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October 9, 2020

Pre-Election Market Update – Alex Petrovic, CFP®

Another quarter has come and gone in this crazy 2020. Only one more to go! What else could happen in just three months?!?

Overall, the third quarter was a good one for the financial markets and economy, at least compared to the first half of 2020. Admittedly, that's an easy comparison.

As the S&P 500 Index had advanced 50% in a 125-day period, a loss of upward momentum didn't surprise Raymond James Chief Investment Officer Larry Adam. "Valuations rose to the highest level since 2001," he explained, "and technical indicators suggested that the market had reached stretched levels."

September is a notoriously difficult month for stocks. In fact, from 1980 to 2019, September has the worst average S&P 500 Index monthly return — and, as if on cue, stocks suffered a mini-correction over the final few weeks of September. The S&P 500 Index was down almost 10% from its September 2 high. However, despite the September slump, the S&P 500 Index gained 8.5% since July 1.

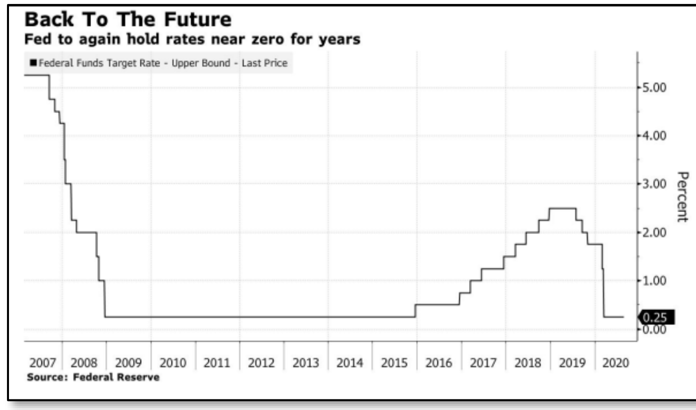
Since the stock market bottomed on March 23, the S&P 500 Index has only had three instances of pullbacks of 4% or more, and we still haven't had one greater than 10%. Pullbacks are a normal part of bull markets. Given the election uncertainty, not to mention COVID-19 uncertainty, we would not be surprised to see more volatility in the coming months… especially if the election results are contested by either side.

However, as I will explain in my next section, *Stock Market History: Election Edition*, I believe the elections and whoever is the next president will not be the primary driver of market returns over the next four years. Rather, COVID-19, corporate profits, the economic recovery, interest rates and inflation will be the primary drivers of investment returns.

While we still believe caution is warranted as we head into a heated election season and COVID-19 may still have some surprises for us as we head into winter, we are not anticipating a major selloff of more than 20%. A correction of 10% or more is certainly possible. Clearly, the stock market is not the economy and (see below) as: 1) interest rates are zero, 2) more fiscal stimulus arrives and 3) corporate profits rebound, we think there is a good chance the stock market grinds higher over the next 12 months.

Let's spend a bit of time talking about these (zero interest rates, the economy and corporate profits) and why they may bode well for the stock market in the coming 12 months.

Interest Rates and Inflation



As I mentioned before, U.S. interest rates are now back to zero. Some of you may remember U.S. Federal Reserve Chairman Jay Powell telling reporters following the Reserve's June meeting, "We're not even thinking about thinking about raising rates." Powell has reiterated this more than once since. The U.S. Federal Reserve has explicitly said interest rates will most likely be zero for two to three years.

Zero interest rates provide us investors with a dilemma: When cash and high-quality bonds won't make much money in the next few years, what can we invest in that has the possibility of making money? Well, the answer is taking risk and owning stocks. We call it TINA (There Is No Alternative… to what? Stocks).

On top of zero interest rates, in September the U.S. Federal Reserve announced it was revising its policy about <u>when</u> to raise interest rates. Remember, the Federal Reserve (or Fed) has a dual mandate: 1) low, stable inflation and 2) full employment, which means unemployment rate around 5%. In the past, the Fed targeted inflation of 2% and raised interest rates <u>before</u> inflation hit 2%. However, achieving this target in the last 10 years has been difficult as inflation has been very low, usually running below 2%.

