Fourth Quarter 2020 Investment Outlook

Engine Room, More Power!

Kirk: Engine room!
Scotty: Scotty here.
Kirk: We'll need all the power you can muster, mister.
Scotty: Don't you worry, Captain. We'll beat those Klingon devils, even if I have to get out and push.
Kirk: I hope it won't come to that, Mr. Scott.

"Unless something dramatic changes or we have a breakthrough sooner than we expect on vaccines, or there is some dramatic change in policy, I think we are in for a grinding recovery from here,"

Neel Kashkari – Minneapolis Fed President and FOMC Member

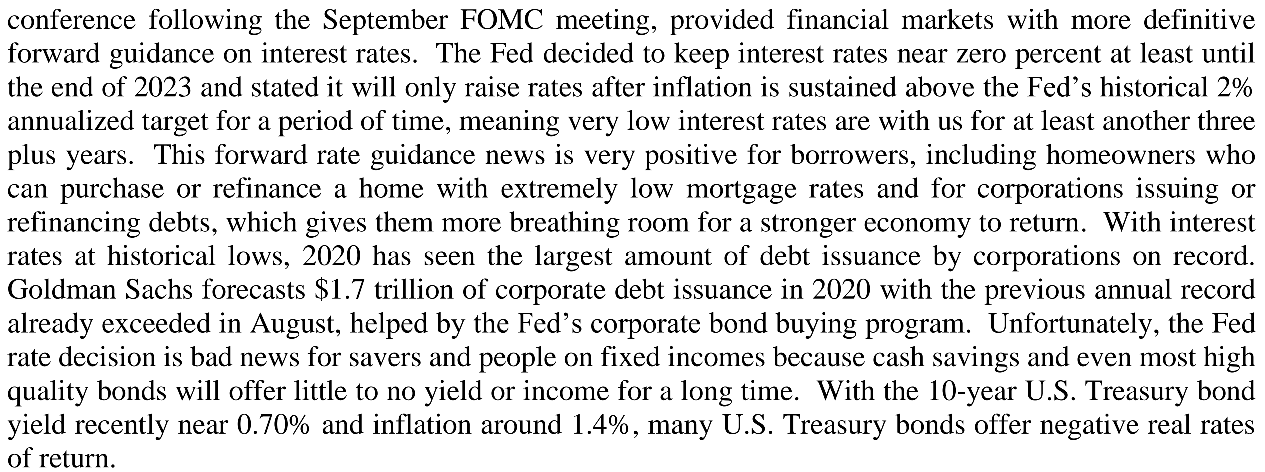
"The end of the epidemic, best case is probably 2022. But during 2021, the numbers, we should be able to drive them down, if we take the global approach. So, you know, thank goodness vaccine technology was there, that the funding came up, that the companies put their best people on it. That's why I'm optimistic this won't last indefinitely."

Bill Gates, Co-Chairman and Trustee of the Bill & Melinda Gates Foundation

Since the U.S. now officially has a Space Force (no, not the one lead by Steve Carrell), it's appropriate to reference Star Trek and the perils faced by the crew in the year 2265 to draw an analogy to our present situation with COVID-19. Star Trek was created by Gene Roddenberry and originally aired on CBS in September 1966 and was on television for three years and 79 episodes. The show and its main characters, Captain James T. Kirk, Chief Medical Officer Leonard "Bones" McCoy, First Officer and Science Officer Spock, and Chief Engineer Montgomery "Scotty" Scott, are iconic characters in television history. In Star Trek, space was the final frontier, and the mission was to seek out new life and civilizations and to boldly go where no one had gone before. Today, pharma and biotech companies are the new frontier, seeking out drug candidates to solve the COVID-19 virus outbreak. Just as Klingons were a constant and deadly threat to the crew of the Enterprise, COVID-19 poses a similar threat to the global economy today.

The world is in the midst of the most difficult time in recent history with respect to a life threatening virus that has had an unprecedented and historic negative impact on the global economy. COVID-19 is one of the most deadly viruses in history and caused the largest and fastest global economic collapse in history (worse than the Great Depression and that's saying something), created the biggest rise in unemployment in U.S. history, required Congress to quickly enact over $2 trillion of stimulus spending to date and run the largest fiscal deficit in U.S. history, and forced the Federal Reserve to provide the largest amounts of monetary stimulus in U.S. history. COVID-19 has no bias or prejudice whatsoever, infecting the entire human race including the President of the United States. 2020 is already one of the most reviled years in U.S. history and the dreaded election is still ahead in November. Who wouldn't want to have Scotty use the transponder and get beamed to a fully stocked tropical island with free WIFI for the next six months?

