POLITICS AND UNCERTAINTY DRIVE SENTIMENT BUT THEMARKET MOVES AHEAD

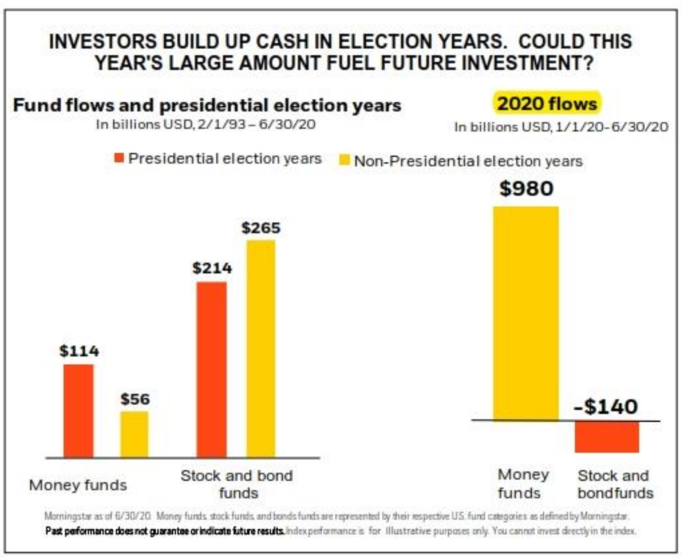
Equity markets continue to impress. The S&P 500 rallied by 8.9% in the quarter even after surrendering about -3.8% in the month of September. By the end of August stocks had gotten extremely overbought with parts of the market in bubble territory. The mild correction we are experiencing currently is very typical and does not necessarily signal the end of the stock market recovery.

Tell us if you've heard this before but growth stock trounced value stocks during the quarter. Last quarter we wrote that long-term laggards need to do well to sustain the market rally. Value, small caps, and international stocks did do well in the quarter, but they all fell far short of the double-digit gains in growth and momentum.

The likely catalyst for growth to relinquish leadership is continued economic improvement as the world economy works through the slowdown caused by the pandemic. The stock market seems to be hinting that this scenario will play out over the next several quarters as evidenced by the double-digit gain by emerging market stocks. While never fast enough, progress is being made on battling Covid-19. Several vaccines are in late stage clinical trials, we have improved therapeutics, and despites the virus's persistency, hospitalizations and the death rate are down significantly from early 2020.

All of which is good news for the President now that he has tested positive for Covid-19. Not surprisingly the stock market paused when the news came out on Friday, October 2nd. The good news is that the reaction was mild considering the uncertainty this development produces.

The election will dominate the news cycle in the fourth quarter and be a focus of investors. The data is agnostic regarding politics and this benign attitude appears in place today. A victory by President Trump will continue policies like lower taxes and less regulation that are market friendly. Surprisingly, the market is sustaining its strong recovery even though Mr. Biden maintains a healthy led in the polls. Perhaps it is because the market is expecting a repeat of 2016 where the polls failed to capture the full level of support for President Trump. Or, as UBS economists have written, perhaps Mr. Biden's spending plans on infrastructure, healthcare and education could add as much as 1% to real US GDP in 2021 neutralizing a large part of his expected tax increases.



We believe the biggest risk is the lack of a new fiscal spending package from Congress. Another risk is a chaotic election that is contested, and perhaps, ultimately decided by the courts. That scenario would probably inject volatility into the stock market. On the positive side, these risks seem to be fully appreciated by investors. While there are usually greater inflows into money market funds during presidential election years, 2020 has seen historically large flows (SEE CHART) of nearly $1 trillion due to the combined effect of the election and coronavirus pandemic providing plenty of dry power to fuel further stock gains.

Longer term it is best to ignore the election and concentrate on the Federal Reserve (Fed). Chairman Powell has boosted its monetary response to the pandemic by projecting no interest rate increases until at least the end of 2023 and indicating it would not tighten policy until inflation had been higher than 2% "for some time". Until investors lose the support of the Fed the path of least resistant is most likely higher. With the market returning to near the pre-pandemic levels it is a good time to review your allocation relative to your comfort for risk. Please feel free to call us if you would like to discuss this further.

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