Insights

Uncommon Sense

No Pain, No Gain

Michael Arone, CFA
Chief Investment Strategist
US SPDR Business

"Somedays you eat the bear, somedays the bear eats you."

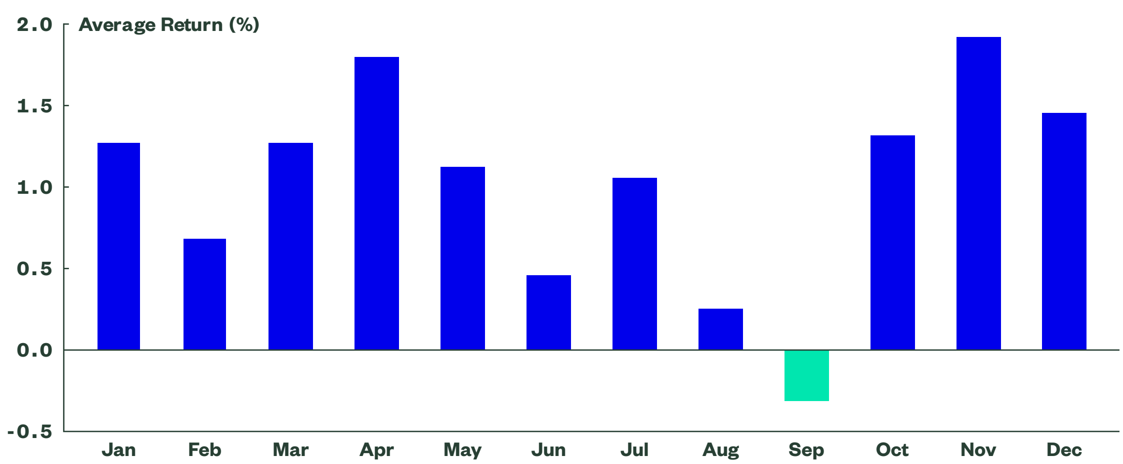
— Mr. T

Investors couldn't believe their good fortune as markets rallied throughout the summer despite some gut-wrenching data on the pandemic, economy and earnings. According to the Johns Hopkins Coronavirus Resource Center, the United States has 7.1 million confirmed cases, with more than 205,000 deaths. Sadly, both of these numbers are the highest in the world. The Commerce Department estimates that US GDP decreased at an annual rate of 31.4% in the second quarter of 2020 — the biggest quarterly plunge on record. And FactSet reports that year-over-year earnings for S&P 500 companies declined by 31.6% in the second quarter. This is the largest year-over-year decline in earnings for the popular US benchmark since the second quarter of 2009. Yet, as of early September, US stocks were at all-time highs. Undeniably, stocks climbed a wall of worry over the past several months.

So, what gives? Although the second-quarter data was terrible, the economic and earnings numbers were much better than the dire forecasts. This bolstered sentiment. Massive fiscal and monetary stimulus in response to the pandemic also built an effective bridge from the brief recession suffered earlier this year to the ongoing recovery. And, there has been emerging optimism that as the calendar turns from 2020 to 2021, COVID-19 will be knocked out.

However, September is a notoriously difficult month for stocks. In fact, from 1980 to 2019, September has the worst average S&P 500 monthly return — and, as if on cue, stocks suffered a mini-correction over the final few weeks of September. Now, as the warm summer winds drift into the crisp fall air, investor sentiment regarding a quartet of well-known risks has turned noticeably cooler too. Until the US election outcome is determined, whenever that might be, more investor anxiety and market volatility is likely.