Under the new regime, the Fed is expected to seek an inflation rate that roughly <u>averages</u> 2% over time, so a modest rise in inflation <u>above</u> target would be welcomed, not feared, after an extended period where it undershot.

What are the implications of this? Interest rates may be lower for longer. "I'd be very surprised if it's less than three years," said David Wilcox, a former Fed official now with the Peterson Institute for International Economics. "I could see it being as much as six or seven years if the damage from the crisis proves to be much more long lasting." The general thought is that as long as interest rates are zero, or very low, this will provide support to stocks.

What will cause rates to rise? Inflation above 2% and/or a very low unemployment rate. Presently, inflation is running about 1.3% annually, and we are still anticipating low inflation for the next year or two. However, the printing of money done around the world to support fragile economies may accelerate inflation in the coming years. But, at this point, no one is talking about significant inflation because workers' wages are not rising, and this is the primary reason economists cite for higher inflation. Historically, stocks have done okay when the economy is growing and there is moderate inflation. As always, we will keep an eye on future inflation and make portfolio adjustments, as necessary.

Better U.S. Economic Recovery

The broad range of U.S. economic data have continued to suggest improvement, but the pace of the recovery has recently moderated. From *The Economist* on 9/16/2020:

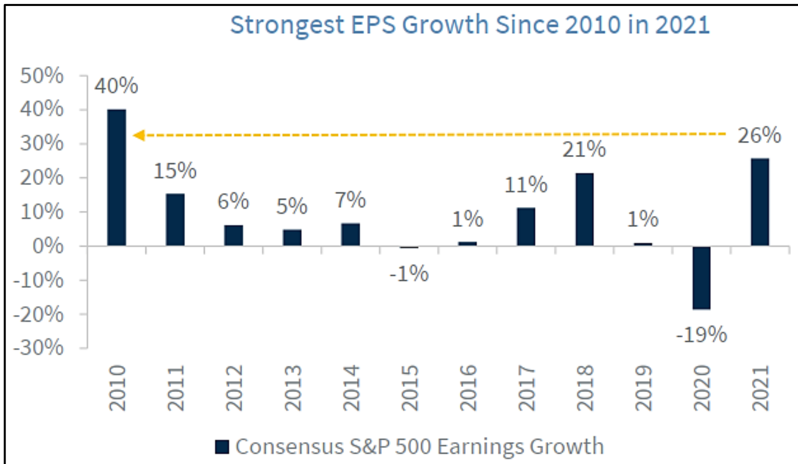
The Fed's rate-setters reckon unemployment will not return to its pre-pandemic rate of 4% until 2023; analysts at Goldman Sachs think it will do so only in 2025. On September 16th the OECD, a rich-country think-tank, predicted that the American economy would shrink by 3.8% this year, rather than the 7.3% expected in June. The outlook was upgraded across the rich world, but nowhere by as much. America still faces a recession about half as deep again as the one it endured after the financial crisis. But expectations are not as apocalyptic as they were—and look better than they do in most of Europe. The OECD highlighted that strong monetary and fiscal support will remain necessary for some time to come as governments must strive to revive optimism in the global economy.

RBC's September publication of its Global Investment Outlook noted, "Even after a vaccine is developed, we believe it will still take the better part of another year for developed economies to return to their pre-COVID-19 peak, and more like two years to return to their full potential. This is to say, mid-2022 and mid-2023, respectively."

Finally, most economists believe further fiscal spending is needed here in the U.S. On October 6, President Trump said that negotiations on a Phase 4 CARES spending bill will cease until after the election. Trump, Republicans and Democrats do agree more spending is needed, but they disagree on how much and to whom the money will go. One of the reasons the stock market has rebounded since the March 23 low has been the assumption that Congress and the Federal Reserve would continue to support the economy. It looks like this will still happen but not until after the election. Assuming Congress delivers at some point in the relatively near future, this will help the economy recover and continue to bolster stocks.

U.S. Corporate Profits

Corporate profits are the lifeblood of the stock market. As you can see from the chart, 2020 earnings are horrible, and projected to decline 19%. Second quarter 2020 earnings for S&P 500 companies were down 33% year-over-year, and third quarter profits are expected to be down 23%.



