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Economic Review & Outlook

FOURTH QUARTER | 2020

U.S. Stock Market Disconnect—Real or Imagined?

In recent weeks, the U.S. stock market has reached new highs after rebounding strongly from the first quarter declines triggered by the arrival of COVID-19. At the same time, some states continue struggling to reopen—from schools to restaurants to sporting events. The unemployment rate remains elevated with close to a million new jobless claims filed each week, and the U.S. economy is not close to returning to its pre-COVID levels.

How should investors think about this perceived divide between financial assets and economic fundamentals? Have Wall Street and Main Street completely uncoupled? We explore this apparent disconnect below.

Economic Overview

THE FEDERAL RESERVE ANNOUNCES A NEW INFLATION STRATEGY

In late August, the Federal Reserve announced a new strategy for its rate-setting framework. They will keep a 2% inflation target but, rather than viewing that percentage as a ceiling or maximum level, they will allow inflation to rise above that as it seeks an "average" rate of 2%. As a result, short-term interest rates may remain low for longer to allow the job market to recover. Previously, the Fed might have employed preemptive rate hikes to prevent potential inflation.

ELECTION SEASON HEATS UP

As the U.S. election season enters the home stretch, the death of Ruth Bader Ginsburg introduces a Supreme Court nomination battle into presidential campaigns that already have polarized electorates. The potential increase of absentee and mail-in ballots means we may not have a definitive result on election night. Consequently, investors may face added uncertainty and market volatility in November.

COVID CONTINUES, GROWTH RETURNS

Although positive COVID-19 cases continue to increase, the mortality rate from the disease has decreased since the early stages of the pandemic. Globally, growth is recovering for most industry sectors, but pockets of weakness continue for industries such as hospitality, travel, and entertainment. China continues to show the most progress and is likely to be the only G-20 country with positive economic growth in 2020.

Asset Class Performance

Even though coronavirus cases in the U.S. spiked during the summer months, markets continued to rebound strongly, continuing the upward trend that began in the second quarter of the year. Stock returns were positive globally with emerging markets leading the way (+9.7%) and U.S. large cap stocks (8.9%) following close behind. International developed stocks had more modest gains (+4.9%). On a year-to-date basis, U.S. stocks have positive returns, emerging market stocks are roughly flat, while international developed markets are still negative for 2020.

Gold continued to provide positive returns in the third quarter (+3.6%) building on its strong year-to-date performance (+21.4%). Commodities climbed higher again last quarter but have struggled year-to-date due to weak energy prices. On the bond side, high yield bonds were strong, consistent with an improving economy. Investment grade corporate bonds, municipal bonds, and government bonds all experienced positive total returns this quarter as well. Bonds have also been solid performers year-to-date. In November, investors may experience increased market volatility leading up to and after the election. We are monitoring events and will incorporate potential policy shifts and market movements into our future allocation adjustments.

Q1	Q2	Q3	YTD
Gold 4.5%	U.S. Stocks 20.5%	Emerging Market Stocks 9.7%	Gold 21.4%
Diversified Bonds 3.1%	Emerging Market Stocks 18.2%	U.S. Stocks 8.9%	Diversified Bonds 6.8%
U.S. Stocks -19.6%	Commodities 17.2%	Commodities 6.5%	U.S. Stocks 5.6%
Int'l Developed Stocks -22.7%	Int'l Developed Stocks 15.1%	Int'l Developed Stocks 4.9%	Emerging Market Stocks -0.9%
Emerging Market Stocks -23.6%	Gold 12.1%	Gold 3.6%	Int'l Developed Stocks -6.7%
Commodities -36.1%	Diversified Bonds 2.9%	Diversified Bonds 0.6%	Commodities -20.3%

Source: FactSet. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Our Perspective

U.S. STOCK MARKET HAS REBOUNDED STRONGLY AND RECENTLY SET NEW HIGHS

When the coronavirus made its way across the ocean and into the United States, panic gradually set in to the markets. The S&P 500 was down by more than 8% in February and went 12.5% lower in March. Then stocks gradually bounced back into the green from May through August, even pushing some market indices to new record highs. However, after a strong August, stocks took a sharp 7% decline in early September, and many investors wondered if this was the beginning of a long-winded stock market drawdown. Fortunately, this pullback was short lived, and stocks quickly bounced back. Even though this brief decline was unsettling, a pullback from all-time highs was probably healthy for stocks as a whole.

