# Tug of War

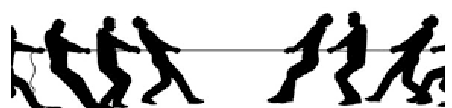
**August 2020**


## Summary

While the market has seen a strong recovery, the tug of war between policy makers and the virus is ongoing. In the spring, the U.S. stock market fell by 34%. Developed international and emerging markets saw similar declines. While the U.S. stock market has recovered much of the drawdown, international and emerging are still well below their 2019 highs.

So far, the government stimulus to fight the recession and economic impacts of the pandemic has been successful. The word “unprecedented” is now somehow commonplace: spread and risk of the virus, Federal Reserve actions, government stimulus, spike in unemployment, rate of GDP contraction, etc. Yet, despite the numerous first-time occurrences, various actions from the Fed and Congress have stopped (at least for now) the downward spiral of the economy and financial markets.

Numerous risks still exist that could derail the recovery. Obviously, the virus is first on the list; elevated valuations, tensions between the U.S. and China, and uncertainty due to the presidential election are risks to a continued recovery. While some aspects of the pandemic are promising (vaccine trials advancing, death rates staying low, etc.), the virus is still a wildcard that is not predictable.

## Is there a disconnect between markets and what is happening on main street…?

A common observation is that the stock market seems to be ignoring the risks of the virus. While it is difficult to feel good about the current environment and the virus is a major uncertainty, there are several aspects of the economy that are doing better than expected. The programs pursued by the Fed and Congress, which were both swift and large, are bridging the gap for now. The Fed purchased over $3 trillion of securities (more than double the amount in the 2008 crisis), and Congress implemented a stimulus package of roughly $3 trillion, which is 13% of GDP. Central banks around the world mirrored Fed monetary actions, and cumulative government fiscal stimulus is roughly 8% of world GDP.

In addition, the largest companies in the S&P 500 have been quite resilient during this crisis. Six technology companies (Amazon, Apple, Facebook, Google, Microsoft, and Netflix) now make up 20% of the S&P 500 and have been supporting the returns of the broader index. However, many businesses not traded on a stock exchange have had more challenges. For instance, independent restaurants and their affiliates employ 16 million workers, whose situation is far from recovered. The toll of the pandemic on these private businesses and workers has been dramatic but not captured in public stock returns.

