Stocks Disconnected from Reality? Here's Why Valuations Are Still Rational

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It's hard to recall a more confusing quarter for investors. While economic data plumbed depression-level depths for most of the past three months, equity markets rallied heavily. This odd juxtaposition led many to opine that markets had disconnected entirely from the economy.

We disagree.

Recall that in our Q1 2020 market commentary we expressed our belief that the market would ignore economic data in Q2. With the data no longer our guiding light, we laid out four milestone markers that we thought needed to be reached on the way to a recovery following COVID-19.

Our first marker was aggressive monetary and fiscal policy to fill the economic valley created by efforts to bend the virus curve (our second marker) via broad social distancing to relieve pressure on hospital systems. We believe the quick, aggressive delivery of relief (no. 1) allowed the market to reach a bottom on March 23, while our initial success in bending the virus curve (no. 2) allowed equity markets to push higher, even against a backdrop of rapidly deteriorating economic data.

Historically, the beginning of the end for past downturns occurs when we start "fixing" the underlying problem that drove the economy into a recession. The reason the economic data was so bad wasn't because of underlying U.S. economic fundamentals; rather, it was COVID-19 and the initial "treatment" to socially distance or close large parts of the U.S. economy to bend the case curve. Put differently, we intentionally caused a collapse in economic data to begin fixing what went wrong — the virus.

MARKETS ARE DISCOUNTING MECHANISMS, NOT MIRRORS

With the virus subsiding in many parts of the U.S., May and June saw efforts to reopen the U.S. economy (marker no. 3) accelerate, and large parts of the U.S. economy came back online. Coincident with reopenings, economic data jolted from a COVID-19-induced slumber and improved at a historic pace. While we still have much work to do (on both the health and economic front), the data has rebounded much more quickly and sharply than expected.

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We can even measure the extent to which data exceeded expectations. The Citigroup Economic Surprise Index (CESI) measures the divergence between U.S. economic data and economists' expectations. Going back to 2003, the index hit an all-time low on April 30 (numbers came in worse than expected) but then spent the next two months climbing to a record high by quarter end. Think of it this way: The market plunge in February and March reflected the anticipation of awful economic data that arrived in April, while the strong Q2 rally reflected the market moving higher in anticipation of better data that was set to occur with the reopening of the economy in May and June. Essentially, the market's swift rebound has been commensurate with the degree of economic outperformance, as measured by the CESI.

Up until the closing weeks of the quarter, markets reflected an economy reopening without significant spikes in COVID-19 cases. Now, we appear to be at an inflection point, as cases in some parts of the country are rapidly accelerating. This raises the question of what's next for markets in Q3 2020. Here's how we're thinking about the months ahead.

A 2-STEPS-FORWARD, 1-STEP-BACKWARD FUTURE

While we expect pushing and pulling as virus updates dominate the daily news narrative in the near term, we believe the U.S. economy will continue its walk out of the economic valley. Steady, intermediate-term progress should provide support for the equity market at current levels. Put differently, we wouldn't be surprised if markets are rangebound nearer term given current virus concerns, but we believe stocks will be higher a year from now. There are three primary pillars supporting this intermediate-term view of equity markets:

1. The odds of another nationwide blanket lockdown are slim. For that reason, we think the virus has already exerted its maximum negative impact on the U.S. economy and markets. This is not a statement that the virus won't potentially flare up and impact certain states and health systems, but from an overall U.S. economic perspective we believe our future responses will be targeted. Broad stay-at-home orders were our best option in February and March when we knew very little about the virus. Several months later, we can now react with precision given expanded testing capabilities, which helps pinpoint where infections are occurring and who is most at risk. From a global economic perspective, we must also remember that there are countries where the virus has subsided more rapidly or even abated, and that can also support equities.
2. Progress on a vaccine or treatment (our fourth and final marker) is trending positively. According to a vaccine tracker from the New York Times, there are more than 145 vaccines in development, with 21 already in human trials. Indeed, during Q3 2020 it is expected that at least three vaccines will enter Phase III trials (the final stage before approval). Keep in mind, many vaccine candidates are already being produced at risk, which means manufacturing is ramping up now so that, if a candidate is proven safe and effective, it will be ready to ship at scale immediately. We are also getting better treatment options. Gilead's drug Remdesivir, for example, has shown varying levels of success treating patients with the virus. Further, late in Q2, a study in the U.K. found that Dexamethasone, an anti-inflammatory drug, cut the chance of death by 30 percent in severe cases. If we continue to see positive vaccine and treatment developments, we believe the market will look past any nearer-term virus setbacks.
3. Most importantly, both fiscal and monetary policymakers stand ready to provide more relief if it's needed. Much as we expected, policymakers have been more aggressive, and bolder, than in past downturns or crises. The Federal Reserve wants to help keep markets afloat or even help them push higher.
   Interestingly, during Q2 William Dudley, former president of the Federal Reserve Bank of New York, wrote a Bloomberg Opinion piece explaining the mechanics and "desired outcome" of the Fed's current quantitative easing (QE) program.