Source: FactSet, as of 9/29/2020.

However, many investors are ignoring 2020 earnings and focusing on 2021 because 2020 is a "throw-away year," and it is assumed next year will be more indicative of profits post-COVID-19. This is another reason why the stock market has rebound substantially and why many stock market prognosticators are bullish for 2021. While Wall Street analysts are notorious for their optimism when it comes to future corporate profits, a healthy rebound could provide more fuel to the bull market fire.

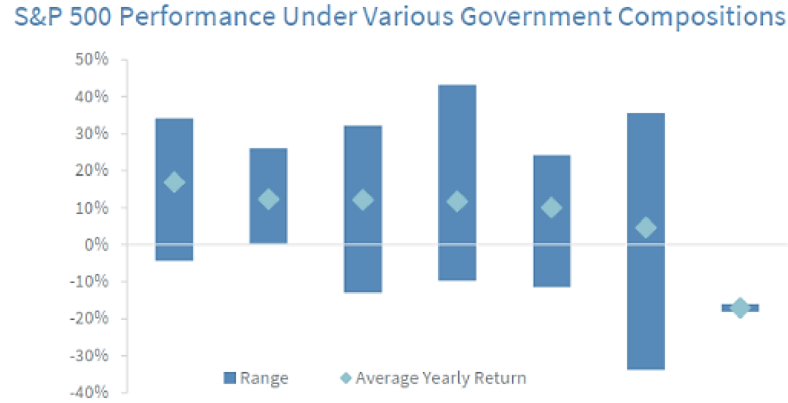
Stock Market History: Election Edition – Alex Petrovic, CFP®

As Jim Stoutenborough's well-written article in last quarter's newsletter illustrated, each President's stock market record was mostly out of his control. Meaning there are bigger forces at play such as economic cycles, corporate profit cycles, interest rate and inflation cycles, debt cycles, globalization, economic/political/commodity shocks… you get the picture.

President George W. Bush did not cause the Great Financial Crisis, but his stock market track record is horrible. President Bill Clinton happened to arrive right after the 1992 recession and can't take credit for the major bull market that followed. Obama arrived at the depths of a financial crisis and isn't solely responsible for the stock market recovery… just as Trump inherited a relatively healed economy and isn't solely responsible for a rip-roaring stock market, up until this year.

<u>So, what is the point? It's too simplistic to assume one political party is better for the markets, or that a President or even Congress can drive the financial markets. The U.S. and world economies are too big and complex to be affected by only four to eight years of an administration. Sure, presidents and Congress can certainly have an effect, but sometimes those effects take years to play out.</u>

As you can see from the chart, since 1945 the average S&P 500 Index annual return under most compositions of U.S. government has been positive. I would argue that most of these are so similar there isn't much of a difference. Plus, each underlying time period has so many events and financial conditions going on that it's too simple to use a president or a political party as a guidepost for investment returns. If there was a significant difference, I would expect the data to be more clear cut.



President	D	D	R	R	D	R	R
Senate	R	D	R	R	D	D	D
House	R	R	D	R	D	D	R
Occurrence	11%	6%	11%	11%	28%	30%	3%

Source: Raymond James Investment Strategy / all data is post World War II

This of course isn't to say that a president or political party cannot have an effect. They certainly can to some degree. Let's take a look at how might a Trump or Biden victory impact the financial markets. This is all speculation because even the consensus viewpoint can be wrong. Before Trump was elected, many investors thought his style of governance would give investors pause, but this wasn't the case. Others thought Obama would damage the economy and stock market, and this did not come to fruition. Guessing the future is a humbling business.

