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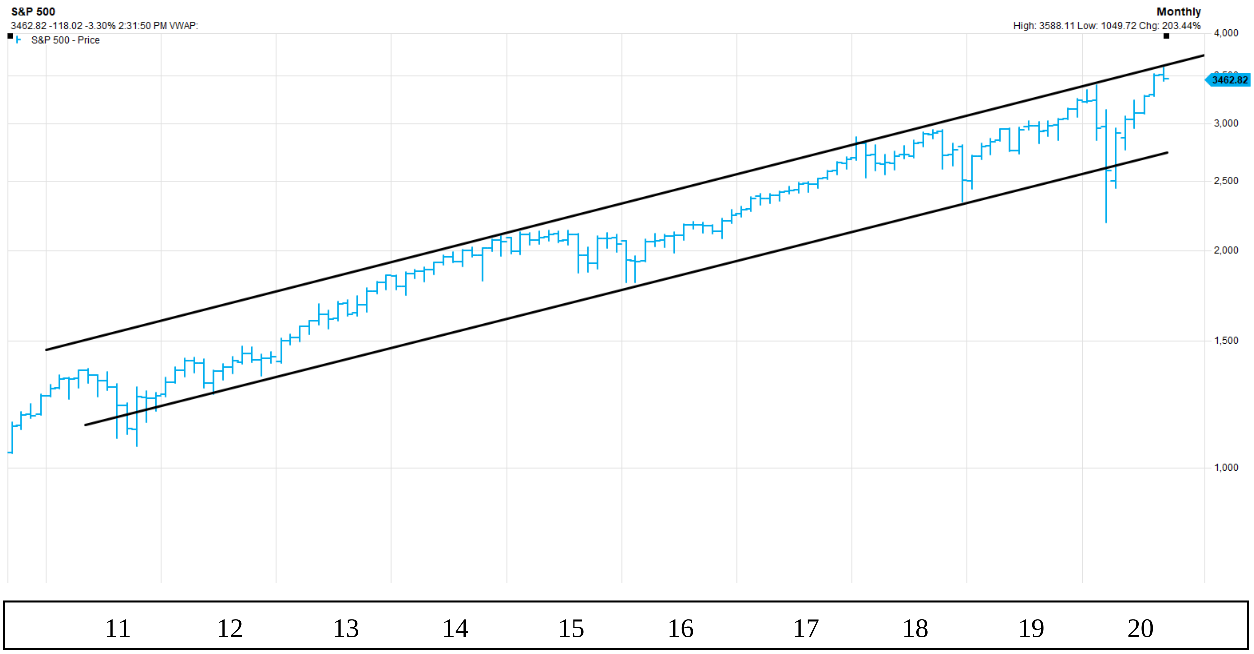
S&P 500



That Was Quick

We expected stock prices to rise through 2020, but the 15% gain in the S&P 500 during the three months through August was unpredictably rapid. As we have seen in recent days, a month or two of digestion is apparently underway. The summer ascent in prices put the S&P 500 at the top of its upward ten-year trend channel, while the 14-day RSI reached about 70, indicating that the market became short-term overbought. Stock prices never move in any direction uninterrupted. September has historically been a month of poor stock performance. A correction in prices after such a strong advance is not unexpected and is reasonable, especially for those stocks that have had the most extreme moves upward.

Despite our cautious outlook for the month ahead, we expect stock prices to be higher during the next six to eighteen months for these reasons:

1. By the middle of next year, the Covid-19 pandemic will be a concern of the past and the global economy will be solidly in expansion mode;
2. Earnings hit bottom in the second quarter of 2020 and are heading higher;
3. The Federal Reserve has committed itself to keep interest rates low for the foreseeable future;
4. Inflation pressures remain low which, along with low interest rates, indicates that stock valuations will remain high.

