October 16, 2020
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Todd Asset Management

Recovery or Relapse?

Todd Asset Management Q3 2020 US Market Commentary

	3Q 2020	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	8.9%	5.6%	15.2%	12.3%	14.1%	12.7%	13.7%
Russell 1000 Value	5.6%	-11.6%	-5.0%	2.6%	7.7%	7.4%	10.0%

* *Annualized Total Returns.*

If you were to ask ten investors what they worry most about, you might get twelve answers in the current environment. The one we see playing out the most in the market is the tug of war between the recovery believers and those worried about an economic or health related relapse. We believe a recovery is the more likely outcome, but you cannot totally rule out the potential for modest relapses along the way. That's why we characterize the recovery not as V, W, or K shaped, but more like a stair step shape. Let's look at the major themes that played out in the quarter leading us to that conclusion:

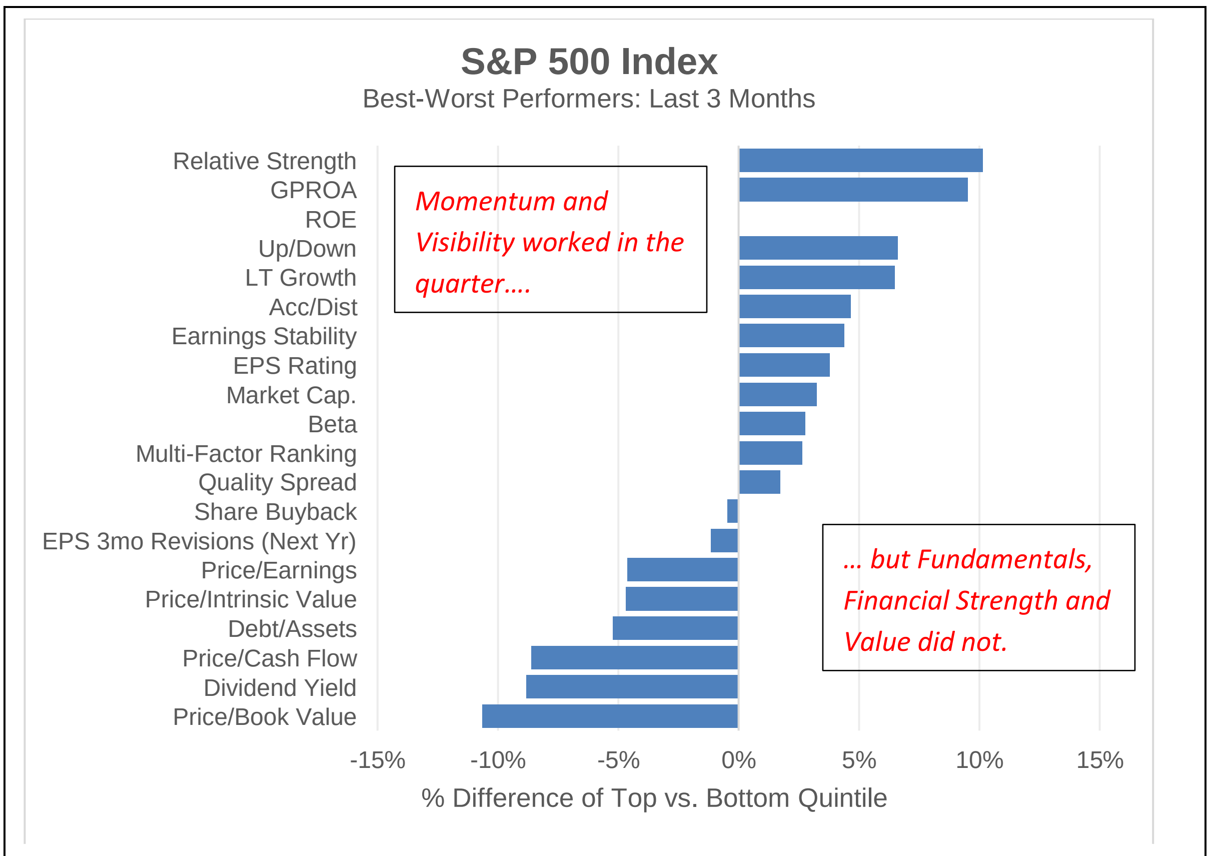
- The S&P gained almost 9% in the third quarter, led by a charge from the mega cap growth names. This suggests to us that sentiment around recovery remains somewhat fragile, as investors are bidding up these names in search of safe growth. The charts on many of these growth stocks have moved parabolic and performance differentials between Value and Growth indexes is at or near extremes. We are seeing better performance from some economically sensitive sectors like Industrials and Materials. A more sustained rotation would probably require sustainably higher 10 year yields based on a more constructive economic outlook. We think that is likely.
- Expectations for further Fiscal Stimulus in the US were on again, off again during the quarter. As we close in on the election, it appears a comprehensive package is likely to have to wait until after US elections are completed. The first fiscal stimulus worked well, as evidenced by better than expected economic numbers and consumer net worth figures. As we move into year end, the recovery we have seen is likely to slow (though remain positive) as a constant stream of new layoff announcements has been a prominent feature of the pandemic.
- The Pandemic is surging and retreating in waves. There is a second wave at work in Europe and the US may be entering a third wave. Fortunately, it appears that progress is occurring on the treatment and vaccine front. That, coupled with more and faster testing is what is needed to fully re-open the economy.
- Durables, like Houses and Autos are selling well. Manufacturing Inventories are low and being replenished. Services are starting to recover. All of these are encouraging and sustainable. Countering that, many consumers are not likely to fly, stay in hotels, eat in restaurants, go to movies or clubs or do anything fun outside their homes until the Pandemic is under control.

