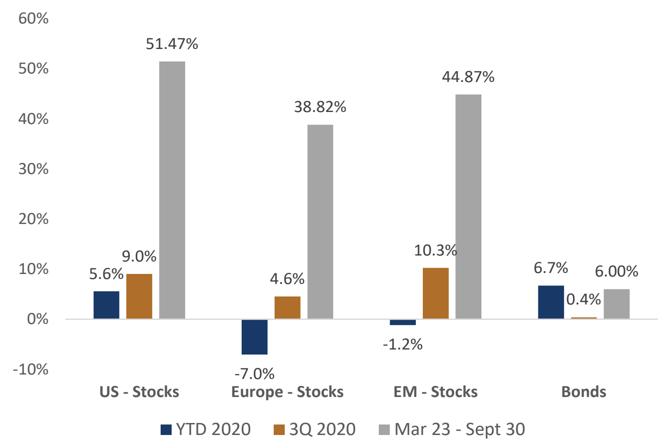
A Blue Wave?

*"If you don't vote, you lose the right to complain"– **George Carlin***

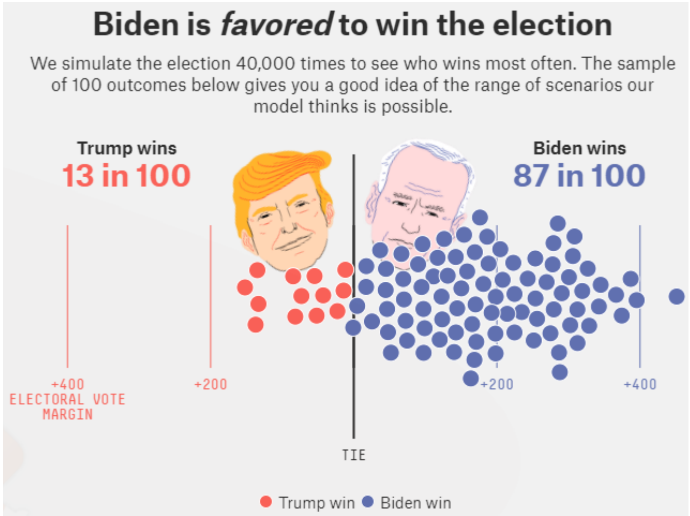
The COVID-19 crisis has resulted in the deepest downturn in global economic activity in the post-war era, but almost certainly the shortest recession. US stocks have rebounded over 50% since the March 23rd lows and the S&P 500 is now up over 5% through three quarters. Historically, the 4th quarter is the strongest quarter of the year, but there are some potential headwinds going into year-end. The largest concerns that we are hearing from clients surround the election and what it will mean for their investments.



Elections

The good news is that there are only two more weeks until the election. The bad news is that those two weeks will probably get uglier and nastier in what has been a very divisive election year. We keep a close eye on the polls but point out that polls have led investors astray in the past. Some argue that this time is different because most voters have already decided how they will vote versus 2016, when many voters were undecided at this point. A blue or red presidential result will most certainly have implications for policies over the next four years, but this year's Senate race will probably be the most impactful for long term legislation. It is Congress that makes the laws, the President just signs them. As of today (10/19/20), FiveThirtyEight, one of the more successful political forecasters, has the probability of a Biden victory at 87% and a Democratic Senate at 73%. We have had many conversations with clients about what this means, with most investors being very worried about markets. However, the markets seem to be taking a "blue wave" (Democratic President, Congress & Senate) in stride and are rallying on the prospects, but why?

1. The ultimate stimulus package will be massive.
2. There is the potential for a large infrastructure bill.
3. Low interest rates and the potential for more Fed stimulus.



