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The Election Correction

Executive Summary

We are writing today to update you on our activities and thoughts since our last note on August 4th. In that letter, we discussed our expectation of heightened volatility with the 2020 election approaching. We also stated that we were likely to be buyers of US equities on any significant weakness. We are glad we used the word "likely," as we have been modest net sellers of equities and specifically technology-focused equities since August. Our next move on US equities is conditional; however, we believe a clear winner from either party in 2020 will be followed by stocks moving higher over the long-term.

Why we were net sellers of US equities in September and are more cautious in the near-term.

We saw several reasons to take some chips off the table heading into September, so we will start by discussing the rationale behind our recent trades. First, after our note in early August, the S&P continued to defy expectations by jumping 8.5% to reach its all-time high on September 2nd. This is a good return for most years, let alone for the month of August 2020 in the midst of a pandemic.

Next, August's rally also left investors optimistic and markets appeared overheated to us, in some ways resembling the 2000 tech bubble. Open call options and first day returns on IPOs reached levels not seen since that year. The S&P market cap-to-GDP ratio also exceeded its 2000 level. The number of "zombie firms" – defined as companies that cannot cover their current interest payments with revenues – neared 2000 levels.

Third and technically, strong rallies in the month of August are often followed by sub-par (or worse) returns in September and subsequent months. A 7% jump in August of 1986 was erased by an 8.5% decline that September. The monster 39% rally in August of 1932 preceded a 33% bear market through February of 1933. In 2000, the August rally of 6% was the last gasp of the tech bubble, which would eventually pop and erase 50% from the S&P. Interestingly, these negative turns in the Septembers of 1932 and 2000 also occurred in election years where the incumbent presidential party eventually lost. While we are not predicting the election, we saw this as an additional risk on top of those listed above; as such, we turned modest net sellers of US stocks in September. Our trimming focused on technology shares, which we assessed as the most overheated and at-risk sector.

If we are seeing weakness, why aren't we buying? What are the risks on the horizon?

Since we began selling equities at the beginning of September, markets have finally started to experience some weakness. The S&P flirted with a technical correction, falling -9.4% from the 2nd to the 23rd of September. The tech-heavy NASDAQ fared worse, declining -12.6% over the same period. Although this type of weakness typically gets us interested in buying equities, we have continued to hold off for several reasons.

For starters, although we have recently seen some weakness, it is hardly the fear-induced selling we experienced earlier this year in March. In fact, with the S&P's strong August and weak September, stocks are just flat since we last wrote. The S&P's near correction is a minor blip compared to the massive 61% rally we have seen off the lows in March. We are waiting for a bit more weakness before we pivot and become net buyers of US stocks. Looking ahead, we see reasons to expect further weakness and volatility.

Before turning to the election, we should note there are other risks in addition to those already discussed above that could drive US stocks lower in the near-term. First, while President Trump, the Federal Reserve and both political parties agree that additional fiscal stimulus is warranted, they have been arguing over the size and focus since earlier this summer. Further complicating a potential stimulus deal, the Senate's recess

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due to a COVID outbreak among its members and the focus on Ruth Bader Ginsburg's Supreme Court seat has a pre-election fiscal stimulus agreement in danger of obstruction or dilution. Indeed, as we finalized this update, the markets dropped on news that the President was calling off stimulus negotiations, then rebounded the next day when talks resumed. Second, The Fed is also likely to remain on the monetary sidelines until after the election, so as to avoid the impression of playing politics. Finally, this all comes at a time when COVID cases are on the rise in many parts of the country including Washington, DC.

As we head into the election, we are carefully considering the potential outcomes and how they may impact US markets and our likely playbook. Since 1928, markets have rallied about 6% in Q4 when the incumbent party wins the presidential election. From an investment standpoint, we do not see any reason why an incumbent victory in 2020 would not play out in similar fashion. A solid, undisputed win by President Trump would likely be beneficial for US stocks in the near-term, given his continued focus on reduced taxes and deregulation. Several recent polls suggest the majority of investors think President Trump will lose the election and that this will be broadly negative for US equities, but a surprise win by President Trump would likely lead to even higher Q4 returns than the average incumbent victory.

Investors who sold stock based on their politics post-election in 2016 missed out on the 14% per annum return that US stocks have experienced since, and we would caution against overreacting to a victory by Vice President Biden or a blue sweep in 2020, as well. We do see some obvious near-term downside risks to US markets if Biden wins. In terms of the risk, Biden's proposed tax increases are the largest we have seen since LBJ in 1968. While Biden proposes to remove just half of Trump's tax rate cut, his other corporate tax proposals call for up to $2.5 trillion in new taxes, which would certainly impact post-tax earnings for US companies. Proposed hikes to individuals could also dampen demand for stocks and Biden's focus on increased regulation in various sectors – such as limitations on oil fracking – will also impact corporate earnings.

