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TRANSCRIPT: Q3 2020 Market Update

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Steve Elwell: Hello everyone, this is Steve Elwell from Level Financial Advisors and this is your third quarter 2020 market commentary. The U.S. and global stock markets continued their March upward, the recovery from the downturn that happened earlier this year. The U.S. stock market as a whole is up a little more than 9%. Emerging markets were up even a little bit more than that, around 9.5%. Developed stocks internationally were up around 5% and global real estate was up a little less than 2.5% for the quarter. Seeing a rebound across various asset classes for the third quarter. If we get a little more specific, emerging markets led the way in big U.S. stocks. We're right behind them. Small stack stocks had a reasonably good quarter, so did value stocks, although not quite as well as emerging markets. Then global stocks and real estate came along.

01:03 Even the bond market had another good quarter, as we look at what the returns were for the different global bond categories, whether its corporate bonds or other categories. Specifically, when we look at the bond market, U.S. corporate bonds led the way, which makes sense because they were hit pretty hard during the downturn in February and March. But also somewhat unsurprisingly, U.S. Treasury inflation protected bonds had a great quarter and are really having a great year overall. As the Federal Reserve and the U.S. government has passed and created so much stimulus for the economy, there certainly are investors out there that are starting to grow concerned about inflation in the future based on all this stimulus. The stimulus is, at the current point, almost four times larger than what was passed in the TARP package back in 2008 in the great financial crisis.

02:11 We're talking about the current moment, Congress is negotiating back and forth with the White House on another round of stimulus. Remains to be seen if this is somewhere between $1.5 trillion and $2.5 trillion, on top of what they already did. I would expect that if they're able to get some type of deal done on that front, that investments like treasury inflation protected bonds probably will continue to do reasonably well if investors are concerned about inflation since another round of stimulus might come. There's really no question that there still are a ton of people that are having to deal with really difficult circumstances, whether it comes to running their small business or their employment or lack of employment. The unemployment benefits, the extra piece that came out from the federal government, has long stopped. I think it was back in July.

03:14 A lot of people are still hurting financially to a great degree, as the global economy starts to slowly recover from the shock that happened in February and March. Actually, we have a chart here from J.P. Morgan that shows all the different crashes or downturns that have happened specifically in the last 10 years. You can see them highlighted here by circles, but you can see the magnitude of this crash and how sharp and deep it was in March. Fortunately, as we look at the S&P 500 at least, which is not obviously the entire stock market, it's just simply 500 companies, but there has been a somewhat V-shaped recovery over the last two quarters since that downturn took hold in February and March. If you compare that to the economy and what things actually look like for the average American or the average citizen, global citizen, the average small business, they're slightly recovered.

04:27 We're making some progress, but certainly not to the extent that the stock market has recovered. In fact, we've got another chart here, and it's an interesting couple of charts actually from J.P. Morgan that shows the seven day moving average of mobility for retail and recreation. They can track people and how much they're moving. That feels like maybe a creepy thing to say out loud, but what you can see from this chart is pretty clear, both in developed countries and emerging markets, you can see this huge drop that happens in February and March. Then this slow recovery that takes place almost back for a lot of places, almost back to pre COVID levels of clearly people are getting out and about. Now that does not mean that businesses are fully recovered.

05:26 We can point to a lot of different investment categories that still have not fully recovered or not even really that close to fully recovering. I think the point of showing this is that economic activity and retail activity and recreational activity has slowly started to rebound. It's not a V-shaped snapback, maybe like the stock market is. We've heard a lot of clients say things to the effect of how is it that the stock market has effectively recovered for the most part, but so many people out there and so many businesses out there are still struggling. Unfortunately, the stock market and the economy are not one and the same. The stock market is certainly forward-looking and jumping in advance of saying investors are pricing securities for what they think the future will look like. Not what it looked like yesterday or last week or last month.

06:35 The trigger for the stock market turning around on top of all the government stimulus and the actions the Federal Reserve took, was really this ultimate peaking in downturn of coronavirus cases, as the lockdown helped slow down cases. Now there have certainly been resurgences in different places, for sure. A downturn in cases, especially overseas and a rebound of economic activity, even if it's not V-shaped, the anticipation after starting to see the light at the end of the tunnel, as the economy did start to slowly reopen and people did start to slowly get back to, I don't even want to call it normal, but something closer to normal, the stock market is certainly going to jump out in front of that.

07:27 That's exactly what it did. We thought these charts were a good visualization of what happened to the stock market, but also what happened mobility wise. Which is, seems again like a weird thing to look at, but in this type of downturn, would this type of reason for the economy slowing down or sharply, sharply slowing down, it's not as if people are scratching their heads and saying, "Why did the stock market go down? Why was there a 30% contraction in GDP?" You don't have to be an economic genius to figure it out. We shut down the economies across the world. Of course earnings and profits are going to be lower if we do that. The stock market does actually a really good job of sniffing out as the bottom hits in economic activity or as the peak hits in coronavirus cases. As the economy starts to slowly regain some of its foot, the stock market does actually a pretty good job of anticipating and sniffing out those facts as they start to take hold. These charts we thought were a good recap of that.