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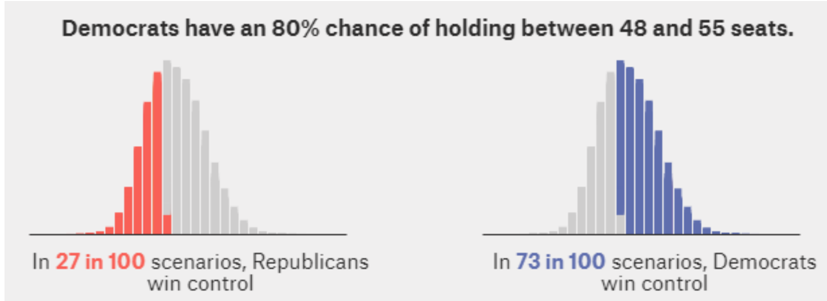
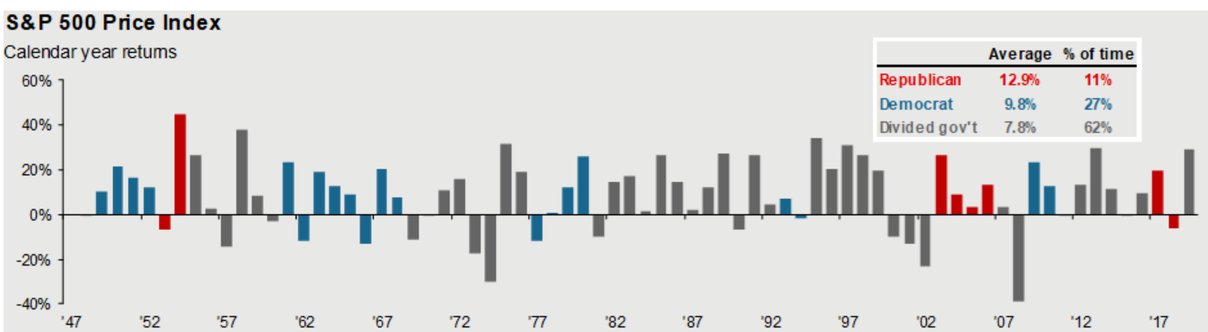
At the end of the day, the market wants stimulus, growth, and low rates, and that is most likely what we will be getting for the foreseeable future. But how will we pay for it? Will taxes go up substantially? If you study the Biden tax plan, the largest tax increases are on large corporations, the same corporations that received the bulk of the tax cuts in 2017. Taxes will go up for individuals, but many of the individual deductions (state & local taxes) that were eliminated may come back into play. Long term, all of this is very problematic for the US deficit, but short term the outlook is very stimulative.



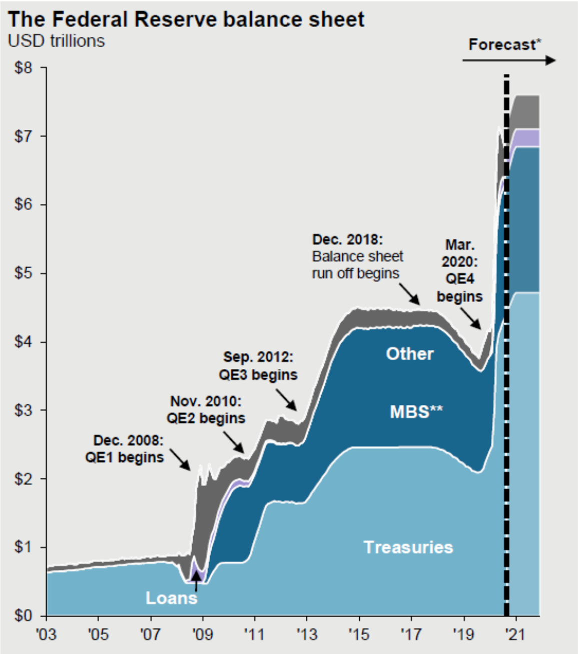
We ran some numbers on election outcomes and they are quite surprising. Since 1990, a blue wave has produced the highest annualized returns for the Dow of any regime, returning 15.5% annually. A Democratic president and a split Congress returned 10.4% annually, not bad. When we study the numbers, a couple of things jump out at us. The blue waves of the last 30 years were from 1993-1994 and from 2009-2010. 2009 marked the end of the financial crisis and the beginning of a new bull market with a dramatic market snap back. Can we thank the Democratic blue wave or was it just the luck of the timing? If we change the time-period and look at results dating back to 1947, it looks different. A Republican regime (12.9%/year) outperforms all others, nevertheless a Democratic regime is respectable at almost double digits (9.8%/year). What does all this tell us? Not much. We all have our biases, but the markets are driven by many different factors and politics is probably not the most important one. Political parties tend to get too much blame and/or credit for the direction of the market.

