Volatility

We have been talking about elevated volatility for the last 21 months. However, back in October, 2018 we did not imagine that we would see a bear market, a bull market, a bear market, and a bull market play out, all within a 21-month time frame. Two of these would have been enough. Four is a lot within less than two years. And today, we suggest the conditions have not changed sufficiently to expect less volatility going forward. If anything, it could be worse.

There are several factors that are influencing day-to-day market action as well as the quick transitions from bull to bear to bull markets:

- Pandemic statistics
- Societal concerns
- Economic recovery
- Fiscal (and monetary) stimulus
- Corporate profits
- Interest rates
- Trading strategies

Pandemic statistics are constantly modeled, remodeled and debated. There are two clear facts, in our opinion. Government agencies are determined to control social and business activities based on their interpretation of some set of statistics. Which restrictions have been in place in which locations and which may be lifted are not the question. The simple fact is that future government agency policy changes are unknowable. Uncertainty as to future statistics and agency policies creates volatility in markets.

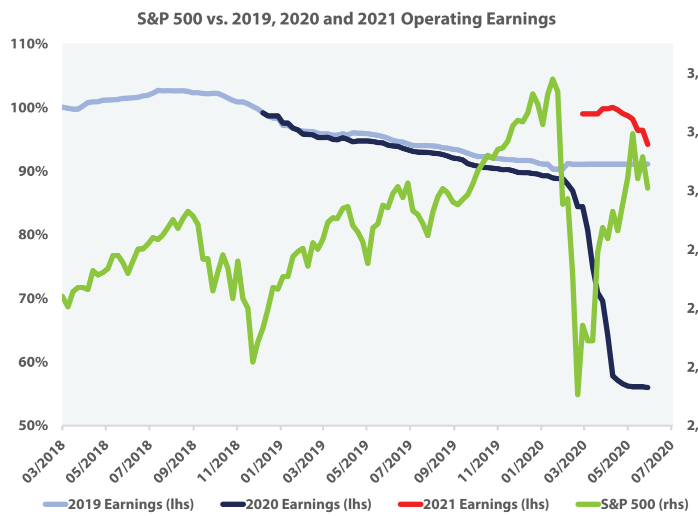
Societal concerns have gripped the nation. Civil unrest and protests nationwide have highlighted growing discord within our population, and with elections looming in November, the heightened rhetoric and fearmongering are unlikely to wane soon.

Economic recovery has started with a bang from the extremely depressed levels of April. Consumer spending, miles driven, housing activity and capital goods orders have all rebounded, yet remain well below levels of one year ago. We expect a continued rebound but a leveling off to a more gradual improvement. Given uncertainty for government restrictions, economic recovery will likely be uneven and subdued in the leveling off period.

Fiscal (and monetary) stimulus has been unprecedented. Fiscal measures enacted have equated to 13% of GDP and monetary measures amount to 27%. Additional fiscal stimulus is estimated at 9%. A combined total stimulus of 49% of GDP has never been attempted before, and the scope of this experiment leads to more questions than answers. Is the stimulus getting where it needs to go? What will happen when enhanced unemployment benefits expire? What will be the impact of low interest rates and will the United States Treasury eventually run into a less accommodating bond market? If the economy languishes, the fiscal measures will become a fond memory and will prompt calls for more. At some point, borrowing and spending with little result will negatively impact the value of our currency and we will find ourselves in an environment with slow growth and high inflation. If the economy gains traction and accelerates rapidly, there is a good chance we would see inflation develop.

The common element here is inflation in either scenario. We are likely to first experience a period of deflation as the economy works thru the impacts of the recession. Afterwards, rising inflation is a good probability. We have said before that Japan has managed to push the envelope with large deficits and accommodating central bank policies. Our economy is more dynamic with better demographics so it is safe to assume that our envelope is smaller than Japan's.

Corporate profits are the lifeblood of stock market valuations. We have apologized for including this chart several times over the last 21 months so we won't apologize again. You can see the persistent decline in 2019 earnings and 2020 earnings…until March. Of course, 2020 earnings "fell off the cliff" as the impact of government mandated closures was realized. 2021 earnings forecasts have declined by 17% from January and now (if realized) would result in a 3% improvement over 2019 earnings. Just throw away 2020. The problem is there is a lot of time between now and 2021 becoming a reality. The first five factors listed above will have a direct impact on future earnings. We track earnings forecasts on a week-to-week basis. Expectations for 2020 are at a new low, with the average for 540 large-cap stocks down by 1.9% over the last 4 weeks. Analysts currently estimate a 30% decline for 2020 earnings vs. 2019.



Interest rates will remain low through 2021; at least that is the message from our central bank. Will it still be appropriate six months from now? Will the central bank be able to manage stagflation or a hot economy with rising inflation? Again, there is much uncertainty as to where we will be 6 to 18 months out. We know a few things for certain. Corporate debt outstanding at the beginning of the year was near an all-time high relative to the size of our economy. And the metric has surely exploded given the pandemic-induced scramble to add cash to the till by borrowing more over the last three months. Quality downgrades have accelerated and corporate bankruptcies are on the rise. We do not expect to see a steadily improving trend in credit quality for some time. For now, we are comfortable with our short term, high quality portfolio. We are sacrificing some income, but this position protects from rising credit risks and affords flexibility to take advantage of higher rates when they develop.

Trading strategies that purport to protect portfolio values in down markets and participate in rising markets have gained popularity over the last 2 years. Managers that follow these strategies are automatic sellers during declines and buyers during rallies – in the hopes of being far enough ahead of a developing trend as to 'beat the market'. Time will tell. What we do know is that these strategies tend to accentuate the extent and the frequency of bull and bear trends.

In conclusion, uncertainties are high yet the stock market has managed to recover to near its February highs. The stock market has a tendency to anticipate future trends – which is why it is one factor used to compile the leading economic indicator data. Maybe the stock market's recovery this quarter is suggesting a relatively quick resolution to current economic constraints and healthcare-based government policies. If it is correct we will look back and say the market was right once again. However, as we look back we will likely have traversed a volatile path.

Your AAMA Team