This dichotomy is currently positive for investment portfolios, but it is also somewhat concerning that many companies are continuing to struggle. For the economic recovery and stock market rally to be sustainable, more companies need to see improvement. As we weigh the environment, indicators (both positive and negative), and the future uncertainty of the coming months, we continue to maintain a neutral positioning for client portfolios.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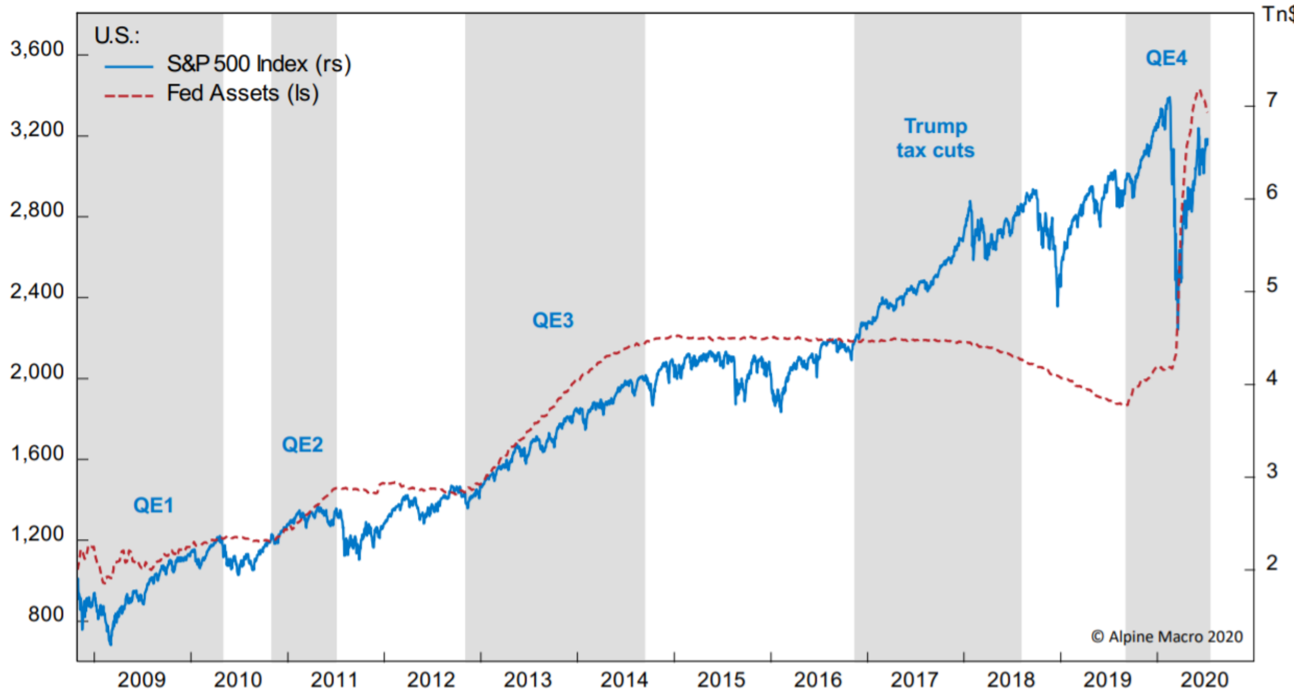
## The Federal Reserve is on a buying spree…

Since the 2008 financial crisis, the Fed has utilized quantitative easing (QE) to support the economy. QE is the buying of securities in order to infuse money into the economy, encourage lending and stimulate investment. Such an approach seems opaque; however, in times of distress, QE can be a major support to the economy. Interest rates stay low, and many companies (even those that may be on the verge of bankruptcy) can obtain financing at low rates.




So far this year, the Fed has almost doubled the amount of its holdings in only a few short months. The correlation with U.S. stocks should not be overlooked (see chart, above). It is easy to spot the increases in volatility of the stock market. During periods of large asset purchases, the stock market rises with low volatility. When the Fed slows or stops buying securities, market returns are lower and corrections in the stock market are more prevalent. Until the recent pandemic, all the recent stock market corrections (2010, 2011, 2015, 2016, 2018) occurred during periods without QE or stimulus from tax cuts.

There are many factors that influence stock market outcomes. QE is a difficult concept to internalize, but security purchases by the Fed have historically been correlated with positive stock returns. Such actions were an important factor in the recent stock market recovery and will be important factors until the threat from the virus has passed.



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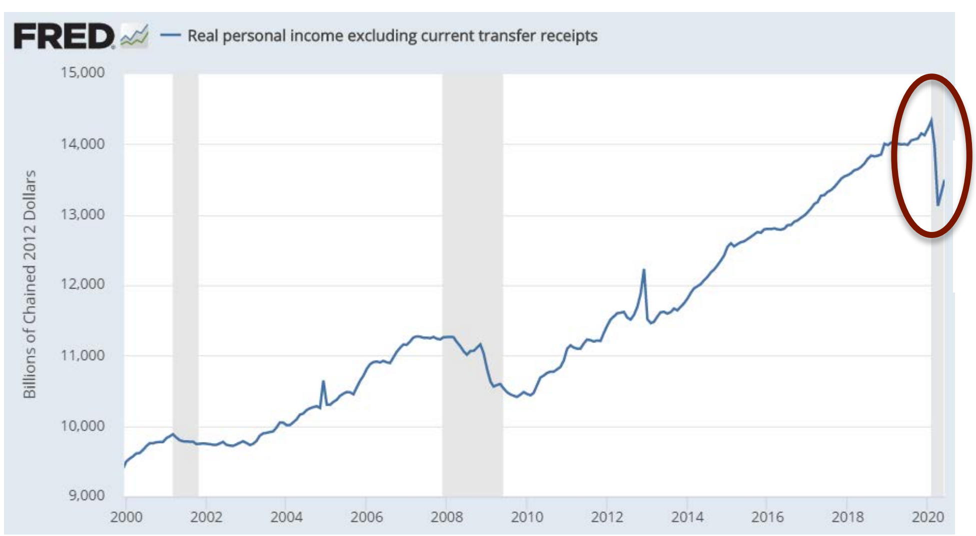
## Fiscal stimulus has sent incomes higher…