Stocks are currently seeing higher valuations. Some of this increase is due to the low interest rates from the Federal

Reserve. Rates near zero result in a low cost of borrowing, allowing companies to continue taking on debt at historically low interest rates. This opportunity allows major companies to adapt their business in the wake of an uncertain world. At the same time, bond yields remain suppressed, leaving investors with an interesting question: where else is there to invest right now besides the stock market?

U.S. ECONOMY STILL FAR BELOW ITS PRE-COVID-19 LEVEL

The stock market has weathered the COVID-19 storm even as U.S. economic data lags. With businesses unable to return to full strength, employees are left in limbo. An unemployment rate of 7.9% is still well above pre-pandemic levels, and many of the job losses resulting from the pandemic are proving to be longer lasting than first expected.

Even though most industries have recovered from their absolute lows in the spring, the economy is not yet back at full strength. At first, it appeared businesses would only have to close their doors temporarily, but ultimately more business closures than expected became permanent. While temporary business closures have decreased over the past several months, the number of permanent business closures has increased and now hovers around 100,000. According to Yelp, since mid-July there has been a 23% increase in closures of local businesses listed on their platform, which includes restaurants, home services, shopping, beauty, and fitness locations.[1] Businesses such as restaurants and retail continue to lag behind, while professional services like lawyers, architects, and accountants have mostly been spared.

When people lose their jobs, they spend less money and consumer confidence shrinks, which is exactly what happened with U.S. core retail sales (defined as retail sales excluding auto and gasoline sales). Retail sales did increase in July by 0.9%. However, with extended unemployment benefits cut, Americans had less money to spend, leading core retail sales to fall by 0.1% in August.

One of the biggest measures of support taken by the U.S. government is foreclosure relief for homeowners negatively affected by COVID-19. Yet, this concession is set to end with no plan in place for additional mortgage relief ahead. Additional fiscal stimulus measures—like increased unemployment benefits and small business loans—are also running dry, putting pressure on Congress to provide more aid to businesses and consumers.

RECONCILING THE DISCONNECT

If you look at the stock market and overall economy side-by-side, you might think something is amiss. The market continues to produce positive returns for investors, even as many parts of the country are still feeling the impact of a pandemic-induced economic slowdown. How can these two trends happen at the same time?

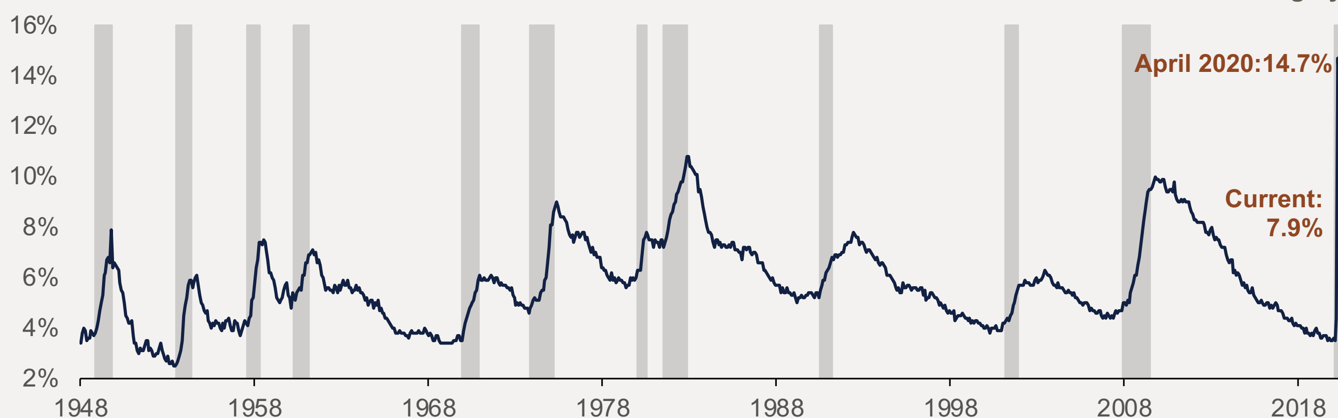
For starters, economic data only tells us information about the past. Numbers, such as GDP growth, unemployment, and consumer confidence, are all backward-looking data. Even though this information may be useful in looking toward the future, these data points can't tell us what will happen, but rather only what has happened. Contrast this reality with the stock market, which is forward looking. The market only cares about past performance as it relates to predicting future events. Therefore, stock prices reflect the expected future value of a company, more than its value today. This distinction is as important as ever in these unusual times.