Biden vs. Trump: Economic and Stock Market Implications – Alex Petrovic, CFP®

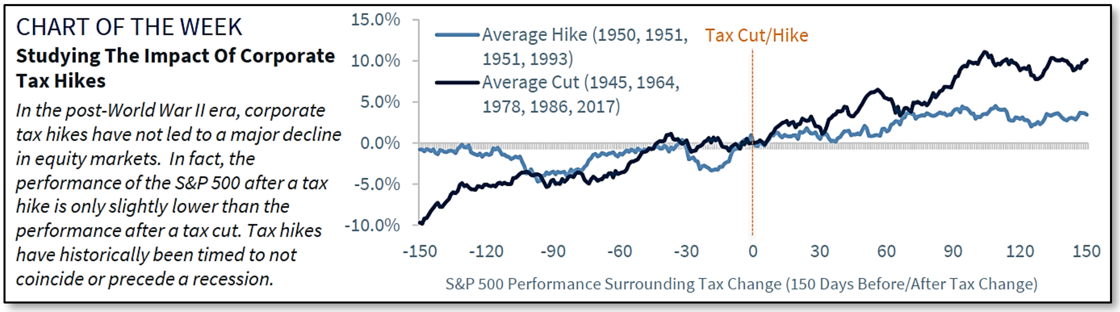
Focusing on what the financial markets care about, let's take a look at a few perspectives from institutional money managers on various election outcomes. Spoiler alerts… 1) these are educated guesses about the future, 2) they assume either victor will actually be able to get his platform enacted, which doesn't always happen and 3) who wins may not matter that much in the long run.

Blackrock – 9/28/2020 (https://www.blackrock.com/corporate/literature/market-commentary/weekly-investment-commentary-en-us-20200928-consequential-election.pdf)

> *We see fiscal policy as the most critical area to watch, as it has been helping bridge the economy through the Covid shock. The two Biden victory scenarios would look very different through this fiscal lens, in our view. A Democratic sweep would likely pave the way for a new round of large-scale fiscal stimulus and boost spending on clean energy, transport and housing – but also increase taxes for companies and the wealthy. A Biden win with a Republican-controlled Senate would lead to much less ambitious fiscal stimulus and infrastructure spending, and no major tax changes. The net difference in fiscal spending between the two scenarios could be several percentage points of GDP over each of the next few years, we estimate. Fiscal spending under a second Trump term would be somewhere in the middle between those two scenarios.*
>
> *The election result will have implications for the key geopolitical risks we track. A Biden win – under either scenario – would likely signify a return to more predictable trade and foreign policy, supporting emerging market assets and broader risk sentiment in the short term. Yet we see U.S.-China rivalry staying structurally elevated across dimensions such as technology, trade and investment under Biden, due to bipartisan support for a more competitive stance on China. A Trump win, by contrast, would likely lead to a doubling-down of the "America First" stance on trade and immigration.*
>
> *We think a "tax-centric" election analysis — with a Democratic sweep seen as a market negative, and divided government a positive — is too simplistic. In a Democratic sweep scenario for example, investors would have to balance higher taxes and tighter regulation with greater fiscal support and predictable foreign policy.*

Raymond James – 9/11/2020 (https://www.advisorperspectives.com/commentaries/2020/09/14/weekly-investment-strategy)

> *Will Biden's Corporate Tax Policy Hurt the Stock Market?* With ~50 days to Election Day and former VP Biden maintaining his poll lead, investors have questioned (assuming a Democratic sweep) the equity market impact of Biden's call for a partial reversal of the 2017 corporate tax cuts (an increase from 21% to 28%). Intuitively, an increase would be a headwind for equities, as it reduces profitability and dampens earnings growth. In fact, our analysis suggests that the proposed higher tax rate, if implemented next year, would cut earnings by ~10%. However, after 'hitting the books' and studying the impact of the last four corporate tax hikes in the post-World War II era, we found that the S&P 500 rallied ~8% in the 150 days following the increase and was positive 100% of the time. In addition, none of the tax hikes caused a recession in the year following their implementation.



> *Bottom Line:* Assuming our elected officials have 'studied' the health of the economy, we cannot unequivocally hypothesize that higher corporate tax rates will lead to a market decline. Other dynamics such as monetary policy, fiscal policy, the economic recovery, earnings growth and investor sentiment may ultimately dictate the direction of the equity market.

