

Election Market Handicap: Democrat vs Republican

By: Henry Pizzutello, Chief Investment Officer

Looking at opinion polls with less than a month before what may be one of the most important Presidential elections in recent times, one might conclude that the result is a foregone conclusion. However, notwithstanding the apparently insurmountable lead that Biden enjoys, it is prudent to note that Hillary Clinton was in the exact same position in 2016. It is also important to note that the Senate elections will be just as important in evaluating how likely it is that policies will be implemented. Given the unprecedented events of 2020, nothing should be taken for granted. We have repeatedly stated that our investment posture does not rely upon prediction but long-term analysis and probability. That being said, there are significant differences in the two Presidential platforms that will likely affect how we view investment after the final decision has been reached.

Effectively, the decisions that matter most to our investment thesis are rooted in monetary, fiscal, regulatory/tax, and global trade policies. Given that the blueprints for each candidate have already been established, a comparison of the potential effect on markets and asset prices is invaluable.

Monetary

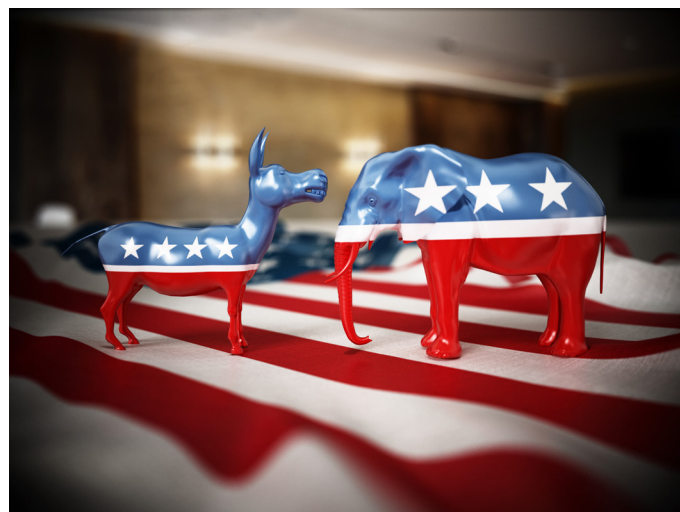
POSITIVE for both Republican and Democrat

Given the unprecedented (there's that word again) actions of the Fed earlier this year, and the continued affirmation of accommodative policy, it is a fairly safe bet that current policy and direction will continue under either Trump or Biden. One aspect of Fed policy that has seemingly flown under the radar given the constant "tweet driven" news cycle is the intention to target inflation as an average rather than a specific dot point. In essence this will allow inflation to rise above historical targets for a period before specific actions are undertaken. This is the polar opposite of the policy direction undertaken by Fed Chairman Volker in 1980 and speaks to the deflationary pressures globally.

Trade

<i>Democrat</i>	<i>POSITIVE</i>
<i>Republican</i>	<i>NEUTRAL</i>

One of the less recognized by-products of the current Administration has been the effect of public opinion on trade, especially with China. Before the "trade war" with China started in 2019, public perception was that it was essential to maintain positive relations because of the potential economic impact. Trade was considered the most important factor in investment concerns in early 2019—now it is barely in the top five. President Trump's stance on global trade, especially with China, has changed perceptions of the relative importance within the United States and probably globally as well. That being said, it seems reasonable to assume that Biden will be slightly more accommodative on trade, at least from a global perspective, if not specifically with China. While Trump has portrayed trade policy as "America First", Biden is more likely to have a softer public stance, even if the underlying policies may not be radically different. This would be more positive on balance for U.S. and global equities.



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Fiscal/Tax

<i>Democrat</i>	<i>NEGATIVE</i>
<i>Republican</i>	<i>POSITIVE</i>

Regulatory

<i>Democrat</i>	<i>NEGATIVE</i>
<i>Republican</i>	<i>POSITIVE</i>

This is clearly the biggest policy difference between the two candidates. The current Administration fiscal policy is based on the assumption that only faster economic growth will allow the country to escape the current deficit. The proposed policies are designed to further that, which may include additional tax cuts even in the face of further deficit increases. The Biden campaign's economic plans, in contrast, include tax increases on personal income, corporate profits, capital gains, dividends, and estates. While applying the math associated with the expected increases would show how corporate earnings are affected, and the negative effect on asset prices, the more important metric may be the potential effect on consumer and corporate confidence. While we have already seen some companies start to incorporate higher tax rates in their forward earnings guidance, the real risk is that companies delay or eliminate capital expenditures and hiring in the face of higher potential costs. In the stage of recovery that the U.S. economy and consumer is still experiencing, this psychic damage may be more significant than the real effect on earnings. However, the true negative impact of the full Biden plan may be lessened if the Democrats do not gain a majority in both Congress and Senate.

One of the early hallmarks of the current Administration was the relaxing of regulations in order to spur economic growth. The Federal Register of Regulations was cut by 35% to 60,000 pages from more than 95,000 under the Obama Administration and was seen as an early key driver of economic growth. It is reasonable to assume that this trend will be somewhat changed under a Democratic leadership. One other issue that has also flown under the radar is the increasing Congressional focus toward potential anti-competition legislation of large technology companies—Apple/Facebook/Google/Amazon etc. As has been well documented, these companies, along with a select few others, have been the primary source of performance for the major indices over the past few years, and the disproportionate effect on returns has been even more pronounced since the onset of COVID early this year. It is worth noting that the concentration of just the top 5 companies in the S&P are now greater than 20% of the index and are more concentrated than the peak of the 2000 era “dotcom” bubble. While individual valuation and profitability metrics for the current concentrated companies are significantly better than those during the previous era, there exists potential for significant market disruption in the short-term if outside regulatory forces intervene.

