Retirement Income Solutions

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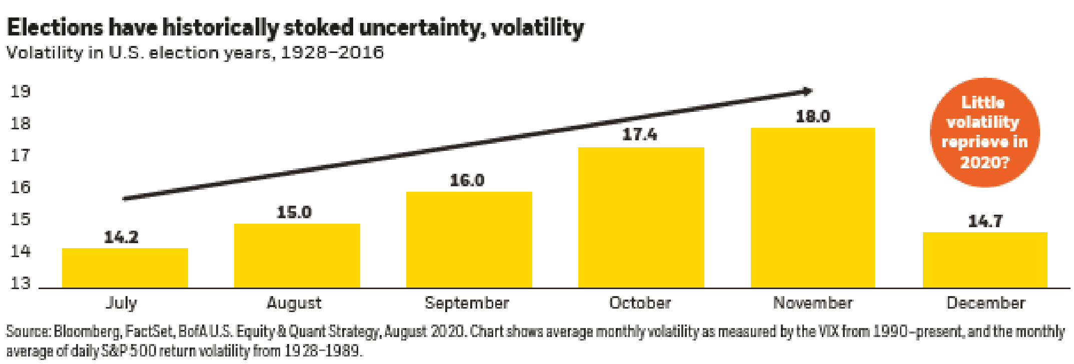
A Time of Transition

September 2020

Summary

Since the stock market low in March, financial markets have gradually recovered. The spring chaos has abated, but anxiety remains high. The stock market seems to oscillate between weeks of steady improvement and sharp drops. These “air pockets,” driven by fear and algorithmic traders, have been unnerving but have all been resolved promptly, lasting only a few days. Despite numerous risks, there have only been three corrections of 5% or more since March.

The list of concerns for the economy and financial markets is long. The pandemic is at the forefront, with many concerns about growing infection rates as the weather turns cold. The economic collapse has been forestalled by fiscal stimulus, but additional support from Congress remains elusive. The election season is now in full swing, and the recent presidential debate did little to lower the emotion and angst in an already challenging time.

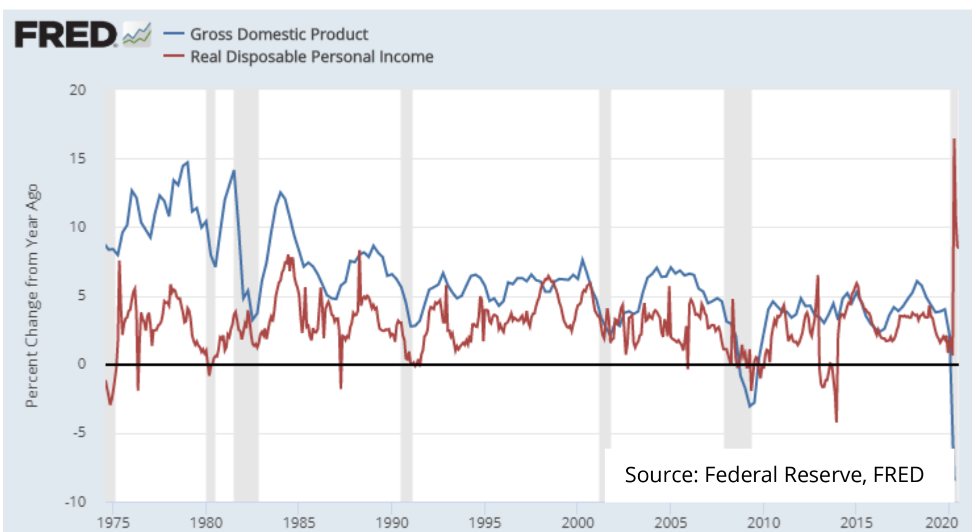


Several portfolio changes have occurred in client accounts this year. To avoid certain areas hurt most by the pandemic, some positions were reduced or eliminated (international stocks, mid-cap stocks, and some riskier bond positions). While such changes were beneficial for much of the year, the resulting portfolios were more concentrated and less diversified. At the end of September, portfolios remain at the “neutral” equity level, but underlying allocations have been adjusted to return to a more diversified allocation mix.

This is not your typical recession...

A record high stock market in February was followed by the biggest contraction in the economy (as measured by GDP) since the Great Depression. Unemployment spiked to 15% in a matter of months. The corresponding loss in jobs, economic output, and wages all set records. Despite the staggering statistics, financial markets have held up relatively well. This is mostly due to massive government stimulus. Congress passed spending equivalent to 12% of GDP. The Federal Reserve purchased $3 trillion of securities. So far, the stimulus is helping bridge the gap for many businesses and individuals. BCA Research posits, "Whenever an economy suffers an adverse shock, a feedback loop can develop where rising joblessness leads to less spending, leading to even more joblessness... Fiscal stimulus can short-circuit this vicious circle by providing households with adequate income to maintain spending."