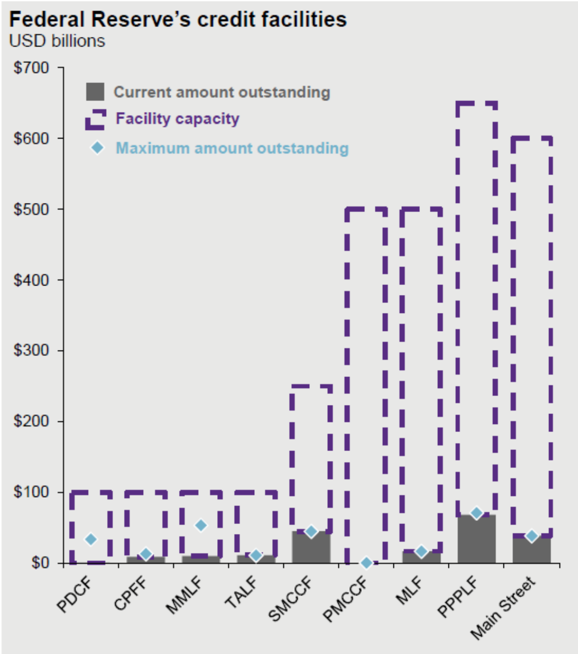
DJIA Performance

When U.S. Government Has A:	% Gain/ Annum	% of Time
Democratic President, Republican Congress	15.06	26.08
Democratic President, Split Congress	10.37	13.01
Democratic President, Democratic Congress	15.49	13.03
Republican President, Republican Congress	10.32	19.54
Republican President, Split Congress	-2.21	12.03
Republican President, Democratic Congress	-5.20	16.42



Perhaps the most important factor for markets is The Federal Reserve. In our opinion the Fed trumps (no pun intended) the election. By pushing interest rates to unprecedented lows, there has been no bigger catalyst to stocks and bonds than the Fed. In addition, the Fed has created a number of credit facilities during COVID for various areas of the economy, including small business, nonprofits and municipalities. As shown below, most of these facilities have barely been tapped and some still have full capacity, meaning the Fed has a massive amount of fire power should the economy worsen. The Fed believes the downside economic risks vastly outweigh the risks of too much monetary stimulus, and it is not ready to consider any sort of tapering in the foreseeable future. We believe the Fed is waiting for the labor market to fully recover before reducing their stimulative efforts.

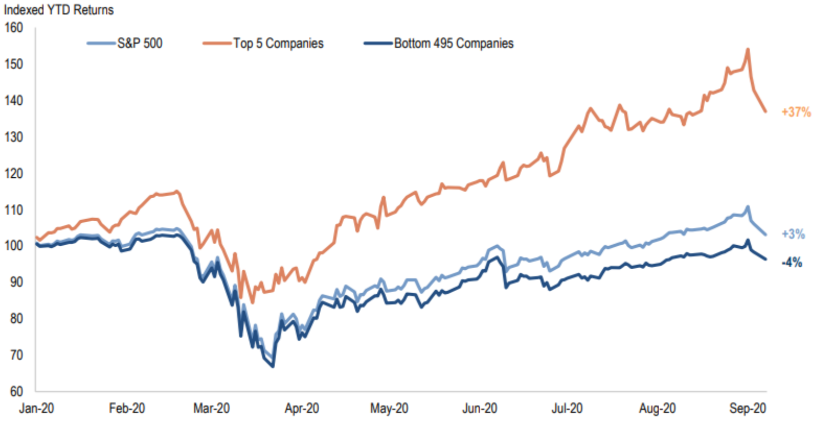




Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.

Security Selection

Although the recovery from March has been impressive, it has not been uniform. There have been very clear winners and losers because of COVID. Today the top 5 companies (Apple, Microsoft, Amazon, Facebook & Google) make up over 25% of the S&P 500, and, as can be seen from this chart, those companies have provided a majority of the returns for the market through September. In aggregate, those five stocks are up 37%. Over the past couple of years, we have been saying that we may be entering a stock picker's market. We do not see this year as an anomaly and expect that trend to continue. One of the things



Source: Bloomberg and GSAM as of September 8, 2020.

that COVID has done is accelerate many of the structural changes that were already taking in place in our economy. A number of those stocks have had extraordinary returns this year and we believe that this trend will continue. That said, once there is a vaccine, we may see a rotation back into those stocks that have lagged during this time-period. We believe it is important to stay flexible in an environment like this because the world will return to normal and COVID will be a memory at some point; we hope sooner rather than later. Therefore, we believe that security selection will be of the utmost importance: discerning which companies will be able to survive COVID and which will be able to continue to take advantage of the structural shifts in society. As a firm, we have spent significant time and resources on our individual stock portfolios and our shopping list of potential opportunities as the world begins to normalize. We have also been very pleased with the performance of our concentrated money managers in this environment. Focusing on technology and communication stocks and avoiding energy and leisure has been the recipe for success in 2020.

Conclusion

First and foremost, we hope everyone is safe and healthy and has been able to adapt to the new “normal” as best as possible. It is our opinion that the coordination between fiscal and monetary policy will still largely determine the success of the markets, but this depends on solving the global health crisis and providing effective crisis relief first. No one knows how long the virus will be with us and how long it will impact the global economy long-term, but recent medical advancements in testing and therapeutics are very encouraging. We believe this could aid in allowing our return to more “normal” daily life sooner rather than later. Specifically, Abbott Labs announced a $5, 15-minute COVID Antigen test that should be available in large scale this Fall. We see faster, reliable testing mechanisms as an important way for our economy to function while we wait for a more permanent solution in a vaccine.

As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management

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