ELECTION, COVID-19 CASES, VALUE STOCKS

The presidential election has not been decided yet but it looks like Biden will win. In the Senate it looks like the Republicans will hold a majority and in the House it looks like the Democrats will hold a majority. The market has rallied big since November 3.

On November 6, 2020 the S&P 500 trailing P/E is 39.81X and forward estimate is 25.15X. The NASDAQ trailing P/E is 36.81X and forward estimate is 31.33X. Both are very high relative to historic norms. It should be pointed out that the S&P 500 has been lead up by a few tech stocks that are approximately 30% of the index. Value stocks in the S&P 500 are still negative year to date. We expect the value managers to do well as the economy opens and a vaccine is developed to stop the spread of COVID-19.

The Federal Reserve has indicated it will keep the Fed Funds Rate at zero and the yield curve low by buying Treasuries, mortgage backed securities, corporate bonds, etc. through 2022. Rates are so low that there are not many places to invest except the stock market. The Fed is creating the largest stock market bubble in history. When the music stops and rates go up it will be real ugly. No need to worry at this time.

The economy continues to improve. It and the stock market have experienced a "V" shaped recovery as the U.S. economy continues to slowly open. Increased cases of the COVID-19 virus are starting to weigh on the economy and could weigh on the stock market. Americans are more and more ready to go back to work. The economy cannot be shut down again as Biden has indicated. I do not think he will do it. Just political talk.

GDP grew 33.1% in the third quarter on an annualized basis. This is a record for one quarter.

FactSet

As of October 23, 2020, FactSet reported the following:

> Earnings: Analysts Expect Earnings Decline of -16.7% for CY 2020
> For the third quarter, S&P 500 companies are reporting a decline in earnings of -16.5% and decline in revenues of -2.9%. Analysts expect earnings decline of -16.7% and a revenue decline of -2.6% for CY 2020.
>
> For Q4 2020, analysts are projecting an earnings decline of -11.6% and a revenue decline of -1.0%.
> For CY 2020, analysts are projecting earnings decline of -16.7% and a revenue decline of -2.6%.
> For Q1 2021, analysts are projecting earnings growth of 14.3% and a revenue growth of 3.1%.
> For Q2 2021, analysts are projecting an earnings growth of 44.1% and a revenue growth of 13.5%.

For CY 2021, analysts are projecting earnings growth of 24.2% and a revenue growth of 7.9%.

Valuation: Forward P/E Ratio is 21.7, Above the 10-Year Average (15.5)

The forward 12-month P/E ratio is 21.7. This P/E ratio is above the 5-year average of 17.3 and above the 10-year average of 15.5. It is also above the forward 12-month P/E ratio of 21.5 recorded at the end of the third quarter (September 30). Since the end of the third quarter (September 30), the price of the index has increased by 2.7%, while the forward 12- month EPS estimate has increased by 1.8%.

At the sector level, the Consumer Discretionary (35.7) sector has the highest forward 12-month P/E ratio, while the Financials (13.5) sector has the lowest forward 12-month P/E ratio.

Targets & Ratings: Analysts Project 11% Increase in Price Over Next 12 Months

The bottom-up target price for the S&P 500 is 3833.16, which is 11.0% above the closing price of 3453.49. At the sector level, the Energy (+34.0%) sector is expected to see the largest price increase, as this sector has the largest upside difference between the bottom-up target price and the closing price. On the other hand, the Utilities (+3.3%) sector is expected to see the smallest price increase, as this sector has the smallest upside difference between the bottom-up target price and the closing price.

Overall, there are 10,348 ratings on stocks in the S&P 500. Of these 10,348 ratings, 53.5% are Buy ratings, 39.8% are Hold ratings, and 6.7% are Sell ratings. At the sector level, the Energy (61%), Health Care (61%), and Communication Services (60%) sectors have the highest percentages of Buy ratings, while the Financials (47%), Consumer Staples (47%), and Real Estate (47%) sectors have the lowest percentages of Buy ratings.

See what Bob Davis said on November 1 in his Caney Creek Report

Trick or Treat?

Writing a market letter a day before this contentious election is not the smartest thing I could do. But it is the first of the month and rules are rules. It will be short as I anticipate having a "special edition" late next week (I hope). I will talk about the markets, but as its been Halloween, I will put the election in the "trick or treat?" category and make some short comments on it at the end.

