus vaccine and well inside of a 24-month horizon.

Overall, our look at the US GDP shows 2020 to be a contraction of 3% compared to 2019, with a 5% increase forecasted for 2021 and by Q2 of 2021, the overall GDP should be higher than that for Q4 2019. Operating earnings of the S&P 500 companies will show a similar recovery. By Q3, 2021, earnings should be higher than in any quarter in 2019. Good corporate earnings coupled with very, very low interest rates produces a high P/E ratio that multiplies a good forecasted earnings level to indicate that the S&P 500 level of 3500 to 3600 in 2021 is very supportable and represents a modest improvement from today's value of about 3400.

The Election

With some trepidation, let's wade into the upcoming election. Note that we are taking an impartial view to the results. Markets can react favorably (or unfavorably) to Republican victories or to Democratic victories. However, markets react in a positive manner to reduced uncertainty and once concluded, an election reduces uncertainty. Our goal is to look at the uncertainty, not the candidate.

Polls on October 1, one month before the presidential election, favored a Biden victory by 8%. On October 2, President Trump reported a positive test for COVID-19. Polls on October 5 now show a Biden edge of 14%. Similarly, on October 2, the website www.realclearpolitics.com, reported a Senate with 46 very likely Democrats, 46 very likely Republicans and 8 toss-up races. Of the 8 toss-up contests, Democrats were leading in five of them by an average of 4%. Republicans were favored in 3 races by an average of 4%. Democratic victories in all five contests would give a Democratic majority of 1 in the Senate, which could couple with a Biden/Harris win of a tie breaking vote and produce a very, very slim Democratic majority.

Historically, successfully elected Democratic presidents have been relatively unknowns prior to their election: Clinton, Carter, Roosevelt (Franklin) and Wilson were little known governors prior to running for President. Obama and Kennedy were obscure Senators. All came to victory following recessions. Well-known Democratic candidates have been consistently defeated – Clinton (Hillary), Kerry, Gore, Dukakis, Mondale, McGovern, Stevenson and Smith.

Biden, of course is a well-known Democratic candidate. The "well-known warhorse" theory stated above does not favor Biden, but the recession and polls do. The polls are not infallible as Clinton (Hillary) and Dewey (Thomas) also had sizeable leads in the polls one month prior to the elections. It all adds up to a fair amount of uncertainty.

Historically, with newly elected Democratic presidents, the market views their platforms as unfavorable to business. However, once elected, the markets see that passing their agendas proves to be difficult and ultimately we often see increased government spending, boosting the economy. Hence markets typically are flat or down going into an election with a Democratic victory. Then markets are positive, as passing new legislation proves difficult. With Republican victories, markets typically view their platforms as "pro business" and react favorably prior to elections. Then markets wane, as passing their new legislative initiatives proves difficult. The cumulative impact, however, is positive as uncertainty is removed. The impact is skewed, however to better returns early with Republican victories and later with Democratic victories.

What is clear is that there is a fair amount of uncertainty with the presidential election, with the make-up of the Senate and with the Supreme Court. The piece that the market is missing is that after the election, these uncertainties will wane and that new sweeping legislation to reallocate individual wealth will likely be hard to enact.

Lowering Uncertainty

Overall, the developments in COVID-19, the economy and the election will lower uncertainty. COVID-19 is not exactly under control, but it is understood. The economy is returning to some degree of health and should make it all the way back by 2021. The election will reduce uncertainty and that even with a Biden/Harris victory, passing liberal legislation of any sort will be difficult without a solid majority in the Senate. Radical liberal legislation will most likely not pass muster with the Supreme Court that will probably become more conservative and not look favorably on new legislation to reallocate wealth. Once the outcome is known, the uncertainty will diminish and the stock market will react favorably.

Other Market Segments

We have looked at the S&P 500 index above and the results of the various other segments of the market that are not as heavily weighted to big tech as is the S&P 500. Internationally, we see a not dissimilar picture. The big tech stocks that are leading the S&P higher are all US based companies. Internationally, technology is less of an important factor and hence these markets are lagging the big-tech driven S&P 500. Such has been the case for many years now and we are very uncertain if and when we will see a shift. The MSCI World index not including the US was down 6.75% for the first 9 months of 2020 and up only 4.88% annually for the last 10-year period. Comparable ten year returns for the S&P 500 were more than double.

So far, for 2020, bonds, when all taken together, have faired well. With interest rates now at historically low levels with no further decreases in sight, returns from bonds looking forward should be about their respective current yields, which are less than, or marginally greater than inflation.

Conclusion

So far this year, the market, as indicated by the tech heavy S&P 500, has produced a modest gain with noticeable volatility. Other segments of the stock market have produced somewhat muted returns, and in many cases negative. Overall, the recovery of the US Main Street economy is way behind that of the stock market. However, given the forward looking approach of the market, coupled with the decreasing uncertainty that we should see with the conclusion of the presidential election, we have every reason to believe that further gains are possible.

As always, we thank you for your support of Traub Capital and look forward to continuing to manage your investment portfolio and work with you on any financial planning needs. Please do not hesitate to contact us should you have any questions regarding this outlook or should you have questions regarding your portfolio, or should you wish us to take a look at your projected financial assets in retirement and other related financial planning.