Although the country is slowly showing signs of relief, it is important to remember that stock market returns, as measured by the S&P 500, are somewhat inflated by the hefty returns of several large companies. Technology giants like Amazon, Google, and Netflix are all positioned extremely well to not just survive the pandemic but thrive. These companies, along with several others, are pushing indices higher even as there is wide dispersion in returns across the stock market.

[1] www.yelpeconomicaverage.com/yea-q2-2020.html

UNEMPLOYMENT RATE

1948 – 2020



Source: U.S. Department of Labor

For example, in the past year, stocks in the technology sector of the S&P 500 have grown by just over 47%, while other sectors—like energy and financials—have lagged. Couple these returns with the fact that technology stocks account for $11 trillion (or roughly 28% of the entire index), and it's not surprising that the overall index reflects returns that are higher than those realized by the average stock.

INDUSTRY SECTOR PERFORMANCE		
SECTOR	SECTOR WEIGHT S&P 500 INDEX	1-Year % change 9/30/2020
Information Technology	28.2%	47.2%
Health Care	14.2%	20.1%
Consumer Discretionary	11.6%	28.9%
Communication Services	10.8%	18.4%
Financials	9.7%	-11.9%
Industrials	8.3%	1.3%
Consumer Staples	7.0%	7.8%
Utilities	3.0%	-5.0%
Materials	2.6%	12.2%
Real Estate	2.6%	-7.3%
Energy	2.1%	-45.2%
S&P 500® Index		15.2%

Source: S&P Global, FactSet

REASONS FOR POSITIVITY AND HOPE

The present might seem fraught with fear and uncertainty, but there is plenty of reason for hope. In fact, it only took the S&P 500 126-trading days to recover from its 35% decline to hit some all-time highs—significantly less time than previous market pullbacks.

Two of the biggest forces of uncertainty within the country—COVID-19 and the presidential election—will come to an end soon. Operation Warp Speed is helping to facilitate the development and distribution of a vaccine, which is expected to be ready sometime in 2021 at the latest, and possibly sooner. Meanwhile, the contentious race for president is also coming to a close.

The Federal Reserve has made it clear it doesn't plan on raising interest rates any time soon. In fact, the Federal Open Market Committee (FOMC) recently announced it expects to hold rates near zero through 2023, giving the economy plenty of time to recover. Fed chair Jerome Powell cited the need to support the recovery above all. "Effectively, we're saying rates will remain highly accommodative until the economy is far along in its recovery," Powell said. This ongoing support should help businesses continue to rebuild once the pandemic has passed and lead the nation's economy toward a brighter future.

Our Investment Strategy

When navigating uncertain times and volatile markets, your perspective matters most. Investors have various time frames associated with the financial goals they have set for themselves. Similarly, those time frames can influence how one observes and evaluates economic fundamentals and the investment outlook.

While the short term in the U.S. economy looks uncertain, the further out you look, the more clear the picture becomes. Your financial goals dictate your investing time frame. Highly liquid and stable investments, such as money market accounts or short-term bonds, are most appropriate for immediate or near-term goals like buying a car because short-term results are less certain. Over the intermediate term, inflation protection and stability are key factors, which makes bonds a reasonable choice for intermediate-term cash flow needs. However, with interest rates hovering near zero, these investments won't currently yield very high returns. Long-term goals are best addressed with growth assets, such as stocks, despite the volatility and year-to-year fluctuation in returns they normally experience. Given time, the volatility of growth assets smooths out and the opportunity for capital appreciation increases with the longer investment time horizon. Growth assets and time allow a portfolio to compound its worth and help build a secure financial future.

Lastly, diversification is key. In the current economic climate, certain industries like utilities and telecommunications are taking a hit while the technology sector is thriving. However, this may not always be the case. A diversified portfolio that includes short-, medium-, and long-term investments, and diversifies across asset classes is one way to mitigate investment risk.

Conclusion

Periods of economic dislocation can cause us to feel concerned and even anxious. Uncertainty is uncomfortable. When asset prices climb higher in the face of a steady stream of challenging news, uncertainty can become compounded with confusion. Our objective is to help our clients see the hope on the other side of a perplexing period and know that they are positioned for long-term success because they are following an appropriately constructed financial game plan that fits their unique investment objectives.

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