With the U.S. economy in the sick bay, we need our Scotty, Chairman Jerome Powell of the Federal Reserve, to provide some extra power and come through for us. Even with our deflector shields fully deployed, the ongoing COVID-19 threat means the economy requires even more power from the engine room. Chairman Powell, via his Jackson Hole speech delivered virtually in August and again at his press



conference following the September FOMC meeting, provided financial markets with more definitive forward guidance on interest rates. The Fed decided to keep interest rates near zero percent at least until the end of 2023 and stated it will only raise rates after inflation is sustained above the Fed's historical 2% annualized target for a period of time, meaning very low interest rates are with us for at least another three plus years. This forward rate guidance news is very positive for borrowers, including homeowners who can purchase or refinance a home with extremely low mortgage rates and for corporations issuing or refinancing debts, which gives them more breathing room for a stronger economy to return. With interest rates at historical lows, 2020 has seen the largest amount of debt issuance by corporations on record. Goldman Sachs forecasts $1.7 trillion of corporate debt issuance in 2020 with the previous annual record already exceeded in August, helped by the Fed's corporate bond buying program. Unfortunately, the Fed rate decision is bad news for savers and people on fixed incomes because cash savings and even most high quality bonds will offer little to no yield or income for a long time. With the 10-year U.S. Treasury bond yield recently near 0.70% and inflation around 1.4%, many U.S. Treasury bonds offer negative real rates of return.

Maintaining interest rates near 0% for a multi-year period should be a warning as to how the Fed sees this recovery playing out. Neel Kashkari, a voting member of the FOMC, has one of the most negative outlooks for the U.S. economic recovery of all of the regional Fed presidents. Maybe being stuck in Minnesota (from his prior life in Newport Beach, CA) has something to do with his poor attitude but the recent Fed interest rate policy guidance suggests a difficult slog ahead for the U.S. economy. In addition, Chairman Powell has publicly implored Congress several times to pass additional fiscal stimulus to help the Fed out in terms of supporting the economy until a COVID-19 solution emerges. The pending election has created political gamesmanship on negotiations for a Phase IV stimulus package. For the time being it has become a moot point as President Trump recently announced he was calling off Phase IV stimulus discussions until after the election. Once the election is over and politicians lock in their seats then a compromise is likely to be struck before year-end.

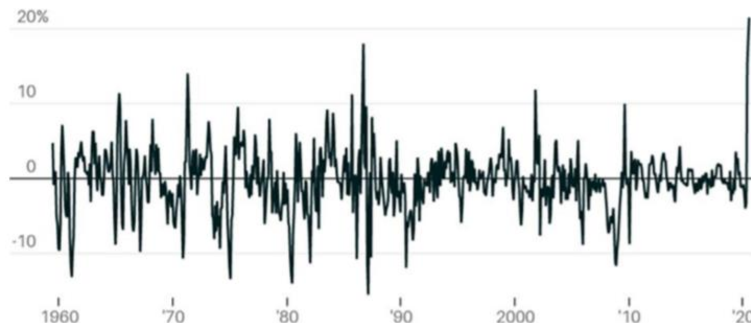
Since the timing of a COVID-19 solution is still unknown, more fiscal spending is imperative since the Federal unemployment support of $600 per week ended July 31st and the payroll subsidies provided to industries severely impacted by COVID-19 shutdowns ended October 1st. As a result, some companies are now implementing large layoffs. Disney recently announced 28,000 job cuts due to low park attendance as it doesn't expect that business to improve until a COVID-19 solution is found. Airlines are also cutting large numbers of jobs or asking their unions for large wage cuts. Movie theater attendance is still down 75% so movie studios keep pushing back all their new movie releases. Several movie chains in the U.S. are teetering on edge of bankruptcy. Cruise lines keep pushing out their cruise starting dates. Times Square in New York City is like a ghost town and Broadway theaters are not reopening until 2021. These are all examples of how broad an impact COVID-19 has had on employment and incomes and why even more fiscal stimulus is needed.

