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The Inevitable Second Round

October 28, 2020

Equity markets were down roughly 3.5% (350 basis points) today and are now down 5.5% (550 basis points) for the week. After a nice rebound from the depths of the March lows, the U.S. equity market has gotten a bit wobbly over the past two months, with many crosscurrents creating anxiety:

- **Spike in infection rates, increased testing and pandemic fatigue.** Europe has seen a 40% increase in mortality over the last week, with the most significant rise in death rates occurring in France, Spain, the U.K., Netherlands, and Russia. President Macron in France and Chancellor Merkel in Germany are calling for the reimplementation of restrictions but emphasized they wouldn't be as broad or harsh as those imposed in the spring. Hospital capacity in the U.S., particularly that of intensive care beds, is being stretched, but not yet close to the same level experienced in April and May. More knowledge of the disease, better treatment options, and less severe cases among the younger population have been mitigating factors.

- **Vaccine.** It's becoming more apparent that approval and broad distribution of a vaccine won't occur until the spring of 2021 at the earliest. Once approved, full availability will be limited by manufacturing capacity and logistical constraints. There's also a strong possibility that consumers will be hesitant to adopt what many believe may be a rushed and not thoroughly vetted vaccine product. News emanated overnight from a U.K. study that a vaccine may only be a temporary cure and won't hold off the disease for an extended period.

- **Fiscal package.** A compromise fiscal relief package seems unlikely until after Election Day. Major stumbling blocks between the parties are the aid for state and local governments, liability protection for businesses, and the final verbiage around a testing/tracing program. The prospect of delayed relaxation of capacity constraints and the reimposition of previously lifted restrictions mean consumers need continued income replacement. Additionally, businesses need access to loans to keep them afloat. We have often surmised that a market reaction would be necessary to prod the two sides to an agreement. Perhaps a portion of this equity selloff is the delivery of that message.

- **Election Day.** The election is only days away, and the markets expect and have grown more comfortable with a Biden victory accompanied by a Democratic Congress. As President Trump has narrowed the difference both nationally and in key electoral states, the prospect of a contested election and a delay in declaring a victor has grown.

U.S. economic statistics have begun to show a wider gap between strong housing and business spending results, which are being offset somewhat by a more hesitant and wary consumer.

- The September durable goods orders report strongly exceeded the August report and the consensus estimates. The more informative core (non-defense, ex-aircraft) orders also exceeded estimates and is at its highest level since 2014. Durable goods shipments, a component of GDP, are now 1.6% above pre-pandemic levels.

- Homebuilder confidence, housing starts, and both new and existing home sales have fully rebounded and now exceed pre-pandemic levels. Delayed demand from the millennial generation and the pandemic-induced desire to leave the densely populated cities have produced a longer-term advance in the sector. Low inventories and the upward price pressures they bring have had a minimal effect on demand so far.

- The timelier October Consumer Confidence survey from the Conference Board is showing some stagnation, if not regression, in the consumer spending outlook. Consumers' assessment of their current situation is fine, but they are beginning to express more concern about the future. Consumer spending comprises nearly 70% of U.S. GDP. So, any slowdown in this sector will directly impact the continuation of the economic recovery.

What This Means for Investors

Although days like today and weeks like this week can be disquieting, there are distinct market tailwinds that should prevent any imminent collapse in the equity markets. The Fed's extremely loose monetary policy should keep interest rates low and, at the same time, prevent any credit freeze. Fiscal policy, despite the political acrimony, should eventually produce some level of income and business support. The progression of the second wave of COVID-19 is a major wild card to the outlook. However, the population has largely learned to adapt to the disease as we await a viable vaccine. Reported third-quarter corporate revenue and earnings are exceeding estimates, and analysts are upwardly adjusting estimates for the fourth quarter and 2021.

The point is not that these positives are definitive outcomes, but that they are possible outcomes as is the possibility of negative outcomes. Financial markets are anticipatory. As news on the virus, fiscal stimulus, and the election ebb and flow, the market is responding accordingly. It's important to look out three months when a number of these issues should be resolved. Given how quickly the news changes, timing these market events can be perilous. At current levels, we think adjusting equity allocations down from the strategic asset allocation levels is unwarranted.

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