That poses a problem because those sectors account for a lot of employment. There is a two speed recovery underway.

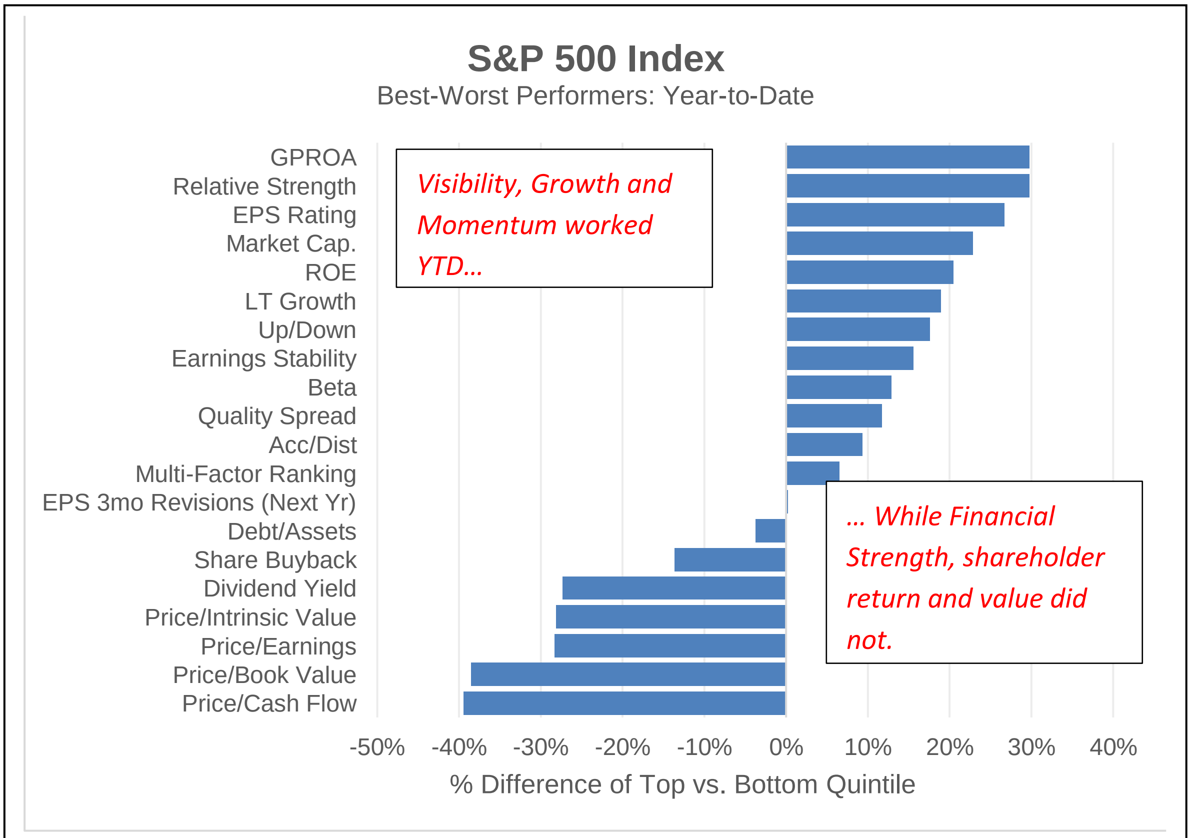
- The election is also a concern for many market participants. Investors worry about taxes rising if Biden gets in, and a re-energized trade war if Trump is re-elected. We think that regardless of who is elected, there will be more fiscal spending. Infrastructure plans probably figure prominently in a post-election stimulus plans.