The Fed has been crafty and used many of its policy tools to support the economy and financial markets. The next chart shows how easy monetary policy (low interest rates) works its way into the real economy. With 30-year mortgage rates now below 3%, home sales are soaring as a result. Your local realtor, residential construction companies, and Home Depot shareholders are some of the few that will have fond memories of 2020. The Fed understands the importance of housing and its impact on the economy. According to economic research, for every $1 spent in the housing market, there is approximately a 1.4X multiplier effect on the rest of the economy. While the Fed will never admit it, it fully understands its zero interest rate policy has created overvaluations and speculative activity in the stock market. However, with the unprecedented negative hit the U.S. economy has taken from COVID-19, the Fed is more focused on

the far greater impact its low interest rate policy will have on the housing market, employment, and the positive add-on spending impacts both will have on the economy.

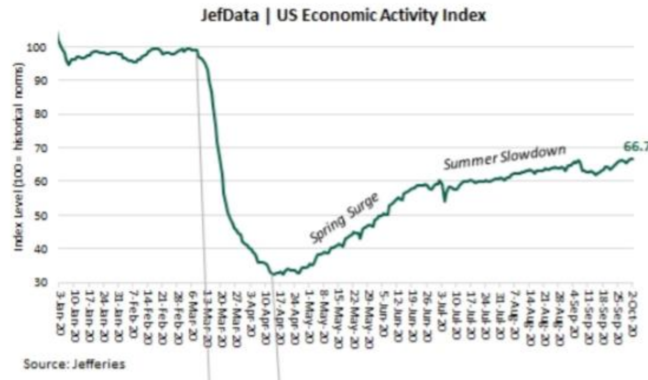
Source: Bloomberg

The next chart shows the rolling six month change between consumer spending on durables minus consumer spending on services. Consumer durables include furniture, appliances, and lawn equipment while services include spending at restaurants, movies, concerts, airlines, hotels, or sporting events. In this hunker down, COVID-19 world, nesting is in full force and people are spending more on housing related projects and less on discretionary spending like dining out, travel, and entertainment. The change in consumer spending behavior due to COVID-19 has been extreme.



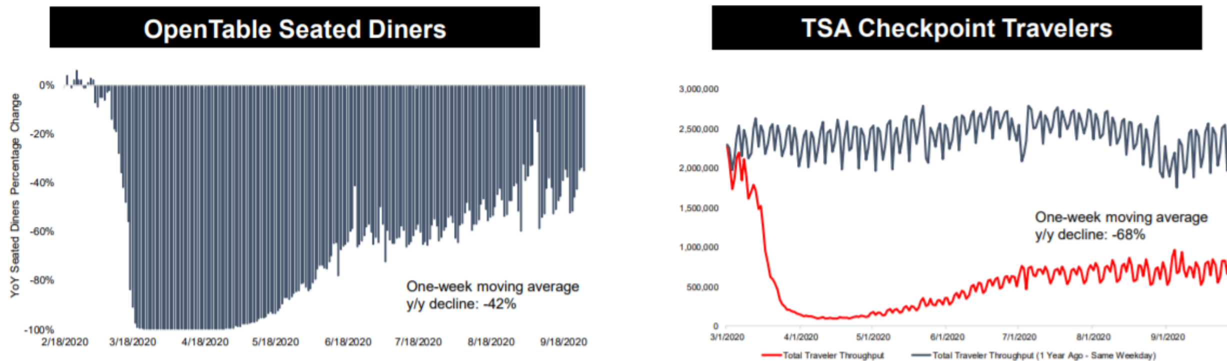
Source: Barron's

Even though the Federal Reserve and Federal government reacted quickly to support the economy, the economy is still well off of its level that existed prior to the arrival of COVID-19. The next chart shows the Jefferies U.S. Economic Activity Index, which captures traffic congestion, retail foot traffic, transit activity, restaurant bookings, and flight activity.



At the height of the economic shutdowns in March and April, U.S. economic activity declined 65% in just 30 days. Six months later economic activity has recovered to about 67% of the level that existed prior to the COVID-19 outbreak. Also note that the pace of improvement has leveled off over the past several months after a Spring surge.