Figure 1
S&P 500 Average Monthly Return (1980–2019)



Source: FactSet, Period 01/01/1980 to 12/31/2019. **Performance quoted represents past performance, which is no guarantee of future results.**

Feel the Burn

What made the unexpected summer rally truly remarkable is that it advanced in the face of well-known risks. Now, with the US election looming and once reasonably predictable outcomes suddenly becoming wildly unpredictable, these risks have been brought into sharper focus and are tilting negative:

1 COVID-19 Resurgence Fears

COVID-19 cases have been rising in countries across Europe since July. Officials fear a repeat of last spring, when intensive care units in Italy and Spain were overwhelmed. Several European countries and the United Kingdom have recently announced new restrictions to ease a second wave of infections while attempting to avoid another economically damaging lockdown. In Munich, large crowds would normally be celebrating Oktoberfest in September, but authorities have banned gatherings of more than five people. In Marseille, France, all bars and restaurants will be closed beginning on October 5. And in London, where the government spent weeks urging workers to return to the city's empty skyscrapers, it is now asking them to work from home. Closer to home, New York City's Mayor Bill de Blasio announced on September 29 that the percentage of people who tested positive for COVID-19 in the city has surged above 3% for the first time since early June.

In addition, the fast-approaching flu season has many people on edge. In the US, flu season typically starts in late fall, peaks in mid-to-late winter and ends in early spring. On average, it lasts about 13 weeks. Fears have been unnecessarily compounded by the very public debate raging between health experts and politicians about the timing and widespread availability of a COVID-19 vaccine. Regrettably, this has drawn attention away from the incredible progress being made on vaccine development and has dampened investor enthusiasm in September.

2 Going over the Fiscal Cliff

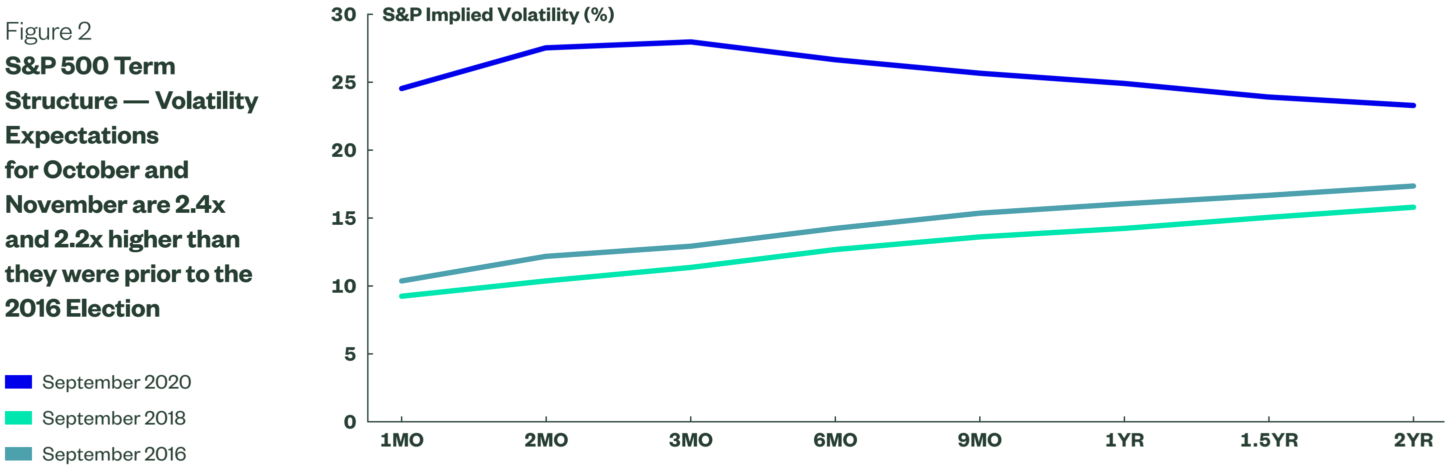
Republicans and Democrats agree that more fiscal stimulus is needed to aid America's recovery from the pandemic. Unfortunately, that's about all they can agree on, as both sides remain far apart on reaching a deal. With the election just five weeks away, neither side wants to hand their opponent a perceived victory before voters head to the polls on November 3. The partisan nastiness regarding the Supreme Court vacancy left by Ruth Bader Ginsburg's passing has further derailed the negotiations.

