A New Gov Put?

Led by the continued sharp rebound in technology shares, the stock market rally off the March pandemic-panic lows continued in the third quarter with the S&P 500 and NASDAQ Composite up 4.09% and 24.46% respectively for the year. By contrast, the Dow Jones Industrial Average is down -2.65% through the end of September, reflecting its more value-oriented mix of companies and underrepresentation in the high-flying technology sector.

Indeed, the technology sector dominated by market cap giants Apple ($2.1 trillion) and Microsoft ($1.7 trillion) now represents 28.2% of the S&P 500. Meanwhile, the Amazon-led ($1.7 trillion) consumer discretionary sector and Google-Facebook-led ($1.1 trillion and $800 billion) communication services sector comprise 11.6% and 10.8% of the S&P 500 respectively. Together, these tech-tilted sectors make up a remarkable 50.6% of the S&P 500 market capitalization.

As we wait for the eventual approval of a vaccine, available treatments and testing capacity for coronavirus continue to improve. As shown with President Trump's recent bout with COVID, those infected and most at-risk are recovering more quickly when treated with the latest steroid, antibody cocktail and anti-viral therapy. Advanced COVID testing technology now allows for various at-home test kits, multiple serological tests and even an antigen test that costs $5 and offers results within 15 minutes. Similar to this good news on the virus front, economic news continues to improve with unemployment down from the April peak of 14.7% to 7.9%, both ISM Manufacturing and ISM Services Indices registering solid economic expansion and the market for residential suburban housing red-hot.

Arguably the most important piece of news during the quarter came from Fed Chief Jerome Powell who announced a significant shift in how the Federal Reserve will set interest rates. Instead of targeting 2% inflation, Fed policy will now aim for inflation *averaging* 2% over time, thereby allowing periods of shortfall where inflation runs below 2% to be offset by periods where inflation runs “moderately above 2%.” This revamp is intended to address the “reality of a quite difficult macroeconomic context of low interest rates, low inflation, relatively low productivity and slow growth.” Powell went on to say that “we've got to work to find every scrap of leverage in helping stabilize the economy.” With the Fed's preferred measure of inflation (core Personal Consumption Expenditure or core PCE) consistently falling short of the Fed's 2% target, the futures market doesn't expect the Fed to raise its target range for federal funds from the current 0% to 0.25% range until late 2024. Former Fed Chief Ben Bernanke opined that this strategic shift “will increase the accommodative power of policy” with “markets expecting a longer period of easier policy that will increase the amount of effective stimulus.”

With interest rates essentially pegged at zero for the foreseeable future and the Fed's newfound intention to ignite moderately higher inflation, investments such as dividend-hiking blue-chips and real estate, asset classes that have performed historically well as hedges to inflation, should continue to receive additional favor. Indeed, financial markets in general are likely to be buoyed by the implicit expansion of the so-called "Fed put", in which the U.S. central bank is seen as rescuing the economy and markets during periods of distress. Bond investors may have the most to lose and big borrowers the most to win as this new Fed policy takes shape.

Speaking of big borrowers, the federal deficit was running at a pace of approximately $1 trillion even before the pandemic and is now projected to total $3.7 trillion for this fiscal year. With the ability to borrow at under 1% for all but the longest maturities, the burgeoning U.S. debt load is much easier to finance and makes Uncle Sam the biggest beneficiary of all. U.S. debt as a percentage of GDP is expected to surpass 100% in the coming fiscal year for the first full year since 1946, when the U.S. debt level exceeded economic output by 6% after years of financing military operations to help end World War II.

Expectations are mounting for a November sweep of the White House and both houses of Congress by Joe Biden and the Democrats that is widely expected to usher in higher income, estate and capital gains taxes in the years ahead. Indeed, a prominent election forecasting model now predicts Vice President Biden's odds of winning the election and popular vote at 82.8% and 92.5% respectively. With the stock market hovering near all-time highs, it is worth pondering why the stock market seems unfazed by the prospects of higher taxes induced by a potential "blue wave."

We believe the answer may lie in the massive fiscal stimulus expected to be enacted by a Biden White House and supported by the House and Senate. The Federal Reserve has been telegraphing that the economy needs additional fiscal stimulus and that monetary policy alone is incapable of bringing unemployment back to previous low levels in the wake of the pandemic. To say nothing about the potential for additional coronavirus relief, the Biden campaign seems committed to massive infrastructure spending (only partially offset by higher taxes and requiring massive issuance of additional debt) which would be highly stimulative for jobs and the economy. Together with the Fed's historic shift, a Biden Presidency may usher in an era of big government previously unseen and give rise to a new "gov put" that dwarfs today's "Fed put." The caveat of course is that polls are famously wrong and elections have the propensity to surprise.

While we are concerned about the long-term implications of big government and the Japan-like balance sheet (230% debt to GDP) we seem destined to pursue, the short-term implications may benefit the stock market. Well-regarded and oft-quoted academic studies illustrate how economic growth begins to slow markedly once debt to GDP ratios surpass 90%. With growth more challenged, interest rates are likely to remain subdued for an even longer period; and companies that can deliver both earnings and dividend growth, hallmarks of the Osher Van de Voorde investment discipline, are more scarce and valuable to own.

For perspective, chief market strategist Keith Lerner at SunTrust recently cited the Rule of 72 (divide 72 by the assumed rate of return) to calculate how long it will take for an investment to double given a fixed annual rate of return. Using a 5% annualized return, it takes equity investors about 14 years to double their money. At today's paltry rates on 10-year Treasuries, it would take 100 years to double one's investment. And it would take 900 years to double one's investment in cash at current money market rates! With returns on bonds and cash so dismally low and the Fed on a path to ignite higher inflation, these asset classes at best offer investors a means to lose money safely.

With current earnings expectations for 2021 at $166.21, the S&P 500 currently trades at 21x forward earnings. This may seem historically rich, but the very low level of interest rates leads us to believe that the propensity will continue for investors to buy the dips. As a source of dry powder for stocks, there remains over $4 trillion on the sidelines in money market funds and trillions more earning next-to-nothing in bonds. With the Fed's recent paradigm shift and rising potential for a blue wave sweep, the government put may make investors even more confident to buy stocks when the markets go through inevitable bouts of volatility, volatility that we see increasing as government-induced asset inflation leads to increasing odds for speculative pricing.