Fidelity – 8/30/2020 (https://institutional.fidelity.com/app/item/RD_9894944.html)

> *For the overall stock market, there are pluses and minuses under all three election scenarios. With Biden, you'd likely have more fiscal stimulus but higher taxes on corporations and higher earners. That could include higher taxes on capital gains and disincentives for share buybacks, which have helped drive stock valuations higher in the U.S. than other countries. With Trump, you'd likely see lower taxes but less stimulus and a more confrontational approach to U.S.-China relations, which has unsettled markets in the past.*

> *That makes it difficult to say which administration would be better for stocks. Says Jurrien Timmer, Fidelity's director of global macro: "It's my personal sense that the 2020 election will have less impact on the markets than some suggest. Ultimately, it's the long wave of economic fundamentals that drives the markets beyond any one election or any one party."*

Let's do the numbers - Jim Stoutenborough, CFP®

- For September, the markets paused after big gains in July and August. Almost everything dropped at least some for the month, the S&P 500 Index was down (-3.8%) for the month but up 8.9% for the quarter. The Russell 2000 Index dropped (-3.3%) in September but was solid with a 4.9% gain for Q3. International stocks also dropped with the MSCI World ex US Index down (-2.5%) for the month but up for the third quarter 4.9%. Bonds were down a skoosh, -0.05% but up 0.6% for the previous 3 months.

- For the last 9 months of the year the stock market indexes are mixed with large companies continuing to drive the rebound with the FAANG stocks (Facebook, Apple, Amazon, Netflix and Google) + Microsoft leading the way – these six stocks are hefty holdings in the iShares Russell 1000 Growth ETF (IWF) in your portfolios.
- For the last three quarters, large U.S. companies, the S&P 500 Index is up 5.6%. The Russell 2000 Index (small U.S. companies), is still down (-8.7%) for the year-to-date. The international index, the MSCI World ex US, ended up in-between the 2 U.S. indexes and was down (-7.1%). Quality bonds are having a good year. The U.S. Aggregate Bond Index (quality U.S. corporate and gov't bonds) is up 6.8%.

Asset Class	**Index/Category**	**As of 9/30/20**	**2019**	**2018**
Cash and cash alternatives	Average 1-yr CD Rate	0.27%**	0.8%**	0.9%**
U.S. Bonds	Barclays US Aggregate Bond Index	7%	9%	0%
U.S. Large Companies	S&P 500 Index	6%	31%	-4%
U.S Small Companies	Russell 2000 Index	-9%	26%	-12%
International Stock Market	MSCI World ex US NR USD	-7%	22%	-14%

*Numbers come from Morningstar and **Bankrate.com*

Inside & Outside of PFS

Alex Petrovic - I hope all of you had an enjoyable summer! Our summer was quite busy but good. At the end of July, Dasha, Benny and I travelled to Estes Park, Colorado for our COVID-friendly vacation. This was our first trip to Estes Park and hopefully not our last. We rented a home with a nice deck and view of the mountains. I was hoping to do some stargazing at night, but most nights were overcast, or the moon was shining brightly. We did however see an elk family up close a couple of times as they grazed around the house and in the neighbors' yards! I also saw elk relaxing in some grass next to the grocery store one day.

We spent about a week in Estes Park, and we explored Rocky Mountain National Park for 4 days. Because of COVID, the park restricted the amount of cars/people, and I think this helped make the trip more enjoyable for us. Each day we hiked a different trail. To ease Benny into hiking, we started out with shorter, relatively flat trails. He did very well as long as we kept him engaged. We looked for flowers, bugs and Golden-Mantled Ground Squirrels, who were quite tame and hungry. We climbed up and down rocks and fallen trees. Two of the hikes we did were well over a mile and one of them was 3-mile loop (out and back) with an elevation gain of about 800 feet. He was worn out, but he made us proud, and we all had a wonderful time!

After we returned home from Colorado, we bought a house. Yes, we moved… to Kansas… to the suburbs. 😊 Dasha and I planned on moving for the last few years, and we debated the whole time about staying in Brookside or moving to Kansas, ideally Prairie Village or Leawood. With the housing market on fire and few houses for sale and after 6+ months of looking and losing out on a few houses, we were able to find a nice home in south Leawood. In late August we moved in and said 'goodbye, for now' to Brookside. So far, we are enjoying our new home, neighborhood and the local parks! Plus, Benny changed schools, and his transition has gone smoothly!