The fiscal stimulus (government spending and reduced taxes) approved by Congress is very large when compared to the overall economy. Recent estimates indicate a total of roughly 12% of GDP for 2020. This stimulus is made up of dozens of programs designed to help individuals and businesses. Normally, during a recession, incomes fall as people are laid off and generally have fewer work opportunities. The current programs have been so successful that, on average, aggregate income in the U.S. went up in recent months.




**Personal income went down excluding government benefits.**

Source: Federal Reserve Bank of St. Louis

**However, total income including government benefits went UP!**

*Real Personal Income is "Income that people get from wages and salaries, Social Security and other government benefits, dividends and interest, business ownership, and other sources. "*

The aggregate income data demonstrating an increase in income seems to be supported by more in-depth research. A study by a group of professors at the University of Chicago concluded the following about earnings and unemployment benefits:

- 68% of unemployed workers will receive benefits greater than their lost earnings
- The median worker will receive 134% of lost earnings, meaning that one out of five eligible workers will receive benefits at least twice as large as their lost earnings.
- The CARES Act actually provides income expansion rather than replacement for most unemployed workers.

## The cost of borrowing is at all-time lows…

One of the consequences of the Federal Reserve programs is the decline in interest rates. The cost for individuals, the U.S. government, corporations, etc. to borrow money is lower than any time in history. The cost for the U.S. government to borrow money for 10 years is 0.6%. Just two years ago, the same rate was 5 times higher, and in the early 2000s, the rate was 10 times higher.

These low rates make financing very efficient for borrowers. Families can more easily afford a mortgage payment (and to purchase a home). The U.S. government can borrow to fund its activities. Corporations can borrow to start a project, retain employees, etc.

Source: Federal Reserve Bank of St. Louis

How much should be borrowed is a topic for another discussion. But, the Fed policy of QE and targeting a Federal Funds Rate near zero has been effective at keeping both short interest rates (which the Fed directly controls) and long interest rates (which are set by the market) low to stimulate the economy.

Lower rates are both good and bad news. They are good for borrowers but bad for bond investors. While the low rates are positive for the economy in the short run, they are a major challenge for investors that do not want to have their entire portfolio invested in the stock market.



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## The pandemic and recession make the Presidential Election Cycle unique...

Every election is unique. Each set of candidates, policies, economies and circumstances are different, but the dynamics of an election year have been very consistent since 1950. Current polls show Biden with a meaningful lead, but polls were wrong in 2016. Regardless, presidents that encounter poor economies in an election year have trouble getting re-elected, and markets struggle a bit after an election when there is a change of control in the White House.

There is a clear correlation between the economy, stock market returns, and elections (see chart, below). If the economy encounters bad news (is in a recession or the stock market declines by 20%) in an election year, the incumbent party has typically suffered. Since 1950, in the twelve election years with positive economic results, the incumbent party has been re-elected eight times (67%). In the five election years with bad economic news, none of the incumbent party candidates have won re-election.