The stock market correction we have been looking for is here in earnest. The S&P 500 has declined close to 10% from its September highs and likely has more to go. Sentiment has been dangerously bullish with Investors Intelligence reporting close to 60% Bulls for several weeks. This correction will continue until sentiment gets back to a "normal" bullish position in the 40s. With or without the election, it will take a while.

> Another, bigger, problem for stocks is the yield curve. The 10-year US Treasury bond closed Friday with a yield of 0.88%. The most recent issue of 10-year bonds had an interest coupon of 0.625%. It came to market at 100. It traded Friday at 97. If you bought the new issue 10-year Treasury bond in August, you have lost 3% in 2 months trying to make 0.625% interest. Longer maturities are much worse. The 20-year Treasury bond ETF (TLT) has declined 8% in price since late August. Higher bond yields are not good for stocks.
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> As bond yields become more competitive, price/earnings multiples on stocks decline. This is happening while the Federal Reserve is buying up bonds and the money supply has been growing year over year at 25% for months. What will happen to bond prices and P/E's when the Fed music stops?
>
> Overbought sentiment and rising rates plus the uncertainty of a worldwide Covid surge and the aforementioned election, and you can see why stocks and bonds are having problems.
>
> About the election - Wall Street has decided that Biden will win. They have been writing "research" reports saying that will be OK. Maybe so. But don't believe that higher corporate taxes and higher capital gains tax rates will not matter. They will reduce earnings and P/E multiples. If the Democrats manage to raise corporate taxes to 28%, forecasted earnings for the S&P 500 in 2021 are reduced from $162 to $145. A multiple of 20X is 2900. The index is today at 3250, already down from a recent 3600. The math is not hard. Trick or Treat?

Low interest rates have created a huge refinancing and home buying surge. The residential real estate market is booming because of low rates and people moving from the inner city to the suburbs and working from home in a home office. This should continue to boost that segment of the economy.

<u>Hoisington</u>

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

Debt Trap

> The concept of the debt trap is consistent with scholarly research, from the 19th century to present, which indicates that high debt levels undermine economic growth. This causality is supported by the law of diminishing returns, derived from the universally applicable production function. Historical declines in economic growth rates have coincided with record levels of public and private debt. Total public and private debt jumped from 167.2% of GDP in 1980 to 364.0% in 2019, with an estimated record 405% at the end of this year. Gross government debt as a percent of GDP accelerated from 32.6% in 1980 to 106.9% in 2019 to an estimated 127% by the end of this calendar year.
>
> Thus, monetary policy is left with one-sided capabilities i.e., they can restrain economic activity by reducing reserves and raising rates, but they are not capable of stimulating economic activity to any significant degree.

Tail Risks

> We identify two tail risks for long term Treasury investors: (1) a huge new debt financed fiscal package and (2) a major change in the Fed's *modus operandi*. The first risk would change the

short-run trajectory of the economy. This better growth, although short lived, could place transitory upward pressure on interest rates in a fashion that has been experienced many times. Over the longer run, disinflation would prevail and the downward trend in Treasury yields would resume.

The second risk would bring a rising inflationary dynamic into the picture, potentially becoming much more consequential. General disappointment with trying to solve economic underperformance by more indebtedness may crystalize along with the realization that debt will not work any better in the U.S. than in Japan, the Euro Area and many other countries.

As long as the federal government's policy prescription is ever higher levels of debt, the path toward disinflation will hold and long Treasury bonds will be the preferred area of the curve. The continuing shift in economic conditions over the past forty years has necessitated several dramatic changes in our yield curve positioning. That flexibility remains constant.

Conclusion

The election resulting in a divided government is good for the stock market. Rising COVID-19 cases is a problem for the economy if another shutdown or partial shutdown occurs unless a vaccine is developed. Another stimulus package will have a short-term positive effect, but more debt will slow the economy long term and create disinflation according to Hoisington. We believe that opportunity still exists in value stocks that have been extremely depressed versus growth stocks. Value managers are still showing negative returns for the year and are bargains at these levels.

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 3rd largest independent registered investment advisor ("RIA") in Texas
- The 8th largest independent RIA in the Southeast
- The 60th largest independent RIA in the United States

As reported by *Financial Advisor* magazine in August 2020

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