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INVESTMENT COMMENTARY & OUTLOOK

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The third-quarter was quite interesting. The stock market experienced net redemptions but continued to rally on relatively light trading volume. Nowadays, Citadel's algorithms largely control stock prices. So the question that we are asking ourselves is if the stock market can rally on light trading volume, then what happens when trading volume soars?

As mentioned on a recent Navellier podcast, there is a lot of cash on the sidelines that is waiting to pour into the stock market once the uncertainty of the Presidential election is resolved once and for all. This is because we are in the midst of a V-shaped economic recovery as demonstrated by the Atlanta Fed (as of October 9, 2020) forecasting annual third-quarter GDP growth of 35.2%. Furthermore, the second-quarter was the strongest quarter that we can remember for earnings surprises and, based on positive analyst earnings revisions, the third-quarter announcement season is shaping up to be magnificent! As a result, it appears that another market "melt up" is likely for the fourth-quarter.

The current market environment is very similar to the "go go" late 1990s. Popular indices like the S&P 500 and the NASDAQ 100 are making the big stocks bigger, so these popular indices are now concentrated in fewer stocks. Back in March 2000, the stock market bubble burst after 54% of the S&P 500 ended up in nine giant technology stocks with excessive valuations. Today, we are monitoring the big stocks, like Apple, Amazon.com, Goggle, Facebook, Microsoft, Netflix, and NVIDIA that account for over 22% of the value of the S&P 500. Frankly, due to positive third-quarter forecasts for many leading stocks, we are not worried about any stock market bubble bursting.

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The Fed recently announced that it will keep its key interest rate at or near 0% thru 2023. Whether Joe Biden or Donald Trump wins the Presidential election makes no difference, since the federal deficit will remain above 100% of GDP. With such a massive debt burden, the Fed cannot raise key interest rates, since the interest on the Treasury debt would crush the federal budget deficit. As a result, the U.S. dollar may remain under pressure as international investors realize that the Fed has to print more money to monetize the Treasury debt.

The Federal Reserve is also aware of the potential of a massive U.S. dollar short squeeze due to excessive U.S. dollar debts taken on by foreign government and corporate entities to the tune of $12.1 trillion as calculated by the Bank of International Settlements. Borrowing dollars is equal to shorting dollars. The Fed will do everything it can to prevent a dollar short squeeze as if it happens it will risk an emerging markets debt criss in the middle of a global pandemic.

The good news is a weak U.S. dollar is great for multinational companies, which is just one reason that third-quarter sales and earnings are expected to be so strong. A weaker U.S. dollar also triggers commodity inflation, since commodities are priced in U.S. dollars. The Fed has tried to re-ignite inflation in recent months, since it sparks economic growth with too much debt in the system. Traditionally, the best inflation hedges have been gold, residential real estate, and the stock market. Since the stock market is the easiest place for many investors to protect themselves against inflation, the long-term outlook remains promising!

The Fed is trying to engineer higher inflation so debts in the system don't cause a depression. The U.S. government faced this identical type of rapid increase in deficit spending during WWII. Federal debt-to-GDP quickly doubled, while interest rates were held at 2.5% or lower on the 10-year Treasury in the 1940s. While we don't have a World War now, we had Iraq, Afghanistan, the 2008 Financial Crisis, and Covid. Those four together brought the federal debt pile up to levels commensurate with WWII.

Speaking of the U.S. economy, the Fed remains worried about Covid-19's lingering impact on GDP growth. Specifically, Fed Chairman Jerome Powell called for continued aggressive fiscal and monetary stimulus for an economy that he said still has "a long way to go." Before the National Association for Business Economics, Powell said, "Even if policy actions ultimately prove to be greater than needed, they will not go to waste." Powell concluded by saying, "The recovery will be stronger and move faster if monetary policy and fiscal policy continue to work side by side to provide support to the economy until it is clearly out of the woods."

The primary risk to both the U.S. economy and the stock market is the risk of a contested Presidential election in early November. Since the Presidential election outcome will likely be determined by key swing states, hopefully any challenge or recount will just encompass one or two states and not be too disruptive. All the stock market cares about long-term is "certainty," so when uncertainty is removed, then the stock market will be poised to surge higher.

An early "January Effect" is already underway based on how our small-to-mid capitalization stocks performed in late September and early October. This early January Effect has typically occurred just before Thanksgiving, which is a seasonally strong time of year. Historically, when we gather with family and friends to celebrate Thanksgiving, people are happy and this also improves investor sentiment, which in turn helps the stock market.

In conclusion, we have a lot to look forward to. First, the third-quarter announcement season is expected to be stunning for our growth stocks. Second, the V-shaped economic recovery is expected to persist. Third, the Presidential election outcome will remove the cloud of uncertainty that caused some investors to hoard cash. Fourth, this cash should pour back into the stock market once the uncertainty is lifted. As a result, we remain optimistic for a Thanksgiving rally and strong finish to 2020!

SUMMARY

We hope you share our enthusiasm for the V-shaped economic recovery that is now underway. The most amazing thing in the Covid-19 economy is that U.S. productivity has soared! Furthermore, consumer spending on goods is now higher than it was pre-pandemic. The Fed has successfully stimulated the interest rate sensitive parts of the U.S. economy, like auto sales and the housing market, with its 0% interest rate policy. Even a weaker U.S. dollar is helping to boost the bottom line of many multinational companies.

The bottom line is the strong third-quarter sales, earnings, and positive guidance are not a fluke. The Atlanta Fed's annual 35.2% estimate for third-quarter GDP growth (as of October 9, 2020) is very exciting! Optimism is addictive and has clearly been rubbing off on the stock market.

The only uncertainty hanging over the stock market has been the worry about a contested Presidential election. However, this uncertainty should be removed soon and potentially unleash a lot of cash on the sidelines. What has been so odd is that growth stocks have been rallying in recent weeks on light trading volume. Any event that would spark the cash on the sidelines to return to the stock market, such as a decisive election outcome and/or a traditional Thanksgiving rally, could cause the stock market to surge! As a result, we remain very optimistic and expect a strong fourth quarter.

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