Buying stock is buying a stake in a company's future earnings stream. The longer that expected stream, the more investors pay for it. The Fed has told us that the expansion ahead will be quite long. That should make stocks more valuable.

HOW DO YOU SPELL VOLATILITY?

From the market's 2020 low made on March 23rd to its 2020 high notched on September 2nd, the S&P 500 rose 60%. That's the good news. The bad news is that the market fell 34% in a little over a month to hit that March 23rd low. The level of volatility this year has been truly jaw-dropping and, no doubt, unnerving to many. Of course, sparked as it was by a pandemic, stock-market volatility may rightly have been the last thing on people's minds.

In quarterly terms, the S&P fell 20% in the first quarter, rose 21% in the second, and gained another 9% in the third. That left the S&P return for the first nine months of the year at 6%.

For the same period, our US stock holdings returned 10%, continuing their dramatic outperformance for 2020. Our global stock holdings, held in our Arjuna Global Impact strategy, also did extremely well, returning about 10% vs. the MSCI World Index return of 2%.

HOW COME?

As we've noted in earlier Market Outlooks, part of our stocks' outperformance in 2020 is the result of our not owning shares of any fossil-fuel companies, which have been crushed this year. For the first nine months of 2020, the stocks in the energy sector as a whole declined a full 50%. Of course, much of this punishment reflects the dramatic drop in fossil-fuel use by airplanes and other combustion-driven transport during the COVID Recession.

But that's not the whole story. The energy sector has been a lousy place to invest for over a decade. Prior to the pandemic recession, the energy sector had returned 2% for the prior ten years—and that's not per year; that's absolute return. Fossil-fuel company profit margins have been shrinking steadily for years as the cost to extract oil has steadily risen—the easy oil has already been drilled. Now, extracting oil from tar sands, through fracking, or with deep-water wells is a very costly and often unprofitable business. And that's only going to get worse as the economy transitions to renewable energy sources.

We've long maintained that the fossil-fuel industry is the poster child for the unsustainable aspects of our economy and we're glad to be out of it, particularly this year.

A LOT OF Vs

If you look at a chart of the S&P 500 this year, it looks very much like a V, not the W form we expected. Why did the market recover so sharply? And has the market, as many pundits claim, lost touch with the economy?

The first part of the answer is that the recession itself was very deep but very short, lasting just two quarters. While we won't see the official numbers until the end of October, it's likely that the US economy expanded somewhere around—or even north of—25% in the third quarter. Granted, that's off of a very depressed base. But it is expansion and a quite vigorous one. So, the COVID Recession was sharp but short and the recovery steep.

For many of us as we look around our daily lives, we might wonder: Where is this steep recovery? Most of us aren't flying. We're not dining in restaurants or staying in hotels. We're not going to the mall. We're not even going into the office. Things still look pretty shut-down to many of us.

But did you know that US retail sales have recently hit an all-time high? And that new home sales, driven sharply higher by low mortgage rates, are back to pre-COVID levels? Household spending on durable goods—cars, appliances, furniture—has exploded since April, exceeding pre-recession levels. Corporate spending on core capital goods—machinery, buildings, equipment--is back to January levels. US industrial production has bounced hard and is now just 2% below January levels,

driving railroad shipments up to a pre-recession high. Auto production has also boomed and is nearing pre-recession levels. These are all V-shaped recoveries that account for a wide swath of the US economy.

K-SHAPED RECOVERY

If everything looks to ordinary folks like we're still deep in recession, what's driving these V-shaped rebounds in the economy? Clearly, it's not the travel and leisure sector, or restaurants and hotels, or department stores. Rather it's the technology, healthcare, manufacturing, and housing sectors that are driving these sharp recoveries.

There are two crucial factors to note about the strong vs. the weak sectors of the US economy. First, the strong sectors employ about three times as many people as the weak sectors. Second, the strong sectors have much larger multiplier effects on employment than the weaker sectors. For every job added in manufacturing, there are seven jobs created elsewhere in the economy. For every retail job added, there's just one other job created.

This bifurcation in the US economy has led many to call this a K-shaped recovery, with some sectors doing well and others doing poorly. While that's true, as an investor it's crucial to understand that those sectors doing well dwarf those doing poorly in terms of their impact on the overall economy and level of employment. They just happen to be less visible at street level than the weak sectors.

GOING FORWARD

While the current expansion may be uneven going forward, e.g., a second wave of the pandemic this winter could slow things down, the economy and the stock market are both telling us that a return to recession is highly unlikely. So, we don't think the stock market has lost touch with the economy. But as we've said countless times, the market isn't pricing current conditions; it's pricing what it sees coming down the road in six months or so. And part of what the market seems to be anticipating are medical breakthroughs that change the game for COVID-19—vaccines and/or treatments. That, of course, is a wild card, but the extraordinary breadth and speed of the research effort is encouraging.

What is definitely coming down the road and soon are the November elections. As recently as three months ago, we felt that a Democratic sweep of the House of Representatives, the Senate, and the White House might be the most significant risk facing the markets. For there's no question if Biden wins and the Dems secure comfortable majorities in Congress, corporate tax rates are going back up, with Dems reversing the corporate tax cuts Republicans passed in December of 2017. As stocks are priced based upon after-tax profits, anything that lowers after-tax profits should also lower stock prices.

And yet, *mirabile dictu*, it appears that the denizens of Wall Street have come to favor Biden over Trump, tax hikes and all. There seem to be two reasons: First, with Biden holding a commanding and expanding lead over Trump in the polls, a Biden win could be big enough to remove the possibility of a contested election. A contested election would be bad for the markets as visibility on a range of economic issues would go to zero and markets are all about seeing down the road.

Second, a Dem sweep would raise the odds of the federal government providing powerful fiscal stimulus to the economy and so ensure the longevity and vigor of the current expansion. This would be good for corporate profits and good for stock prices.

SPEAKING OF VISIBILITY

In our Market Outlook last quarter, we said, "With no signs of inflation in sight and a Federal Reserve committed to ongoing monetary stimulus, we should expect a very long period of economic expansion ahead. And that may well be part of the message the stock market is sending." That is, the message the market is sending with its sharp, V-shaped recovery.

Most recessions and bear markets in stocks—the recent declines being an exception—are created by the Fed raising rates to cool an overheating economy and so prevent inflation. Recently, the Fed indicated it will be years before it raises rates. That signals to investors that the major cause of recessions and bear markets is off the table for a very long time—ergo, the future earnings streams investors are buying into through stocks will be unusually long. And that makes stocks more valuable.

Farnum Brown, Chief Strategist

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