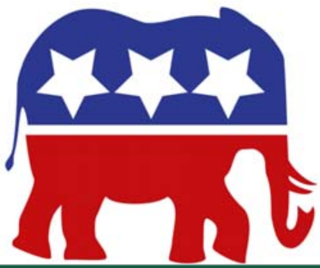
THE ELECTION, RECOVERY, FED & PANDEMIC

As the election draws near, I'm frequently asked if I think equities could continue to be kind to investors under Democratic leadership. I'm not one to make market predictions, but since history is available for study, I offer you the following analysis on the chance it could be constructive:

S&P 500 Average Annual Performance: 1933—2019



Republican Presidents with:	Average Annual Return
Republican Senate/Democrat House	+13.4%
Democratic Congress	+4.9%
Republican Congress	+12.9%

Democratic Presidents with:	Average Annual Return
Democrat Senate/Republican House	+13.6%
Republican Congress	+13.0%
Democrat Congress	+9.3%

Source: Strategas Research. (Returns shown above exclude data from 2001—2002, as power in the Senate changed three times during that period.

If you're wondering why returns are missing for the combination of a Democratic president, Democratic House, and a Republican Senate that seems at least somewhat plausible, it's because political power hasn't been configured this way since 1886.

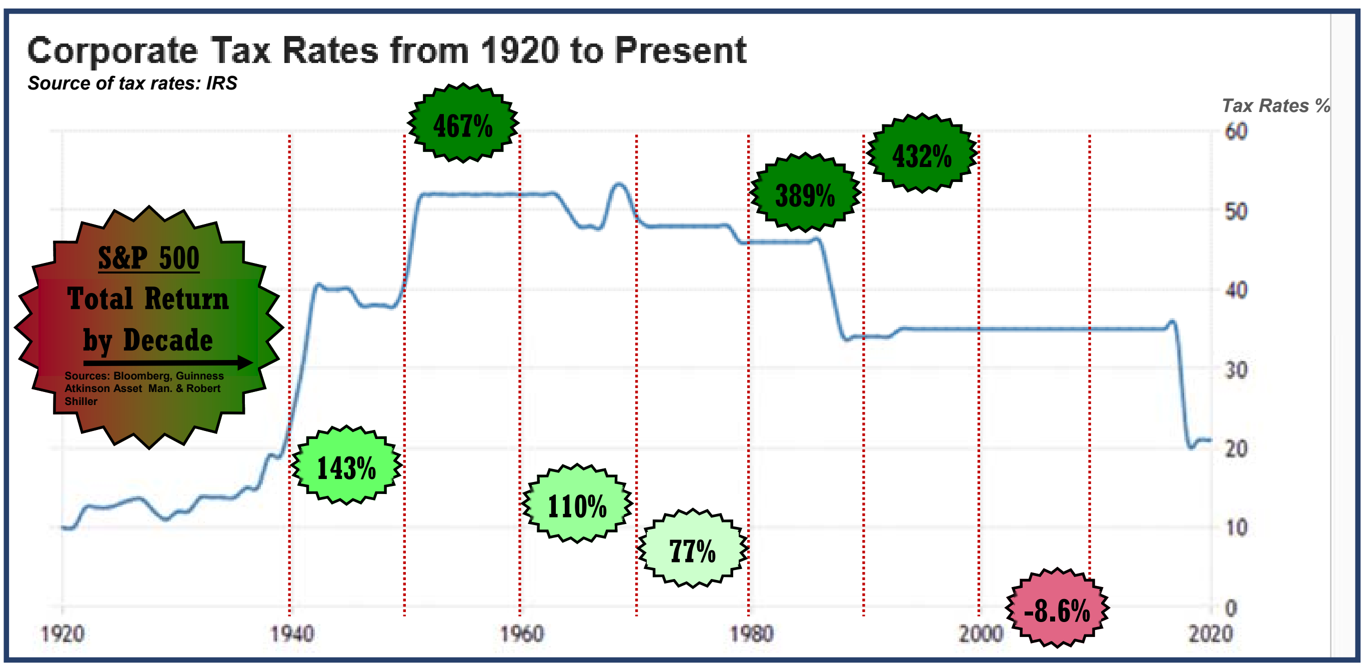
According to Zacks Research, Democratic presidents "have been better for equity market returns." Since 1933, for example, Democratic presidents have been associated with marginally higher stock market returns than have Republican presidents. But if one were to strip away the outsized gains during the 1990s tech boom under Clinton's watch and the declines of the dot-com bust in 2000 (also Clinton) and the Financial Crisis (which developed under Bush), the difference in returns between Democratic and Republican presidents would become a wash.