Perhaps one of the best depictions of how this recession is "atypical" is personal income. This is the first recession (gray shaded areas) where personal income increased during the recession. Each of the prior five recessions shown below saw marked declines in income (red line) prior to or during the recession. This is the first recession where incomes not only went up, but also spiked dramatically.



The massive stimulus has worked so far; however, the delay and / or failure of Congress to pass an additional stimulus deal will continue to create volatility. The upcoming Supreme Court confirmation process could further distract lawmakers. If the stimulus is removed too early, it will be difficult for the economy to regain positive momentum. This may be a self-fulfilling prophecy though. If markets pull back due to increased risk, Congress is more likely to act.

Thankfully, September is in the rearview mirror…

September is a period of transition. The relaxation of summer comes to an end, children go back to school, and many people use the start of fall to refocus. Such changes occur in financial markets as well. Corporations begin to assess their goals and results. Wall street strategists shift their attention to the next year. Mutual fund managers typically have an October fiscal year end and review their portfolios in detail. Momentum of stocks in one financial sector shifts to another.

Since 1950, September has, on average, been the worst month for stocks. More than half of the time, the month resulted in negative returns. 2020 followed suit with the S&P 500 losing nearly 4% during the month of September.

Monthly Stock Market Returns

S&P 500, 1950-2019

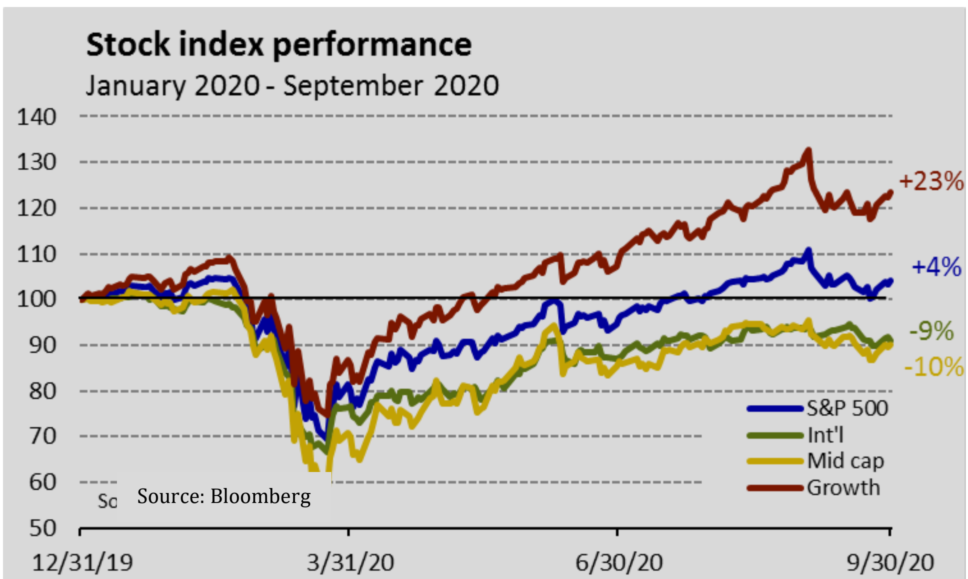
Month	Mean Return	Loss years	Rank
January	1.12%	39%	5
February	0.08%	44%	10
March	1.18%	36%	4
April	1.48%	29%	2
May	0.16%	41%	8
June	0.09%	46%	9
July	1.07%	43%	6
August	-0.07%	46%	11
September	-0.43%	53%	12
October	0.82%	40%	7
November	1.58%	31%	1
December	1.48%	26%	3

Source: Bloomberg

In many years, the end of summer weakness starts a new chapter in financial markets. After a period of reorganization, the market often rallies at the end of the year. October is the most common month for bear markets to end and bull markets to begin. There is no buzzer that sounds on October 1 to hail the end of market turmoil; October can still be a challenge. This is particularly true in election years, presumably from the negativity of campaigns and the uncertainty surrounding which party will gain or lose power in Washington. On average, October generates a positive return of 0.82%, but in election years, the month has posted a loss of -0.74%.