If all of these developments sound concerning, they are! We would also point out they are temporary. As we get elections resolved, stimulus undertaken and developments on the Pandemic announced, we anticipate the market will start to have more confidence that the economy has recovered into a new expansion. If that is the case, <u>the past five recoveries lasted an average of eight years, and market gains averaged 250% over the life of the recovery.</u> The Pandemic has forced a recession on us, but it is also forcing companies to bring their technology adaption plans forward by years. This is changing the structure of the economy with productivity and margins the likely beneficiaries of this trend. This could make for a better earnings outlook than many investors expect. We do expect setbacks along the way, but with the amount of government spending, the low level of rates, the lean inventories at companies and changing demand patterns for housing and other durables, this expansion should have enough reasons to last for some time once we get the pandemic out of the way.

<u>Factor Work</u>



Source: Bloomberg, William O'Neill + Co. And Todd Asset Management



Source: Bloomberg, William O'Neill + Co., and Todd Asset Management

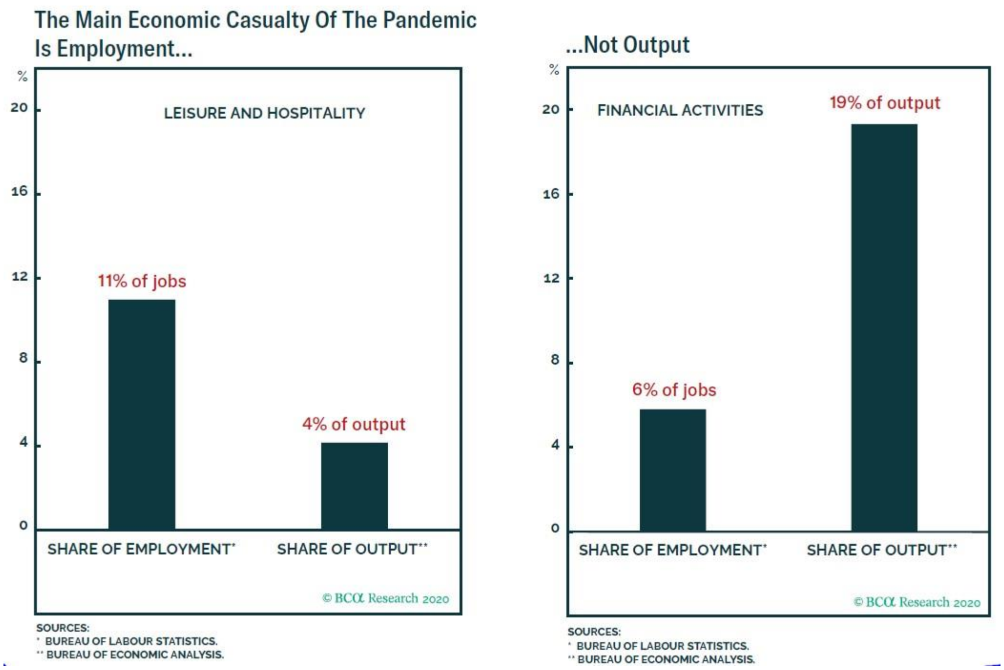
<u>Interesting Charts we saw this quarter</u>