Has the Market Run Out of Steam?

By: Henry Pizzutello, Chief Investment Officer

The biggest question that investors are facing today is whether or not the historic equity rally from the low levels of March has run its course. While there are a number of scenarios that could cause equity prices to reverse, the question of valuation seems to be at the forefront of many investment concerns. Additionally, the disproportionate price effect of the top five companies in the S&P is at the highest level since 2000, which prompts fears of a return to the “tech wreck” environment that followed. However, although there are countervailing issues that could change the positive momentum of equity markets, it would likely need to be something significant in order to offset the strong monetary growth driven by Fed actions to counteract the weak economic growth.

With 10-year Treasuries yielding 70 basis points and 15 trillion of foreign debt at negative yields, there are not a lot of viable options for investment. This is borne out by looking at market money flows during September. During the month, in which the S&P lost 6% and the NASDAQ more than 9%, there was little movement out of equities into fixed income. Instead, there was a rotational re-allocation from the strongest momentum stocks, like technology, into more defensive and value sectors. The top 10% performing stocks YTD lost an average of 12% during September, while the bottom 10% lost only 0.4%

More importantly, the current equity cycle makes more sense if we look at the metrics from a historical perspective over the last 70 years.

	<u>Historical Ave.</u>	<u>Current</u>
CPI	3.5%	1.3%
S&P P/E Ratio	16.0x	26.9x
10-year Treasury Yield	5.60%	0.70%
Dividend Tax Rate	53.1%	23.8%
Capital Gains Tax Rate	24.9%	23.8%
Nominal GDP	6.6%	-31.7%

The metric above that most doomsayers point out is the large disparity in the S&P P/E ratio of current to historic. Coupled with the high concentration percentage of the top five stocks in the S&P and NASDAQ indices, it is easy to construct a plausible negative market scenario. What this fails to take into account is the absolute low level of Treasury yields, especially when compared to historical levels. During the period 2000 – 2010, which includes the dotcom bubble era, 10-year Treasury yields ranged from 6.5% - 10% as opposed to 0.7% today. One statistical measure that takes this relationship into account is the Equity Risk Premium (ERP). The ERP measures the additional return expected for the investor to invest in equity over fixed income. The current ERP level is at one of the highest levels in history, which is another way of saying that equities are very inexpensive to Treasuries on a risk-adjusted basis.

While the expansion of the Fed balance sheet and debt has also been a source of worry, it is also comforting to note that more than 70% of the current U.S. debt obligations mature within the next five years. As the Fed has pledged to keep rates low, this provides an opportunity to extend maturities at historically low yields as they are refinanced.

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One of the best ways to gauge the health of the market is to look at the conditions that were present during past periods of over-valuation that led to the severe market corrections in 2000 and 2008. In the words of Winston Churchill “Those who fail to learn from history are doomed to repeat it.”

	<u>2000</u>	<u>2007</u>	<u>2020</u>
Equity “Melt Up”	<i>Yes</i>	<i>Yes</i>	<i>Not Yet</i>
Although the S&P is about 10% above its 200-day moving average, and some areas like technology are showing signs of excess, the recent correction in September has brought valuations back to more reasonable levels.			
Strong Equity Inflows	<i>Yes</i>	<i>Yes</i>	<i>No</i>
Asset inflows into Bond funds have been \$420B this year while equity mutual funds and ETF’s have seen outflows of almost \$1.0 trillion. There is plenty of money waiting on the sidelines to invest in equities.			
Increased M&A activity	<i>Yes</i>	<i>Yes</i>	<i>No</i>
M&A activity has increased in absolute dollar terms, although off historical highs. However, as a percent of relative values of total market-cap, it is still low.			
IPO activity	<i>Yes</i>	<i>Yes</i>	<i>Yes</i>
IPO activity has shown a significant pick-up lately and issuance of SPAC (blank check) companies have raised more capital this year than they did in the prior five years combined. This is one area that bears watching as it is a sign of speculative excess.			
Rising real interest rates	<i>Yes</i>	<i>Yes</i>	<i>No</i>
Decreasing earnings estimates	<i>Yes</i>	<i>Yes</i>	<i>No</i>
After earnings were slashed in response to the economic shutdown, reported corporate earnings have been strong and analyst estimate revisions are trending higher.			
Decreasing number of stocks making new highs	<i>Yes</i>	<i>Yes</i>	<i>No</i>
Breadth has expanded significantly during the current rally.			
Equity towards defensive sectors	<i>Yes</i>	<i>Yes</i>	<i>No</i>
Tech has been a leader all year, and although there was a rotation into defensive sectors during the September correction, technology shares have begun to regain momentum in October.			
Widening credit spreads	<i>Yes</i>	<i>Yes</i>	<i>No</i>
Credit spreads blew out during the pandemic but quickly reverted back to pre-pandemic levels. The addition of the Fed backstop of credit is a further tailwind to credit.			

While conditions can change quickly, as we all witnessed in March, analysis of the facts at hand presents a picture of equities that still have “room to run” as we move back to normalcy. However, given how unpredictable the events of 2020 have been, we must still retain an element of caution until there has been significant resolution of the COVID virus issue. Notwithstanding the positive conditions described above, our investment stance remains cautiously optimistic.