PCM
Peak Capital Management

Is Democracy at Risk?

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The rhetoric going into this Presidential election appears to be particularly acrimonious, but is just an example of recency bias that is easy to slip into. I have learned that taking a step back and understanding the narrative is important when performing a scenario analysis of the impact of an unknown outcome. It has been interesting to see how both sides of the political aisle this year are emphasizing to their base that Democracy is what is at risk if their side were to lose. Similar to a sporting event where both teams claim the officiating was not fair, that narrative is almost always wrong.

It was exactly two years ago, November 2018, when the title of the PCM Report was 'Purple Wave'. Democrats in that election took over control of the House while Republicans increased their majority in the Senate. The statistical chances of a Blue Wave or Red Wave, while slightly higher than two years ago, is again remote and we are likely to have a divided government, which tends to be a positive for the markets.

Forecasts are a lot like armpits — everybody has them, and most stink. Historically, about the only people who have avoided bad predictions are those who did not make any. Data is not the deodorant to stinky forecasts as evidenced by the Federal Reserve. No one doubts they have more data and analytics at their fingertips, yet their forecasts are continually shown to be as accurate as asking a Magic 8-Ball.

Presidential Cycle Stock Market Performance

Presidential Elections						
	Average Return in Election Year	Average Return 1 Year Post-Election	Average Return 2 Years Post-Election	Average Return 3 Years Post-Election	Average Return 4 Years Post-Election	Frequency of Positive Return in Election Year
All Presidential	7.15%	6.77%	3.46%	16.96%	7.15%	88.24%
Split Government	13.11%	4.11%	4.47%	15.80%	7.48%	100.00%
United Government	0.44%	9.77%	2.31%	18.27%	6.78%	75.00%
Democrat President	3.74%	14.28%	2.88%	16.21%	12.24%	71.43%
Republican President	9.53%	1.52%	3.86%	17.49%	2.62%	100.00%
Incumbent Wins	11.82%	11.65%	5.88%	15.18%	1.39%	100.00%
Incumbent Loses	2.99%	2.44%	1.30%	18.54%	13.62%	77.78%

Source: Haver as of October 21, 2020 Note: These results are since 1945.
All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary

When the election cycle pauses after November 3rd (sadly only for about 6 months), we will likely find that Democracy was not at risk, regardless of who prevailed. There are stark differences between the candidates and what conservatives, liberals, or moderates believe is best for the country, but our Founders did an amazing job of structuring our Republic in a way that is not fragile. That is something that all people who love our country should be grateful for.

Given the stark difference in economic policies between the candidates and parties, some have argued that the outcome of this election will dictate how investors do over the next four years. This also will likely be shown to be a false narrative. Tax hikes versus tax cuts, increased regulation versus more deregulation, healthcare, foreign trade, and energy policy will be different depending on who wins the election, but are not as certain to dictate market performance as some might believe.

Of concern for investors should be the reality that the stock market may do poorly regardless of the outcome of the election, based on current valuations. The Shiller PE ratio is at 32 today, the 2nd highest level in history, only trailing 1999. The well-known Buffet Indicator, market capitalization of the Wilshire 5000 divided by gross domestic product (GDP), is the highest in history at 152%. This metric formerly peaked at 136% in 2000 and just 105% in 2008. John Hussman and Jeremy Grantham, both highly respected analysts and asset managers, have models suggesting domestic stocks will have negative average annual returns over the next 10 years. I have not suddenly forgotten what I wrote about forecasting above, but the reality of current valuations cannot be ignored.

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Setting the glaring differences between the parties aside, there is an area of agreement that all investors are counting on — monetary policy and the Fed. Monetary policy is often among the strongest influences exerted by governmental policy on the markets, and both sides will want the Fed to do everything possible to stimulate economic growth and support the markets. The problem is that the Fed has used most of their ammunition at this point, and may have to resort to unproven and speculative policy actions to support growth. Like an athlete experimenting with steroids to boost performance, the long-term consequences can be far more harmful than the short-term benefits.

The risks associated with a contested election are likely overblown in my opinion, although if that occurs it will likely lead to much higher volatility. In the 2000 Presidential election, the result was unknown for about 6 weeks as the courts decided which Florida ballots were legitimate or disregarded (the infamous hanging chad). The markets fell by around 5% during the period when the country waiting for the results to be affirmed. It was not the uncertainty about the election that caused the Nasdaq to fall 68% and the S&P 500 45% over the next two years. It was unsustainable valuations that have only been exceeded by today's valuations. Those who fail to learn from the past . . .

