Stock Market Update

September 24, 2020

A Story, a Lesson, and Perspective on the Way Forward

Bottom Line: *The investing environment will never be free of uncertainty. We can use this uncertainty to our advantage - getting positioned to make the most of opportunity while trying to steer clear of unnecessary risks. Adapting to the ever-changing and unforeseen conditions with which they are confronted is a reality for investors.*

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."
-William Arthur Ward

While I did not spend the summer at sea, I did enjoy multiple opportunities to go sailing on Lake Michigan. Heading out of the Milwaukee harbor with a favorable breeze and the sun overhead can lead to an exceedingly pleasant afternoon on the water, providing a welcome respite during a period of economic uncertainty and COVID-related disruptions. It is an environment tailor-made for full sail, full speed, and full enjoyment. On another occasion, a cold wind, overcast skies and large swells inside the harbor made for a rare summer evening that, in the words of our skipper, was "a good night to stay on land."

Most often conditions were somewhere in between the extremes. We would go sailing and pay close attention to our environment. Making headway was possible but staying on course took some effort. As conditions changed, so did our tactics. Across open water there can be many paths to the same destination. If an obstacle was in our way, we would adjust to new heading – we did not argue with concrete.

The experience of sailing provides context and perspective as we consider the financial markets overall and the journey we take as investors. In a world of ample computing power, multiple scenario analysis, and the quantification of possible risks and potential returns, we can get a false sense of security believing that portfolios are like powerboats – set the heading, determine the speed and hold on until you arrive at your destination. The reality tends to be closer to a sailing expedition. Initial heading and expected speed can be (indeed, often are) altered by unforeseen circumstances, fortuitous tailwinds as well as storms that can blow us of course. Investors, like sailors, need to be mindful of the environment, taking risk when appropriate and trimming sails when warranted.

As we move toward the fourth quarter of a tumultuous year, we continue to lean on our weight of the evidence – our gauge of the balance of risks and opportunities in the current investing environment. As with sailing, market conditions are never static. Risks and investor risk tolerances are often dynamic. After nine months of unexpected twists and turns and enough "never befores" to support almost any narrative one might choose to endorse, we continue to ponder two main questions.

On the macro front: Can monetary stimulus alone sustain a recovery that is increasingly in need of fiscal support?

Getting to a deal on another round of fiscal stimulus was always a challenge with a presidential election approaching and the equity market was probably too sanguine about the possibility that partisanship would trump good policymaking. The introduction of a Supreme Court nomination battle has dropped the likelihood of a deal from negligible to nil. Equity market valuations have already expanded in anticipation of continued progress in the economic recovery. The lack of fiscal stimulus and continued un-rest ahead of the November election raise the risk that the pace of recovery will not just slow, but that activity may actually tick lower. While pleading with Congress for additional fiscal support, Fed Chair Powell made it clear that the Federal Reserve will continue to do what it can to support the recovery. Fed-supplied liquidity can easily inflate asset prices on Wall Street, but fiscal policy tools would be more effective at fueling gains in the Main Street economy

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On the market front: Does the correction that began in the wake of new highs for the S&P 500 earlier this month remain on a healthy footing?

We have argued that a price correction that is accompanied by unwinding optimism and resilient breadth could be limited in degree and duration. This would set the stage for the cyclical rally to resume as election-related uncertainties subsided. While optimism has begun to retreat it would be premature to suggest that it is unwound or that meaningful levels of pessimism have emerged. Moreover, the three measures of broad market strength that we highlighted as important in an update earlier this month have all meaningfully deteriorated this week. From our perspective, this is more consistent with a trend that is breaking down than evidence that selling is becoming exhausted.

For now the weight of the evidence remains neutral, but downside risks seem to be building. Our operating assumption has been that the breadth thrusts that emerged as stocks rallied off of Q1 lows could provide self-sustaining upward momentum, fueling a broadly supported cyclical rebound. Of increasing concern is the possibility that just as charts of the economy have been distorted by the scale of the weakness and rebound in the economy, market volatility has distorted the signal from some of these historically reliable indicators. We continue to struggle to reconcile the new highs seen on the S&P 500 and NASDAQ Composite (as recently as earlier this month) with a continuing pattern of lower highs being seen on other US composites (notably the Value Line Geometric Index) as well as internationally (both developed and emerging markets). Financial markets have been buoyed by central bank accommodation. Further gains may hinge on evidence of a broadly based strength on both Wall Street and Main Street.

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