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From Bounce to Grind

In this edition of Investment Strategy, readers hear from CAPTRUST’s Kevin Barry and Sam Kirby on the major themes influencing our thinking as we near the conclusion of 2020. With a look at the impact of the elections, investing amid uncertainty, and containment of COVID-19, our experts report on what you can expect in the second phase of the economic recovery.

Despite a pullback in September, all major asset classes posted solid gains in the third quarter, continuing a powerful rebound from March lows. Emerging markets stocks led the way with a return of 9.6 percent, buoyed by continued recovery in China and a weaker U.S. dollar. U.S. stocks also posted strong returns, with the S&P 500 Index up 8.9 percent in the third quarter, bringing year-to-date (YTD) returns into positive territory. Both bonds and real estate posted positive results for the quarter, although the latter still shows double-digit losses for the year, due to COVID-19-related impacts to the office and retail sectors.

Figure One: Major Asset Class Returns
The September swoon that saw U.S. stocks dip by nearly 4 percent may portend a season of heightened volatility, as investors grapple with a trio of uncertainties heading into year-end:

- **COVID-19.** Virus cases and hospitalizations are again on the rise across many parts of the U.S. and abroad. Vaccine progress has been slowed, as two vaccine trials (Johnson & Johnson and AstraZeneca), as well as the development of an antibody treatment by Eli Lilly, have been paused. Other trials remain underway, albeit with unknowns surrounding timing of availability, effectiveness, and duration of immunity.

- **Stimulus.** Fiscal support programs, including the Paycheck Protection Program and direct income replacement to consumers, prevented an income shock with severe consequences over the spring and summer. Although the pre-election political environment has placed the next round of relief in limbo, we believe a post-election fiscal deal is likely, in a mid-to-late-winter timeframe.

- **Elections.** Elections are now underway in most U.S. states, and investors are wary of potential policy implications of different outcomes, as well as the risk of uncertainty from delayed or contested results. The outcome of Senate races, in particular, could tip the scales of policy changes that impact specific sectors and companies.

Compounding the risk is the interconnectedness of these three sources of uncertainty. Until the virus is contained, the economy will require continued and timely fiscal stimulus to bridge the gap. Yet, the pre-election political climate has stymied lawmakers’ desires to pass further relief measures. These types of policy-maker-driven, binary-outcome risks are among the kind most dreaded by investors, because they are difficult to anticipate and model. It is hard for an investor to have an edge in any of these areas, and, often, the result is higher volatility.

But amid these risks is room for investor optimism. The U.S. Federal Reserve’s swift and aggressive
policy response, including taking its fed funds policy rate to zero and massive liquidity and lending facilities, have played a significant role in the rapid recovery of markets since the spring. This has translated into higher prices for stocks and residential real estate. Home sales reached a 14-year high in August, as buyers took advantage of record-low mortgage rates, while tighter inventory and rising lumber costs pushed home prices to new highs. Figure Two shows annual home price appreciation for a handful of U.S. cities.

Figure Two: Annual Home Price Appreciation

Source: Freddie Mac. Price for each city is seasonally adjusted and based on its Metropolitan Statistical Area (MSA) average. Home price index is estimated with data, including transactions on single-family detached and townhome properties serving as collateral on loans purchased by Freddie Mac or Fannie Mae.

More recently, the Fed has pledged to keep rates low for an extended period—perhaps several years—which creates a favorable backdrop for a new bull market for equities once virus uncertainty is reduced. Exceptionally low rates reduce borrowing costs for businesses and consumers. They also make bonds less attractive relative to stocks, providing further support.

Outlook

We believe we are entering the second phase of the economic recovery, where progress will be more gradual and, perhaps, with a half step back for each step forward. Importantly, the next phase must be supported by improvements in the fundamental economy, including jobs, income, and profits, rather than primarily driven by government support. A sustainable recovery will require the large, stimulus-driven gap between the financial economy and the real economy to shrink to a healthier level.

Heading into year-end, several major themes influence our thinking and client conversations: the impact of the elections, the recovery’s unevenness, and the shape of its trajectory from here.
Election Impacts

Elections are always accompanied by emotion and speculation, but, amid a global pandemic and economic crisis, the angst is supercharged in 2020. While elections can introduce short-term uncertainty, long-term impacts are far less. As shown in Figure Three below, the stock market has demonstrated a clear long-term uptrend, regardless of the party holding the White House.

