October 4, 2020

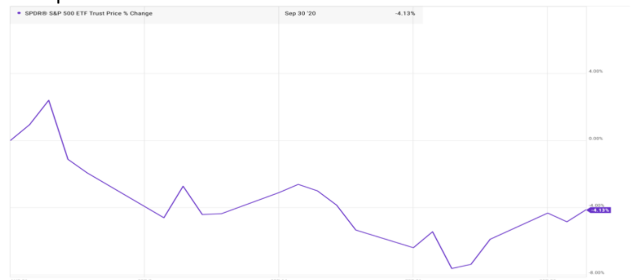
Overview

After relentlessly moving up in July and August, US equity indices reversed course in September. The S&P's 500 ended the month down **3.80%** on a total return basis. The Nasdaq Composite dropped a sharper **5.10%** while the Russell 2000 (Small US Caps) was down a milder **1.95%.** Internationally, the broad EPAC BMI (developed economies) was down **2.51%** and the MSCI EM (emerging markets) a smaller **1.60%.**

The market reversal started early in the month as investors took profits from elevated technology stocks. It then gathered momentum with rising Covid cases around the world calling into question the sturdiness of the economic rebound since March.

Generally speaking, a mild risk-off environment developed. In the fixed income sector this caused investors to seek some protection using the US long bond as safe haven and moving out of other riskier sectors. Intermediate corporate and high yield bonds were down **.29%** and **1.03%** respectively.

For illustration, below is a chart of the performance of S&P's 500 (SPY) in September:



In September, our client portfolios dropped between **.56%** and **1.58%.** Over the same period, a portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) slumped **1.52%**.

As of September 30, the YTD performance of our client portfolios ranged from **-1.13%** to **4.40%**. This compares to a **4.20%** performance for our benchmark and of **5.57%** for the S&P's 500, over the same period.

As a reminder, the equity allocation in our clients' portfolios ranges currently from 35% to 65%, depending on risk profiles.

Market developments

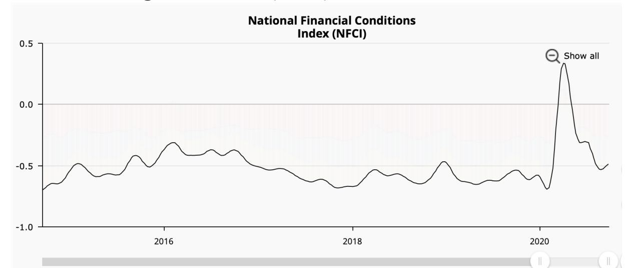
As earlier mentioned, US equity markets reached all-time highs in the first days of September before correcting about 7% to 10% for the major indices and the technology heavy Nasdaq 100 respectively. There was no particular trigger for the start of the sell-off, just a take-profit move away from high-flying stocks.

Over the next two weeks, the combined effects of rising Covid cases around the world and the inability of Congress to come up with another stimulus package kept investors in a risk-off mood. As happens often in such situation, the USD went up against most currencies, long-term bonds rallied and every other risk assets, from equities to commodities, depreciated.

Later in the month, around the 21st, banking stocks dropped on revelations of a lack of responsiveness from some of them upon learning of potentially fraudulent transactions in years past. Deutsche Bank went down 7% and US bank stocks finished that day down 3% to 5%. Given the relatively high weight of financial stocks in many international indices, most developed equity markets dropped significantly.

The national and international news cycles are particularly short these days and most of the hard-hit markets have since recovered following signs of progress on the elusive stimulus package in the US, supportive messaging from the Federal Reserve (no rate tightening before 2022) and encouraging employment numbers in the US, on the last day of the month.

While an investor has plenty to worry about in this environment of weak economic visibility and political instability, it is encouraging to note that financial risk remains generally subdued. Below is a chart of the Federal Reserve Bank of Chicago risk index (NFCI):



The index is now at -.5, a level that is broadly in line with pre-pandemic conditions.

Tilts and Allocations

The asset allocation of most client portfolios did not change meaningfully in September. Except for recently opened accounts where I slowly reduced cash positions, broad asset allocations were unchanged. The lack of economic visibility and political turmoil on the one hand and the abundant liquidity available to financial participants on the other seem to represent two forces that tend to balance/cancel each other for now. As a result, I see no reason to make any major investment moves.

When opportunities arise though, I try to capitalize on them. SCHW went down 5% on September 21 for what looked like unconvincing reasons. They reported slightly depressed interest income numbers AND the acquisition of a large number of new clients. The market focused on the first item, I focused on the second. I added to our SCHW positions at about $34. The stock is currently at $37.5.

Moving away from specific asset allocation issues and of broader concern to investors is the coming US Presidential election. If Joe Biden were elected president and the Democrats were to obtain a majority in the Senate, while keeping their control of the House of Representatives, a market sell-off could ensue. However, I believe that it would be short-lived and rather shallow. That is because there is abundant liquidity in the financial system and that a large number of investors stand ready to pounce whenever the market corrects. The experience we had in September is a good case in point. The sell-off was rather short-lived. Additionally, the increasing probability of finding a solid therapeutic solution to the pandemic or of a vaccine in the not-so-distant future could actually lift markets before too long.

If I had to decide on the direction of US equity markets between now and the end of the year I would say "neutral to slightly negative", all things equal otherwise. This assessment seems to be more optimistic than that of strategists at Capital Economics, but not significantly so.

Below is a table of their return forecast for equities on a year-to-date basis (Start-Latest), between now and year end (Latest-End) and for the whole of 2020 (Whole Year). In the left column (DM) stands for developed markets:

Table 1: Actual and Projected Returns (US Dollars, %)

	M/M	2020			2021-22 Ann. Average (f)
		Start – Latest*	Latest – End (f)	Whole Year (f)	
Equities					
Global	1.6	2.7	0.2	2.9	10.8
US	1.6	7.8	-3.4	4.1	8.8
Europe (DM)	2.2	-5.5	6.2	0.3	11.8
Pacific (DM)	2.5	-4.5	9.9	4.9	13.2

Conclusion

I will close this letter with the conclusion of a statistical analysis conducted by Goldman Sachs (GS) that links the performance of the US stock market in the three months before a presidential election and the chance of re-election of the incumbent president. The data used covers the period from the late 1800's to the present.

As per GS, a sitting president is re-elected 88% of the time when the performance of the US equity markets is positive over the three months prior to the election. Let's say from August 1 to October 31 for simplicity.

With this as background, below is the chart of the performance of the S&P's 500 since August 1 and through October 2:

Since August 1 the S&P's 500 has risen 2.24% (as of Friday's market close). October should be a volatile month, on many levels.

Thank you for your continued trust.

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