TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
September 2020

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Stock Market Development

The presidential election is dominating the headlines given the polarized political environment. At the beginning of September, the market started to react to policy proposals, and election uncertainties which is typical two months prior to the elections. Long term, however, fundamental factors, such as economic growth, rising corporate profits, and interest rate conditions, will determine the market's direction. We do not expect the election results to be good or bad for the markets. We expect market fluctuation to continue after the election if the result is disputed, or inconclusive, and, also to a lesser degree, during the transition from election anxiety to the focus on the economic recovery.

Historic data since WWII shows that the average market return after a Republican win was 8.5%, and when the incumbent Republican party lost to the Democratic party, 14.1%.

By March 23, 2020, the S&P 500 Index had fallen 35% from an all-time high as a result of the pandemic induced sell-off. Since then the index rallied 61% by September 2nd, and then corrected 10% between September 2nd and September 20th.

The market outlook for the rest of 2020 will depend on whether the U.S. Congress will extend the benefits package to people who were very affected by the pandemic, the outcome of the Presidential election, and the availability of an effective vaccine.

Fixed Income Markets

Large-cap corporate issuers, with credit ratings of BBB and above in the cable/telecommunications, defense, regulated utilities, and consumer staples sectors, look undervalued. However, despite the Fed injecting liquidity into the markets, corporate earnings are expected to fall due to the 50% plunge in oil prices, and the economic shut-down which affected industries like travel, retail, restaurants, and energy in particular, increasing the risk of debt being downgraded. Warnings about potential downgrades cover at least $2.7 trillion of corporate bonds. The 10-year treasury yield declined from 1.9% at the beginning of the year to 0.7%. The Fed's pandemic response of cutting interest rates to almost zero, and resuming their crises-era bond buying program, led to a +22% bond performance in the iShares 20+ Treasury Bond ETF. We do not see any performance potential in treasuries at this point. Given the strong market rally across most corporate bond sectors, we recommend focusing on relative value opportunities, and reducing cyclical exposures. We currently prefer high quality investment-grade corporates which may provide attractive risk-adjusted returns across a range of recovery scenarios. There are also opportunities in select financials, including banks, as well as non-cyclical BB rated high-yield bonds. At the sector level, analysts are most optimistic on healthcare, energy and telecommunications services.

Economy

The economic recovery in Q3 has been supported in large part by the extra $600 a week paid to the unemployed. We expect real GDP to rebound 17% in Q3 after a nearly 33% contraction in Q2 which will leave growth deeply in negative territory of -6.4% for the year. Following an initial rebound after the lockdown eased, consumer spending is likely to be constrained by lasting damage to household finances, and by a massive dislocation of labor. 11.5 million jobs have yet to be recovered to reach pre-pandemic levels. Households remain cautious amid elevated uncertainty. The savings rate was the highest on record in the last 4 months as enhanced employment benefits more than replaced income relative to the pre-pandemic trend. The loss of benefits, unless congress acts soon, will have a sizeable impact on overall income growth.

Federal Reserve Policy

The Federal Reserve will keep interest rates lower for longer by adopting average inflation targeting, the new official policy approach. The new framework allows inflation to overshoot the target of 2%, which means the Fed allows the economy to run "hot" before applying the interest rate brakes. It de-emphasizes previous concerns that low unemployment can lead to excess inflation. The Fed expects sizeable downside risks in the medium term, and intends to maximize policy to include continued quantitative easing, and emergency lending in order to mitigate lasting damage triggered by sluggish productivity growth, worker-skill atrophy, and cascading bankruptcies.

Outlook

S&P 500 valuations look extreme, but have been distorted by recession-related earnings weakness, and the top-heavy technology sector. Absent tech, the index P/E stopped rising with the Federal Reserve's balance sheet in June. Still, 90% of its members offer an earnings yield above the current mid-grade corporate credit yield, the equity risk premium is in the 86th percentile of history since 1960, and half of the index trades with a price-to-book ratio below their five-year average. Excluding the tech sector, and big tech stocks in discretionary and telecommunications, the S&P 500 trades at, or below 20 since June. A scenario for moderate EPS recovery, as interest rates stay low over the next 12 months, may result in a fair value P/E of 23.9, implying non-tech valuations may have room to catch up while technology sags. The median P/E for the S&P 500 is 19.7, well below the market cap-weighted average of 28.

The momentum driven technology sector, having reached unprecedented highs, has begun to slow down at the beginning of September, and there are signs of a rotation into more defensive, dividend paying blue chips. We believe that large discrepancies between price and value will eventually be decided in favor of value.

The total decline in share buybacks in the S&P 500 Index were down 50% this year, with the exception of the technology sector, which had declined by 33%. Share buybacks have been the main driver for the market in recent years. We assume that this will reverse during the course of economic recovery when demand for capital preservation abates.

We will continue our course and stay invested as we have confidence in the long term potential of the market. We see attractive opportunities in the market on the whole, and in sectors that have not yet participated in the overall recovery of the market.

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