AN EQUITY MARKET CONUNDRUM

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There exists the potential for a major shift in long-term strategic asset allocation models because of the exceptionally low expected rates of return from fixed-income markets. For example, rather than the traditional balanced portfolio split of 60% equities and 40% bonds, a shift to a mix of say 75% stocks and 25% bonds could become standard. If so, trillions of dollars of funds in balanced portfolios could be transferred from bonds to stocks over the next three years.

Summary and Major Conclusions:

- The outlook for the US equity market should be divided into two hypothetical timeframes: A pre-vaccine and post-vaccine period. Current economic conditions are weak and unlikely to truly strengthen until there is a safe and effective vaccine for COVID-19, in my judgment.

- Regulatory approval of a vaccine followed by a ramp-up in production should create a massive *inflection point* in the movement of stock prices. Market *expectations* for a healthy and sustained economic recovery should spark an immediate rally in the equity market, even though the real economy will respond more slowly as 2021 unfolds.

- Availability of a vaccine in large quantities should also trigger a massive *leadership shift* from the technology winners of the past year to cyclical stock groups that have been punished severely by the pandemic.

- It is debatable whether the equity market has lost its connection with the real economy. The answer to this question is predicated upon two issues: (1) The time horizon of investors; and (2) The index used to measure market performance.

- The equity market is the quintessential forward-looking indicator, discounting future economic trends well in advance. Concrete news of availability of a vaccine for mass production should be an immediate spark for an equity market rally.

- Another critical aspect regarding the relationship between the equity market and the economy is the choice of equity market index. Performance results can vary significantly depending upon whether the index is capitalization weighted or equal weighted.

- Capitalization-weighted indexes — like the S&P 500 — can be heavily influenced by a small group of stocks with very large market capitalizations. Conversely, indexes with equal weightings measure the performance of the median or typical stock.

- An examination of stock market internals reveals that a very small group of stocks with very heavy weightings in the S&P 500 Index — concentrated in the technology, communications, and media sectors — have performed extremely well this year, while the vast majority of stocks in the index have lagged badly.

- Stocks in these highly favored groups number only about 50, representing just 10% of the entire index but comprising nearly 45% of the composition, or dollar weighting, of the index. The year-to-date gain for these stock market darlings is 25%.

- The remaining 450, stocks or 90% of the S&P 500, have lost nearly 7% on a year-to-date basis. Included in this group are airlines, retail, banks, restaurants, and other cyclically sensitive industries. Many of these industries are direct casualties of the pandemic and have suffered year-to-date declines in excess of 40%.

- The cumulative gain for the S&P 500 this year is 5%. This positive rate of return can be attributed exclusively to the fact that the S&P 500 is a capitalization-weighted index. Other indexes comprised of equally weighted stocks have performed much worse since the pandemic began and are in the red.
- Standard & Poor's produces a companion equal-weighted index, wherein all 500 stocks have the same weighting. This index has lost 5% of its value this year. Similarly, the Value Line Index of 1700 stocks is another equally weighted index, and it has declined by 13% this year.
- In theory, there are several powerful underlying forces that could be quite favorable for the equity market outlook over the next several years. Many of these pertain to the classic business cycle and record-low interest rates. Others involve pure supply and demand forces systematically boosting common stock values.
- There exists the potential for a major shift in long-term strategic asset allocation models because of the exceptionally low expected returns from fixed-income markets, to the benefit of the equity market.
- For example, rather than the traditional balanced portfolio mix of 60% equities and 40% bonds, a shift by fund managers to an allocation, of say, 75% stocks and 25% bonds could become standard. If so, trillions of dollars of funds in balanced portfolios could be transferred over the next three years.

Under normal circumstances, investing in common stocks is enormously challenging; in the midst of the current COVID-19 pandemic, the challenges have risen to a new level. One of the few safe conclusions that can be made is that investing in the equity market has become a ***binary process***, with the availability of a safe and effective vaccine in mass quantities serving as the sole decision variable.

A vaccine will mark an ***inflection point*** in the direction of the economy and the growth in company earnings, and therefore, the movement in stock prices. This week's *Economic Perspective* provides answers to questions pertaining to the currently highly complex economic and investment landscape.

WHAT IS YOUR OUTLOOK FOR THE US EQUITY MARKET?

For optimal effectiveness, any forecast of the US equity market should be divided into two hypothetical time horizons: A pre-vaccine and post-vaccine period. ***This analytical process is based upon the notion that economic conditions are unlikely to truly strengthen until there is a vaccine for COVID-19, available in several hundred million doses***. In the interim, given a highly fragile and stagnant economy, company earnings are unlikely to grow, *suggesting a sideways movement in stock prices*. Market leadership is likely to remain with the beneficiaries of the pandemic that have performed so well this year.