I share Zacks' view that market and business cycles are likely to impact equity returns more in the long run than the balance of political power does, so I continue to encourage folks in my orbit to resist the temptation to make wholesale changes to their portfolios in the quest of dodging short-term volatility.

FEAR OF HIGHER TAX RATES IF BIDEN WINS

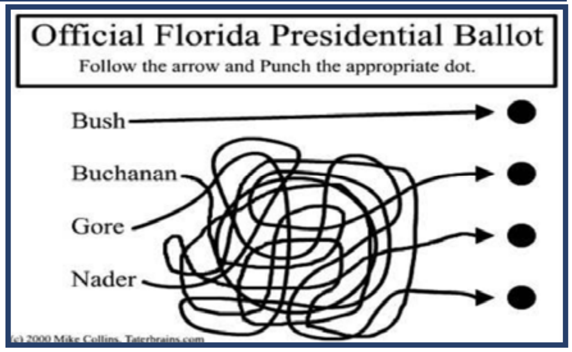
The Biden campaign has proposed raising individual income tax rates from 37% to 39.6% for those earning over $400,000 per year while also proposing a slight increase to Social Security payroll taxes on the high end of the income spectrum. Biden has also proposed raising the corporate income tax rate from 21% to 28% after it was slashed from 35% under the Trump administration's Tax Cuts and Jobs Act.

Since income taxes reduce corporate earnings and because they also reduce the amount of cash that is generally available for investment, higher income tax rates are an unambiguous headwind for earnings and equity markets. Tax proposals made during a campaign don't necessarily materialize as advertised, but I'm sometimes asked for my view of the equity markets if Biden were to win and his tax proposals were to be codified. Again, I'm not one to make predictions, but I suppose a decade-by-decade view of the S&P 500's performance under varying tax rates could be instructive.



To help defray the cost of World War II, corporate tax rates were much higher during the 1950s than they were during the 40s, yet the S&P 500 soared during the 50s. Tax rates drifted lower during the 60s and 70s, but equity returns languished. Rates were substantially and uniformly lower during the 1990s and 2000s than they had been since the early 50s, but equity returns could hardly have been more different during those two decades.

If a relationship does exist between tax rates and equity returns, I don't see it. If one were to try to fit a regression line to that relationship, I imagine it might look a bit like this satirized version of Florida's 2000 presidential ballot. Unless tax rates become truly punitive, my guess is that other issues are more deserving of investors' attention.

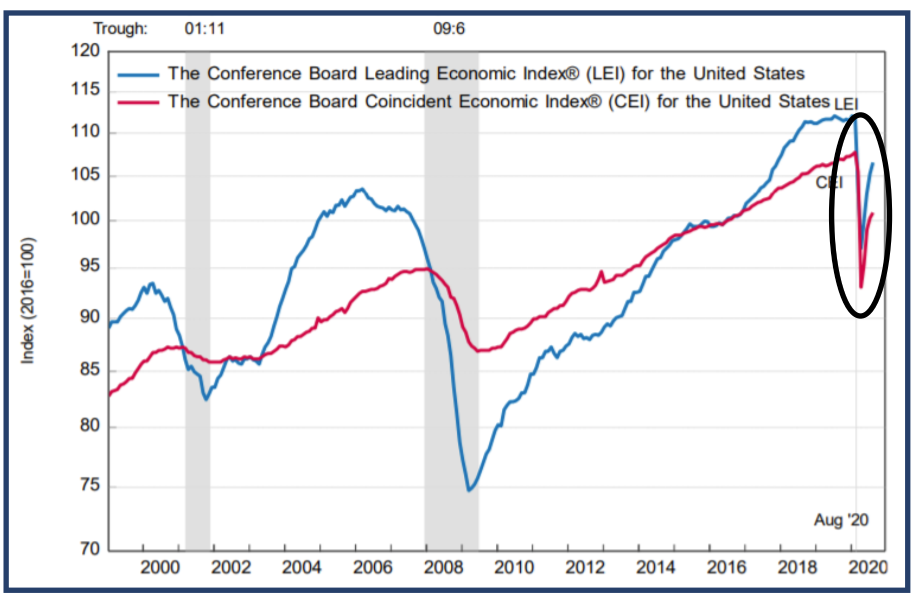


S&P 500 CONTINUES TO DRIFT HIGHER

Although the Coronavirus is now raging on with renewed vigor in this country and elsewhere, equity valuations continue to drift higher. As I write this in mid-October, the S&P 500 closed at a six-week high and well above its pre-pandemic levels.