Investment positioning and risk… a slow return towards normal…

The environment has been dynamic and challenging this year, and client portfolios were adjusted several times to adapt to the rapidly changing conditions. While the market has recovered faster than expected, some areas have adapted to the pandemic better than others. Early in the crisis, portfolios were adjusted rapidly to significantly reduce exposure to international stocks and mid-cap U.S.-oriented investments. At the same time, portfolios maintained a steady overweight to growth-oriented stocks. Most years, there is not such a large dispersion of returns across different sectors of the stock market. However, in 2020, it has been beneficial to be less diversified and more concentrated in specific equity areas.

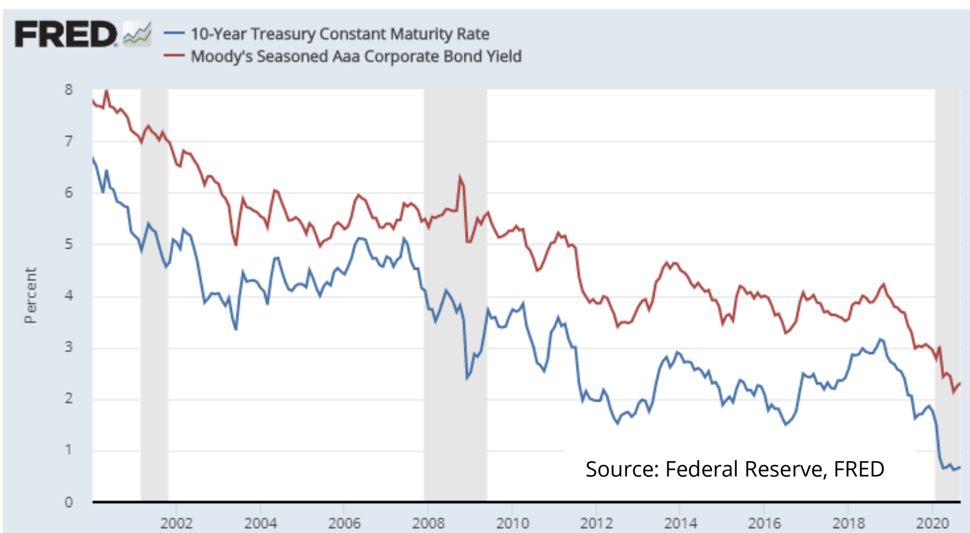


Currently, most portfolios remain roughly at a “neutral” equity position (or slightly above), which is defined as halfway between the maximum and minimum equity targets. While equities will likely be attractive on a one-year horizon, there could be some more bumps in the near term. In this time of transition, there is a lot for the market to digest. The list of worries is long, and optimism is hard to come by (except for those booming technology companies!). There are three primary risks on the horizon:

1) An increase in Covid-19 cases around the world
2) Uncertainty from the presidential election
3) No action on (or a weak) fiscal stimulus package from Congress

Accordingly, short-term volatility could continue. Equities could go lower in the near term as election and pandemic uncertainty are high. However, the election will be concluded; the financial and economic impacts of the virus continue to lessen; and meaningful stimulus is likely to continue after the political season is over. Therefore, volatility from these issues could create buying opportunities for those that were positioned very cautiously or those seeking to take advantage of drawdowns on an intermediate basis. Such actions may be uncomfortable, but, over a 12-month horizon, stocks should continue to generate better returns than bonds.

At the end of September, changes were made to client portfolios to begin to bring them back to a more diversified construction. For most of the year, portfolios were very light on international exposure, and that allocation was brought back to a more normal weight. International stocks have lagged a bit over the last few years, 2020 included. However, international stocks tend to do well when a) the global economy is improving broadly; and b) the U.S. dollar is weakening. Both are likely in the next year, and U.S. stocks are somewhat expensive when compared to their global peers. As the world slowly extracts itself from the pandemic, the expansion is likely to offer a larger benefit to international stocks. The U.S. dollar tends to move in longer-term cycles of roughly three or more years. After three years of a stronger dollar, it has weakened slightly this year. With U.S. interest rates so low and monetary stimulus so large, that weakness is likely to continue.



On the non-equity side, the environment remains quite challenging. The 10-year treasury bond hit a record low this year and hovered near 0.7% for most of September. Almost 20 years ago, the same U.S. treasury bond paid 10 times the current rate! Most bond yields are correlated with treasuries, and corporate bonds are paying record low yields as well. Consequently, over the past few months, non-equity allocations were returned to a more diversified mix as well. Most portfolios were adjusted to reduce allocations to the lowest yielding bonds in favor of those with a slightly higher coupon or other non-correlated assets [important note: non-equity options can vary widely by account].

Final Thoughts

We hope that you and your families are staying safe and healthy during this challenging time!

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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