   Mr. Dudley described why the Fed was so busy buying Treasurys and mortgage-backed securities, among other instruments, from the private sector. Here, he clearly spells out the central bank's underlying rationale:
   "The private sector may react to the increase in cash and deposit holdings forced on it by the Fed by seeking other riskier higher-yielding assets. In fact, this is a major motivation of quantitative easing. By reducing the supply of safe assets and increasing the amount of deposits that the private sector must hold, the Fed generates a demand by the private sector for more risky assets. The result is a rise in financial-asset valuations and an easing of financial conditions. The Fed's asset purchases change the mix of assets available to be held by private investors, and this influences asset valuations."

   The Fed's actions are helping to push prices and valuations higher for riskier assets such as stocks — by design. And while we are empathetic to those who say absolute equity valuations appear pricey, we believe valuations are a better relative value tool. With the Fed's purchases helping to keep 10-year Treasury yields near 0.7 percent, we believe equity prices, relatively speaking, are rational at current levels.

   The bottom line is that the Fed has equity investors' backs; Chairman Jerome Powell still has more tricks up his sleeve, and, importantly, he is willing to use them. At a recent Princeton University online event, Powell was asked about limits to the Fed's crisis toolkit. He replied that there were few limits and further noted that in fighting "an emergency of a nature we haven't really seen before ... we crossed a lot of red lines that had not been crossed before, and I am very comfortable that this is that situation where you do that."

   This naturally begs the question: How long can this last? We believe this can continue until there is a more pressing, immediate opposing consequence that the Fed needs to consider. Currently, its actions are without immediate consequence because there is low inflation, the U.S. dollar is strong and interest rates are low. But at some point in the future, a moment of truth will occur when the Fed must balance taking further actions that risk rising inflation, rising interest rates or a falling dollar against letting the economy fall into recession. At that point, the Fed will have to decide which outcome is worse. However, until the Fed reaches such a crossroads, we think it will reach deep into its toolbox. Ultimately, that will provide a crucial third leg of support for markets.

Now, combine these three factors with one final fact: Many investors — even professional investors — still have large amounts of cash on the sidelines. They are likely to view future market dips as buying opportunities to try and play catch-up. Taken together, while we think the market may take a step back in the near term, we also believe there's plenty of support to push it two steps forward shortly thereafter.

EVERY INVESTOR'S RECIPE FOR SUCCESS

In our Q1 commentary we concluded with a plea to investors to not overreact during this time period. Investor behavior has a profound impact (positively and negatively) on long-term growth and financial security. We can't stress this enough. A sound, level-headed approach to financial planning is a core principle underpinning all the work we do each day with our clients. So, given the recent (and likely continued) volatility, we think it's important to reemphasize and expand on our wealth-building guidelines, especially since this is such an emotional and confusing time for investors.

> We believe it is important for investors to, first, have a plan and second (and more importantly), stick with the plan, especially during confusing times.

As a review, we said these emotional time periods are when financial futures are often made. We believe long-term financial success is not garnered by how you behave when times are good — anyone can invest or own stocks during the good times. Rather, long-term financial success is achieved based on your behaviors in difficult environments. Certainly, the past few months and, likely, the next few months, qualify as difficult.

Within this context, we believe it is important for investors to, first, have a plan and second (and more importantly), stick with the plan, especially during confusing times. Given the recent rally, I am sure many people are now wondering whether they should stay in the market or get out in advance of the next correction. Let me answer the question in two parts:

1. If you are asking this question from a market-timing perspective, you are missing the message the market is broadcasting via violent downside and upside: You cannot time this market. For example, U.S. West Texas Intermediate crude oil started the quarter at $20 and fell to -$37 (yes, negative) by April 20. It finished the quarter at $39. It's impossible to time such severe volatility. Traders trade while investors invest. We are investors and we will continue to invest.
2. If you are asking through the lens of a well-constructed, long-term plan, and you are worried that you might not be able to handle another downturn, then yes, we recommend you speak with your advisor and assess your situation right now when the market is in a good place. Recall how you felt during the month of March, or even December 2018, when the market plunged. Honestly evaluate how you'll feel and act when that happens again. Remember, history has shown that those who panic during these times end up worse off than those who don't. If you're feeling uncomfortable, now is the time to call your advisor.

You've heard us say it before, but we'll say it again (and again): The key to building and maintaining financial security is through an unending commitment to a long-term, diversified portfolio. No one knows for certain what the future looks like. The way we deal with this uncertainty is the same way we deal with all uncertainty — diversify and don't fall prey to falling in love with any one stock, one sector or one asset class. An all-weather portfolio will keep you financially healthier than those designed for only sunny or rainy weather.

Commentary is written to give you an overview of recent market and economic conditions, but it is only our opinion at a point in time and shouldn't be used as a source to make investment decisions or to try to predict future market performance. To learn more, click here.

There are a number of risks with investing in the market; if you want to learn more about them and other investment related terminology and disclosures click here.