Gusher Running Dry

S&P 500 SECTORS - YEARLY RETURNS (%)

Last Update: 30 September 2020

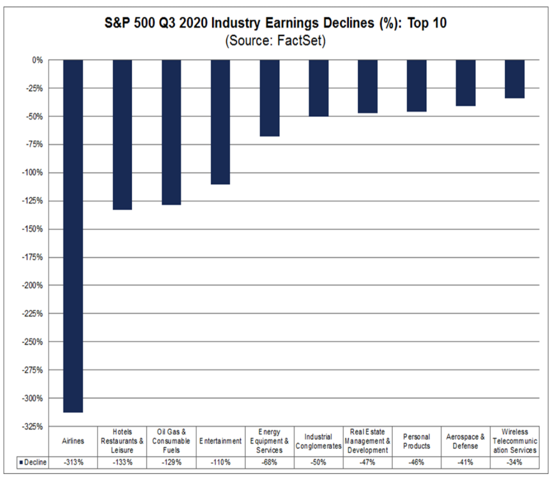
ETF	2017	2018	2019	2020(*)
S&P Information Technology **(XLK)**	+34.25	-1.66	+49.86	+28.60
S&P Consumer Discretionary **(XLY)**	+22.82	+1.59	+28.39	+18.28
S&P Healthcare **(XLV)**	+21.77	+6.28	+20.45	+4.95
US Large Caps **(SPY)**	+21.70	-4.56	+31.22	+5.58
S&P Industrials **(XLI)**	+23.97	-13.24	+29.09	-3.94
S&P Consumer Staples **(XLP)**	+12.98	-8.07	+27.43	+3.80
S&P Utilities **(XLU)**	+12.03	+3.92	+25.91	-5.56
S&P Real Estate **(XLRE)**	+10.69	-2.37	+28.69	-6.79
S&P Financials **(XLF)**	+22.00	-13.04	+31.87	-20.14
S&P Materials **(XLB)**	+24.00	-14.87	+24.13	+5.43
S&P Communication Services **(XLC)**	-	-	+31.05	+11.53
S&P Energy **(XLE)**	-0.90	-18.21	+11.73	-47.39

Source: Standard and Poor's Inc.

The resurgence of U.S. energy production over the last ten years had made energy one of the best sectors for investors. Energy produced strong dividend yield, as well as annual returns that were typically among the top of sector performance. Those days seem an eternity ago as COVID has impacted the energy sector nearly as much as the hospitality sector. Low demand for air travel and a forecasted warm winter suggest the oil market will struggle to return to 2019 levels for quite some time. No analysts are suggesting we could return to April prices when you literally could not give away oil as the futures market was negative, but it seems unlikely the headwinds for a recovery in oil prices will subside anytime soon.

- Oil demand in the 4th quarter is forecasted to be 90.2 million barrels per day. That is down 450,000 barrels from the 3rd quarter and lower by 9.5 million barrels from the 99.7 million barrels per day in 2019.
- Royal Dutch Shell has slashed their 2021 exploration budget by 40% as a result of weak oil prices, and U.S. production has fallen from 13.1 million barrels per day to just 10.7 million since January 2020.
- The energy sector is the only S&P sector with a negative trailing 3-month return, and by a wide margin is the worst performing sector in 2020 and the worst sector over the last 3 years.

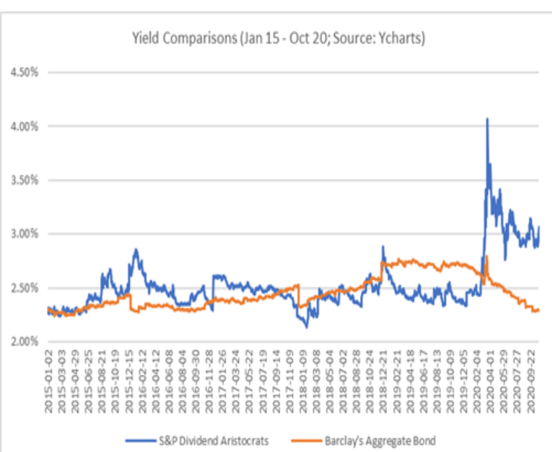
Earnings Surprise(ish)



Q3 earnings are being reported in full force. Earnings can produce bad news or negative results, and may be worse or not as bad as analysts anticipated. According to Factset, nine of eleven sectors in the S&P 500 index are reporting a year over year decline in earnings. Further, there are 63 industries represented in the S&P 500. 44 of 63 are reporting or are projected to report a year over year decline (Factset). The energy sector led the year over year declines, while airlines led the industry declines over the same time period.