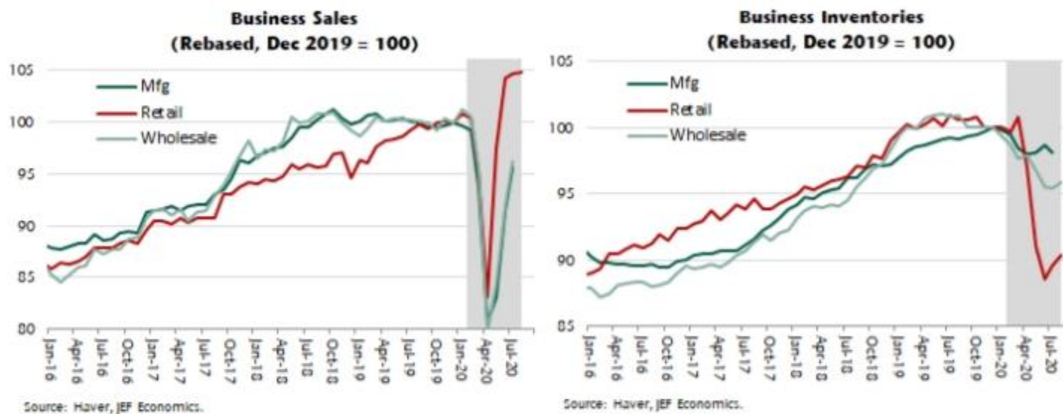
The next two charts capture the level of activity at restaurants and airports. Activity levels for both are still well below pre-COVID-19 levels but continue to show grinding improvement. It is estimated that over 16,000 restaurants have closed permanently due to COVID-19. Airlines are still running limited schedules with demand still depressed and despite offering low fares to try and generate demand.



As devastating as COVID-19 has been to some industries, one important point to make is that there is significant amount of pent-up demand being created due to the extended shutdowns or limitations brought on by COVID-19. When an effective therapy or vaccine is identified, and consumer confidence fully recovers, economic activity will begin to accelerate like the U.S.S. Enterprise did when warp speed commenced. The last major deadly global pandemic called the Spanish Flu killed 675,000 Americans and started around the Spring of 1918 and lasted for approximately eighteen months. Once the virus burned itself out and life returned to normal, the Roaring Twenties commenced and even with Prohibition in place. It is highly likely after a COVID-19 drug solution is found or the virus eventually burns itself out (Farr's Law) that the global economy will experience an outsized economic recovery. Of course, the $64,000 question is when will that happen?

For now, cautious spending remains the norm for both families and companies. The personal savings rate was near 14% in August compared to the normal level of 6.5% in recent years. The next two charts capture

recent data on business sales and inventories. Business sales on the left side chart show a V-shaped recovery off the April lows, more so for retail (especially online) than manufacturing. However, the right side chart shows the inventory recovery remains muted to date, especially for retail. You may have experienced this effect when shopping at a major retail chain and noticed shelves with limited selection or some products out of stock.



Lack of product availability is created by retailers limiting how much they order because of concerns about future consumer demand (second wave fears) or its due to the inability of suppliers to meet the level of increased demand with existing capacity. Whatever the case may be, one way to address this issue is to ramp up production. Rising inventories add to GDP growth and so the inventory chart implies that future GDP growth will get a strong boost when inventories are increased to catch up with recovering demand. Unfortunately, one negative side effect of government policies such as providing $600 per week of extended unemployment assistance is that it provides disincentives for some people to return to work because they make more income on unemployment than they did working prior to COVID-19. This issue is one of the points of contention between Republicans and Democrats in getting a Phase IV fiscal spending bill passed. Democrats want to re-up the $600 per week payout while Republicans want a lower level and with payment limitations tied to prior wages. Labor constraints limit the ability to increase production of goods. There are many businesses interested in hiring but cannot find people interested in working at the wages offered or because many people are still uncomfortable working in close contact with others due to COVID-19 concerns.

