COVID-19 AND THE MARKETS

The stay at home mandate started in March 2020 and continues in some states, as others have opened - some maybe a little early. The stock market indexes peaked in February 2020 after a great year in 2019. Before COVID-19 we had a historically low unemployement rate of 3.5% with African American and Latino unemployment at historic lows as well. The economy was doing great as well as the stock market. The Dow peaked at 29,568, the S&P 500 at 3,393 and the NASDAQ at 9,817. At this writing the Dow is at 26,896, the S&P 500 at 3,262 and the NASDAQ at a record high of 10,593 lead by tech stocks that have benefited from the work-from-home mandate from governors and mayors.

The S&P 500 is almost back to where it was before the COVID-19 shutdown. As we know, more and more companies are filing bankruptcy and many small businesses will never reopen due to the closing of our economy. There are mixed opinions from industry pundits about what will happen going forward. In reality, it depends on the virus and when we get a vaccine. As we know there has been an increase in cases primarily in the South due to people not adhering to the CDC guidelines. The big question is, how long will it take for the economy to recover to the pre-COVID levels if it ever does? The stock market and the economy are disconnected at the present time. The market may have another correction as corporate earnings fall, the stock market continues to rise and the economic shutdown continues. The US is currently in a recession and some believe it can last longer than we think.

FactSet

As of July 17, 2020, Factset Earnings Insight has calculated the following from analysts:

Earnings: Analysts Expect Earnings Decline of -21.1% for CY 2020

For the second quarter, S&P 500 companies are reporting a decline in earnings of -44.0% and decline in revenues of -10.5%. Analysts expect earnings decline of -21.1% and a revenue decline of -3.7% for CY 2020.

For Q3 2020, analysts are projecting an earnings decline of -24.4% and a revenue decline of -5.4%.
For Q4 2020, analysts are projecting earnings decline of -12.4% and a revenue decline of -1.8%.
For CY 2020, analysts are projecting an earnings decline of -21.1% and a revenue decline of -3.7%.
For Q1 2021, analysts are projecting earnings growth of 12.1% and a revenue growth of 2.8%.
For CY 2021, analysts are projecting earnings growth of 28.0% and a revenue growth of 8.4%.

Valuation: Forward P/E Ratio is 22.3, Above the 10-Year Average (15.2)

The forward 12-month P/E ratio is 22.3. This P/E ratio is above the 5-year average of 16.9 and above the 10-year average of 15.2. It is also above the forward 12-month P/E ratio of 21.7 recorded at the end of the first quarter (June 30). Since the end of the second quarter (June 30), the price of the index has increased by 3.7%, while the forward 12-month EPS estimate has increased by 1.0%.

At the sector level, the Consumer Discretionary (46.6) sector has the highest forward 12-month P/E ratio, while the Financials (14.7) sector has the lowest forward 12-month P/E ratio.

Gary Shilling, A. Gary Shilling & Co., Inc.

Gary Shilling is an experienced and respected money manager who tends to be conservative. His views of the market and the economy going forward are as follows:

The corona crisis and the global recession are unfolding in two phases. First, dominated by fears over the virus itself, faded somewhat as the numbers of new cases fell, hopes for a vaccine rose and investors trusted fiscal stimulus to affect a second half economic recovery. As a result, stocks have rallied since late March.

In contrast, he believes phase two will get underway as the likelihood of a deep global recession stretching into 2021 becomes more apparent, and perhaps because of the renewed leap in cases in states that reopened early. This would make "risk off" investment strategies fruitful. Everyone expects a second-quarter economic swoon, but the tale will be told as evidence of third-quarter performance develops.

He expects the recession to persist in the second half of this year and into 2021, and when this becomes apparent to most investors, the current "risk on" investment strategy will revert to "risk off".

Hoisington

The following commentary is from the Hoisington Investment Management Company "Quarterly Review and Outlook Second Quarter 2020":

Enormous Challenges

Four economic considerations suggest that years will pass before the economy returns to its prior cyclical 2019 peak performance. These four influences on future economic growth will mean that an extended period of low inflation or deflation will be concurrent with high unemployment rates and sub-par economic performance.

First, with over 90% of the world's economies contracting, the present global recession has no precedent in terms of synchronization. Therefore, no region or country is available to support or offset contracting economies, nor lead a powerful sustained expansion.

Second, a major slump in world trade volume is taking place. This means that one of the historical contributions to advancing global economic performance will be in the highly atypical position of detracting from economic advance as continued disagreements arise over trade barriers and competitive advantages.

Third, additional debt incurred by all countries, and many private entities, to mitigate the worst consequences of the pandemic, while humane, politically popular and in many cases essential, has moved debt to GDP ratios to uncharted territory. This insures that a persistent misallocation of resources will be reinforced, constraining growth as productive resources needed for sustained growth will be unavailable.