- The chart to the left shows that airline industry Q3 earnings were down over 300% year over year.
- Wireless telecommunications services had the least decline in earnings at 34% (Factset).
- As of October 23, 2020, the percentage of S&P 500 companies outpacing earnings estimates are at near record levels (Factset).

Dividends vs. Bonds

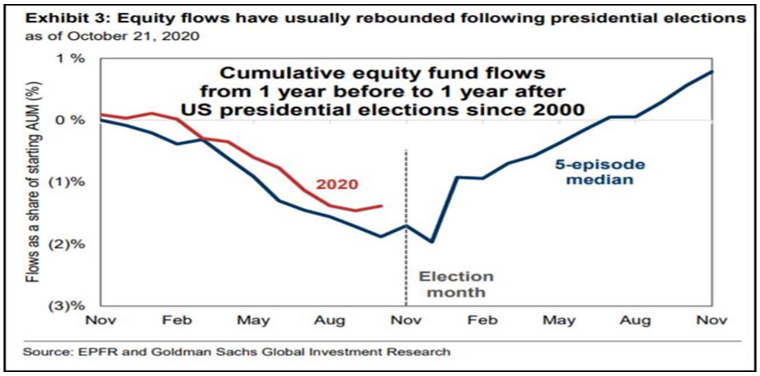


In previous commentaries we've highlighted the challenges that dividend-paying stocks have faced this year, particularly with declines in the energy and financial sectors, and value biased stocks overall. The chart to the left plots the dividend yield of both the S&P Dividend Aristocrats Index and the Barclay's Aggregate Bond Index on a daily basis going back to 2015. The S&P Dividend Aristocrats Index measures the performance of stocks in the U.S. that have a history of paying steady dividends, while the Barclay's Aggregate Bond Index measures the performance of investment-grade fixed income securities in the U.S.

- The current yield for dividend-paying stocks is roughly 3%, compared to a current yield of approximately 2.2% for investment-grade bonds. The spread of roughly 0.8% is at the highest level since 2015, as dividend-paying stocks have taken the brunt of the pandemic and bond yields have fallen for the year.
- On a risk-adjusted basis, picking up an additional 0.8% yield with dividend-paying stocks might not seem that attractive now. However, if the yield gap continues to widen, there will likely come a point where investors consider the added volatility of divided stocks worth the additional yield and begin rotating out of bonds.

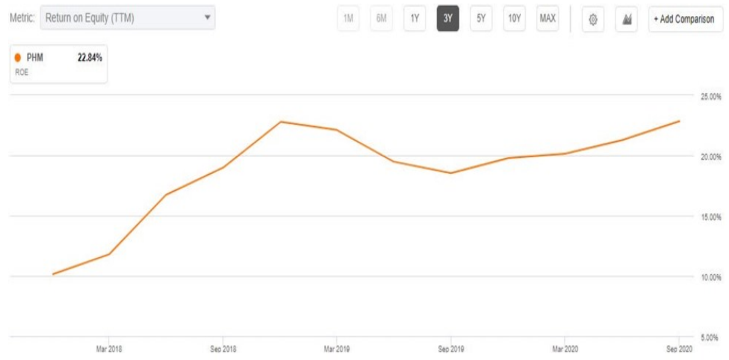
Macro View – Follow the Money

Tracking flows in and out of mutual funds and exchange traded funds can offer a window into retail and institutional sentiment. An industry leader in tracking flows, ICI, communicated that as of October 21st, equity mutual fund outflows were $15.8bb versus $4.6bb the week of September 23rd. On the contrary, bond mutual funds had inflows of $11.2bb the week of October 21st versus inflows of $5.9bb the week of September 23rd. Money market mutual fund values were relatively constant the month of October, at a total of $4.38bb the week of October 7th versus $4.35bb the week of October 21st. Exchange traded fund flows reflected the same rotation as mutual fund flows demonstrating $10.8bb in equity outflows the week of October 21st and $15.6bb in ETF bond inflows for the same week. This was a consistent trend the month of October. The chart below provides a graphic representation of fund flows leading up to the election, coupled with previous rebounding trends in fund flows post election.