<u>Economic Indicators Show a V-Shaped Recovery</u>

Source: Evercore ISI

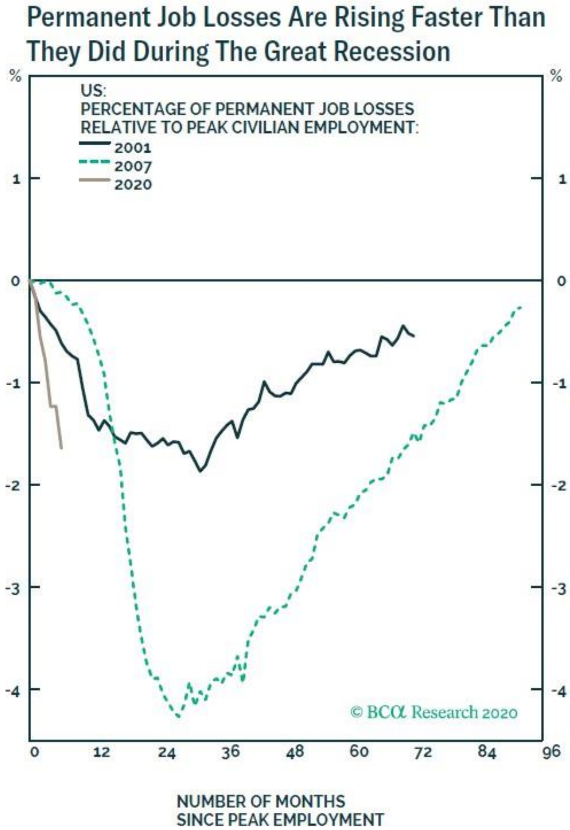
Third Quarter Growth should be record setting, off a depressed base. These is still a long way to go to recover to the trend. This recovery should have room to run.

Unemployment is Concentrated in Labor Intensive Industries

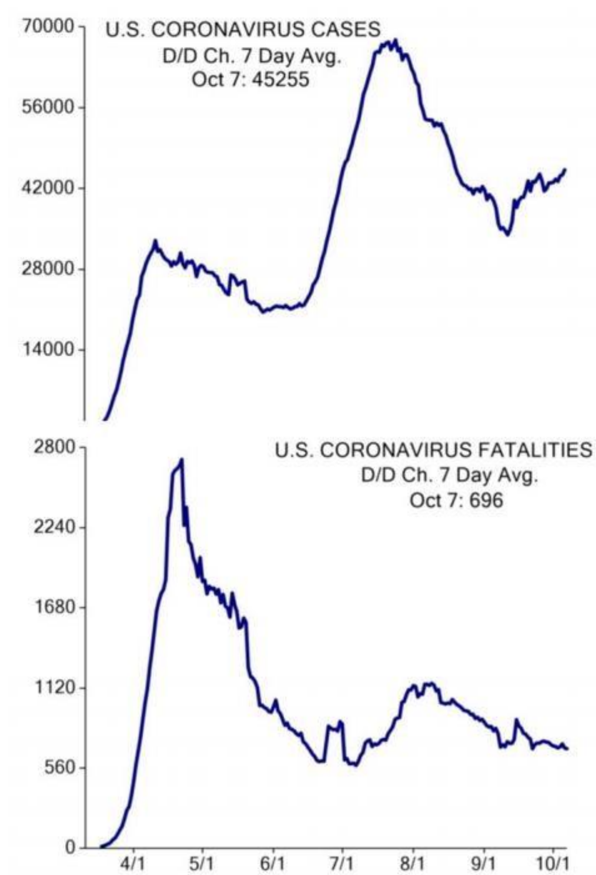


Source: BCA

This pandemic has impaired industries that are not a large portion of the economy, but employ a lot of people. The charts above compare the share of employment versus the share of economic output for two industries, Leisure/Hospitality and Financial Services. While Leisure/Hospitality employ 11% of workers, the industry accounts for only 4% of output, while the Financial Services provided 6% of employment but accounted for 19% of output. Additionally, average salaries in L/H are lower than in Financial Services, so the lower paid workers seem to be bearing most of the burden of the pandemic.