However, there are several mitigating factors that investors should consider before aggressively selling stocks based on a potential Biden victory. Markets typically experience an 8% correction ahead of the election when the incumbent president's party loses, but we already experienced such a correction in September. Professional market participants largely expect a Biden victory and expect his policies to be net negative for US equities; and in part, in anticipation of that outcome, investors are already broadly over-allocated to cash and underweight US equities. While the historical data should be taken with a large grain of salt, it is worth noting that since 1928, a Democrat-controlled government has been associated with median returns of 10% per annum for US stocks (slightly behind the average 11% return under divided governments, but ahead of the 7% average under Republican-controlled governments).

Again, we would consider these historical results skeptically, but also note that Biden's proposed taxes are merely *proposed*. Should he be elected and face a divided, or even Republican-controlled Congress, these tax hikes may very well fall by the wayside. Even if we do see the "blue wave," Biden's tax hikes may be delayed as a result of current economic weakness. His spending proposals, such as $2 trillion toward infrastructure, are targeted at workers and areas of the economy that could potentially deliver large economic multiplier effects. In sum, we do not think that any one president or political party can completely derail the long-term positive tailwinds for America and its businesses.

What's the biggest election-related market risk?

The biggest risk we see heading into the election is a close, contested election with no clear victor emerging and a drawn-out process undermining domestic trust in fair elections. We are not alone in this concern. A recent poll by The Economist showed that over 35% of independent voters have little to no trust that the 2020 election will be fair. Options bets around the election make the 2020 election the most expensive US event to hedge ever, based on relative implied volatilities. For some historical perspective, in the 2000 election during the Florida recount battle, the S&P fell -5% and gold jumped 12% from election night to

December when the Supreme Court ruled in Bush's favor and Gore conceded. We think a close, disputed and drawn-out 2020 election is a low probability, but high impact scenario that could cause more damage than the Bush-Gore precedent, and we have modestly reduced our equity exposure accordingly.

How does the year 2000 inform our posture heading into November and beyond?

For our purposes, the most noteworthy thing about the 2000 election is that the initial 5% loss was just a small blip compared to the 50% losses stocks suffered in the ensuing tech bubble, or more importantly the 240% positive return achieved since that election to date. We cannot blame President George W. Bush for the tech bubble finally popping, hence the grain of salt comment above, but there are other comparisons to the fall of 2000 that help to inform our thinking moving forward.

First, we address the similarities. Heading into October 2000, the S&P traded at roughly 23 times next year's expected earnings versus roughly 21 times earnings today. This equated to a 4.4% earnings yield in 2000, not far from today's 4.7% rate. In 2000, average first day returns on IPOs neared 50% versus close to 40% today. The percentage of zombie firms peaked at 16% versus 15% today. Finally, in the fall of 2000, we headed into a close, contested election where the incumbent party won the popular vote but ultimately lost the Electoral College, with the Florida recount case decided by the Supreme Court.

While the similarities between the market in 2000 and now should not be ignored, there are key differences that suggest more optimism ahead. In 2000, the Federal Reserve hiked short-term rates from 5.5% to 6.5% to cool off the "irrational exuberance" that Chairman Greenspan warned of in 1996. Today, the Federal Reserve is committed to keeping short-term cash rates at near 0% for another three years and is not concerned with asset bubbles. In 2000, there was no such thing as quantitative easing or the idea of the Fed flooding the market with cash; whereas today, the Fed's balance sheet is $7.1 trillion, including a staggering $3 trillion recently printed. Furthermore, the Fed's policy stance in 2000 left the 10-year Treasury yield at 5.8% versus a paltry 0.8% rate today. If we compare the earnings yield on stocks in 2000 at 4.4% to the then 5.8% on Treasuries, investors earned an extra 1.4% sitting in bonds, not to mention an additional 2.1% just to sit in cash. Today, the earnings yield on stocks is 3.9% above the 10-year bond yield and 4.5% above the target Fed funds rate for cash.

Finally, and most importantly, in the year 2000, despite solid 6.5% yields on cash versus 3.5% on inflation – for a real, risk-free return on cash of 3% – investors held record low cash balances. Today, cash balances sit near 10-year highs despite a 0% nominal yield and inflation of 1.3% for a -1.3% real, risk-free return. In October 2000, equity analysts were wildly bullish and often were compensated to prop up shares – they projected the S&P to deliver $63 in earnings in 2001 and $65 in 2002. Actual earnings eventually came in 30-40% lower than expected over the next two years. As we stand now, last year's actual earnings and analysts' expectations for next year's earnings have already plummeted to reasonable levels with modest anticipated earnings growth.

Conclusion

In conclusion, we grew modestly concerned with markets heading into September and took some chips off the table. While we have since seen a correction and certainly face uncertainty ahead, we view US equity markets as under-owned versus cash with no yield. The market and its participants are anticipating a Biden victory, are already largely positioned for such an outcome, and may well be surprised to the upside. We are likely to be buyers of equities on any weakness that is accompanied by a clear presidential victor as we continue to believe in the long-term prospects for American businesses.

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