**Presidential Elections**

Incumbent Party & Poor Economic Environment

| Year | 20% decline or recession | Incumbent party | Incumbent party win / loss |
|---|---|---|---|
| 1952 | No | Democrat | Lose |
| 1956 | No | Republican | Win |
| 1960 | Yes | Republican | Lose |
| 1964 | No | Democrat | Win |
| 1968 | Yes | Democrat | Lose |
| 1972 | No | Republican | Win |
| 1976 | Yes | Republican | Lose |
| 1980 | No | Democrat | Lose |
| 1984 | No | Republican | Win |
| 1988 | No | Republican | Win |
| 1992 | No | Republican | Lose |
| 1996 | No | Democrat | Win |
| 2000 | Yes | Democrat | Lose |
| 2004 | No | Republican | Win |
| 2008 | Yes | Republican | Lose |
| 2012 | No | Democrat | Win |
| 2016 | No | Democrat | Lose |
| 2020 | Yes | Republican | ??? |

Source: Ned Davis Research

Interestingly, Ed Clissold of Ned Davis Research writes about the chicken and the egg aspects of this data, "The economy is integral to both the election and the stock market. Is the market declining because of a recession, so the incumbent party suffers? Or is the president penalized for his economic performance, and the markets reflect the uncertainty? The answer is probably some of both."

One important aspect of this election is the blame for the current recession. Typically, a president receives too much blame and too much credit for economic results. How will voters assess President Trump's response to the pandemic? Will the voters blame President Trump for the current recession, or give him a pass due to the exogenous nature of the shock?



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The election outcome is obviously important in many ways. In terms of forward-looking stock market performance, incumbent party losses tend to lead to poor short-term returns, and incumbent Republican party losses tend to lead to worse short-term returns. Stock returns since 1900 demonstrate that markets tend to do better when there is consistency (no change in presidential party). It also shows that markets are more volatile around Republican incumbents; the difference between a Democrat winning and losing is 8% on average, while the difference between a Republican winning and losing is 25% in the next calendar yar.

| Election outcome | Stock market returns (next year) |
|---|---|
| Incumbent Republican party wins | **+17%** |
| Incumbent Democratic party wins | **+6%** |
| Average all elections | **+5%** |
| Incumbent Democratic party loses | **-2%** |
| Incumbent Republican party loses | **-8%** |

Source: Ned Davis Research

**Some polls are projecting a democratic sweep... what would be the impact?**

At first blush, a democratic sweep seems likely to be negative for financial markets in the short run. The prospect of higher taxes and increased regulation are typically a drag on financial results and thus the stock market. However, the impacts may not be as large if that situation becomes reality. There are numerous considerations here: First, it is more likely that Democrats continue with the large fiscal stimulus outlays that have been successful at stopping the downward economic spiral. Stimulus will be important as long as the virus remains a threat to the economy. Second, given the risk to the economy from the virus, it is unlikely that a new administration will rapidly pursue tax increases. If an "all hands on deck" policy is maintained, tax policy changes may be delayed or diluted. Third, a large risk to the economy and markets over the past two years has been the trade war with China. A democratic lead would likely utilize a less combative approach.

One particular policy aspect of the current election that is worth mention is corporate taxes and their potential impact on stock prices. Typically, a company is valued based on cash flow available to shareholders; this is effectively "after-tax profits." If taxes go up, after-tax profits obviously go down (at least in the short run). Due to the 2017 tax legislation (Tax Cuts & Jobs Act) , the effective corporate tax rate fell over the past few years from 24% to 18%, on average. If those tax cuts were reversed, a rough estimate of the impact would be a valuation reduction of 8-12%. If only part of the tax cuts were reversed or phased in over time, a rough estimate would be roughly half of a full reversal, or a 4-6% to stock market values.

## Final Thoughts

The impact of the virus is clearly a significant wildcard, and we all wonder how quickly the threat will be mitigated. It is a challenging and emotional time. As we navigate through economic anxiety, we also acknowledge uncertainty in many aspects of our lives and wish you and your families health and well-being.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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