Approval of a vaccine followed quickly by a ramp-up in production should create an explicit ***inflection point*** *in the equity market*. My assumption is that major medical advances will be a clear signal to equity investors that the US coronavirus pandemic will soon be under control and that the economy can be restarted at a more aggressive pace.

Market ***expectations*** for a sustained economic recovery should result in an immediate increase in economic confidence, sparking a sharp rally in equities. *Availability of a vaccine in mass quantities should also trigger a massive leadership shift from the technology winners of the past year to cyclical stock groups* that have been punished severely by the pandemic.

IS THE MEDIA CORRECT WHEN IT ARGUES THAT THE STOCK MARKET HAS BECOME DISCONNECTED FROM THE ECONOMY?

This is a complex issue, which must be analyzed with great care. ***In many respects, the answer depends upon the time horizon of equity investors***, as discussed above. It also depends upon the specific market index used to measure investment results. *Performance results can vary significantly depending upon whether the index is capitalization weighted or equal weighted*.

Capitalization-weighted indexes — like the S&P 500 and the NASDAQ — can be heavily influenced by a small group of stocks with very large market capitalizations. Conversely, stock indexes with equal weightings measure the performance of *the median or typical stock in the market* without regard for the market size of individual securities.

Corporate America Versus Main Street: Capitalization weightings aside, another issue is the enormous divergence between very large corporations and the tens of millions of small businesses within the domestic economy. Whereas the small business sector has been crushed by the pandemic, the economic impact on large US multinationals has been far less severe.

Earnings Disparity: For example, earnings for the companies in the Fortune 500 — which comprise roughly one-fourth of total economic profits — might decline by only **20%** this year. Earnings for businesses with 500 or fewer employees — which comprise nearly 50% of economic activity — could decline by more than **60%**. Large-company earnings should rebound strongly next year, while millions of small businesses will fail.

COULD YOU ELABORATE ON THE IMPORTANCE OF CAPITALIZATION-WEIGHTINGS AND EQUITY MARKET PERFORMANCE?

A close examination of stock market internals reveals that a *very small group of stocks with very heavy weightings in the S&P 500 Index* have performed extremely well this year, while *the vast majority of stocks* in the index have lagged badly. Specifically, market leadership has been concentrated in a *select group of mega-cap stocks* in the technology, media, and communications sectors that have benefitted from the pandemic.

Included in this list are computers and peripheral equipment, internet content, software infrastructure, consumer electronics, semiconductors, and internet retailers. *Stocks in these groups number only about 50, representing 10% of the entire index but comprising more than 40% of the market weighting of the index*. The year-to-date gain for these highly select stocks is 25%. Even more amazing, *the largest five stocks in the S&P 500 comprise nearly 25% of the index, and have increased in value by more than 35%*.

The remaining 450 stocks, or 90% of the S&P 500, have lost nearly 7% on a year-to-date basis. Included in this group are airlines, retail, banks, travel, restaurants, entertainment, and other cyclically sensitive industries. *Many of these industries are direct casualties of the pandemic and have suffered year-to-date declines in excess of 40%*. The Russell 3000 Value Index has declined by 10%.

HOW HAVE THESE DIVERGENCES AFFECTED OVERALL EQUITY MARKET PERFORMANCE THIS YEAR?

As a whole, the cumulative gain for the S&P 500 this year is 5% through August 10, approaching its all-time high during February. *This positive result can be attributed exclusively to the fact that the S&P 500 is a capitalization-weighted index*. *Other indexes comprised of equally weighted stocks have performed much worse since the pandemic began*.

Standard & Poor's produces a companion equal-weighted index, wherein all 500 stocks have the same weighting. This index has lost 5% of its value this year. Similarly, the Value Line Index of 1700 stocks is another equally weighted index, and it has declined by 13% this year.

The bottom line is that the performance of the S&P 500 has been significantly distorted by the dominance of a select group of mega-cap stocks that are coronavirus beneficiaries and that have performed extremely well. Steep losses in a much larger group of coronavirus victims are barely reflected in the overall index because of those stocks' relatively small weightings.

Conclusion: The S&P 500 and the NASDAQ are indicative of the performance of a small select group of very large technology and internet stocks, rather than the broad equity market. Equal-weighted indexes are indicative of the performance of the typical stock, and therefore the broad market, which has performed poorly in 2020.

