BULLS&BEARS

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Election Consequences

Large market moves are neither irrational nor unexpected. Going back to the fundamentals, the value of a financial asset is equal to the discounted value of its future cash flows. Research indicates that public markets discount future cash flows 10-15 years in the future, so the large daily price moves we experienced in March were an indication that the equity market was pricing in new information about COVID-19 that could have had a significant, long-term impact on shareholder value.

The good news is that none of the election outcomes—even a Blue or Red Wave—are likely to have as significant an impact on markets as COVID-19. Even so, elections do have consequences. It's currently too early to be highly confident about the election or policy outcomes, but the result will, on a relative basis, create winners and losers within the equity market, have an impact on tax policy, and shift the drivers of macroeconomic growth and risks to that growth.

Too Expensive?

Well, markets certainly aren't cheap, and just looking at the history of P/E multiples will lead you to that conclusion. However, the last 25 years of market history took place in an entirely different economic landscape and with higher interest rates. Today, the Fed has cut the policy rate to zero and has committed to keeping it there for the foreseeable future. Interest rates are critical to understanding valuations because when interest rates are low, there are fewer attractive options for investors. For example, if you could go get a 6% risk-free yield from a government bond, that might be pretty tempting! But you can't do that, because interest rates are near historic lows. This makes stocks more valuable to investors.

More technically speaking, low rates mean the rate at which investors discount future cash flows is also low, which makes future cash flows from earnings more valuable. The truth is, there is really no historical precedent for this, and therefore we think that historical comparisons of P/E multiples should be taken with a grain of salt. We're not saying to entirely toss them out…the history exists and it's real. We just need to reconfigure how we think about valuations to take account for this new world in which we find ourselves investing.

Ultra-Accommodative

The September FOMC statement provided further clarity on what the new policy of "average inflation targeting" would mean for monetary policy, coming from the "robust updating" of Fed Policy released at the Jackson Hole Symposium. The Fed expects to keep the federal funds rate in its current range of 0-0.25% until inflation (as measured by PCE) has risen to 2% and is on track to exceed 2% for some time and until labor market conditions have reached levels which they regard as consistent with full employment. This labor market requirement is vague but, based on Jay Powell's press conference comments, seems to encompass achieving the Fed's long-term unemployment projection of 4.1% along with higher labor force participation and stronger wage growth. Even after the Fed has started to raise short-term interest rates, monetary policy will remain accommodative until inflation has exceeded 2% for some time.

In our view, the main takeaway from this update is that the Fed's depository rate will stay at or near zero for years to come. Though we were just at their employment target in February, it'll likely take years to get back there due to the job losses and industry changes that the pandemic has created. These low rates and ultra-accommodative monetary policy may ultimately be a long-term tailwind for risk assets.

Please contact us at 1-855-829-7192 if we may be of assistance.

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Market Indicators

9/30/20	Year-to-Date Change
S&P 500	5.57%
NASDAQ	25.33%
Russell 2000	-8.69%

Interest Rates	9/30/20	3/31/20
10-Year Treasury Note	0.68%	0.68%
3-Month Treasury Bill	0.11%	0.13%

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