Taking Stock – Homebuilding in Focus

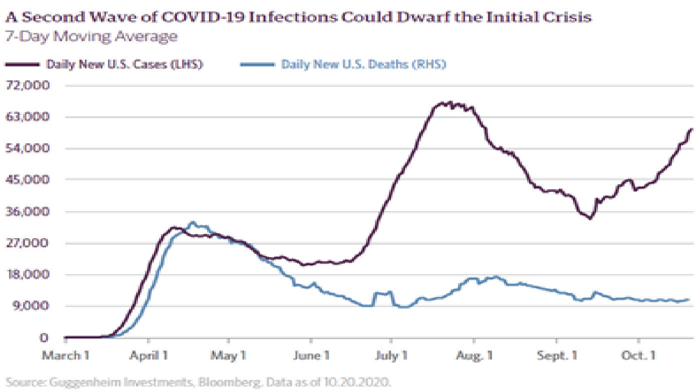
Homebuilders and residential real estate demand have been a surprise in the midst of global pandemic. The National Association of Home Builders (NAHB) maintains an index of builder confidence specific to newly built single family homes. The index is currently at a record level as of October 19th. Low interest rates are largely driving demand to such a large degree that labor, lumber, and building materials are becoming problematic and creating extended construction times (NAHB). The index results have played well in to the performance of homebuilding companies like Pulte Group (PHM). The chart below shows Pulte's return in equity over three years, at about 10% in 2018 while nearing 25% in October of 2020. Consistent with demand, Pulte has committed to increasing land acquisition and development to $843mm in Q3 with a total spend of $2.7bb for the fiscal year 2020 (Seeking Alpha).



Source: Seeking Alpha

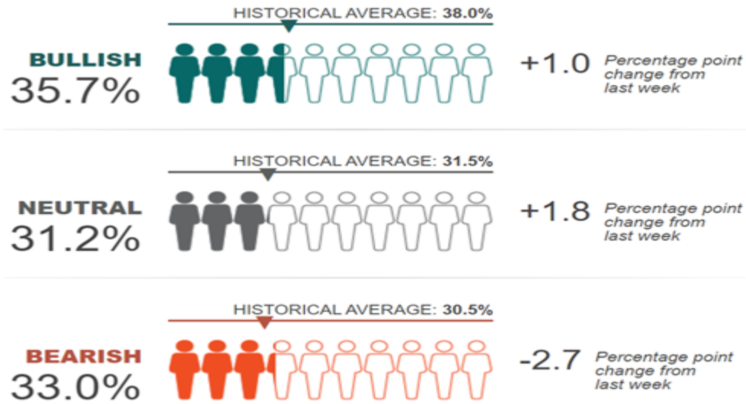
Fixed Income - Pandemic Investing

Data about the dreaded "Second Wave" of COVID-19 infections appears concerning, with significant investment implications. The 7-day average of new cases is approaching the high in July and countries in Europe are implementing national lockdown policies again. While newer cases appear to be less severe and our ability to effectively treat the virus has improved, the economic impact cannot be ignored. Tighter lockdown policies will further harm an economy that is struggling to recover from recession earlier in the year. If the trend of new cases continues, the most compelling investment would be long dated U.S. Treasury bonds. Yields have recently risen to the highest level this year, in part on expectation that further stimulus from Congress would be forthcoming. In the absence of stimulus, yields may fall near the lows for the year and Treasuries may outperform risk assets in the 4th quarter.



Technical - A Balanced Sentiment

The American Association of Individual Investors, founded more than 40 years ago by James Cloonan, publishes a weekly sentiment survey based on its 150,000 members' outlook for the stock market over the following six month period. Historically, the AAII survey has been effective at identifying technical points of inflection and is utilized by some analysts as a forward indicator. The current survey suggests individual investors are just slightly less bullish today than the historical average with a corresponding tilt towards bearishness. When bullish percentage declines below 30% that is often treated as a buy signal for equities, and when it rises above 40% it is often viewed as a time to take profits and reduce risk exposure. The survey is widely followed because of the sheer size of the participants, but actually interpreting what the survey tells us is challenging.



Source: www.aaii.com

Covid and Factor Returns

Clint Pekrul, CFA

We've written extensively in recent reports about the dispersion of returns across equity factors amid the COVID pandemic. As we approach the end of the year, we offer some perspectives on how various factors might perform in 2021, given a set of assumptions about the future economic developments due to the COVID pandemic.

