MAP Views
Third Quarter 2020:
Rebound versus Recovery

Stocks posted a sharp rebound during the second quarter, as investors bid up prices in anticipation that the economy would enjoy a sharper than expected bounce-back from depths of the COVID-19 nationwide shutdowns that occurred in late March and early April. Stock prices put in their best quarterly performance in 22 years, as employment data for May and June were more robust than economists were forecasting. Along the way, stocks were able to shrug off wide-spread civil unrest, coupled with a recent resurgence of the COVID-19 virus late in the quarter.

Some of the states most aggressive in re-opening have had to take remedial measures to contain the spread of the virus, pausing and/or progressing openings. While it appears unlikely that these actions will lead to April-type job losses; at the very least, it could dent the momentum of the job gains.

We do not profess to be epidemiologists, and hence are not about to forecast a “second-wave.” However, it is realistic to expect that COVID-19 will be an issue to contend with at least until there is broad access to a vaccine, which appears to be a first-half of 2021 event.

Over the past two months, portions of the economy have rebounded sharply from the troughs of April. As such, some investors have speculated that we will enjoy a “V” shaped recovery. We are skeptical of such views and believe that a recovery will be gauged by when the economy will return to levels seen prior to the COVID-19 pandemic, an event we believe is still a longways away. In particular, Wall Street analysts are forecasting corporate earnings to pick up in 2021, at levels 8% higher than 2019. We, however, are suspect of such forecasts and believe that these seemingly aggressive estimates could be a risk to the market, as more realistic assumptions begin getting priced into the market.

Separate to the pandemic, we are growing increasingly concerned about the upcoming U.S. elections and the implications for the broader markets. Recent polls indicate that Joe Biden and the Democratic party are pulling away from Donald Trump and the Republicans. Indeed, the 2016 election proved that polls are not infallible and that we are still just under four very long months away from Election Day. President Trump is trailing in most polls with less than 18 weeks to go. Yet, Harry Truman in 1948, George Bush in 2004 and Barack Obama in 2012, all were trailing in the polls 18 weeks prior the election and staged comebacks to win in November. With that said, four months can seem like an eternity in the world of politics. To frame this into context we can all relate to, four months ago, the CDC reported that 53 Americans had contracted COVID-19 and no American had died from it. Today, there have been more than 3 million cases and over 130,000 deaths.

We are not going to take political sides in this heated political environment, but rather discuss the upcoming elections objectively. Markets tend to favor a political landscape that promotes lower taxes and less
regulation. Hence, investors tend to perceive that Republican administrations are better for stocks than Democratic ones. The fact is, the markets have fared better under Democrats, as Republicans were in the White House for the crashes of 1929, 1987 and 2008. Furthermore, the average annual return on the S&P 500 from 1926 to 2018 is approximately 10% to 11%. Adjusted for inflation, the average return on stocks has been approximately 7%. There were 16 different presidents during that span, all with different approaches to governing based on their political affiliation and personal philosophies. Over a two-year period, since 1789, the market does better following a Republican win (+8.3%) than a Democratic presidential win (+5.8%), according to numbers analyzed by Fidelity.

Perhaps more important to the broader markets is who controls Congress. Referencing the same Fidelity data above, when Republicans sweep the House and Senate, the two-year average forward return for stocks is 12.2%. But when Democrats sweep, stocks return 3.4% over a two-year span. Currently, the Democrats control the House and the Republicans hold a majority in the Senate. Even if Joe Biden wins the election, he would likely need to have a landslide type victory to have coattails long enough to capture the Senate, thereby sweeping the election.

Our stance on the election is that unless there is a Democratic sweep in November, the actual impact on the economy and, subsequently, the broader markets will likely be less than the press would lead you to believe. One of the benefits of being a global manager is that we have the flexibility to invest in multiple geographies. If one country is looking less favorable from an investment perspective, we can look elsewhere.

At present, 2020 forecasted earnings for the S&P 500 are expected to be approximately what they were in 2017, the year before corporate tax cuts went into effect. At that time, stocks were carrying a price-to-earnings ratio of approximately 17 times. Today, those same earnings carry a much loftier valuation, specifically 25 times. We believe the markets have more than gotten ahead of the economy, albeit due to the unprecedented action on the part of the Fed. However, while we acknowledge historically low interest rates can justify paying a premium for stocks, we believe it prudent to ask, “how much?”

It goes without saying that 2020 has been a year for the record books. However, remaining complacent is not a prudent action during these unprecedented times. Given our above-mentioned concerns, we continue to anticipate carrying outsized positions in sectors that do not require strong economic growth, including Consumer Staples and Technology, with increasing weightings in Utilities and Health Care. Conversely, we remain underweight Financials, Materials and Consumer Discretionary sectors. With interest rates at historic lows, we expect to hold bonds with maturities of less than 2 years. Our Global Equity accounts carried above average cash positions during the quarter. This decision was certainly a detraction to performance as stocks had a banner quarter. Given the cornucopia of issues in the macro world, it is a decision that we believe is prudent.

We wish everyone an enjoyable summer. Stay safe, sound, and healthy.

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