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2020 Third Quarter Review
"Drum Roll, Please!"

The much-anticipated U.S. election is just 3 weeks away. Investors are understandably preoccupied with the outcome and its ramifications for the economy and the stock and bond markets. Tension is high and volatility is on the increase. Many have delayed making changes to their portfolios until after the outcome of the election is decided. Others are betting on one side or the other prevailing with various theories as to what opportunities and dangers either outcome will bring. The movement of the markets reflects all those participants' actions as well as intervention by the Federal Reserve and the U.S. Treasury. In just 3 weeks we will hear the drum roll and prepare for the announcement, "…and the winner is…" Or maybe not.

Back in 2016 the conventional wisdom was that a win by Hillary Clinton was fully discounted in stock prices and a Trump victory would tank the stock market. After the election, the market declined for less than a day, then took off as investors reassessed the possibilities for stocks with the new administration. The polls were wrong about the election results and the pundits were wrong about the stock market's reaction to a Republican win.

This time around it is most interesting that the consensus regarding the effect of either party's winning the presidency and/or the Senate majority has recently shifted again. Through the summer the conventional wisdom had been that a victory by the Democrats would be a "market negative" as the likelihood of higher corporate and capital gains taxes as well as government regulation would increase. However, the recent strengthening of the Democrats in the polls has coincided with a spirited market rally (after the sell-off in September). Now the emergent thinking is that a win by the Democrats may bring with it an enormous stimulus package that would be far larger than that of the Republicans. The Democrats' economic stimulus might be large enough to raise economic activity and corporate profits as well as the general level of stock prices. A victory by the Democrats has gone from being seen as a "market negative" to a reason for a "Biden Bump" rally, anticipating a change in the party in control of the White House and possibly the Senate as well.

The specter of a protracted battle contesting the election results is not to be dismissed. An ambiguous outcome could be disruptive to economic activity and to the markets. However, we went through something similar in the 2000 election; although this time there is an incumbent who may refuse to concede to anything less than an overwhelming defeat. Once again, the conventional wisdom has appeared to swing recently, leaning more toward the possibility of a larger than expected margin for a Democratic victory leaving little room for doubt as to the election results. A clear outcome would resolve at least one uncertainty and could be cause for a "relief rally" by itself. Otherwise, a closer outcome will probably make investors worry about a messy transition and may weigh on stock prices.

Whichever way the election turns out, several conditions will remain. We will still have a pandemic to work through, a huge increase in monetary and fiscal intervention, and interest rates that are

practically zero for short-term "riskless" investments. A big part of our job is preparing for what comes next.

The pandemic has accelerated changes that were already occurring, but it has sped up and intensified those changes dramatically. Trends toward more online retail commerce, distance learning, virtual meetings, work-at-home, and mobile entertainment have been catapulted by the lockdowns and restrictions that have been put in place to curb the spread of the virus. Stocks in those industries have done very well and some may be so richly valued as to present more of a risk to potential investors than an opportunity at these price levels. These economic trends will continue, but that is not to say that the investments in many of the hottest stocks in those industries will do well. We refer again to the lessons of the year 2000 to remind us that valuation matters and that you can be right about the industry, but wrong about the ultimate value of a particular stock in that industry. Accordingly, we should be careful

With the huge influx of monetary and (soon) more fiscal stimulus to the economy, we should be aware of the risks of reemergent inflation. The rebirth of inflation has been prematurely predicted many times in the recent past, but the unprecedented monetary and fiscal interventions have already begun to show their effects in the prices of lumber, houses, cars, transport, and many other areas of everyday life. Precious metals prices have risen as they represent a traditional store of value and a haven from inflated paper (and digital) currencies. The deflationary effects of cheap goods from China is probably a thing of the past. Mexico will likely be our next big source of low-priced labor, but goods are still likely to be more expensive.

Whenever economic recovery does occur, it will likely bring with it higher interest rates. Currently, the Federal Reserve is holding short term rates at zero, with no plans to raise rates for several years. The yield on 5-year US Treasury Notes is currently 0.30%, the 10-year yields less than 0.75%, and the 30-year US Treasury Bond yields a paltry 1 ½ %. The Federal Reserve controls very short-term interest rates, but they don't control the rates on longer maturities (although they can influence them). Intermediate-term rates are more likely to rise with an economic recovery, and that could be a boon for a particularly unloved sector, the banks.

Two industries that may represent classic value at this moment are the banks and the pharmaceutical companies. The "drug stocks" are under the cloud of possible price reductions with either party winning the White House, but the bank stocks are almost universally shunned for a variety of reasons that make sense on the surface. However, that may already be more than fully discounted in their current stock prices. With the influx of monetary stimulus, banks are awash in record levels of deposits. A steeper yield curve (i.e. higher rates at longer maturities) would be a boon for banking company profits. Bank balance sheets have largely been unscathed and will likely increase book value this year. They are already highly regulated and would probably not face the scrutiny that large tech companies will undergo in any Democratic administration. Bankers have taken large reserves against losses which may be released to earnings if defaults are lower than expected. In addition, P/E ratios are historically low. Color us interested.

The current investment mosaic is obviously complex and constantly shifting with too much to describe adequately in a short letter. Rest assured we are working to protect your assets and to guide a successful course through these obstacles and opportunities. Lastly… remember to vote!

Sincerely,

Claude Carmichael CFA