In previous letters I've mentioned that the Federal Reserve has injected a lot of liquidity into our economic system, so it's inevitable that some of it has found its way into the capital markets. Optimism is also building around the various COVID-19 vaccines that are progressing through their respective phases and trials. (Refer to the enclosed COVID-19 Tracker for some interesting data.)

Because capital markets are forward-looking by their very nature, many investors are now much less focused on the downstroke of the most recent "V" that has recently developed in The Conference Board's Leading Economic Index than they are on the subsequent upstroke that seems likely to continue to form.



STRATEGISTS GENERALLY UPBEAT (ABOUT EQUITIES)

Source: Barrons (estimates as of September 14th, 2020

Targets for Year or Year-End ...

	BlackRock 2020	BlackRock 2021	Goldman Sachs 2020	Goldman Sachs 2021	Nuveen 2020	Nuveen 2021	Yardeni Research 2020	Yardeni Research 2021	Average	YoY Change
S&P 500 Target Year-End:										
2020	3650		3600		3600		3500		3588	
2021		3850		3800		3800		3800	3813	6.3%
Aggregated S&P 500 Earnings per Share:										
2020	$125		$130		$130		$125		128	
2021		$165		$170		$160		$155	163	27.5%
10-Year U.S. Treasury Yield Year-End:										
2020	1.00%		1.05%		0.95%		0.75%		0.94%	
2021		1.25%		1.45%		1.25%		0.75%	1.18%	
Fed Funds Rate Target Range Year-End:										
2020	0-.25%		0-.25%		0-.25%		0-.25%		0-.25%	
2021		0-.25%		0-.25%		0-.25%		0-.25%	0-.25%	
U.S. GDP Growth/Decline 2020										
2020	-5.5%		-3.8%		-5.0%		-5.0%		-4.83%	
2021		4.5%		6.1%		4.5%		3.5%	4.65%	9.9%

There are a few takeaways from the data shown, above. First, the strategists from these firms are unified in their expectation that equity valuations will rise further next year, but only modestly — 6%, or so. Their projections exclude dividends which could be worth an extra couple percent. The prospect of an 8% return is not overly exciting, but in an environment where the yields available on fixed-income instruments are often less than 3%, a high, single-digit return becomes comparatively attractive.

Before I discuss the "S&P Earnings per Share" metric, I'd like to ensure readers understand why this metric matters. In short, it is nothing more than the summation of the expected, per-share earnings of *one* share of common stock for *each* of the 500 companies within the index. If an investor were to purchase one share of the S&P 500 index by paying $3,534 for that share (as per the S&P 500's index value on the previous page), owning that one share of the index would then represent a claim on $128 worth of earnings from those 500 companies during 2020, $163 during 2021 (circled), etc.

Just as one might expect a drink that contains twice as much alcohol to be twice as costly, one might reasonably expect that 27.5% increase in per-share corporate earnings to induce a commensurate increase in the associated index, but the capital markets don't work that way.

Although these strategists are projecting per-share earnings of companies that comprise the S&P 500 to advance 27.5% during 2021, they envision that earnings increase to translate to an increase in this index of only 6.3%, or maybe 8% if we include the impact of dividends (boxed area).

This disparity is a function of the forward-looking nature of the capital markets to which I already alluded. The earnings rebound these strategists expect to occur next year is a primary reason stocks have *already* performed well. To the extent this optimism further increases, I would expect equity valuations to continue to drift higher. But if optimism wanes, stock valuations would likely fall *before* that waning optimism morphs into reality. For now, however, investors seem to expect the upstroke of the "V" to continue.

THE FED'S DUAL MANDATE & DEFLATIONARY SPIRALS

For decades, our Federal Reserve has been pursuing policies that are sympathetic to achieving the bifurcated goals of maximum employment and stable prices. This bifurcation is sometimes referred to as the Fed's dual mandate. Although there are times where Fed policy may further the achievement of one of these goals without sabotaging the other, there are times where this is not possible, or even advisable. As a result of the pandemic, the Fed has declared that we're now in one of those times. (More on this, later.)