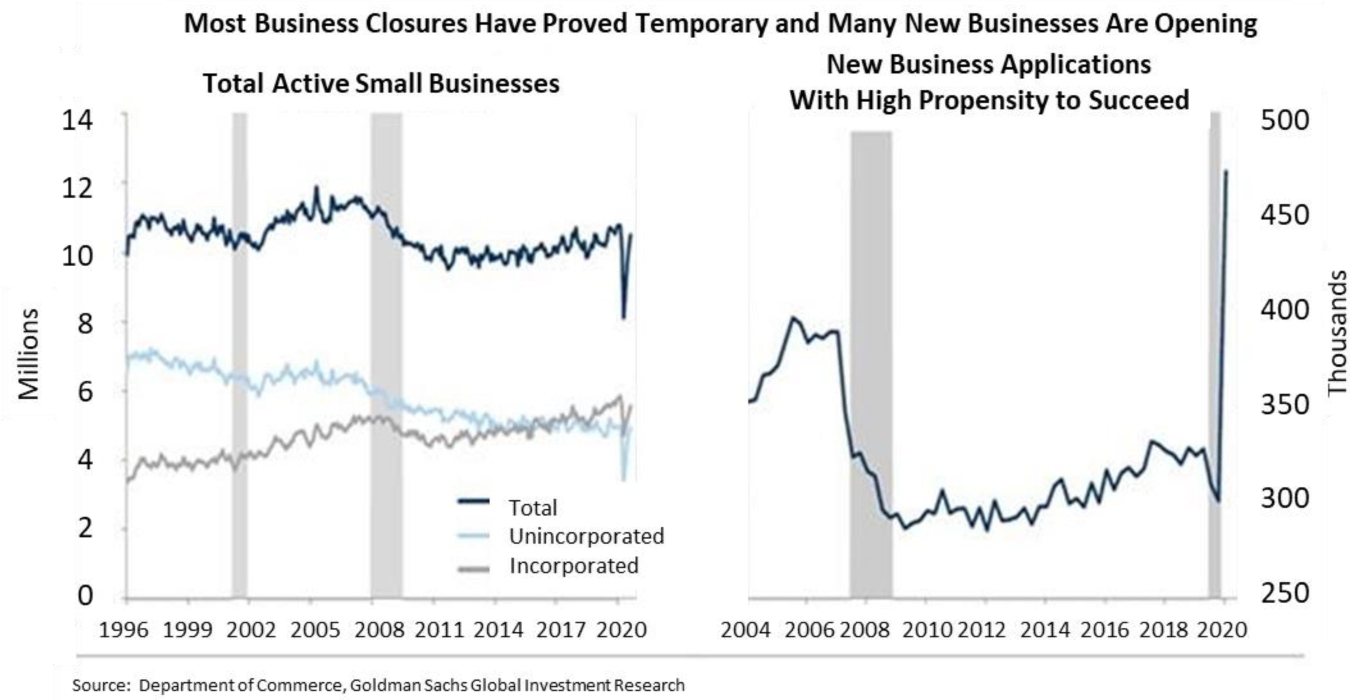


The chart to the Left, from BCA Research, compares the permanent job losses for the Pandemic Recession to the recessions of 2001 and 2007. The initial plunge in permanent job losses for the Pandemic recession is steeper than either of the prior recessions. Then again, the economy stopped on a dime during the pandemic where the prior episodes took time to develop. If the economic recovery continues to improve and maintains a modest V or stair step shape, we would expect permanent job losses would moderate, though the bottom of this trend may still be several quarters away.

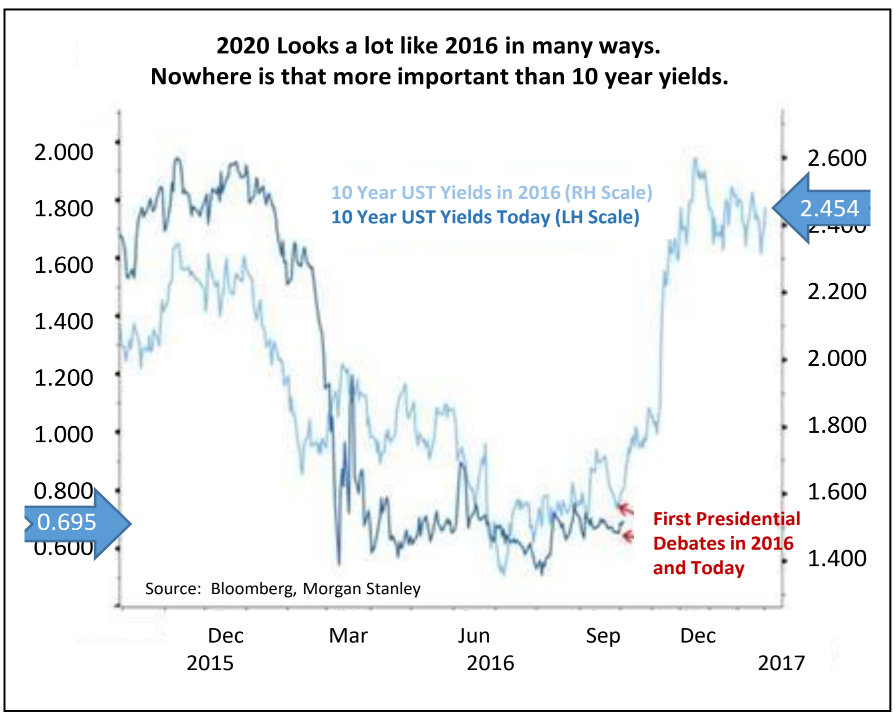


The Chart to the right, from Evercore ISI, shows the number of US Coronavirus Cases in the top panel and Fatalities in the bottom, through October 7.

