FFG Market Pulse Newsletter

Q4 October 2020 Edition

Newsletter Highlights

Latest Developments:

Election Updates

Latest Developments

The 2 questions that I have been fielding most often have been the following:

How can the market be reacting the way it is with all Covid uncertainty? What do you think we should do with the election?

I will go into detail on the latest research on the election in the last section of the newsletter so let's delve into the first question.

Sometimes it may seem irrational but here are the top 4 reasons why we believe we have seen resiliency during the pandemic.   Now these rationalizations don't take into account the possibility of a terrible second or third coronavirus wave, a contested election in November, a delay in the discovery of a medical treatment, inflation popping up, dollar strengthening, trade war with China flare ups, budget deficits, social unrest or any other risk. They are only an explanation as to why. However, these risks are real and there will be volatility going forward. For these reasons we will continue to stay hedged along with being extremely selective in our portfolio construction.   As a refresher, we focus on achieving risk adjusted returns.   We have been able to participate a tremendous amount on this recovery because of our high quality individual company stock selection.   Importantly, we have hedges in Gold, Cash, Inflation Protection & Convertible Bonds in our discretionary accounts and this allows us to be nimble to attempt to limit any potential downside and to take advantage of any potential future opportunity.

1.) Historic Monetary and Fiscal Stimulus

The Federal Reserve & Federal government literally threw the kitchen sink of liquidity at the markets as the pandemic was really starting to take hold of the country. As for the Fed, in February, its balance sheet was about $4.1 trillion. That has since exploded to above $7 trillion today. This expansion of the balance sheet was accomplished through various lending facilities programs and direct asset purchases. Around the same time, the Federal Government passed the first fiscal stimulus package with the Cares act in March which accounted for over another $2 Trillion. This was direct payment to individuals and the PPP program. This monetary and fiscal stimulus created over $5 trillion and counting (as there will be more coming) in newly created money flows. That is unprecedented liquidity. The goal of this was to flood the economy with liquidity so capital was free flowing. The targeting of these programs can be debated (and they will be in future) as to their efficiency however the goal of adding incredible liquidity was accomplished.   This additional liquidity is the exact reason we own Gold, Inflation Protection & Convertibles in our discretionary accounts. The downside to this liquidity creation is that it will likely cause certain dislocations in growth and interest rates which can benefit those asset classes over the long term.

2.) The Big Got Bigger – Take a look at some of these figures that illustrate the point

<u>Here is the big:</u>
Amazon: profit up 100%
Walmart: profit up 80%
Costco Digital Sales: up 101%
Home Depot Digital Sales: Up 100% with 60% of that being fulfilled in stores

<u>Here is Mom & Pop</u>
Small businesses: 21% closed; revenue for rest down 30%.
We're seeing a monumental wealth transfer from mom & pops to conglomerates. This is because the large corporations had the supply chains to #1 keep up with pandemic demand and #2 have the scale and technology to be flexible as buyer mentalities changed. This leads to further evidence to the "K"-shaped economic recovery and show a widening gap between the Have's and the

Have Not's. The idea behind the K letter is that some have managed to get through the health crisis in not just good but great shape, while many others are suffering. The takeaway from this is the stock market trades these large, immensely profitable billion and sometimes trillion-dollar sized companies. It does not trade the local pizzerias and nail salons which are suffering.

3.) The stock market is a forward-looking indicator

The markets are a classic forward-looking indicator. Many things influence stock prices on the short term but over the long term at the core the price you are paying for a stock is the price of the estimation of that company's earnings in the next 12-18 months. The contraction of the economy we saw back in March was unlike anything the country had ever seen in terms of steepness and speed. Much of the contraction was focused in on the very near term and more concentrated in certain sectors, i.e. Travel, Leisure & Restaurants. Corporate earnings expectation did fall during that time along with the drop in the markets. However, earnings expectations have slowly been rising on the prospect of 2021 getting back to a closer level of normalization. Currently, 12 month forward looking earnings expectations are about $155/share for the S&P500. That would equal a Forward PE ratio of about 21x earnings. Historically, that PE is on the higher side which bears to be monitored. However, that PE also should also be discounted by some level because of the near zero interest rates that are currently in place and that have been telegraphed by the Federal Reserve to be staying that way for multiple years.

