Investment Commentary

October 12, 2020

The financial markets have been relatively tame over the last few months in spite of uncertainty and sensational headlines. The stock market is up modestly in the last few months and continues to be out of sync with the economy. The bond market has been flat.

A complete reopening of the economy is at least a year away as we continue practices to minimize the spread of Covid-19.

The Election

Elections typically have little effect on the financial markets. In most cases the stock market rallies after an election is over since the uncertainty has been lifted and the outcome known. If there is a change in political party, the stock market will engage in "sector rotation" rather than a big moves up or down. Investors will make changes to portfolios based on which industries will benefit from the change in government.

A big uncertainty with the current election is the possibility the outcome will not be known for weeks after election day due to vote counting and legal proceedings contesting the election process. Financial markets do not like uncertainty and that could result in a modest correction (5% to 10% or so). The only recent precedent we have is the Bush - Gore election in 2000. The results were delayed from November 3rd to December 15th resulting in a decline of 8.4% in the stock market.

As we get closer to election day, the odds favor a scenario where the results are known in about a week or so, or possibly even on election night. That scenario certainly reduces the possibility of a correction. But the current economic environment and possibility of a subdued holiday shopping season will prevent the stock market from the typical after - election rally.

I discount the election as having much effect on the overall performance of the stock market over the remainder of this year.

The Economy

The effects of previous stimulus legislation have run out and negotiations for new legislation will likely not resume until after the election or possibly not until next year. Economic recovery has stalled out and more stimulus is needed.
But it remains to be seen how effective more stimulus will be. At best, the economy will not have recovered completely until well into 2022. And the effects from a stimulus package will likely be short lived.

Without a new round of stimulus, renters and landlords face an eviction crisis in 2021. Some 30 to 40 million Americans face the threat of eviction as a result of the pandemic. The ripple effect would have a significant impact on the overall economy.

Modern Monetary Theory

Modern Monetary Theory (MMT) is a set of ideas that has come into prominence in recent years promoting the idea that budget deficits can largely be expanded without consequences. It starts with the idea that a sovereign government, in control of a sovereign central bank, can never be forced to default on its own currency debt. Provided it has a light touch on both the gas and the brake, an economy can emerge from recessions faster and stay close to full employment for longer.

While MMT is a theoretical concept, many governments, including the U.S. government, are effectively putting MMT into practice. As long as inflation remains low, there is little cost to a massive increase in money supply or in total financial assets. Over a long period of time, this could all end very badly. The eventual outcome could be an increase in inflation and a falling U.S. Dollar.

The Stock Market

The economy goes through a process of innovation and "creative destruction" as new companies emerge and some companies disappear. This takes place over a period of years, even decades. An example of this is what we have seen happen in the retail sector in real time. This process started in the late 90s when a company called Amazon started selling books online.

This year the creative destruction process has occurred in a matter of months rather than years and divided stocks into winners and losers. This is one reason for the big divergence in the growth style led by big technology stocks and the value style where the losers reside.

For now the large cap growth style, even though it is overvalued, will likely continue to outperform the value style. And large cap stocks will continue to outperform small and mid-cap stocks.

The stock market has moved within a narrow range in the past few months with the exception of a quick spike up and then 8% correction in early September. The primary focus of the stock market at this juncture is not the election but the status of stimulus legislation. Passage appears unlikely before the election and it is anyone's guess what will happen after the election (depending on the outcome of course). Stocks will likely continue in a narrow trading range until stimulus legislation is passed.

Even though the economy is still in recession and complete recovery not likely until 2021, the stock market will probably not experience another big move down in the near term. The more likely scenario is very modest upside, primarily in large cap growth stocks. And interest rates have a significant impact on stock market performance. The Federal Reserve has indicated it is not likely to raise short term rates until 2024. As long as interest rates remain very low, the stock market is unlikely to experience any significant downside.

International stocks have underperformed U.S. stocks for years but could begin to outperform. Other countries are at different stages of the pandemic and some are at more advanced stages of reopening their economies. And a decline in the U.S. dollar (due to the massive Federal budget deficit) would increase the investment returns of international stocks.

Brexit is finally coming to a head and it remains to be seen if a deal can be made or if there will be a "hard exit" with no deal. Failure to reach a deal would result in turmoil in international stock markets but the effects would be short term.

The Bond Market
Bonds will not provide much return for the next several years. Certain sectors of the bond market such as corporate bonds are providing a higher return than U.S. Treasuries. Investors will have to increase the risk of their bond allocation to get any kind of return from the bond market. But interest rates will likely remain low for years to come and the market has already sorted out the winners and losers. That minimizes any potential downside.

Actively managed bond funds are preferable to index funds (a total bond market index holds a large portion in U.S. Treasuries and other government bonds). And mutual funds are better vehicles for investment than electronically traded funds (ETFs) for many sectors of the bond market.

In the near term, an allocation to short term corporate bonds is advisable to minimize interest rate risk. They also serve as a source of liquidity since the yields on money market funds are nearly zero.

Private Real Estate Investments

There is a recent discussion about investment in privately held real estate ventures by pension fund managers. These funds diversify across various asset classes and usually have 7% to 10% invested in private real estate. Going back to the late 70s, these investments have significantly underperformed a conventional portfolio of stocks and bonds and also publicly traded real estate investment trusts. And yet these fund managers continue to invest in them.

This confirms my belief that an investment in an illiquid venture (typically a limited partnership) of any kind is not a good idea for most investors. A limited partner has no say in the management of the venture and if unhappy with investment performance cannot readily sell the investment. In an environment of low investment returns, potentially for years to come, it is especially important to resist sales pitches for an investment in a limited partnership that promises a higher return than a conventional stock/bond portfolio.

Overall Perspective

Once we are past the election, the focus can shift back to the economy and overcoming the spread of Covid-19. There is still a long way to go but the worst is over and the end will be in sight.