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SUMMARY

- Generally speaking, American companies are adaptable and have always been quick to adjust, in our view.
- Improvements in health solutions are also improvements for the economy, in our view.
- We believe another stimulus package will boost equities while punishing savers.

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What if the Stock Market is Right?

This Halloween, be more afraid of what you know that isn't so

It's only 8 days until the US election. People around the world are trying to understand the market implications of a Trump vs Biden presidency, and the potential make-up of the House and Senate. The upcoming election has caused some investors to 'freeze', with many waiting to see the results of the election (and any potential chaos following the election) before returning to stocks.

Investor concerns go above and beyond the upcoming election. For much of the last 6 months, there has been widespread disbelief about the stock market rally. In fact, it would be easy to fill these pages with all the reasons that equities might not be able to sustain their all-time highs.

We think a more provocative exercise is to explore the possible reasons that can help explain the strength in equities. In other words, think about what the market might be seeing that the naysayers are missing? As the saying goes, "it ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." This week, we'd like to highlight four positive views of the current concerns that we think help explain the stock market's strength this year and its buoyancy in recent weeks.

1. The election won't materially affect the resiliency of corporate earnings.

Throughout history, stocks have prevailed through Democratic and Republican administrations, changes in tax code, trade policy, and labor reform. In other words, American companies are flexible and have always been quick to adapt to the prevailing environment. We don't think the outcome of the election changes this paradigm.

With a Joe Biden victory, where the Senate also goes to the Democrats, corporate tax rates will likely increase from the current rate of 21%. Higher corporate tax rates would be a direct hit to net income and might also lower the multiple that investors would be willing to pay for future earnings.

However, we think a Biden administration is less likely to push for higher corporate tax rates if the economy is still struggling to recover from the COVID-19 crisis. For this reason, the stock market may already be realizing that a Biden win might not be that damaging to corporate profitability especially as fiscal spending is very likely to increase (see point 3 below). On the other hand, a Donald Trump victory would probably result in a continuation of the policies of the last four years. Markets like consistency, so we don't think a President Trump re-election would be harmful to stocks either.

2. A vaccine, a better understanding of the virus, and improved treatments mean the 2nd surge of COVID-19 will have less fatalities, despite a similar number of cases.

Despite the recent spike in cases, we think (and pray) that the magnitude of tragedy that occurred in the first 6 months of the pandemic is unlikely to be repeated for a couple reasons. First, the improvement in testing, as well as its availability, is drastically better than what the country experienced in March and April. This is important because individuals that feel sick have greater access to testing, and knowledge from test results can slow the spread of the virus. This was not the case in the initial wave. Second, while the search for a vaccine continues, we now have a better understanding of how to treat the virus, leading to better outcomes and lower morbidity rates.

The stock market may also be signaling that the improvements in health solutions are also improvements for the economy. In other words, the rise in stock prices is rational because another nationwide shutdown is less likely with these more sophisticated treatments and medicines. Bulls believe the spread of COVID-19 cases is partly due to more tests being conducted, and so it should not be as disruptive as people adapt to life with the virus.

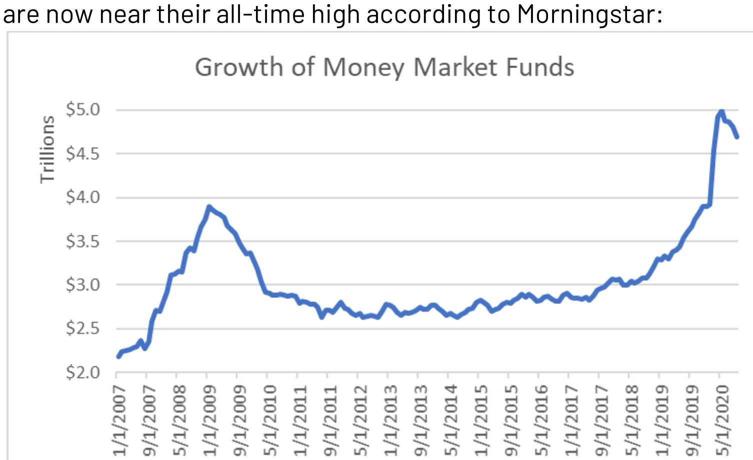
3. Stimulus is Coming… it just might have to wait until after the election.

With the economy in a less desperate situation, passing the next phase of stimulus seems to be held back by partisan bickering. However, regardless of who wins the presidential election, the stock market seems to be signaling that another stimulus package will be delivered to the American people. The size of the package will depend on the election outcome, but some perspective on the current figures being discussed is useful. For example, a $2.2 trillion plan, which was the original proposal from Democrats, equates to roughly 6% of the market capitalization of the US stock market, or roughly 10% of 2019 Gross Domestic Product (GDP). Thus, the amount of aid being considered is extremely large.

Simply put, stocks love stimulus. In our view, the announcement of another stimulus package will boost equities while punishing cash and bonds. The average interest rate paid on checking accounts in the United States is barely above zero, so even a small amount of inflation erodes purchasing power. Instead, we think stocks and real assets, such as property, will continue to be the prime beneficiary of additional fiscal stimulus.

4. Beware the Crowd: There are many individuals worried about the election and waiting in cash.

Stocks are typically cheapest when fear is at its greatest. The magnitude of cheapness is usually dependent on the "scariness" of the current environment. When there is nothing left to worry about (clearly not the case today), stocks are no longer cheap! Bulls recognize that elevated levels of fear and concern are healthy for a sustained rally because there are plenty of potential buyers among the skeptics. In our view, much of the "worried selling" has already happened, whether the angst is about COVID-19 or the upcoming election. We think this can be demonstrated by the growth of money market fund assets, which are now near their all-time high according to Morningstar:



Source: Morningstar. Past performance is no guarantee of future results. Shown for illustrative purposes. Not indicative of RiverFront portfolio performance. Index definitions are available in the disclosures.

Assets in money market funds hit a record high of almost $5 trillion in May as investors flocked away from stocks and into safe havens like cash. The previous record of about $3.9 trillion was set in January 2009. We think large amounts of cash help explain why pullbacks in the S&P 500 have been relatively shallow. As this record amount of cash on the 'proverbial sidelines' gets redeployed, this pattern is likely to continue.

Conclusion: The stock market is considered to be one of the best leading economic indicators. Over the last six months the stock market has been signaling that economic strength is on the horizon. **Instead of wondering how the market is wrong to be near all-time highs, we believe investors should spend more time trying to understand why it might be right.** The upcoming election will bring strong emotions from both sides of the aisle and probably some volatility as well. However, when the dust settles, we believe the US economy is poised to continue its recovery, just like stock prices have been saying over the last six months.

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Index Definition:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

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