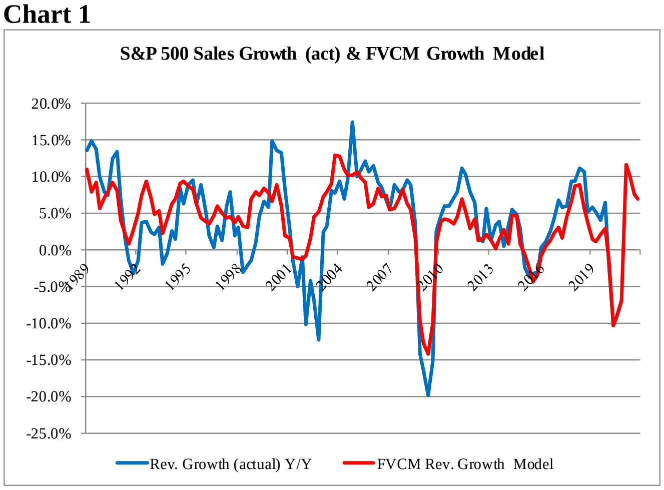
Any decline in stock prices during September and perhaps October should be considered as an opportunity for investors sitting on cash to accumulate new positions for the year ahead.

The 7% gain in the S&P 500 during the month of August was astounding, but the moves in some of the trendy "pop stocks" was a true head scratcher. How can one explain a 21.4% one-month gain in a giant company like Apple? Or the 39.9% gain in Salesforce.com, or the 74.1% gain in Tesla! All the while the energy sector continued to seemingly drift into oblivion. In 1980 four of the ten largest capitalization stocks in the S&P 500 were energy stocks. Today, the entire energy sector is only 2.2% of the S&P 500, which is less than a third of Apple's weight alone, which is now 7.2%. There are certainly reasons why earnings for the modern technology companies should continue to trend upward in the years ahead while there are some major headwinds for the energy sector, but sometimes trends become distorted by irrational exuberance, to borrow a phrase from Alan Greenspan the former chairman of the Federal Reserve. Investors naturally want to pile into investment ideas that have momentum, but the risks are high. Sometimes the tortoise will beat the hare. We certainly wish to participate in the technological transformation underway, but a more conservative approach—by keeping an eye on valuation—is perhaps a more prudent style.

U.S. real GDP is forecast to contract 5.2% for all of 2020. Looking forward, the economy is forecast to expand 4.3% in 2021 and further still in 2022. The U.S. economy had been in the longest post-war expansion up until early 2020, and the pandemic proved to be the perfect event to trigger the worst contraction since the 1930s. Fortunately, bad things do not last forever just as good things do not. Manufacturing is already in an expansionary phase and the backlog of new orders has been rising while inventories have been falling. This combination of factors signals a very positive outlook ahead. The service side of the economy is also now in an expansionary phase but less so. It will probably not be until later this year or early 2021 when a Covid vaccine is widely available before the service sector expands sharply. But we think that is coming.

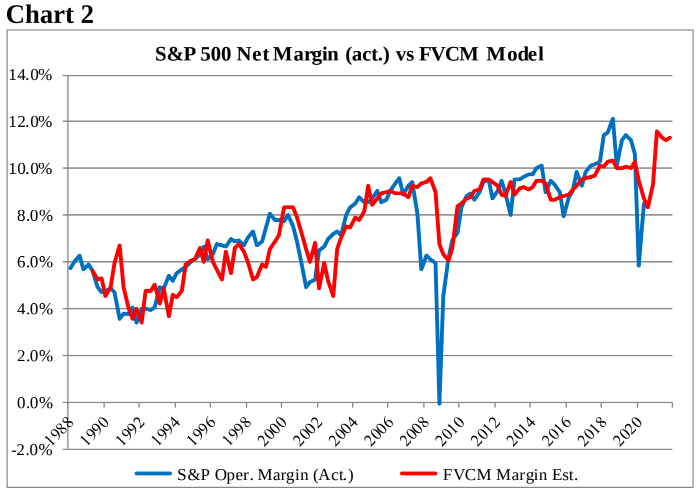
We expect operating earnings for the S&P 500 to be down 33% to 105 this year, from 157 in 2019. But earnings for 2021 are forecast at 163 thanks to rebounding sales and margins. In addition to the rebound in GDP growth now underway, sales and earnings for the S&P 500 are getting a boost from the recent weakening of the U.S. dollar in foreign exchange markets. A weaker dollar means any given level of foreign sales and earnings translates back into a larger quantity of dollars. It also gives a boost to merchandise trade. Sales are estimated to contract by 7% in 2020 but come back and increase 9% in 2021. The operating margin for 2020 is estimated at 8.0%, down from 11.1% the previous year. The 2021 margin estimate is 11.4%. Earnings for the S&P 500 should reach a record high in 2021 thanks to both higher sales and margins.

