Raymond Capital Advisors LLC

July 19, 2020

Market Review: Covid-19 Market Therapeutic… Heavy Doses of Liquidity!

Stock & Bond Benchmark Total Returns %
For Periods Ending June 30, 2020

	QTR	YTD	1-Year	3-Years	5-Years	8-Years
S&P 500	20.54	-3.08	7.51	10.73	10.73	13.15
Bloomberg Barclays U.S. Aggregate Bond	2.90	6.14	8.74	5.33	4.31	3.38
60/40 TAA Composite Index	13.32	0.99	8.58	8.93	8.42	9.37
3-month Treasury Bills	0.03	0.30	1.15	1.58	1.09	0.70

Returns (%) greater than one year are annualized. Sources: S&P Dow Jones Indices, Morningstar, Federal Reserve.

After plunging 19.60% in Q1, stocks surged 20.54% in Q2. It was their best quarterly gain since 1998! U.S Treasury Notes that mature in less than 3-years now yield near 0%!

Question 1: "How could the stock market have such a strong rebound in the face of the global pandemic?"

Answer: Heavy doses of liquidity! Liquidity is strongly linked to investor fears. When investors become fearful, they sell stocks and shift their money into money markets funds. This liquidity then becomes the fuel for the next market advance. So it was in Q1 that the fears from the Covid-19 market panic added $1.6 trillion to money market funds. A total of 14.7% of total stock market value now resides in money market funds yielding near zero percent. Added to this fuel, was unprecedented amounts of new liquidity committed by the Fed and fiscal authorities (up to $6 trillion, 30% of GDP), effectively providing the best cushion the markets could have hoped for. With a huge cushion of liquidity, and the aid of computerized trading algorithms, a record rebound was achieved. To be sure, markets continue to benefit from the liquidity cushion, and stocks are now less than 5% from their all-time highs (S&P 500 Stock Index). But as the excess liquidity is absorbed, the importance of future economic and earnings growth will increase.

Question 2: "How are we going to pay for all of the trillions of dollars being spent?"

Answer: The impact of our added debt burden from Covid-19 is likely to result in a combination of higher taxes, inflation, and lower economic growth. Much is likely to fall on future generations. Adding to our national debt brings risks, but for a government an outright reneging of debt is unnecessary since it has the ability to print its own money. More commonly, the way national debt burdens are managed involve what economists' call "financial repression"… First interest rates are lowered, often to very low levels, and inflation is increased to levels somewhat above the interest rate. The low interest rate makes the debt payments more manageable, while the inflation allows for its payback in cheaper dollars over time, and with less public outrage. An additional strategy is to lengthen the payback period of a nation's debt by selling longer dated bonds (e.g. issue 50 or 100-year bonds, in place of 30-year bonds). Finally, if all else fails, the final option is to inflate more aggressively (i.e. print money). But here, inflating too much runs the risk that bond investors (i.e. holders of the debt) will want to sell their bonds as inflation diminishes the value of their holdings. And if bond investors sell, interest rates rise making debt payments even more precarious. Ultimately, it's about credibility and faith. "In God We Trust" is printed on the back of our currency. But while faith is indeed required, God is not the backer of our currency. More accurately, we're trusting the Treasury, the Federal Reserve, and Congress not to print so much currency that it's rendered worthless!

Below, an example from not so long ago (2008) of what happens when bond investors lose complete faith in a government's ability to manage its debts. Left with no other choice, governments will print and inflate. Fortunately, we believe the U.S. is far from this extreme example, but it is important to understand the avenues that are often taken when governments come under extreme pressure.

This is not to say that the long-term outlook is one of gloom and doom. The U.S. dollar remains widely used in global trade and is the "world's reserve currency." Innovation, demographics/immigration, bankruptcy and fair-trade laws, and other factors also play big roles in the trajectory of economic growth, productivity, and controlling inflation. Today, new advances in sciences, technology, biotechnology, energy and materials are occurring at an accelerated pace. That economic dynamism, to which the United States has the best in the world, can spur employment in new industries, keep productivity and the supply of goods and services high, inflation down, and is also reason for long-term optimism.

It's been awhile since debt concerns have been at the forefront of investor concerns, but here's a 2013 CNBC interview where Lance Stonecypher iterates the key points of financial repression:
https://www.cnbc.com/video/2013/07/05/us-stocks-offer-value-strategist-.html

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Outlook: Limited Downside/Limited Upside

Turning back to the markets… Certainly, a re-shutting down of the economy from increasing Covid-19 cases can become problematic for the economy, as are increasing concerns of higher corporate taxes and regulation pending November's election outcome. But the Fed has also indicated a willingness to keep interest rates low for a prolonged period (likely at least through 2021), or until the economy can resume a solid footing. More fiscal stimulus is also currently in the works. Accordingly, a reasonable outlook scenario calls for somewhat higher levels of volatility than what we have seen in the recent rebound phase... e.g. both modest upside, as well as normal stock market corrections in the 8% to 10% range. Large drawdowns would seem less likely unless another black swan event emerges. A "melt-up" (i.e. strong rise in stock prices) scenario also seems possible given the rapid progress being made on the vaccine front and the near zero return investors are getting in money markets, bonds, and CDs.

RCA Tactical Asset Allocation strategies were modestly overweighting stocks from early April through late May, and are now back at neutral benchmark weightings. On the fixed income side, maturities were kept somewhat shorter than benchmark. Within the equity portfolio Computer/Technology holds the largest weight at 30.9% (slightly overweight using Folio sectors). This concentration reflects the strong outperformance by the sector which is viewed as benefiting whether the economy is in Covid-19 lockdown or not. In fact, of the top ten stocks contributing to the S&P 500's return in Q2, nine could be considered to have a strong technology orientation. These same stocks also contributed a whopping 7.92 percentage points (39%) to the S&P 500's 20.54% return. Relative to the S&P 500 benchmark, sector exposure is currently overweighting Medical, and underweighting Finance. Large-caps occupy 71% of the equity portfolio, with the balance in mid-caps. We continue to rebalance portfolios each week according to our models and rankings, which adjust to emerging trends.

With best regards,

Geoff & Lance

Raymond Capital Advisors, LLC
A Retirement Wealth Advisor