Figure Three: S&P 500 Index (Logarithmic Scale)


Markets have also demonstrated the ability to produce strong returns under any division of power between the White House and Congress – whether controlled by a single party or divided. Traditionally, markets have favored divided government because political gridlock reduces the risk of sweeping policy change. However, amid a resurging global pandemic – when the need for swift and decisive policy action is greatest – political gridlock and a slower policy engine may not hold the same benefit.

At present, we believe the degree of uncertainty is too great—and the outcome too unpredictable—to translate into tangible changes in portfolio positioning in anticipation of election results. But when the outcome and specific policy priorities start to become clearer, we will assess investment implications through our four-policy framework that considers changes to the monetary, fiscal, regulatory, and trade policy environments. We would not anticipate major differences in monetary policy, and, regardless of outcome, we believe another round of fiscal relief and stimulus is very likely after the election. The greatest market impact would likely come from tax or regulatory policy shifts, particularly in the event of one-party control of both houses of Congress.

Uneven Recovery

A key theme this year has been the stark differences between companies and industries, which has led this recovery to be described as K-shaped—with some firms benefiting from the acceleration of trends and changes in behavior while others have been severely impacted. Through the end of September,
the price return difference between technology, the S&P 500 Index’s best-performing sector, and energy, its worst-performing sector, was a whopping 78 percent—a performance gap not seen since the dot-com mania of the late 90s.

This time, however, the performance gap is justified and supported by earnings. As shown in Figure Four, the difference in earnings growth between sectors this year has been enormous, with some (e.g., technology and health care) demonstrating positive growth due to pandemic-driven tailwinds, such as ecommerce, cloud computing and other work-from-home benefactors and healthcare investments, while earnings growth in more cyclical and economically sensitive sectors, such as energy, industrials, financials, and materials, has been materially impaired.

Figure Four: S&P 500 Earnings Growth for Calendar Year 2020

Employment

The labor market’s health is critically important to the recovery’s pace and sustainability. In May, amid the peak of pandemic lockdowns, the number of people filing for continued unemployment benefits spiked to a record-high 24.9 million people. Continuing claims is an important statistic because it points to long-term unemployment, which poses material risks to consumer sentiment and spending.

Between May and September, and as the economy reopened amid a summertime slowdown in the spread of the virus, the U.S. economy added 11.4 million jobs. Yet, the pace of improvement is slowing, and gains from here will likely be harder won, as shown in Figure Five. Further, the longer the crisis continues, the greater the risk that temporary layoffs will become permanent.
Despite continuing high levels of unemployment, consumer confidence continues to improve, and consumer spending has remained strong. According to the U.S. Department of Commerce, August retail sales were 2.6 percent higher than at the same time last year. Of course, the complexion of consumer spending has changed significantly, with large gains in non-store retail, home and garden, and sporting goods offsetting large declines in travel and leisure, gas stations, and restaurants.

So far, consumers’ ability to spend has been supported by high levels of pre-pandemic savings, rising home equity, lower mortgage payments (for those able to refinance), lower gas prices, and direct government support. However, these sources will not last forever. And regardless of their savings account balances, consumers will close their e-wallets if they lose confidence in the economy’s future.

Investing Amid Uncertainty

Investors who stayed the course during a scary spring were rewarded over the summer, as equity markets staged a record-breaking comeback. As we near the conclusion of this tumultuous year, uncertainties are again mounting as U.S. daily virus cases reach new highs while policy response has ground to a halt, in the final days of a contentious election.

When risks mount, it is important to remember three fundamental tenets of investing:
• Time in the market is far more important than timing the market. Seeking to time the market is not only next to impossible, but it is also risky. Missing just a handful of the best days can lead to disappointing long-term results.

• Although markets can be volatile in the short term, and stocks can show significant declines in any one-year period, longer investment horizons greatly increase the likelihood of positive returns. In fact, our research tells us that, since 1926, 87 percent of 5-year periods have been positive for the S&P 500, increasing to 95 percent for 10-year periods, and 100 percent for 15-year periods. When uncertainty rises, reaffirm your time horizon.

• Amid elevated uncertainty, it is important to focus on what you can control, which includes asset allocation and portfolio diversification. While a well-diversified portfolio cannot prevent a loss, it may help dampen the impact of surprises.

The greatest advantage that long-term investors hold is the ability to control the clock. Remaining invested in a way that is consistent with their goals may help investors weather near-term storms, yet still participate in the next bull market made possible by medical progress on COVID-19, low interest rates, supportive policy, and a healing economy.

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