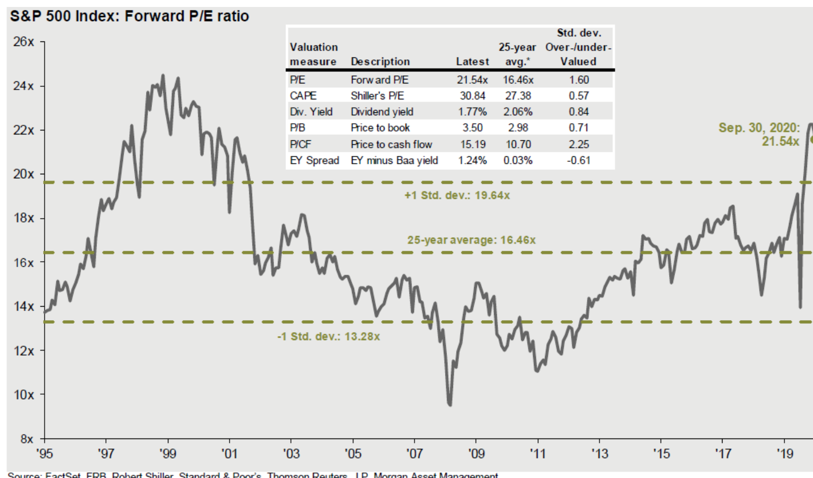
Similar to the varying degrees of impact COVID-19 has had on different segments of the economy, the stock market is also experiencing some of the most extreme return outcomes at any time in history. These return distortions are reflected in the +4.8% return year to date through 9/30/20 of the S&P 500 Index while the broader smaller cap Russell 2000 Index has returned -8.0%. Investors are nervous about uncertainty brought on by COVID-19, so they are crowding like a herd of elephants into large/mega cap stocks.

The following chart breaks down all the stocks that trade in the total U.S. stock market and segments them into various return buckets. The data shows the U.S. stock market is heavily tilted towards stocks experiencing outsized negative returns year to date. The median stock in U.S. equities has fared far worse than the major market indices. The chart shows the distribution is shifted towards the negative left tail with the most populated return buckets down 20%-30% (412), down 30%-40% (398), and down 40%-50% (347). On the other end are 203 stocks now up over 100% year to date. The highest performing stocks are the ones investors perceive to the positive beneficiaries of COVID-19 nesting such as Work From Home, home entertainment, exercising at home, online shopping, home improvement, and cooking at home. However,

the stocks benefiting from consumer behavior changes are swamped by stocks and companies negatively impacted by COVID-19. 1600 of the nearly 3,664 listed stocks or 44% are down 20% or more with the median return (e.g., the 1832nd ranked return) at -14.8% and compared to the +4.8% return of the S&P 500 Index return. This data suggests that the biggest weighted or largest companies in the U.S. stock market are generating a disproportionate amount of year to date returns. In fact, without the FANMAG stocks (Facebook/Amazon/ Netflix/Microsoft/Apple/Google), the S&P 500 Index return would be in negative return territory year to date through 9/30/20.

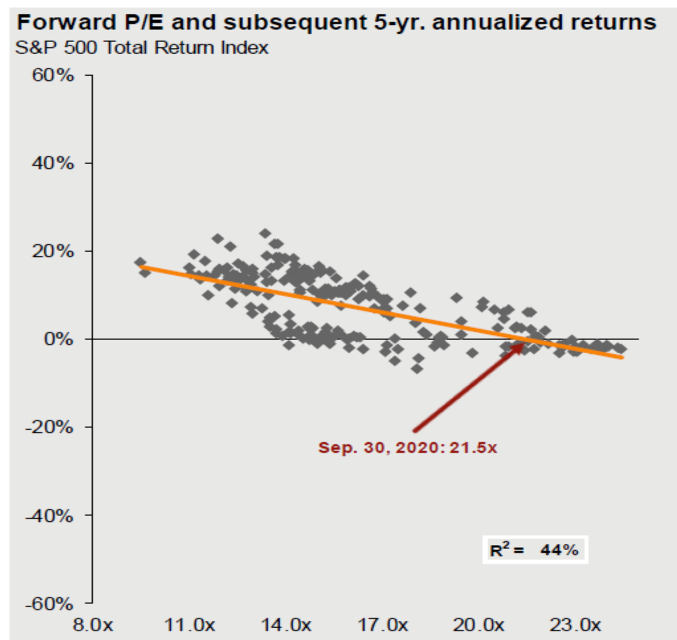
Source: Ploutos-Seeking Alpha

With a select number of very large/mega cap tech related stocks dominating the S&P 500 Index, and all of these stock trading at very high price/earnings ("PE") multiples, the S&P 500 Index today is well above its historical valuation averages. The next chart shows the forward PE ratio of the S&P 500 Index going back to 1995. The average PE multiple for the past 25 years has been 16.4X and today the S&P 500 Index trades at a 21.5X forward PE multiple. Note that during the tech bubble of 2000, the S&P 500 forward PE peaked near 24X. Compared to that tech bubble era, many of the biggest tech stocks today are well managed, established businesses that have solid earnings. However, it is only because the Fed is keeping interest rates near zero that many U.S. stocks are trading well above historical valuation averages.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.54x	16.46x	1.60
CAPE	Shiller's P/E	30.84	27.38	0.57
Div. Yield	Dividend yield	1.77%	2.06%	0.84
P/B	Price to book	3.50	2.98	0.71
P/CF	Price to cash flow	15.19	10.70	2.25
EY Spread	EY minus Baa yield	1.24%	0.03%	-0.61