08:38 One other thing that I think is worth pointing out as I look at this other chart... We've shown this one before, and I want to show it again. The Federal Reserve, as we mentioned earlier, has really taken a lot of action to try and help stem the problems in the economy, to keep money flowing, to keep the investment markets liquid and active. One of the ways that they do that is lowering interest rates and that's not unique. We saw that as this chart shows from 2008 to 2015 interest rates were effectively zero. We started getting some increases in 2016, 2017, 2018. We got back to almost a more normal scenario. Then of course, coronavirus hit and all of a sudden interest rates were dropped back down to zero. Now what's unique beyond the other bond market related things that they did and all the facilities they created to maintain liquidity. I'm going to ignore that piece for a second and just specifically talk about the Federal Reserve's guidance on forward-looking interest rates and forward-looking inflation.

09:48 Let's keep in mind, the Federal Reserve is tasked with two jobs, maintaining steady employment, if too many people are unemployed, they're trying to stimulate the economy so employment comes down to what they view as low as it can get unemployment wise, and then also to maintain stable prices. Stable prices in their mind generally meant somewhere around between 1.5% and 2.5% inflation. You don't want inflation to be negative, which would, of course, be deflation. You don't want too much inflation because that can spiral out of control, sort of like it did in the 70s and early 80s. They're trying to maintain just a little bit of inflation and keep people employed. That's pretty basic. That's pretty easy to understand. They've lowered interest rates to effectively zero. What's unique about this time around is they have very clearly said that they are intending to keep interest rates low, not just for the remainder of 2020, which seems like a no-brainer, but also 2021, 2022 and 2023.

11:09 That's a pretty long guidance. They're really telling us that they're anticipating keeping rates low for three more years. Now, that's something that was different from past guidance of their lower interest rates. Also, they have said that they are potentially willing to even let inflation run a little higher than their expectations, then their targets, their initial targets, in order to help the economy out. That has really put people who have cash and CDs in a pretty tough spot and not exactly a new spot because they were in low interest rates back through 2008 throughout 2015. But back then, the understanding was, now it didn't happen as fast as people thought it would, but when it was 2009, 2010, 2011, it was pretty widely expected that pretty soon the Federal Reserve would start to raise interest rates.

12:16 Now they didn't ultimately really start doing that until 2015, 2016. As we went through 2013, 2014, at least, for sure 2013, the markets started to expect that interest rates were going to go up. If you were someone who had cash on the sidelines, you could think to yourself, I'll wait a little bit longer and I'll finally start getting some interest. What's unique about today is they're basically telling you the next three years, you're going to get nothing. If you're really nervous about what's going on in the stock market and even the bond markets, and you're concerned about the global economy, you may be willing to say, "Listen, I'll accept no interest just to maintain the safety of my money, because I'm worried about potentially values of any other investments, even if they're bonds, going down." I think when the Federal Reserve tells you four years, three, four years is what you're going to have to wait, I think you start to come to the point and say, Wait a minute. This is a downturn caused by a global pandemic.

13:27 If we have any faith in the science and the medical community to be able to do one of two things, either provide a vaccine that works or therapeutics that reduce the fatality rate and the length of sickness for people to a much lower percentage. Or quite simply, if we just end up determining ways to better stop the spread, whether that's a national mask mandate or whatever the case may be. If you're of that mind that at some point we're going to solve this particular problem, do you think it's going to take three years, four years? If the answer is no, if you think it's going to be something shorter than that, then the Federal Reserve is effectively telling you it's time to do something productive with that cash. They don't care whether you spend it, whether you invest it, whether you start a business, you buy a car, you loan it to your son, you buy another property, you invest it in Google stock. They don't care.

14:36 They're effectively trying to stir the pot economically in saying, "We're going to let inflation run higher than normal, we're sure it will get there and we're going to still keep interest rates at zero. That's a pretty negative for someone who has a lot of cash sitting in the bank or in CDs that are maturing soon.

14:58 We have another J.P. Morgan chart here that shows that. It shows all these blue dots that are effectively the amount of income you need to beat inflation every calendar year for what looks like the last 26 years. Generally that's run for $100,000 account. You need somewhere between $2,000 to $3,000 of interest, just to keep up with inflation, which makes sense because inflation was about 2% or 3% a year, over that timeframe. If you need $2,000 a year of interest on $100,000 savings account, but current interest rates on a savings account or on a CD might be a 0.25%, maybe a 0.5%, if you're really lucky, but inflation is running at 2%, you're effectively going backwards, going down in real value by 1.5%, 1.75% per year and they're telling you they're going to let that happen for the next four years.