Today it appears that the COVID pandemic is worsening if measured by the number of positive cases. While the death rate is not rising materially, governments around the world are locking down business activity, which has recently put downward pressure on equity return expectations.

Momentum Stocks

So far this year, momentum stocks have done relatively well versus the broader market, as measured by the S&P 500 Momentum Index. This outperformance is no surprise given the sharp rally off the March lows. This group of stocks is dominated by mega-cap technology, discretionary and healthcare names (e.g. Apple, Amazon, Microsoft, J&J, United Health), which have either benefited directly from the pandemic or have been largely immune to its effects.

If the pandemic worsens, momentum stocks could continue to run and outperform other factors as investors would see few compelling reasons to rotate out of these names. However, valuation levels are now stretched by many historical measures, so potential mean reversion is an issue worth considering. The average price-to-earnings ratio on stocks in this group is north of 35 times.

High Quality Stocks

High quality stocks – those characterized by strong balance sheets and manageable debt loads – have performed relatively well versus the broader market so far this year, as measured by the S&P 500 High Quality Index. Similar to the momentum factor, the high-quality factor has a concentration to technology stocks, but with a value tilt. Likewise, this group of stocks has a meaningful weight to consumer discretionary and financials. Some of the bigger names in this equity group are Home Depot, Nvidia, Visa, and Mastercard, which in general have benefited from the pandemic.

Valuations on high quality stocks are a bit above longer-term averages, with a price-to-earnings ratio just above 20 times. Similar to momentum, high quality stocks might be a bit stretched in terms of valuations.

Small Cap Stocks

To no surprise, smaller capitalization companies have faced significant headwinds during the pandemic. Investors in general have shunned smaller cap companies with the expectation that many might not survive government-imposed shutdowns. For the year, the S&P 600 Index, which measures the performance of companies with a market capitalization of less than roughly $2.5 billion, has underperformed the broader large cap S&P 500.

If federal and state governments continue to impose lockdowns due to the COVID pandemic, smaller cap stocks will likely continue to underperform the broader market. Access to credit is critical for companies in this group to sustain operations and grow. While smaller cap companies have struggled so far amid the pandemic, a Congressional stimulus package should improve their return prospects. A potential stimulus plan won't likely be uniform (some will benefit more than others) but would nonetheless be a welcome sight for stocks in this group.

From a valuation standpoint, small cap stocks are trading at a price-to-earnings multiple of roughly 15 times, which is about half the valuation of momentum stocks and more in line with longer-term averages.

Value Stocks

As with small cap stocks, value stocks have underperformed the broader market as measured by the S&P 500 Value Index. Within the group, financial and industrial stocks maintain a relatively larger weight to other factors. Some of the larger holdings in this group are IBM, Intel, GM and AT&T. In general, these stocks have underperformed the broader market as investors have favored momentum (growth).

Not surprisingly, the valuations on this group are considerably lower than the other factors, with an average price-to-earnings ratio of roughly 12 times (versus roughly 35 times for momentum and 20 times for high quality). While value stocks have faced stiff headwinds this year, this group could be poised for a breakout if the trend in the pandemic improves. For example, investors could begin to rotate out of pricier momentum stocks (take profits) and reallocate into value names.

Low Volatility Stocks

Typically, low volatility stocks are considered more defensive than the broader market. The group has underperformed the overall market for the year, as measured by the S&P 500 Low Volatility Index. This group overall has a value bias and trades at a price-to-earnings multiple of roughly 20 times. Some of the larger names in this group are Verizon, Costco, Walmart, and Dollar General.

Interestingly, low volatility did not hold up relatively well in the initial market drawdown. However, the constituents in this group have been rebalanced multiple times since March, which might better position the low volatility factor to outperform on a relative basis.

Q: Is housing immune from weakness in the economy?

Residential real estate, whether looking at single-family homes or multi-family dwellings, has remained incredibly strong in the face of the greatest economic displacement since the Great Depression. The strongest evidence that housing may be immune in today's environment is data from the National Association of Realtors (NAR). There are 181 MSA's (Metropolitan Statistical Areas) in the U.S., and 174 of the 181 had rising prices in Q2 of 2020. When 96% of housing markets show gains at the same time nearly 30 million jobs are lost it is almost incomprehensible.

At the heart of understanding housing lies affordability. Households typically can allocate no more than 25% of their income to housing costs. In today's environment we have had rising incomes coupled with historically low mortgage rates, allowing families to be able to afford more house than in the past. Also putting upward pressure on home prices is very low inventory levels. The number of homes on the market earlier this year was 18% lower than the same period last year, according to NAR data.

