3Q 2020 Market Commentary

The key economic and investment topics of the first nine months of 2020 have been the fundamental changes wrought by the COVID-19 pandemic. In the midst of this health crisis, the economy was shut down by government mandate while Congress passed trillions of dollars of support payments to tide businesses and individuals during the trough of the punishing contraction. Only “essential” businesses were allowed to remain open during this time and at the same time the Federal Reserve Board adopted Modern Monetary Theory (MMT), putting trillions of dollars of theory into practice by flooding the market with liquidity and suppressing interest rates. Economic activity and financial markets have been totally distorted in the process. Yet now the economy is on a solid path of recovery even while the long-term challenges from deficits and debt leverage must be faced in coming years.

While the brunt of the stock market pain from the economic shutdown was felt in the first quarter of the year, the acceleration of economic trends already in place bifurcated the markets’ response into the “stay-at-home” stock winners and everything else. The valuations of “everything else” were driven to extraordinary lows in late March. Even with their rebound in the second quarter, the ups and downs in new cases and deaths gave a final boost to stay-at-home valuations through the end of August. As stay-at-home is typically classified as Growth, by September, the disparity had reached such extremes that Growth had outperformed Value every single month since September 2019!

The economy adapted remarkably fast to required changes from the virus, painfully so for many during the economic lockdown. Retailers have finally been forced to consolidate over-stored malls across America, with permanent store closures and bankruptcies aplenty. Expenditures boomed on remote communications and other tech equipment, software and cloud services for all who could work at home. Home pantries likely haven’t been this heavily stocked in decades. Online shopping and shipping soared, permanently raising the share of the retailing dollars spent this way. The safety of driving cars, vacationing in RV’s, and owning homes in the suburbs will have long-lasting impacts on demand for these products. This will be the new normal even when the entire economy is finally allowed to reopen.

Yet there are vast areas of the economy that essentially remain closed—air travel and live events to cite just two examples. After the huge toll of illness and death from the virus, these still await good news on the COVID-19 front.

All of the uncertainties are still front-page news, and yet the apparent reduction in death rates gets lost in the noise of daily statistics. Here’s a bit of the good news for the nation (using Johns Hopkins Coronavirus data): from the peak in April’s 14-day average deaths rate at 2,174 per day, the daily death rate fell 52% to the secondary peak at 1,034 per day (14-day average) during the first half of August. It fell 29% more to 730 per day in the 14 days ended September 30th. Even while the number of daily cases has gyrated up and down and is higher today than in April, the 14-day average death rate fell 66% from the April peak.

This is not to say the country can let down its guard, and at the same time, it now appears that we may have reached a transition point. The U.S. states, much like Italy, that early on experienced the most devastating rise in cases and deaths, have seen death rates plunge and stay low, even while case rates have risen again. These results can be seen mostly in northeastern states where the virus did the most damage early on and include Connecticut, Maryland, Massachusetts, Michigan, New Jersey, New York, and Pennsylvania. Out west, only Arizona and Colorado show a similar pattern.

No one really knew how this pandemic would unfold, and the high and low forecasts were far off of the actual trend. The test of wearing masks and maintaining social distancing clearly has had a positive impact by flattening the curve and providing hospitals with breathing room. Beyond this, rapid tests, treatment with antivirals and antibody therapeutics, better hospital protocols, and self-quarantine practices each should have beneficial impacts on incidence and on severity, giving the economy the opportunity it needs to open up, even before a vaccine is widely available sometime in 2021.

It's bad enough that COVID-19 had to distort the economy and markets without the matter being complicated by a presidential election. Regardless of who wins, the near-term performance of the economy is more dependent upon states opening up further before and after the election than on the election's actual result. Furthermore, many voters and investors appear to like divided government and the limitations it imposes on government action. An election outcome that leaves the House and Senate divided would likely calm market fears, not heighten them.

So much federal stimulus has been pumped into the economy, combined with unprecedented monetary policy stimulus from the Federal Reserve Board, just the progress made to date should be enough to have caused a robust 25-30% GDP rebound in the third quarter just ended. It would take another four quarters of 5% annualized GDP growth just to recover to where the economy stood at the beginning of 2020. While the still high level of unemployment and layoffs could be a drag on the pace of recovery or cause a secondary dip in real GDP, the last job openings measure (from the JOLTS survey) suggests there at 6.5 million jobs available and waiting for states to fully reopen.

Certainly Treasury bond yields are pitifully low with the 10-year T-bond yield at only 0.68%. The Federal Reserve Board has used most of its ammo driving 10-year T-bond yield down 100 basis points over the past year. You can't live on that income! Under MMT, real yields are negative and nominal yields provide little income and minimal downside protection. Higher price inflation than currently expected is a likely result from current Fed policies.

The result? 2020 has not been a market of stocks, just a market of stay-at-home stocks. With opening and continued recovery in the broad economy, these stay at home stocks may have seen their best days. Growth rates were unsustainably raised as folks dutifully watched every possible TV rerun. How many times can one watch *Vikings* episodes on Netflix or for older audiences, *Murder She Wrote* reruns on Hallmark? When the economy really opens up, binge watching should diminish and new subscriber growth slow. September's sharp selloff in the stay at home technology stocks may have been a precursor of what's to come for these extraordinarily overvalued stocks.

And the average "everything else" stock, not the market indexes, appears to be the place to be, especially those in deep value territory that have been shunned but would benefit from improving earnings with stronger economic growth and restored dividends.