Fourth, 2020 global per capita GDP is in the process of registering one of the largest yearly declines in the last century and a half and the largest decline since 1945. The lasting destruction of wealth and income will take time to repair.

The Elephant in the Room

Robert "Bob" Davis, CFA was the founder of the large cap money manager firm called Davis Hamilton Jackson and Associates, a Houston based investment advisory firm. They sold the firm and have now retired. Bob writes a newsletter each quarter and I am lucky enough to be one of the recipients. He lives on his ranch in Chappell Hill, Texas and calls his letter the "Caney Creek Report". I am including Bob's entire letter because I think he very eloquently makes points that we should all pay attention to:

> Over my long career with big, and not so big, companies, I have had the "privilege" of attending many "offsite" conferences. That is when you spend a lot of money and precious time away from the office discussing things, team building, etc. It is usually an expensive waste of time for one reason – The Elephant in the Room. That is the thing that is lurking in the background that nobody really wants to talk about.
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> Today, the elephant in the room is the November election. The talking heads on CNBC and most Wall Street strategists have hardly mentioned it as they breathlessly jump for every uptick in virus infections in Texas as a reason to worry. The markets, of course, are moving past the virus as evidenced by the record 20% gain in the Standard & Poor's 500 in the quarter just ended. More on that later. Let's talk about the elephant.
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> First, no matter the outcome, the sun will rise on November 4, 2020. So, everyone calm down! Recently, in a discussion with a friend, he was lamenting the "chaos" in the country. I laughed as I reminded him that in my 72 years there have been very few periods where it wasn't "chaos." I will admit though that the 24 hours-per-day cable news cycle helps keep the blood pressure up!
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> Having said all of that, the election will have consequences for the market. Yesterday, Mr. Biden, who currently has a significant lead in the polls, actually said something in public. At a fat cat fundraiser, Mr. Biden said he would roll back the Trump tax cuts and do away with "loopholes" like capital gains rates and stepped-up basis. Of course, that would include the "death tax." You didn't hear that on the evening news, did you?

A basic rule of finance is that it is not how much you make that matters, but how much you keep. Mr. Biden is talking about big money. In 2019, estimates are that $28 of the $160 of the earnings of the S&P 500 companies came from the Trump Tax cuts. So, even if the world were to return to "normal" after the virus, after-tax earnings for the S&P 500 might be like $135 under the Democrats.

The Index closed at 3100 June 30. The price/earnings ratio on totally recovered earnings would be 23x. Add to that an increase in capital gains rates to the same rate as earned income and some haircut in the PE is highly likely. It is also likely that the E (earnings) would be considerably lessened if the administrative state begins to reregulate the economy.

This is not a political statement. As an investor you must be prepared for whatever the environment is. A Democratic sweep in November would likely result in a stock market that is lower for longer.

However, what are the odds of a sweep? Let's say Mr. Biden is elected and the Democrats hold on to the House of Representative. But, the Republicans keep the Senate. The sweeping tax "reform" won't happen. If President Trump manages to win and the Dems take both houses of Congress, tax "reform" won't happen. Gridlock looks highly likely to continue at this stage. That is comforting to investors. But, as the election gets closer, the markets, which are much better prognosticators than any TV pundits, will discount the outcome.

Meanwhile, the S&P 500 has enjoyed a spectacular recovery from the March bottoms, led by the big tech stocks. The QQQ, the exchange traded fund for big tech was up 30% for the quarter and is now up 17% year-to-date. The equal weighted S&P 500 which counts the tech giants the same as smaller companies was up 21% for the quarter but is still down 12% year-to-date. The forward PE for the equal weighted index is 14x. For the regular capitalization weighted index, it is 25x.

Stocks have rallied from a very oversold position in March when Investors Intelligence reported more Bears than Bulls. Today, there are close to 60% Bulls and less than 20% Bears. The markets have responded to a Federal Reserve that is "printing money" and buying any debt instrument offered. The money supply in the U.S. has grown 24% over the last twelve months. All of this liquidity is good for the "real" economy as it recovers from the virus shutdown. In the short run, it is like gasoline on the campfire in the markets. It cannot continue forever.

With the elections coming into view, valuation stretched, and with sentiments exhibiting a high level of complacency, it is time for a little caution on Stocks. Take a little off the table to await a better entry point. Stay away from U.S. Treasury bonds which have yields being managed by the extraordinary measures of the Federal Reserve. The election is only 4 months away, you won't miss much if you are wrong.

<u>Rosenberg Research</u>

David A. Rosenberg, Founder of Rosenberg Research is the former Chief Economist at Gluskin Sheff in Canada and Merrill Lynch in the USA. David is a conservative economist. I have included below some of his comments from a Special Report he sent on July 6, 2020:

What Happens if the Democrats Sweep?

