Santa Fe Advisors

October 14, 2020

Strange Days

In recent days I have struggled to settle on a theme for this commentary, particularly how I might synthesize into a brief note the important takeaways from monumental events that have converged in 2020. It occurred to me that this month marks the 50th anniversary of the conviction and sentencing of the late Doors singer Jim Morrison for lewd behavior at a concert the previous year in Miami. Immediately my thoughts went to the Florida courts, and the Doors song Strange Days, of their eponymously titled second album. At least, I have my title.

This year we have experienced a global pandemic, the swiftest stock bear market in US history (the one day crash of '87 excepted), an economic shutdown causing the second deepest recession in US history, riots in major cities, and an expansion of national debt to an all-time record. Additionally, we have a presidential election at a time when our country is divided by partisan vitriol and incivility probably exceeding that at any time since the Civil War. To boot, some of us have multiple teens in the house doing school online.

Yet, the US and global economies have rapidly rebounded, with service sectors in particular responding with great resilience to the new reality and future unknowns. Many companies and workers have adapted to working remotely. While company profits have not yet reached pre-COVID levels, they have rebounded rapidly and, if this continues, are on pace to hit records sometime in 2021. And the US stock market has enjoyed a remarkable rebound, rallying 60% from its March 23rd low, even surpassing the pre-COVID record high.

Strange days have indeed found us.

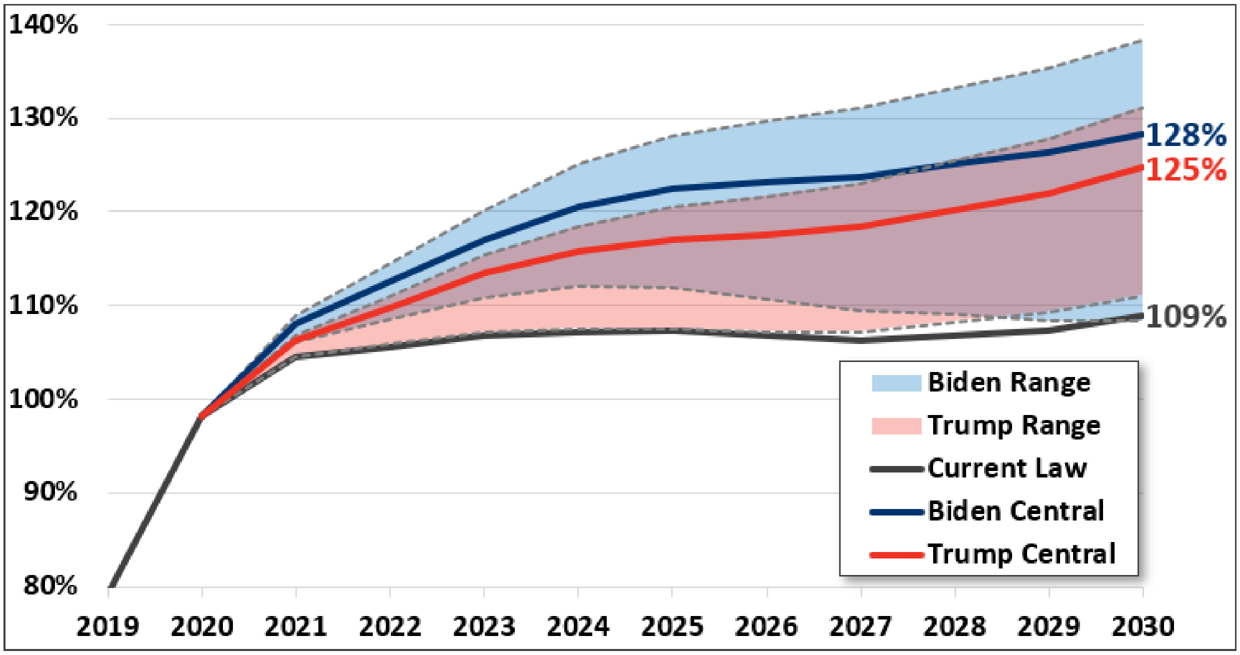
The Election

As always, we hear the usual blather from opposing directions that this is the most important election of our lifetime. Whether or not this is true, it is our responsibility to analyze the likely economic and market consequences of either election outcome (as well as the risk of a contested election). And objectively, the Democratic and Republican parties and respective economic policy proposals have diverged starkly, and are almost certainly as different as they have been in all of our lifetimes, and possibly as different as ever in our country's history.

This requires that we take views, as dispassionately as possible and without regard to anyone's political sensitivities. We are, after all, fiduciaries. Above all, it is critical that we do our best to avoid the human tendency to conduct economic and market analysis through the lens of our personal political preferences… indeed no small task.

Despite the differences between the Democratic and Republican platforms we voters have to choose from, there are at least two major commonalities: both platforms offer plenty to criticize, and both parties are currently addicted to debt and deficit spending. Graph 1 shows US public debt/GDP projections (from the non-partisan Committee for a Responsible Federal Budget) under both Biden and Trump administrations.