Last but not least, Dasha and I are expecting another munchkin in late January 2021. Dasha is doing well overall, and so far, all signs have been good regarding her health and the baby's. We recently celebrated our 15^{th} year of marriage, and all of us, including Benny, are excited to add another member to our family!

I hope you and your loved ones are doing well, staying healthy, and trying to make the best of these interesting times!

Ann Kloster - As with many folks, I haven't done much these past few months to write about. But it was great to watch every single Royals game this season -- and that's a first. I am hoping we can return to the ballpark next spring so the boys can hear us diehard fans cheering them on.

Hoping you and your families are well and safe.

Jim Stoutenborough - Continuing to continue to shelter in place. One very interesting thing I got for my birthday was a DVD that was a history of my early ancestors to this country. At that time, we were "Stoutenburgh", or as my daughter refers to it – us before the "o". My early family actually made a good-sized footprint in early American history. One of the two items, among many, that we found intriguing was that Jacobus Stoutenburgh had a house on the Hudson River and was a well-known patriot during the revolution with 4 sons in the revolutionary army – 3 as officers, so whenever the British sailed ships up the Hudson toward Kingston, New York, they made a point to fire some cannons at his house. The second was the house of William Stoutenburgh was part of the underground railroad. It's good to know, that more often than not, we were on the right side of history. We are still watching too much TV; and I binged through "Cobra Kai" which I really enjoyed and me and the kids watched Rocky's 1 and 2. We paused, but plan to finish 3 and 4 before year-end, Milken the cat does one really cool thing. Usually once a day he will take 10 minutes and fly through apartment at full speed running from room to room and jumping from furniture to furniture. When he does this, because of the hardwood floors in the apartment, he will stop his front paws at full speed and then his back half will skid around, doing a 180 so that he is facing the opposite direction like Starsky and Hutch used to do in their car.

Jeannine Shaffer - Fall is absolutely my favorite time of year! The sky has a deeper blue hue to show off the colors of the changing leaves to shades of my favorite color, orange. Warm days for gardening with cool crisp mornings to enjoy coffee on the porch and chilly evenings to enjoy a glass of wine by the fire on the patio. The only thing missing is the company of family and friends.

Our daughter will only allow outdoor visits, so we have taken a few walks with our almost 3-year old granddaughter. They have been to places in KC we were not that familiar with, like the Troost Nature Center, the Kaufman Memorial Gardens, and the extensive sculpture garden at the Nelson. Hope our daughter's attitude about the pandemic changes before the snow falls. I do not like cold weather!

Bryson Slater - It was an interesting summer, to say the least. Many of the weddings and other events I was supposed to attend were canceled. Even with the pandemic, I was able to make the most of these crazy times! I spent more time at the lake than I have in many years. Golfing and going to the pool were a couple of other ways I spent my time.

We have thankfully made it to my favorite season, Fall. Filled with football, bonfires, cooler weather, sweatshirts and fall foliage! Plus, we get to watch our Kansas City Chiefs (hopefully) "Run It Back"!

Marsy Gordon - Many thanks to each of you who have inquired about my family's well-being and my husband's and my recovery from our health issues. Both of us are doing well. In fact, we made a trip to Virginia in September to visit our son and his family, and to meet their new baby. It was a long drive, but all involved agreed the health risks of driving would be better than flying this time.

Our new granddaughter is a beauty with a sweet disposition – a totally objective Grandma opinion, of course. This gives us an even half-dozen grandkids – three girls and three boys – blessings and treasures all.

As all of us look forward to the Holidays over the next few months, may we not just count and give thanks for our blessings, but truly cherish each and every one of them.

Marilyn Brohm – My puppy is now huge and still getting into everything. He’s a good boy, but sure knows how to make a mess! We’ve been going to the off-leash dog park every afternoon and the old adage ‘a tired dog is a good dog’ holds true. Really missing giving my mother a hug and seeing the grandkids. Hope this whole mess goes away soon – “like a miracle”.