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Why Was This The Time For A Defensive Shift?

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Many times we have written how the stock market cannot stand uncertainty, and it is usually a financial or an economic circumstance that is the source of the problem. This time, however, it is the very foundation of our governmental institutions that are at risk. The political climate is so toxic and partisan that the electoral process itself is in jeopardy. Both parties have assembled armies of lawyers to contest every phase and aspect of voting. There are predictions that a winner may not be known for weeks or months after November 3. And even when a winner is declared there are threats of violence and social unrest to follow. One of the great strengths of the United States of America has been its stability and its history of smooth transitions of power. If this chaotic prediction comes to pass, it will certainly unnerve the markets which was the rationale for lowering our risk exposure at this time.

It is ironic that the economy and the markets are not the problem. In fact, the economic outlook is quite favorable. Most indicators are showing better than expected recoveries from the pandemic crash. Consumer Sentiment is a good example: "The University of Michigan's consumer sentiment for the US was revised higher to 80.4 in September of 2020 from a preliminary of 78.9. It remains the highest reading since March, mainly due to a more optimistic outlook for the national economy (75.6 vs 68.5 in August)." *—Trading Economics (Univ of Michigan study)*

The employment numbers have also been very encouraging. According to the Bureau of Labor Statistics (BLS) the unemployment rate dropped in September to 7.9%. The rate was not expected to fall below 10% before the end of the year. This occurred in spite of several large states remaining in partial pandemic lockdowns (California, New York, New Jersey, Illinois and others). Over 11 million nonfarm jobs were added from April through September 2020. Employment is the key to recovery, and the rapid development of vaccines is showing great promise that will enable many more people to go back to work. *— Bureau of Labor Statistics, US Dept of Labor*

The Federal Reserve Board (Fed) has a very optimistic view of U.S. third quarter Gross Domestic Product. Investopedia defines "Gross Domestic Product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. GDP provides an economic snapshot of a country used to estimate the size of an economy and growth rate." The Atlanta Fed estimates that the third quarter GDP will have a record annualized rate of 34%. The Fed as a whole predicts GDP will achieve a 4% growth rate for year 2021 (to put that into historical perspective, the last time that the U.S. had a 4% growth rate was the year 2000). *— FederalReserve.gov*

Clearly the economy did not warrant a defensive move and, if the electoral process is restored to the point that confidence returns to the American people, then we will gladly reverse our position. At this point we have only taken 25% off of the table which can be put back quickly. However, if events become more chaotic then we are prepared to remove even more of our exposure to the uncertainty and market volatility.

What Happens Once We Get Through the Election Process?

A surprising conclusion that we have arrived at is: once we have a settled election, the market and economy should benefit for a period

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of time regardless of who wins. The power of the recovery and the favorable tax and regulation policies already in place along with massive liquidity supplied by the Fed and the stimulus from the government should propel prosperity well into 2021. That is not to say that really bad actions or “black swan” type events couldn’t derail it, but all that momentum and liquidity should last at least through the first quarter or half of next year. We are not saying that each candidate and party are anything alike, and we fully acknowledge that once in power whoever wins will shape governmental policies in accord with his own philosophy.

If Donald Trump is victorious and a vaccine is ready in early 2021, then we should experience a continuation of the economy that existed from the time of his inauguration up through the time that Covid-19 attacked America. The President’s strategy combined reduced taxes and reduced regulation along with a business-friendly environment. His strategy was very effective and produced record employment (including minorities), a booming economy and a record-setting stock market. In a second term, he would likely double-down on his approach and favorable results should follow.

If Joe Biden is victorious, the approach would be very different. Vice-President Biden has said that if elected, he will raise taxes by about $4 trillion over a 10-year period. The heaviest burden is expected to fall on the wealthy and corporations. The corporate tax rate will increase from 21% up to 28%. Increased cost due to taxation makes it more difficult for U.S. companies to compete globally. The Biden administration will increase regulation which is another burden on corporate competitiveness. The Biden approach could be considered business unfriendly; however his Wall Street supporters say that increased government spending will offset the negative tax and regulation effects. Whether that is correct or not will have to be borne out if he is elected.

It is evident that America is facing two radically different scenarios depending upon the ultimate outcome of the election. But, there are three distinct time frames that we must consider before determining the long-term strategy for dealing with the consequences of the election.

First — the period of time that it will take to get through the electoral process and the ugliness of a disputed election, legally and maybe violently. This is the reason we have taken the first defensive step and the reason we are prepared to do more if it seems necessary.

Second — the time after the election has been finalized and the time before the winner’s policies start to go into effect. This should be a lower volatility period and one that enjoys the benefits of the pent-up economic strengths from the 2020 recovery efforts.

Third — the time when the victor’s policies begin to go into effect. Then we will finally be able to determine if the outcome of the election is favorable or not.

OUTLOOK

This outlook will be more brief than normal because this entire version of this newsletter is really a comment on our view of coming events. In summary of 2020 through the present, the recovery since the March 23 low due to the pandemic shutdown has been dramatic from both an economic and a market standpoint.

We will be able to see what the future holds once we get through the electoral process and the election itself. The present economy is in good shape and two further developments are potential contributors.

- First, corporate earnings are coming in stronger than expected and fourth quarter projections are being raised.
- Second, it looks like negotiations regarding a stimulus package are back on which would be beneficial for both the economy and the market.

To conclude: We will be watching the electoral process to see if we need to become more defensive, stay on hold, or unwind our defensive position and return to a normal investment stance.