4.) TINA – Acronym for "There Is No Alternative"

In the world of liquid investments, being in low yielding bonds or a fixed account, can potentially lose value because of inflation or a rise in interest rates. Low yielding fixed income type investments have a very poor risk/reward set up. The question investors have been asking what is the rationale with buying a 10-year treasury that is currently yielding 0.66%. Essentially you can tie up your capital for a return of 0.66% per year for the next 10 years. The alternative is buying a company like Home Depot for example, that has a 2.1% dividend yield plus you have the opportunity for long term growth given the current state of the evolving consumer that we touched on earlier. The investment with the better risk/reward parameters are clear. See below for chart of 10-year treasury. As you can see on chart below from Ycharts, we are all time lows for rates. As a comparison, in the late 90 and early 2000s, treasuries were paying around 6%.

2020 Election Update

On to that ever-popular question about the election.

First, let's get something out of the way. Understand that Presidents do not make markets. Never have and never will.   Markets make Presidents.

We obviously are nearing the election in November and emotions are running high however caution should be used when mixing portfolios and politics. The reason why is because one would have to handicap the result, anticipate the makeup of Congress, figure out the key policy priorities, evaluate the likelihood of them becoming law, estimate their economic impact and then determine how much has already been priced into financial markets. Sound Possible? More examples, in 2016, a Trump win was initially viewed by Wall Street as a negative because of his unknown political track record. That was the incorrect assumption. It was also thought that energy and financial stocks were viewed as the best bets under a deregulatory Trump administration; they've been the worst sectors since 2016. From a pure market perspective, the markets are far more influenced by state of the business cycle then they are factors going inside of Washington DC. This includes factors such as current tax rates or proposed tax rates.

Taxes are one of the hot button items every election but very much in this one. Looking back in history there is not much correlation between tax policy and stock market returns. For example, incredibly low taxes rates in the early 2000s resulted in the start of a lost decade of returns.   Alternatively, the post-World War II economic boom of the 1950s resulted in the strongest 10-year annualized return for the S&P 500 in 70 years at 19.3%, despite extremely high taxes.   Even increases in capital gains tax rates didn't stop bull markets in 1986 and 2013.   Now this isn't a political statement one way or the other nor does it marginalize the effect tax policy can have on individuals or business. This is purely stating the fact of tax rates and market returns historically have little to no correlation.

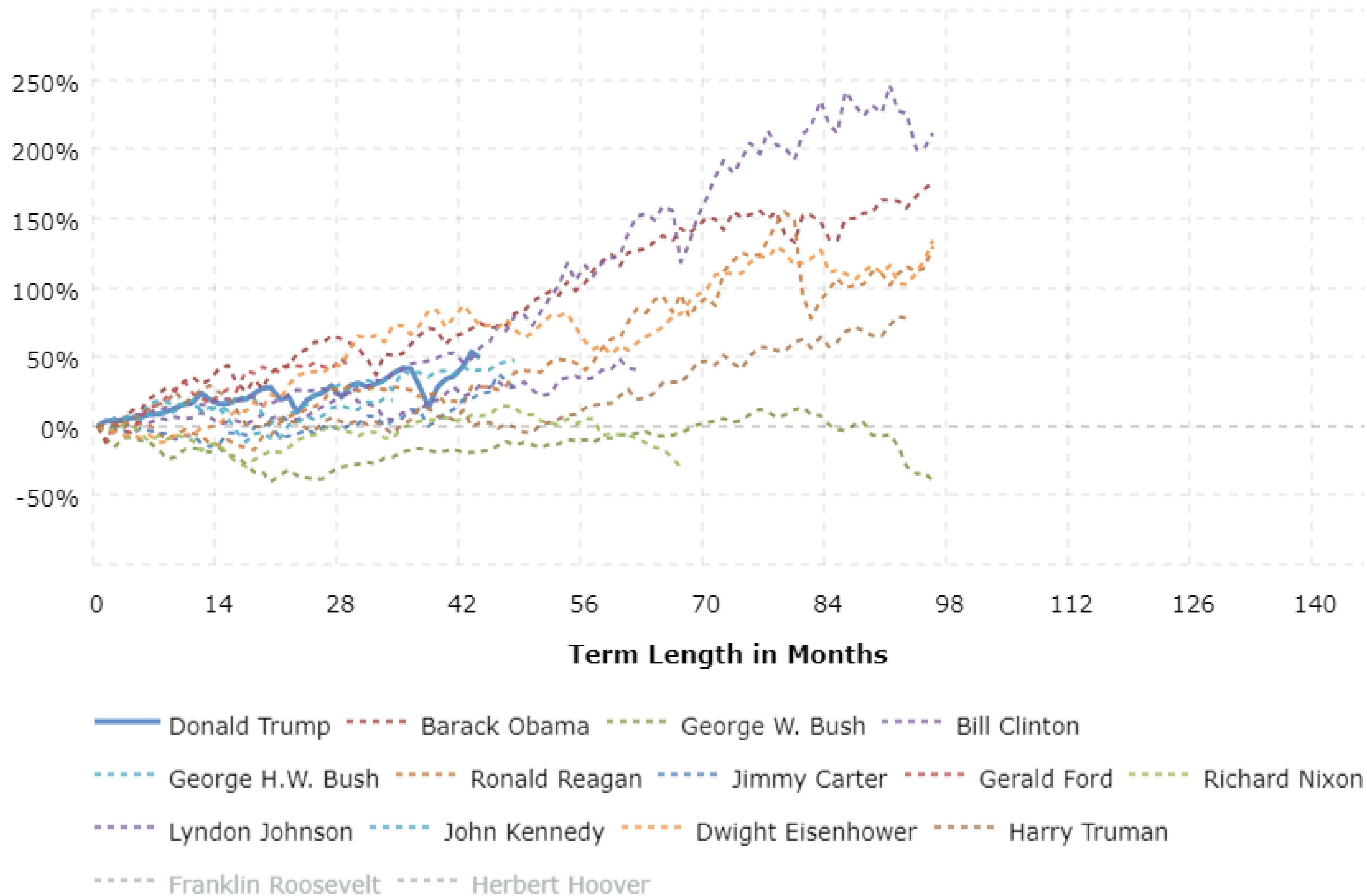
There is often a bit of turbulence as Election Day draws nearer and considering the twists and turns of 2020 so far, volatility may be higher. Again, this is why we own hedges and are very targeted in the names we own. The bottom line is that market volatility is likely to increase surrounding the election no matter which political party wins, with growth anticipated over the long term – again no matter which political party is in power. Looking at historical data on the next couple of pages is further evidence elections tend not to change the economic or business cycles.

