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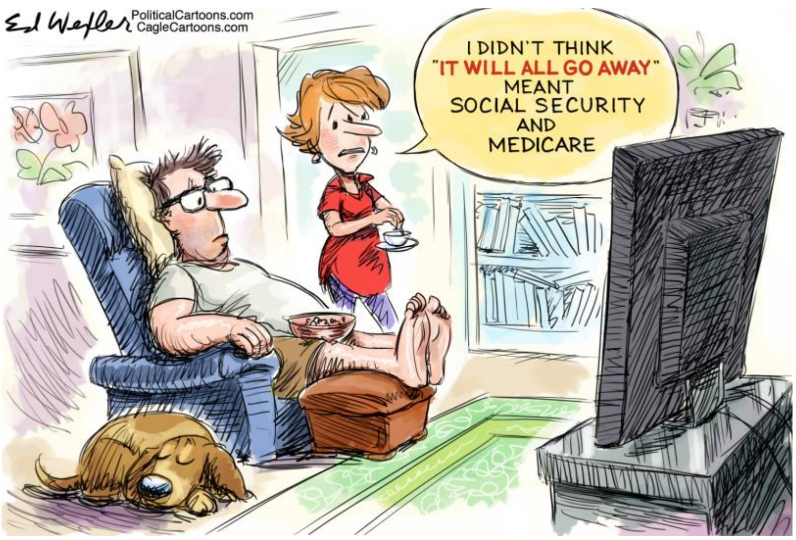

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INSIDE THIS NEWSLETTER

A Distinction without a Difference -

Article by Mark Lazar

Politicians and diapers must be changed often, and for the same reason. **Mark Twain**

November 3rd is fast approaching. In addition to the presidential election, voters will decide the outcome of 35 senatorial seats and 435 Congressional seats. Political tensions are running higher than ever. But despite the hand-wringing between now and then—on both sides of the political aisle—this too shall pass.

In addition to providing a place for buyers to make a (hopefully) profitable investment, and sellers the ability to liquidate shares, the stock market is also a price mechanism, a signaling mechanism, a feedback mechanism, and a harbinger of the future. Security prices reflect the collective wisdom of the entire human species. In other words, at any given moment, the share price of Apple is exactly what eight billion people agree it should be.

While not perfect, markets can and do signal expectations of election outcomes. In fact, since 1928 the stock market has correctly predicted the winner of the presidential election 87% of the time. According to Ryan Detrick, senior market strategist at LPL, "When the S&P 500 has been higher the 3 months before the election, the incumbent party usually won; whereas when stocks were lower, the incumbent usually lost," Which begs the question, what is the market signaling today? The following are a few observations that are worth noting:

- The yield curve, an XY graph of Treasury yields plotted out to thirty years, is upward-sloping. Positive yield curves are indicative of future economic growth. The bond market is giving a thumbs-up.
- Credit spreads are falling. Widening interest rate differentials between Treasury notes and corporate bonds portend turmoil and future corporate defaults. Spreads have fallen 1.72% since March 23. The market is now within half a percent of pre-COVID levels. Spreads are signaling optimism about the future.
- S&P 500 earnings are currently forecast at $124.79 for 2020 and $163.31 for 2021, which puts forward P/E multiples at 27 times earnings for 2020 and 20.65 times earnings for 2021. These numbers are high by historic standard, which generally indicates the market is expecting faster earnings growth in the future. The stock market seems quite bullish at the moment.
- The breakeven rate of inflation stands at 1.65%; meaning the market is forecasting inflation will be 1.65% over the next ten years. The Fed's target rate of inflation is 2%. Currently inflation is healthy.
- The U.S. dollar index (DXY) has tumbled ten percent since March. This shouldn't surprise anyone since the Federal Reserve increased the money supply (printed money) by 24% since then. However, due to the COVID-induced drop in velocity/aggregate demand, inflation isn't a concern—yet. When velocity recovers, inflation will likely become a problem unless the Fed reverses course and shifts to hawkish monetary policy.

What do elections cycles mean to the stock market? According to research by Fidelity Investments, the first two years of a presidential term tend to produce below-average returns, while the last two years' returns are well-above average. However, over the full four-year term, the average difference is statistically insignificant. Furthermore, over a two-year period, the market does better following a Republican win (+8.3%) than a Democrat win (+5.8%). And when the Republicans sweep, the difference is even more extreme with the two-year average return of 12.2% versus a Democrat sweep producing 3.4%. But when measured over the four-year term, the difference is much less (+8.6% versus +8.2%).

But not all Administrations are created equal. For example, the Clinton Administration's policies—a reduction in the capital gains rate, deregulation, the largest welfare reform in history, plus a budget *surplus* for four consecutive years—were cheered by the market. At the end of Clinton's term the economy averaged 3.89% growth and the stock market returned 12.63% per year. Likewise, Reagan cut business and personal tax rates, and deregulated; the economy grew at nearly 3.5% per year and the market averaged over 9% during the same period.

At the end of the day, the stock market is indifferent to politics. However, the market is very concerned about *policies* that affect earnings. Expectations of policies that reward capital investment, innovation, entrepreneurship, hard work, and thrift, will be rewarded with higher earnings multiples (i.e. stock prices). Whereas contrary policies, or those that impede free markets, interfere with trade, and punish capital and savings, will do the very opposite.

Human nature isn't complex; when you reward something, you get more of it. When you punish something, you get less.

Wasatch Team Vacation Updates

Mark

Mark & Savina enjoying the lake

John

John out for a recent mountain bike ride

Beth

Beth visiting the East coast last month

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