Why do valuation levels for stocks matter? Because the valuation level an investor pays today will impact the returns the investor earns in the future. For example, at the tech bubble peak in 2000, when the S&P 500 Index traded at 24X forward PE multiple, the next 10-year annualized return for the S&P 500 Index was close to 0%. The next chart shows the historical relationship between forward PE valuations and subsequent 5-year annualized returns. The current market valuation of 21.5X forward PE is marked by a red dot. When the S&P 500 Index traded at this valuation level in the past, the next 5-year annualized return was slightly negative. Note how future returns go higher when forward PE multiples are lower. For example, buying the S&P 500 Index near a 10X forward PE multiple has meant earning a high-teens annualized return over the ensuing 5-year period. In contrast, paying anything above a 20X forward PE multiple has meant mostly negative annualized returns over the ensuing five year period.



Source: JP Morgan Asset Management

Of course, no one is forced to buy the S&P 500 Index to gain U.S. stock market exposure. Investors have many ways to get stock market exposure via different types of Exchange Traded Funds or mutual funds that offer specific stock market exposure including non-U.S. stocks. It just so happens that the S&P 500 Index is the most popular, low cost indexation product with investors in the U.S. However, as shown in the chart above, the odds of winning or producing the highest returns with the top 500 U.S. stocks may no longer be the best opportunity for an investor to consider.

With the Fed maintaining an extended period of low interest rates, most U.S. stocks already trade well above their long-term PE averages. The next chart shows how different segments of the U.S. stock market are valued compared to their 20-year PE average. This data shows the most extreme valuation levels reside in both large cap stocks and growth stocks. For example, if we use the large blend category as a proxy for the S&P 500 Index, we can see this segment of the U.S. stock market trades at nearly 140% of its 20-year PE average. However, the valuation situation in growth stocks is even more extreme, no matter what capitalization bucket you consider. Large growth stocks trade at nearly 164% of their 20-year PE average while small cap growth stocks are even more extremely valued at 194%. In contrast, large/mid/small value stocks all trade at around 125% of their 20-year PE average. It is important to note that stock valuations go

higher as interest rates go lower. However, with interest rates already near the zero bound level, low interest rates appear fully priced into U.S stocks valuations. It is not surprising that with interest rates at historical lows, the entire U.S. stock market trades well above its long-term average PE. However, the best odds for making decent returns in U.S. stocks are predominately found in the value segment of the market. Value is not the area of the market that houses the current FANMAG darlings that investors are currently obsessed with owning, regardless of the high valuations they are paying today to hold these stocks into the future. Ironically, the previous chart shows that investors overly eager to buy the FANMAG stocks at today's very elevated PE multiples only increase the odds they will earn poor returns over the next five years.

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	126.3%	139.7%	163.6%
Mid	125.6%	136.9%	187.4%
Small	123.9%	174.6%	193.8%

Summary

To live long and prosper, the COVID-19 pandemic must end for life and the economy to return to normal. However, even when a vaccine is determined to be effective, that is not the same thing as the vaccine being widely available or consumer spending and the economy immediately returning to its pre-COVID 19 levels. People are naturally going to be cautious until confidence returns and that is going to take time. In all likelihood, 2021 will continue to have a high degree of uncertainty associated with it unless a vaccine or therapy is deemed effective and gets deployed quickly. Many medical professionals believe wide scale availability of a vaccine is a second half 2021 or 2022 event. That being said, the economy should continue to grind higher as time passes on, but the economy will also need more power from the engine room to bridge the gap to when normalcy returns. Even after $7 trillion of monetary and fiscal support has already been supplied, the U.S. economy will need more of both to help people and businesses make it through to the other side. It is a daunting amount of government debt being issued today to support the economy and it will be a headwind to growth in the future. However, there is no choice. As Captain Kirk implored to Scotty to "give it all you got" to save the U.S.S Enterprise from getting sucked into a black hole, the U.S. economy will need the same from the Federal government and Federal Reserve until a COVID-19 solution becomes a reality.

Mark J. Majka, CFA
Chief Investment Officer

October 8, 2020

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