First, a caveat, we are not doctors. We have never been to medical school, and try to avoid hospitals. We do have a handle on numbers though. Pandemic fatalities are about a third of their peak, despite increases in infections. This is encouraging and probably based on improved treatments.

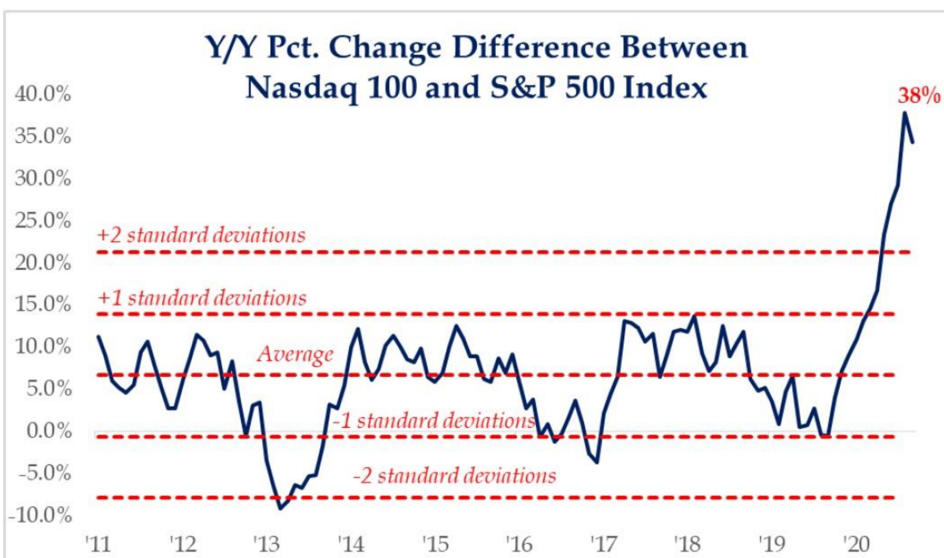


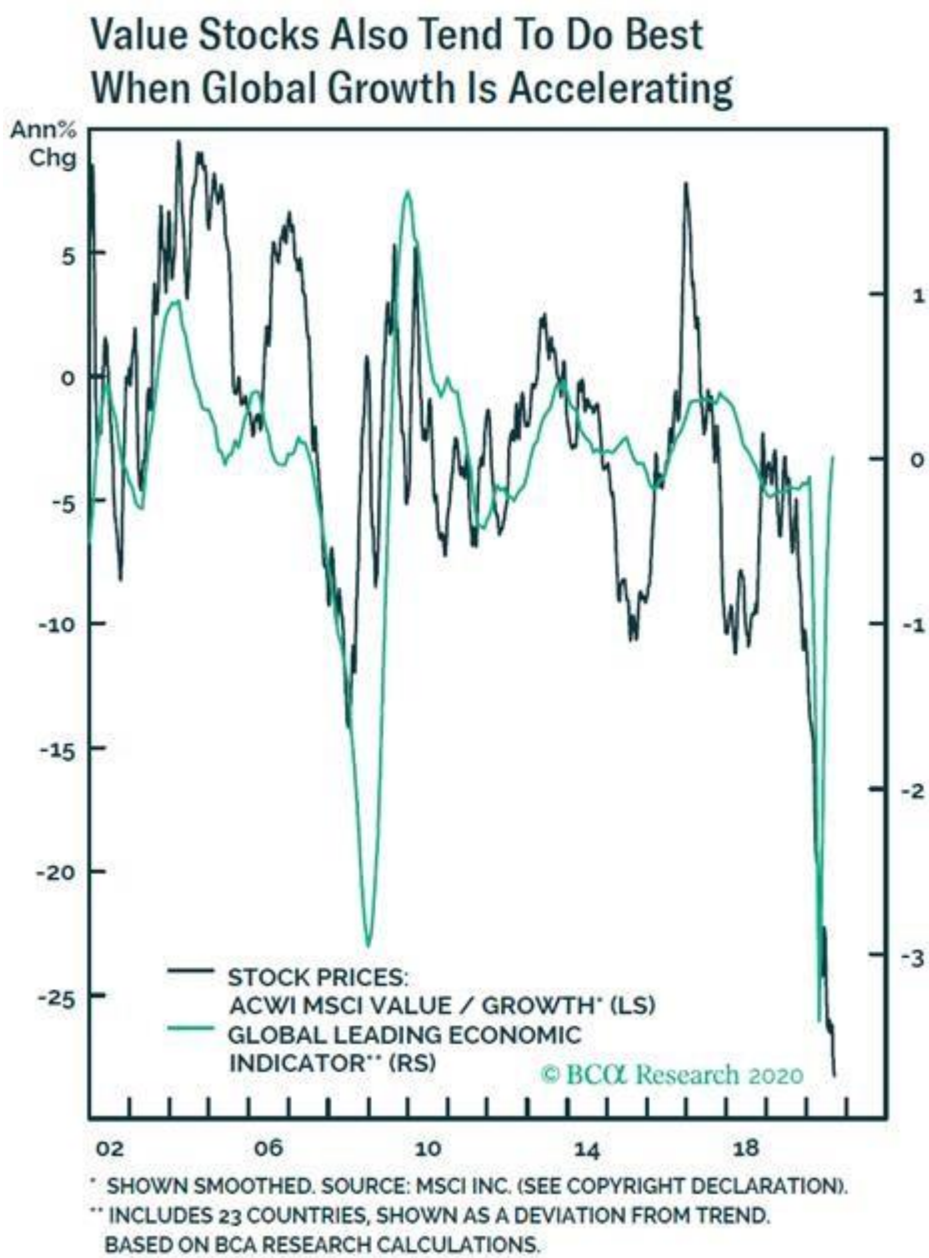
The chart above, from Goldman Sachs, shows new business applications have surged following the closure of many small businesses. This is a healthy sign. We are still amazed at the size of the fiscal response to the pandemic, especially when compared with the Global Financial Crisis. More stimulus is likely to come, and this is one of the reasons we believe the economic recovery will continue.



The chart to the left from Morgan Stanley, compares the path of rates during the slowdown of 2016 and the current episode. Rates are lower now than in 2016, but the pattern looks very similar. The setup looks similar too: a contentious US election, worldwide economic turmoil, and Brexit to name a few. Bonds still anticipate a poor economic outcome. In 2016, once we got past these same issues, Rates increased dramatically in a sign of confidence in an economic rebound. We suspect something similar could happen this year too.

These chart, from Strategas, show the growth in Money Supply (above) and the year over year difference between the NASDAQ 100 and the broader S&P 500 (below). Both of these relationships have been driven to *extraordinary extremes* by investors seeking safety. The money supply has surged as investors and banks moved capital into safer money market accounts. The NASDAQ surged, as investors equated the FANGMA stocks as safer alternatives because of assured growth. Statistically, moves this extreme should almost NEVER happen, and they usually revert from these high levels to more normal levels. We believe high cash levels provide fuel for investors to get back into equity markets, and rotate out of the crowded growth trade into the broader market as economic visibility improves.





Global Growth is accelerating. History suggests that value style stocks should recover (potentially by quite a bit) as this occurs.

Summary

Until the election, investors are probably going to be edgy and volatility is likely to remain high. Once we get an election result (which may not happen on election night) we believe investors should focus on plans for the next four years. Importantly, we think portions of the candidates agendas are probably similar and would include continued fiscal stimulus and infrastructure spending. Given that base, the economy should continue recovering and inflation probably rises a bit. Regardless of who wins, unemployment is still high, restructurings continue, economic uncertainty remains elevated so the politicians have been given approval by public opinion to provide much more stimulus for the economy. Differences between the candidates do exist though. A Democratic sweep would bring concerns about increasing taxes and re-regulation, while a Re-election of President Trump would result in renewed trade war worries. Given current unemployment rates, we think the most likely outcome is more stimulus and the cyclical areas of the economy are likely to see continued demand, regardless of who wins the national election.

As always, if you need any additional information, please feel free to contact any of us.

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10/16/20
S&P 500 – 3,484
Russell 1000 Value – 1,215

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