On September 28, Democratic lawmakers unveiled a revised $2.2 trillion COVID-19 relief bill. US House of Representatives Speaker Nancy Pelosi described it as a compromise measure because it reduced the overall cost of the fiscal policy package from the roughly $3.4 trillion that Democrats initially sought. Formal talks between Republicans and Democrats broke down in early August. But, in a sign that stalled negotiations may now be restarting, Pelosi and Treasury Secretary Mnuchin began speaking again at the end of September.

However, there remains precious little time to negotiate and pass into law more fiscal stimulus before the election. Investors had already priced in a substantial fiscal spending plan. Today, with prospects for a package fading, investors should expect greater market volatility until a deal can be reached — likely sometime after the election.

Figure 2

S&P 500 Term Structure — Volatility Expectations for October and November are 2.4x and 2.2x higher than they were prior to the 2016 Election



Source: Bloomberg Finance, L.P., as of 09/25/2020. Term structures were measured on September 25th of each respective year.

3 Power Grab — US Election

Understandably, the US presidential election has taken a backseat to the pandemic for most of this year. But, beginning with the first presidential debate on September 29, potential election outcomes have reclaimed voters' and investors' frenetic attention spans. President Trump continues to refuse to commit to a peaceful transition of power after the election should he lose to Joe Biden. With a record number of mail-in ballots expected as a result of the pandemic, odds of a contested election are rising. It may take days — if not weeks — to determine the winner.

As a result, the Supreme Court vacancy has many election watchers rattled. And the battle to replace Justice Ginsburg has turned ugly, bringing out some of the worst on both sides. If the Republicans go through with their plans to fill the vacant Supreme Court seat prior to the election, some Democrats have threatened to stack the court and eliminate filibuster rules — an extreme idea that the Biden ticket has failed to forcefully rule out. Polls suggest that a so-called blue wave is plausible. Not surprisingly, futures markets indicate that investors are expecting significant volatility around the election. Investors dread uncertainty and the potential for extreme outcomes. Until the election results are determined, investors should brace themselves for continued market turbulence.

4 Rising US-China Tensions

Many investors had naively hoped that with the signing of the US-China Phase One trade deal earlier this year, tensions between the world's two superpowers would finally cool. Disastrously, things have only gotten worse since then. China's handling of the COVID-19 pandemic has resulted in a lot of finger pointing from the US. However, throughout the summer rally, investors were able to look past China's sweeping new security law imposed on Hong Kong and the mutual closings of the Chinese consulate in Houston and the US consulate in Chengdu. A lot of the tit-for-tat actions between the two countries this year could easily be dismissed as tough talk and political posturing before November's US elections.

But, the US-China tensions took a strange turn in early August. President Trump issued executive orders banning two popular Chinese-owned apps, TikTok and WeChat, that are widely used by US citizens. Citing national security concerns to justify the orders, President Trump claimed the apps "capture vast swaths of information" from users that could be used by the Chinese government. The original executive orders were scheduled to go into effect on September 20. Since then, two separate court injunctions have at least temporarily thwarted the president's efforts to ban the apps in the US. Further, the agreement by ByteDance, TikTok's Chinese owner, to sell a minority stake in a new US company to Oracle and Walmart has resulted in more confusion than clarity.

As I outlined in last month's Uncommon Sense, our data has become the most valuable commodity in the world. Naturally, the world's two superpowers are battling for control of this valuable resource. As the drama played out throughout much of September, investors were no longer able to ignore the fact that US-China tensions had shifted from political posturing to economic reality. As a result, the range of possible outcomes of the rising US-China tensions has widened noticeably, unnerving investors.