Chart 1



Source: S&P, Federal Reserve, Factset, FVCM

Chart 2



Source: S&P, Federal Reserve, Factset, FVCM

The Federal Reserve announced a new policy of targeting an average 2% rate of inflation, meaning that it would tolerate inflation above 2% to compensate for periods when inflation is below 2%. Jerome Powell, the Fed Chairman, apparently is concerned that deflation could take hold and he is trying to “anchor” inflation expectations with this policy change. In effect, the Fed is promising to keep interest rates low for an indefinite period. What Powell was also effectively saying was that the Fed will no longer rely on the discredited Phillips Curve, which postulated that inflation is a result of unemployment falling too low. That is good news. As we have written about extensively in the past, inflation is the result of a rate of spending beyond the economy’s ability to produce real goods, not because too many people are employed. Specifically, inflation tends to follow the average rate of spending in the economy over the previous three years. In the second quarter of 2020 nominal spending fell by nearly 10% (a 33% annualized rate) and the three-year average annual rate has fallen to 0.9%. With spending so depressed, inflation is not likely to be a problem anytime in the near future. This bodes well for equities, although not for investors seeking fixed income.

The markets may react negatively if the Democrats take control of the Senate as well as win the White House on November 3rd. There are many parts of the Democratic party’s agenda that could have negative implications for U.S. business. Taxes on business and individuals would increase. Government spending would increase massively even beyond the already historically high levels. The U.S. had become the world’s leading producer of energy and has benefitted from having very low energy prices thanks to modern drilling methods which some Democrats promise to make illegal. Other promises like new employment regulations and even further income subsidies would likely reduce incentives for work, increase costs and reduce production. Nevertheless, the U.S. system of “checks and balances,” which includes three equal branches of government, would constrain some of these initiatives. Furthermore, the Democratic party itself still has some moderate members that could divert some extreme actions even as the party drifts further to the left.

As mentioned earlier, U.S. corporate earnings are expected to get a boost thanks to the weakening dollar. However, we have low confidence that this relationship will last. The Euro has been in a declining trend against the dollar since 2008. The recent strength in the Euro has put it at the top of that trend. Also, a strong Euro is likely to increase deflationary pressures there and penalize exports. The ECB will likely face increasing pressure to somehow match the recent easing of monetary policy by the Fed. We do not recommend investors make decisions based upon relatively small changes in currencies, but now does appear to be a good time for Europeans to buy dollars.

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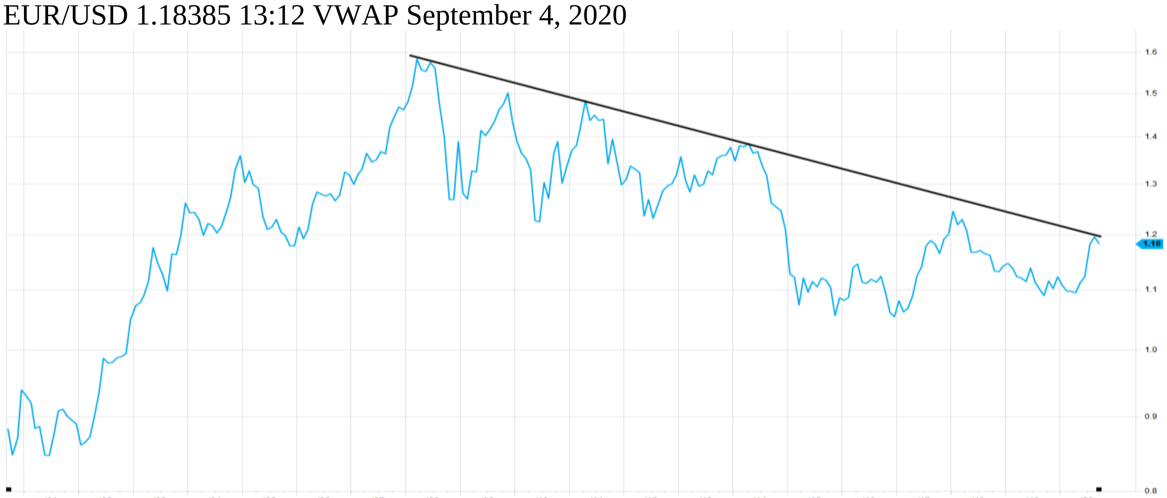

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