The Fed's target for inflation had been 2% for quite a while. Although it would be nice to function in an economy entirely devoid of inflation, a 0% inflation target would pose an intolerable threat that our economy would lapse into a deflationary spiral where the prices of goods and services would persistently fall.

Imagine a scenario where the Fed aims for that utopian inflation rate of 0%, but overshoots that target a bit such that prices begin to decline by, say, 2% per year. Once people notice those declines, they are apt to delay further purchases, where possible, to maximize their spending power. As that mindset galvanizes and people begin waiting for prices to fall further, economic activity stalls. I've just described The Great Depression which made life difficult in this country for at least a decade.

If the Fed were able to act with perfection, it might be able to set and achieve a 0% inflation target, but neither the Fed's data nor its policy responses is perfect, so the Fed necessarily allows itself some margin for error — thus its familiar, 2% inflation target.

LANDMARK SHIFT IN FED POLICY — SIGNAL TO INVESTORS

In August, the Fed announced that it would, henceforth, place more emphasis on bolstering the U.S. labor market while placing less emphasis on maintaining a moderate level of inflation. According to the U.S. Department of Labor, the current rate of inflation within the U.S. was only about 1.4% over the 12 months ended September 30th. That's well within the Fed's long-standing 2% target, but this shift in stance has important implications for investors.

If inflation were to begin to encroach on the Fed's 2% target, the Fed might *previously* have let a little air out of the economy's tires by raising interest rates. As I've written many times, higher interest rates can present a stiff headwind to both equity and bond valuations for a multitude of reasons so I'll not rehash any of that, here.

In a statement released by the Fed in late August, however, it pledged to address "shortfalls" from the "broad-based and inclusive goal" of full employment. Accordingly, it declared that it would begin placing much more emphasis on bolstering the U.S. labor market while placing much less emphasis on maintaining a moderate level of inflation.

If you refer back to the bracketed data on page 4, you'll see that each of the firms referenced in that grid has decoded the Fed's August policy statement to mean that neither short-term interest rates (approximated by the Federal Funds Overnight Rate) nor longer-term rates (approximated by the yield on 10-year Treasury Securities) are likely to rise at all for at least a year. For now, the Fed has its foot on the gas pedal.

ROCK-BOTTOM INTEREST RATES BOOST EQUITY VALUATIONS ...

In general, low rates represent a tailwind for equity valuations for a number of reasons. Mathematically, equities are worth more when interest rates are low. First, corporations may refinance their debt at lower cost which then allows a greater share of corporate revenues to flow to stockholders. More importantly, low interest rates allow dividend-paying equities to become comparatively more attractive, especially to income-starved investors. When deciding between a 10-year Treasury Bond that might offer 1% per year for the next 10 years (refer to page 4) and an equity that offers dividend yield that's two or three times as high, it's easy to imagine even relatively timid investors venturing into the equity markets to capture some incremental income. This is the DNA of asset bubbles (overvalued assets) and this is one reason strategists are still relatively sanguine about the equities markets.

… BUT CREATE PERIL FOR BOND INVESTORS

As a result of the downturn of 2008/9, the Fed injected trillions of dollars into the U.S. economy and more or less allowed that extra liquidity to remain until it was convinced our economy was strong enough to tolerate the removal of at least some of it. Before the Fed was able to make too much progress on this front, the pandemic hit and the Fed needed to inject liquidity, again. As previously mentioned, the Fed has signaled it will remain in liquidity mode until it sees improvement in the labor market, even if that stance causes inflation to temporarily exceed its normal, 2% target.

Before I describe the peril bond investors currently face, allow me to recite a few bond-related truisms without being burdened by proving any of it:

