Weekly Market Flash

An Autumn of Uncertainty

September 11, 2020

It's that time of year again. Labor Day is behind us and for investors the trickiest two months of the year are underway. September and October have delivered a bevy of surprises over the years. Many of us well recall that auspicious day in September 2008 when Lehman Brothers went bankrupt. Some of us were around to watch the stomach-churning plunge that seemed to come out of nowhere in October 1987. The Crash of '29 is a bit more distant, but as students of economic history we have diligently studied it.

And of course today's date reminds us of that harrowing experience to which we bore witness on a crisp Tuesday morning in September, 2001. In the days that followed the deaths in Washington DC, New York and Pennsylvania we came together in shared grief along with a renewed sense of common purpose and determination – qualities we sadly appear to have subsequently lost as a nation.

In 2020 it is fair to say we have already had enough disruption to last a lifetime – and yet there is a great deal more uncertainty that potentially lies ahead. As we talked about last week, volatility is very high in equity markets despite the vigor and duration of the rally that began in late March. Here are some of the things keeping investors up at night – and a couple possible reasons why things might not be so bad.

The Election

You've heard it from us hundreds of times: the market typically pays scant attention to politics. This year, though, is a glaring exception. Futures contracts on the VIX volatility index that expire in early November, around election time, are higher than they have ever been in an election season. The fear here is not really rooted in the identity of the candidates, but rather the concern that a messy election result could precipitate a constitutional crisis. If we get to December and the year 1876 is a mainstay of news headlines it will not be a good thing. In that year Rutherford Hayes and Samuel Tilden both claimed to have won the election with no clear outcome in the Electoral College. A crisis was only averted when the Republican candidate Hayes agreed to end Reconstruction by pulling Union troops out of the South (which in turn effectively ushered in the era of Jim Crow laws and enforced segregation in the South for nearly a century more). This year there are any number of things that could go wrong, too many to enumerate here. Suffice it so say that the market is hoping against hope for a clean and decisive outcome in November.

The Economy

If the worst-case scenarios did not come to bear in the aftermath of the economic lockdown this past spring, it was largely due to the passage of the $3 trillion CARES Act in March, along with the Fed's liquidity facilities to support the Act's different provisions for relief to households, enhanced unemployment benefits and monetary support programs for troubled businesses. Those benefits all expired more than a month ago, and Congress has not been able to get past its partisan differences to secure passage of a follow-on program. There has perhaps been a diminished sense of urgency with a series of better-than-expected jobs numbers, driven mostly by the return of workers on temporary furlough in the leisure, hospitality and retail industries.

But the number of jobs considered to be "permanently lost" has been rising throughout this period as businesses – particularly small and mid-sized ones, continue to shut down. Renters and homeowners with mortgages are delinquent on payments in increasing numbers. A hit to consumer spending will slow down the pace of recovery in GDP, which remains well below where it was before the pandemic. This in turn will affect company profits and put a spotlight back on yet another variable of uncertainty: valuations.

Stretched Valuations

The price-to-sales ratio of the S&P 500 reached a level of 2.53 times in late August, just a shade below the all-time record of 2.6 times the index attained in March 2000, at the height of the dot-com madness. Even that level does not do justice to some of the really jaw-dropping numbers you see in the high-flying tech sector. Microsoft has a P/S ratio of 12.1 times, while Tesla's is more than 20 times. Let's be clear here – we're talking about sales. Not net earnings. A P/E ratio of 20 times is normally considered "expensive." A P/S ratio of 20 – well, Tesla would practically have to have to own the entire market for electric cars for the next two decades to deliver the returns that kind of valuation implies.

We like to say that when Big Tech sneezes the market catches cold. If Big Tech catches cold the market could well come down with pneumonia. Right now the tech sector is at the center of the bumpy ride that has been September thus far. It's not hard to imagine the conditions for a repeat of the Nifty Fifty downturn of the late 1960s, when the highest-flying names in that market led the way into the successive bust-and-boom-and-bust era of the 1970s. In a market driven by momentum, valuations don't tend to matter. When the momentum music stops, they can matter more than anything else.

Covid-19

The virus has not gone away. In Spain the number of new cases now rivals the worst of March and April when the pandemic was in full swing in Europe. Our own new case numbers remain resolutely above 30,000 on most days, and the daily death count continues to hover around 1,000. We will have more than 200,000 fatalities within the next week or so. Medical experts are almost unified in their concern about a new outbreak as the weather gets colder and people head indoors – and the possibility for this to coincide with the flu season. The decision earlier this week to temporarily halt Phase 3 trials for one of the most promising vaccine candidates reminds us that a quick fix and return to normal life is highly unlikely.

Good Vol, Bad Vol

All these things may sound pretty bad, but that does not necessarily mean that we are in for another dramatic plunge in equity markets. Remember that volatility cuts two ways – it can go up or down. Any of the factors we mentioned above could be a catalyst for sending stock prices higher (good volatility) as well as lower (bad vol). Markets often react not so much to the substance of events as they do to outcomes relative to expectations. Take corporate earnings as an example. Many companies have reported fairly dreadful sales and profit numbers in the recent earnings season. But often those results were seen as better than what they could have been, and the stock price went up as a result. Likewise, if you watch political pundits talking about the election on any given day you come away with a picture of chaos, piles of disputed ballots, bags of unopened mail and riots in the street. It may well turn out that these and other related problems are overblown (we really, really hope that is the case).

Still worried? Don't forget the Fed! It is more likely than not that Jay Powell and his team have a few more tricks up their sleeve if need be. Meanwhile, the best advice we can give is to stay calm, patient and disciplined. These truly are uncertain times, but we do believe it to be more likely than not that we will get through them as we always have in the past. Even if this fall does serve up more tricks than treats.

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