Housing will not always be immune to economic weakness. If wages stagnate and interest rates rise, the affordability index reverses and housing will struggle even in the midst of strong economic growth. Multi-family unit growth is expanding so rapidly there is a risk in many markets they will become overbuilt in the next year or two, leading to a correction in that segment of housing.

So far it doesn't seem that the current economic slowdown has adversely impacted the housing market. In fact, housing has held up relatively well considering the harsh circumstances brought on by the coronavirus. Demand for new construction remains high, as does homebuilder confidence. The National Association of Realtors (NAR) found that in August, existing home sales reached a 14-year high. Meanwhile, supply remains limited, which has pushed prices higher overall. The NAR reported that in September housing inventory reached a new low of just under a three-month supply. Furthermore, according to data from Realtor.com, the national median asking price in September was $350k, which was up roughly 11% from the previous year.

Much of the boom in the housing market can be attributable to record low interest rates. With 30-year rates hovering around 3% to 3.5%, financing a house can be affordable. The challenge is limited supply, which has been an issue for some time. In some cases, offers will come in over the asking price, which essentially offsets any interest savings due to lower rates. If this trend continues, many potential homeowners will continue to simply be priced out of the market.

Q: What sectors are likely to lead in 2021?

My initial reaction is that it depends on who prevails in the election as the vision and priorities of the candidates vary greatly. However, I am not sure it will make that much of a difference in the short-term. The priority will be boosting job growth, and the fastest way to accomplish that is through an increase in infrastructure spending. Much of the improvements being rolled out will focus on telecommunications as the IoT continues to rapidly expand. Global telecom infrastructure companies are going to see new contracts to update communication systems.

A Biden victory would also be beneficial for utilities in my opinion. The push to move away from gas-powered vehicles to electric vehicles (EV) will increase demand for electricity and benefit companies who enable efficient transmission of electricity. Regardless of the winner in November's election, I would expect technology to continue to lead the way in 2021. Finding growth will continue to attract a premium in valuation, and technology should be able to deliver. Valuations in many tech companies are stretched, so applying a GARP (growth at reasonable price) in the sector may be necessary.

There are two sectors that should do well if Trump is reelected that I would be cautious about in a Biden victory. Healthcare should see increased interest and perform well with the status quo, but investors would likely sell first and ask questions later with Biden. The same would be true with energy exploration.

It really depends on what becomes of the coronavirus. As we've seen so far this year, there are sectors that have actually benefited from the pandemic, while other sectors have been devastated. I think it's a fair assumption that if the trends of 2020 continue into next year, the relative performance across sectors probably won't change much in the near-term. That is to say, sectors like technology and consumer discretionary will likely continue to outperform sectors like energy and financials. However, I think it's important to look at current valuations.

Momentum stocks collectively are currently trading at roughly 35 to 40 times earnings. This group of stocks include the likes of Tesla, Amazon, Netflix, and Apple, which are all higher by over 50% for the year. At this point, there are legitimate concerns about whether these stocks have been stretched too far in terms of valuations. Another interesting point is the separation between growth and value. The current ratio of the Wilshire Large Cap Growth Index to the Wilshire Large Cap Value Index is at its highest level since 2000. While nothing is written in stone, it seems like we could be approaching inflection points in terms of valuations and relative performance. As such, returns in 2021 could look much different than in 2020.

All weights as of November 1, 2020

Income	
Mortgage Backed Bond	54.64%
Investment Grade Credit	16.29%
High Yield Bonds	7.73%
Preferred Stock	13.80%
US Dividend Equities	4.54%
US REITs	3.00%

Balanced Income	
US Dividend Equities	14.77%
International Dividend Equities	17.09%
US REITs	10.54%
High Yield Bonds	28.07%
Long Term Treasuries	29.53%

US Growth	
Low Volatility Factor	14.47%
High Quality Factor	13.04%
Small Cap Factor	10.74%
Value Factor	14.64%
Momentum Factor	9.40%
Long Term Treasuries	37.69%

Global Growth	
Low Volatility Factor	7.22%
High Quality Factor	6.24%
Small Cap Factor	5.15%
Value Factor	7.09%
Momentum Factor	4.52%
Developed Market Equity	17.05%
Emerging Market Equity	18.39%
Long Term Treasuries	34.34%

Weights are approximations only and are subject to change.

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