IN THEORY, WHAT ARE THE SPECIFIC LONGER-TERM ARGUMENTS IN SUPPORT OF EQUITY INVESTING?

In theory, there are several powerful underlying forces that could be quite favorable for the equity market over the next several years. Many of these pertain to the traditional business cycle and the extraordinarily low level of interest rates. Others involve pure supply and demand forces systematically boosting common stock values. Still other factors pertain to the record-low interest rates on long-term bonds. *JP Morgan's Global Government Bond Index has a current yield of 1.3%, an all-time low, and well below its 44-year average of 6.4%*.

1. ***A new business expansion appears set to begin in earnest in 2021****,* assuming the availability of vaccines and therapeutics for COVID-19 at that time. In both theory and practice, stock prices generally rise and fall in tandem with the classic business cycle. Given the vast underutilization of productive resources, this new expansion cycle could be especially long-lived. The stock market always performs best in long-duration expansions, as in the 1960s, 1990s, and 2010s.

2. ***The Federal Reserve has made it very clear that monetary policy will remain accommodative for an extended period***. In most previous cycles, the Fed began to tighten monetary conditions along with a rise in the inflation rate. In the current cycle, *the Fed has promised to maintain an expansionary policy even when inflation begins to exceed the Fed's long-term target of 2%*, a very bullish condition for common stocks.

3. ***Equity market valuations benefit from record low interest rates***. Common stocks are the *ultimate long-duration financial asset*. Record low bond yields should boost the value of equities as the future stream of cash flows — earnings and dividends — are discounted back to the present. Specifically, *the present value of expected corporate cash flows 10 -to -15 years in the future is amplified by low and declining interest rates.*

4. ***There is currently an unprecedented mountain of cash on the sidelines earning close to zero***, most notably in money market funds, bank deposits, and short-duration Treasury notes. A significant portion of these funds will eventually be deployed into the equity market, exerting upward pressure on stock prices.

5. ***There exists the potential for a major shift in long-term strategic asset allocation models*** because of the exceptionally low expected rates of return from fixed-income markets. For example, rather than the traditional balanced portfolio mix of 60% equities and 40% bonds, a shift by money managers to an allocation, of say, 75% stocks and 25% bonds could become standard. If so, trillions of dollars currently held in balanced portfolios could be transferred from bonds to stocks over the next three years.

These are long-term secular forces that could play out over the next several years. Any argument in support of the equity market must look beyond the next six months to a time when the coronavirus has been brought under control. Until then, the economy will remain hostage to the pandemic, and the equity market will remain hostage to a sluggish economy.

COULD INVESTORS CONCEIVABLY LOOK BEYOND CURRENT ECONOMIC RISKS AND BID STOCK PRICES HIGHER PRIOR TO THE AVAILABILITY OF A VACCINE?

<u>The equity market is the quintessential forward-looking indicator and could potentially look beyond the various risks of the next six months</u>. <u>However, there is a high likelihood that investors will respond negatively to any bad news on the economic, coronavirus, domestic political, geopolitical, or economic policy fronts in the short term</u>. Specifically, a more bullish short-term market outlook is dependent upon investor perceptions with respect to three critical variables:

- <u>The pace of progress within the medical community in developing a safe and effective vaccine</u>, and the timing of mass inoculation for the population. The odds of market selloff would increase in response to disappointing news and delays in mass inoculations. Conversely, positive surprises in timing and availability of a vaccine could encourage investors to extend their time horizons, pushing stock prices higher sooner.

- <u>The severity of a second wave of the US COVID-19 pandemic</u> in the fall and winter. Infections and hospitalizations nationwide have plateaued at a high level; a severe second wave of transmission would likely spook investors, triggering a temporary selloff until a vaccine is available. Conversely, a more modest uptick in infections would allow for more aggressive reopenings, and a stronger economy sooner.

- <u>The relationship between the level of infections and changes in opening and reopening the economy</u>. Continued progress in managing the pandemic — through better treatments for ICU patients and more aggressive public health measures — would reduce the death rate and potentially lift investor confidence.

Nonetheless, the most likely scenario for the equity market is a resumption of weakness, assuming a resurgence in coronavirus infections in coming months consistent with a new wave of the US pandemic. While impossible to predict in advance, it seems prudent to assume cases will sharply rise in the fall, as schools and colleges open their campuses and stores and businesses continue to open.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

Russell 3000 Value Index: Measures the performance of the broad value segment of US equity value universe. It includes Russell 3000 index companies with lower price-to-book ratios and lower forecasted growth values. It is market-capitalization weighted.

S&P 500® Index: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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