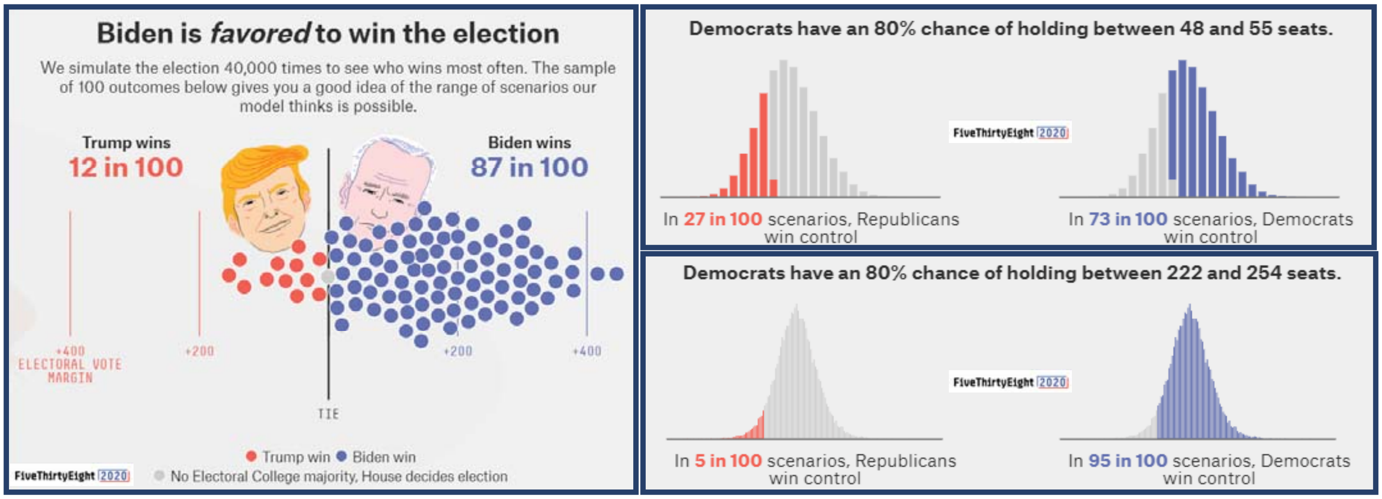
1. Investors prefer higher yielding bonds over lower yielding ones.
2. Longer-term bonds tend to offer higher yields than do shorter-term ones.
3. Lower-quality bonds tend to offer higher yields than do higher-quality ones.
4. The market value of bonds tends to vary inversely with changes in the level of interest rates (i.e., bond values rise when rates fall and fall when rates rise).
5. The market values of shorter-term bonds tend to remain relatively stable in the face of changing interest rates, whereas the market values of longer-term bonds do not.

No better situation exists for bond investors than to buy bonds while interest rates are high and on the cusp of a decline. In the 1980s, income yields of 10% — 16% were readily obtainable from good quality bonds. Once interest rates and bond yields started to subside, short-term bondholders benefitted from an extra smidgeon of capital appreciation while many longer-term bondholders reveled in double-digit dollops of it, courtesy of points #4 and #5, above.

BOND INVESTORS LOOKING DOWN WRONG END OF BARREL

The converse situation exists, today. Yields are uniformly low across the maturity spectrum. As an example, good-quality bonds rarely offer yields over 3%. Disregarding the possibility of negative interest rates, it seems far more plausible for rates and yields to rise rather than for them to decline further. Whereas points #4 and #5 provided quite a tailwind to bond investors in the 1980s, not only are bond investors suffering from paltry yields, they face a stiff headwind if or when rates rise. I think bonds still deserve a place in investors' portfolios, but the risks associated with rising rates deserve heed.

ELECTION ODDS (AS OF OCTOBER 18TH)



A FEW THOUGHTS ABOUT THE VIRUS

As dispiriting as the daily counts of infection and death may be, I'd like to offer a bit of historical perspective here, too. As such, please refer to the "Pandemic in Context" graphic on the enclosed COVID-19 insert which depicts the number of monthly deaths per one million people in this country since 1900.

Not only is our current death rate nowhere near either wave of the Spanish Flu or even the Flu of 1929, it's well below the rates of death experienced during most of the first half of the 1900s. Even ignoring the elevated death rates that occurred during WWI (1914—1918) and WWII (1939—1945), the U.S.' current, Coronavirus-augmented death rate remains below the rate the U.S. typically experienced during the first four decades of the 1900s (before the use of Penicillin became widespread). Although the Spanish Flu infected approximately a third of the global population and killed approximately 195,000 Americans in October of 1918, alone, the ensuing decade was so conspicuously prosperous that it became known as the Roaring Twenties.

It is estimated the H2N2 ("Asian" flu) pandemic of 1957—1958 killed 1—2 million people worldwide, 116,000 of whom were American. Yet, the period that followed was one of the most prosperous economic stretches in U.S. history. During the 1960s, real GDP growth (growth in excess of inflation) averaged 5% and spiked as high as 8.5% at times while payrolls shattered records for job growth over the course of the decade.

While I would not argue that a pandemic sets the stage for prosperity, I don't think it necessarily precludes the possibility, either. — Glenn Wessel