Graph 1



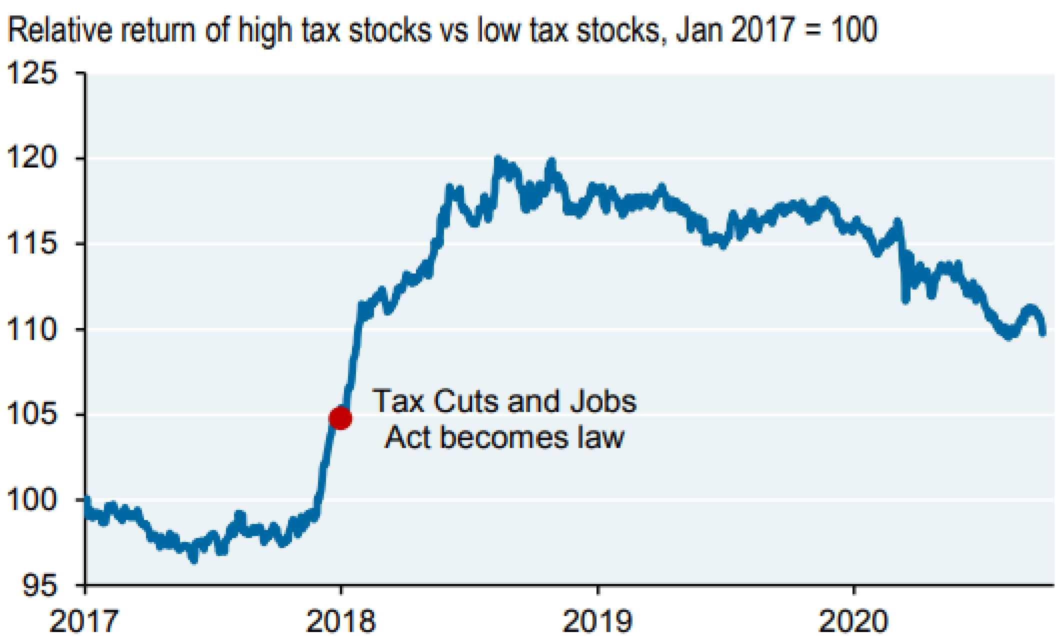
Those who fear the economic and market impact of a Biden administration can rightly point to the staggering cost that proposals such as the public healthcare option and his climate proposals would entail. While actual costs (should these policies be enacted) cannot be known with any certainty, even conservative estimates are in the tens of trillions of dollars over just a decade, and these programs would have to be funded with far higher taxes, and/or more debt spending. Additionally, Biden has vowed to raise the US corporate tax rate from 21% to 28%, which would decrease the competitiveness of the US corporate sector, and the attractiveness of the US as a destination for capital. These are material economic and market risks.

Critics of the Trump administration's policy proposals can question the wisdom of another promised income tax cut, particularly at a time of a rebounding economy and trillion dollar deficits stretching to the horizon. While high taxes suppress economic activity, increasingly lower taxes offer decreasing stimulative effect, while presenting the certainty of higher deficits. While this proposal may offer short-term political gain for the candidate, the bill will come due down the road. Additionally, a second Trump administration represents a risk of continued trade protectionism, a potential continued decline in international trade flows, and less competitive industries....for the dubious benefit of protecting American manufacturers, with the American consumer footing much of the bill.

One of the most important things we can do (certainly when managing portfolios, but perhaps also in life) is to regularly ask ourselves how we might be wrong. Those who cannot envision a bullish market environment under a Biden administration should consider that (for better or worse) the stock market rally has been driven to a great extent by free money and "fiscal stimulus" (i.e. deficit spending), and in the event of a Democratic sweep of the executive and fiscal branches, the chance of greater stimulus is much higher. Those who cannot see a second Trump administration as being bullish for markets should consider that a business friendly regulatory environment and tax regime matter, as was demonstrated after the 2016 election.

Finally, as risk managers we have to take a view on what markets are actually expecting, as surprises are what move markets…at least in the short run. As of this writing, gambling lines suggest that the odds of a Biden victory are roughly 2-1. While this makes him a heavy favorite, markets were pricing a far greater 7-1 probability of a Hillary Clinton win in 2016. Consequently, there might be less potential for post-election volatility than four years ago, particularly in the event of a Trump win, as the degree of surprise would be less. Graph 2 shows that US companies with higher tax burdens (which significantly outperformed before and after the Trump tax cut) have lagged peers in recent months, as Biden has risen in the polls. This suggests that at least some of market fears about a corporate tax rate hike have already been priced in.

Graph 2



Source: JPM, BBG

Our Current Portfolio Positioning

Even if we knew the election outcome, or when a COVID vaccine will be widely available for that matter, we still would not know with a high degree of confidence what markets would do. Amidst all the current uncertainty, perhaps the most important bullish factor is the extraordinary availability of almost free money, courtesy of the Federal Reserve. Money has to go somewhere, and much of it is flowing into risky assets. Perhaps the most bearish near-term risk is the fact that stocks are terribly expensive – the S&P 500 currently trades at a Price/Earnings ratio almost 50% higher that its long-term average. One day the US will have another debt crisis, but in the near-term market direction will likely be dominated by these two factors. Given the uncertainty, we are currently positioned with a modest underweight position in stocks and are considering the advisability of a further risk trim if the market rally continues.

Thank you for your trust, and please do not hesitate to contact an SFA team member with any questions, or to review the appropriateness of your current asset allocation.

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Appendix

Source: Doors album Strange Days, Elektra Records, 1967

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