Wake Me Up When November Comes

Despite the short-term pain leading up to the election, longer-term support mechanisms are in place to suggest stocks may be higher a year from now. Once the election outcome is determined, these four factors will likely provide a solid foundation for risk assets over the next 12 months:

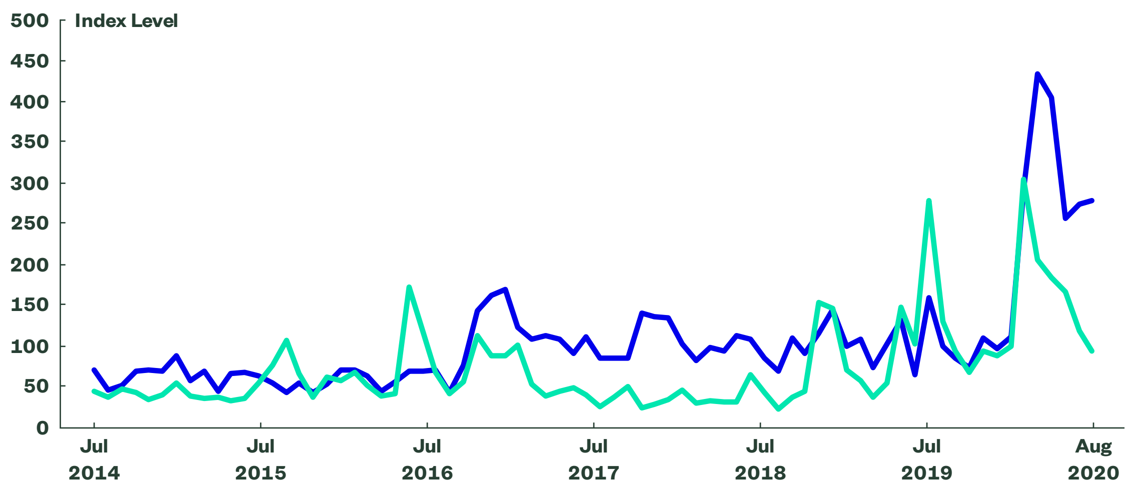
1 **Negative Real Interest Rates** A target federal funds rate below inflation and growth is supportive of financial asset prices and valuations. And as the labor market improves, the currently elevated savings rate will decline as more money finds its way into the economy.

2 **More Policy Stimulus** Despite their policy differences, both presidential candidates have committed to additional fiscal spending. So, no matter who wins, expect another huge fiscal policy package after the election. Meanwhile, the US Federal Reserve has pledged to keep interest rates low for the next several years and to do whatever is necessary to support the economy.

3 **A COVID-19 Vaccine** More than 150 coronavirus vaccines are in development worldwide — and the US government's Operation Warp Speed initiative's goal is to deliver an effective vaccine by January 2021. With a number of vaccines already in or approaching phase 3 trials, there are indications that a vaccine could be developed for emergency use before year's end.

Figure 3
Fiscal vs Monetary Policy Uncertainty

Fiscal Policy Uncertainty
Monetary Policy Uncertainty



Source: Baker, Bloom & Davis, Bloomberg Finance, L.P. Period: 07/31/2014–08/31/2020. Fiscal Policy Uncertainty is represented by the US Categorical Economic Policy Uncertainty Fiscal Policy Index. Monetary policy is represented by the US Categorical Economic Policy Uncertainty Monetary Policy Index.

4 **Improving Economy and Earnings** The economy is expected to grow 4% in 2021[1] and earnings are forecast to climb 26.2%[2] year-over-year, reaching levels similar to 2019. That would be a strong and quick recovery for both.

It's likely we'll see more short-term investor anxiety and market volatility. However, once the US presidential election outcome is determined, the long-term backdrop looks supportive for higher asset prices. The challenge for investors over the coming weeks is to block out all the noise and look ahead, toward the healthy rebound in the economy and earnings that is still expected next year.

Endnotes

1 FOMC, Summary of Economic Projections, September 16, 2020.

2 FactSet, Earnings Insight, September 11, 2020.