The COVID-19 crisis has laid bare some of the growing social anxieties in the U.S., with millions out of work and the recovery largely skewed in favor of higher income workers. As we search for a letter to best describe the shape of this recovery, Peter Atwater, in an article for the FT has suggested we use "K"; a two-pronged outcome where higher-income Americans who can work from home will recover quickly while those in lower-income brackets (often minorities) will face unemployment, bankruptcies and further disenfranchisement. This kind of growing disparity (to destabilizing levels, mind you) will be a huge campaign issue leading up to the Presidential election in November.

The Democrats, with Joe Biden at the helm, have already taken a wide lead over President Trump in the polls and PredictIt now puts the probability of a Biden presidency at a whopping 60% compared to Trump at 40%. The impact of this shift will be most pronounced in industrials, materials and energy; areas that are most sensitive to the re-regulation and additional tax burdens associated with a Democratic government.

Key Policy Proposals in the Democratic Party Platform

Category	Proposal
Taxes	
Capital Gains Tax	Capital gains and qualified dividends tax rate will be increased to the ordinary income tax rate of 39.6% for those making more than $1 million in income (a return to the previous top capital gains tax rate)
Corporate Income Tax	Increase the corporate income tax rate to 28% (from 21% - the 2017 Trump tax cut was from 35% to 21%) and impose a 15% minimum tax on corporations with at least $100 million in net profits (so they can't avoid paying taxes)
Top Marginal Tax	Increase the top marginal tax rate to 39.6% (back to where it was before Trump tax rate cut to 37% for top marginal) and put a 28% cap on the value of tax breaks for wealthy taxpayers
Infrastructure	
Infrastructure	Invest $1.3 trillion in infrastructure over 10 years
Green New Deal	Support the Green New Deal with an investment of $1.7 trillion over 10 years (paid for by reversing the Trump tax cuts for corporations, reducing tax haven/evasions/outsourcing, ending subsidies for fossil fuels)

Labor Costs	
Unions	Strengthen unions and collective bargaining including the Protecting the Right to Organize Act (PRO Act)
Federal Minimum Wage	Raise the federal minimum wage to $15/hr (from $7.25 currently)
Guaranteed Basic Income	No specific platform for GBI
Education	
Education	Forgive federal student loan debt for those who attended public institutions as well as historically black colleges and universities and private minority-serving institutions
Student Loans	Simplify the Public Service Loan Forgiveness program which cancels the debt of borrowers who work in public service jobs for 10 years; Reduce the interest rate on federal student loans; End rules that making discharging student loan debt in bankruptcy difficult
Teacher Salaries	Triple Title 1 funding for teacher salaries
College Tuition	Make public colleges and universities free for those making less than $125k per year
Other	
Defense	Boost defense spending (no estimate)
Antitrust	No specific platform for tech competition & antitrust; however, most 2020 Democratic candidates urged federal regulators to investigate anti-competitive conduct

Source: Politico; Joe Biden Presidential Campaign

To be clear, given the largesse in fiscal spending we've witnessed this year even a Republican government would need to consider raising funds through tax hikes in 2021 and the Tax Cuts and Jobs Act (TCJA) cuts to income taxes were already set to expire in 2025. But the composition of tax reforms will be different under the Democrats, and the additional support to those with lower income through collective bargaining and a higher minimum wage are distinctly tools of the Left.

Reducing inequality through redistributive policies is a key feature of the Democrat's agenda. And there's a good reason for this: remember that since the early 1970s, the share of income going to the top earners in the country has skyrocketed to levels not seen since 1929. While temporarily disrupted by the recessions of 2001 and 2007-2009, inequality has continued to grow, with the top 1% receiving over 20% of all income in 2018.

Conclusion

You will recall that we continued to recommend a 40% stock, 60% fixed income/alternatives asset allocation throughout 2019 and during the shutdown. We continue to recommend this allocation because of all of the reasons stated in this Review & Outlook. The stock market is disengaged from the economy and may have a correction at some point in the near future. Stocks are not being purchased based on fundamentals. Interest rates will stay low and may go lower. The Federal Reserve has stated that the Fed Funds rate will stay at zero through 2021 and possibly longer. As the election gets closer the stock market should respond based on what it thinks will happen on November 3. Volatility will continue.

Jamison Monroe
Chairman & CEO
Director of Consulting

Monroe Vos has over $5.5 billion under advisement for 100 clients. Recent rankings are as follows:

- The 2nd largest independent registered investment advisor ("RIA") in Texas
- The 8th largest independent RIA in the Southeast
- The 54th largest independent RIA in the United States

As reported by *Financial Advisor* magazine in July 2019

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