HISTORICAL PRESIDENTAL RETURNS OVER THE PAST 70+ YEARS

One party or another really cannot lay claim to superior economic or financial market performance. The following charts show performance of every president going to back Eisenhower in 1953. 70 + years of data over 6 Democratic and 7 Republican presidents. Most presidents go through at least 1 boom and bust cycle during their tenure mostly depending on the business cycle at the time of their presidencies. These 2 charts illustrate this perfectly.

President	Political Party	Years In Office	S&P Return(%)
William J. Clinton	D	1993-2001	210
Barack H. Obama	D	2009-2017	182
Dwight D. Eisenhower	R	1953-1961	129
Ronald W. Reagan	R	1981-1989	117
Harry S. Truman	D	1945-1953	87
George H. W. Bush	R	1989-1993	51
Lyndon B. Johnson	D	1963-1969	46
Donald J. Trump	R	2017-	43
Jimmy E. Carter	D	1977-1981	28
Gerald R. Ford	R	1974-1977	26
John F. Kennedy	D	1961-1963	16
Richard M. Nixon	R	1969-1974	-20
George W. Bush	R	2001-2009	-40

Source: YCharts. Table: Forbes



Source: YCharts. Table: Forbes

There seems to be a nonstop flow of headlines coming from Washington that will keep us all occupied. Most recently was the President contracting Covid along with many others inside his administration. There was the death of Justice Ruth Bader Ginsberg. With her early passing, Washington's attention has been absorbed by the empty seat in the Supreme Court. This has come in conjunction with the on again and off again new COVID aid stimulus package. It's difficult to see where Congress is going to work together on the stimulus and the funding, while at the same time battling over the process to fill the Supreme Court position. This could be a factor in the short-term volatility going into the election that was mentioned earlier. There seems to be some very recent movement on stimulus aid but could fall apart at any time.

Senator McConnell holds all the cards in how the Supreme Court seat will be decided. If his number one priority is to keep the Senate in GOP control in 2021, then he will likely wait until after November 3rd to put the seat to a vote. There's no incentive for him to rush the SCOTUS candidate through confirmation if he thinks that it could get more conservatives to be interested in voting this election—and also not upset potential liberal voters in going to the polls.

Once he has the election results, and if the Senate keeps its majority, he will put the SCOTUS candidate through to a Senate vote. If he does lose the Senate GOP majority after the election, then he'll need to decide if he has the votes to put the candidate through to a vote. If there aren't enough votes, then the Senate in 2021 will fill the seat. Jamming a candidate through the Senate without control of the Presidency and Senate does little but guarantee a larger Supreme Court bench in 2021.

On the positive side of the ledger, last week the Federal Reserve made their case for keeping the Fed Funds rate lower for longer. Although, Jerome Powell also strongly suggested that more aid was needed from Congress to help the one million plus unemployed get past the virus. Without a new round of aid, consumer spending and financial payments will likely come under pressure in the fourth quarter and become a more important part of the November 3rd vote.

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