16:03 That's a pretty rough scenario. That's a pretty high cost for someone who's looking to maintain the principal value of their money, in real terms. They're effectively saying if you're that concerned, you want to hold on to this cash for the next three or four years. You're probably going to lose 4%, 5%, 6% in real dollar terms after inflation. Probably going to lose 4%, 5%, 6% on your money. They're trying to stir the pot. That is definitely what they're trying to do. They're trying to stimulate economic activity. This is the biggest economic contraction they've seen since the Great Depression, even though it's, I don't want to call it man-made, but we obviously, to stem the spread of the virus, we made the active choice to shut down much of the global economy to put a bit of a pause into how quickly the virus was spreading.

17:01 Ultimately we'll see how that plan shakes out. Maybe inflation might end up running faster, much faster, than what they're thinking about or could turn out like it did in 2008, when everyone thought inflation was going to run through the roof and it just never really showed up. It is a somewhat unique scenario, cash wise, interest rates wise, as to how far out they're giving this low interest rate guidance and that they're willing to let inflation run a little hotter than normal. Something that's worth pointing out and talking about.

17:35 What I want to talk about beyond that is really a couple of other items. One is what almost entirely the focus of the stock market and the news cycle is on today, which is the election. That's coming up here in a couple of weeks, less than a month. We get a lot of questions, not just this year, which feels like the most intense election ever, but any election period, whether it's midterms or a presidential election. The question always is number one, should I do something different with my investments because the election is coming up? Number two, if this party wins, what should I do and if that party wins, what should I do? Unfortunately, if you look over the course of all the past elections, presidential elections mainly, but midterms as well, you see no discernible pattern. You see no playbook that says, if this happens, you should buy stocks and if that happens, you should sell stocks or this or that.

18:46 In fact, we had put one video from our friends at DFA on our website, and then another post from Vanguard on the website, both about the election and both coming to the same conclusion. For instance, Vanguard had researched a 60% stock, 40% bond portfolio and they found no statistical difference in returns in election years versus non-election years. Basically saying that your expectations should be no different just because an election is happening this year. One of the other, what seems like should be intuitive and gets repeated a bunch in the financial news all the time, is even if that's true, shouldn't the markets be more volatile around the election either before or after, because this is such a big event that we're all paying attention to? Vanguard studied that as well and they said election years versus non election years, when you look at the 100 days prior to the election and 100 days after the election, there is in fact less volatility than in non-election years.

20:08 That's totally counterintuitive, but the end result ends up being, making investment decisions when there're no patterns, when there's no statistical difference in a balanced 60/40 portfolio, and when there is in fact less volatility in election years than normal, you come to a conclusion based on evidence that says, of course we shouldn't make any big portfolio changes based on the election. No matter who we think is going to win, who we think is going to take the Senate or take the House or take the White House. We get a lot of questions on that and the answer is, unsatisfying as it is, is the evidence tells us there's no reason to make any big change to our portfolios. Having said that, there is one thing that I do think is important and that is to evaluate each party and each candidate's plans for things that we potentially can strategize around, which are things like taxes. We already have a pretty clear picture of what has changed tax code wise under the current administration.

21:28 There have certainly been ways that we've been able to plan based on these new changes. Ultimately, if there is a change in the White House or a change in the Senate or a blue sweep, then we absolutely will want to take a deeper look at what the proposals are for the Democratic party and what might be coming down the line, if we think they might be able to pass some changes to the tax code. That's something that not just at this election, but any time, no matter which party is proposing it, there are changes coming to the tax code or potential changes coming to the tax code. That type of plan is extremely important because often once you know what changes are coming, and once they actually come, you can start to plan around, what changes does that mean for me? Should I do something differently than what I'm doing now, based on how I'm saving or how I'm spending or how I'm allocating investments.

22:32 That's certainly something we'll be doing. Keep a lookout for that as we take a look at the different proposals that are out there and ultimately as the election plays out. The markets typically after the election is over, and we saw this a little bit with Brexit, actually, even though it was a surprise election. We saw it in 2016 as well. The markets typically are just simply relieved when the election or the vote is over and that uncertainty is gone and the market can refocus on everything else that's out there because the reality is who's in the White House or who's in control of the Senate or the House or foreign governments is certainly a variable that affects the economy and the global economy, but one of thousands of variables that affect the global economy.

23:30 We don't ever want to put too much weight on one particular vote or outcome or one particular variable as it comes to the overall economy. With this recap... It's been a recap of the third quarter, 2020. In short, it was a good one for markets and portfolios have continued to recover. We're certainly happy to see that in the markets now focused on the election. When we circle back here for the fourth quarter review in three months, I'm sure we'll have a lot to talk about. Until then, have a good quarter and we'll talk to you soon.