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Keeping Up, Sorting Out

Investors have focused for months on Coronavirus, the economy and elections. Recent outcomes have come with a rush, some with certainty and some with further clarity ahead. The paths for policies await U.S. Senate leadership and new administration priorities. And the direction of economic activity ahead awaits these outcomes. With little fanfare last week, the Federal Reserve reaffirmed its very low interest rate policy. With much fanfare this week, some very good news on a Coronavirus vaccine emerged. It has been challenging to keep up at some times and to sort out important from merely interesting. A review of some key factors known at this time can provide some perspective for investing yet ahead.

PERSPECTIVE

An historically low interest rate regime has been in place since the Great Recession over a decade ago. A nascent path to higher rates was abandoned fully in the face of Coronavirus. The Federal Reserve has indicated a policy of very low interest rates may well prevail for a few years. As a result, the role of interest bearing investments, cash equivalents and bonds, has been questioned. As Chart I shows, the income advantage of bonds over stocks has all but dissipated. This would seem to argue for increasing portfolio allocations to stocks at the expense of bonds. At the same time, stock prices are more volatile than bond prices by multiples as shown in Chart I. Most recent stock price volatility relative is seven times that of bonds. Any substitution of stocks for bonds should weigh the potential increase in overall portfolio volatility relative to income considerations.

Recent valuations, as measured by price/earnings ratios, indicate stocks may be fully valued after the recent market recovery. Over time, stock markets have moved ever higher. Chart II shows the 50-year and the 10-year trends for the Dow Jones Industrial Average. Trendlines reflect annualized returns of +7.4% and +9.1% respectively. The trends to higher levels have come with wide swings of over- and under-valuation around the trend lines. Current valuation positions relative to these trendlines suggest the stock market may be fairly valued at present. Maintaining an allocation to stocks for potential growth remains appropriate, but at levels consistent with individual investor risk tolerance.

Performance by sectors within and among stock markets have varied widely in the year-to-date. Growth generally and technology specifically have out-performed most other sectors by wide margins. More recently, there have been signs of some leadership “rotation” to other sectors. Chart III highlights sectors that have under-performed and could benefit from rotation. Certainly, recent under-performance alone is not the basis for an investment strategy. It does provide a place to start strategy considerations along with valuation measures and forward return and risk expectations.

INVESTMENT IMPLICATIONS

Keeping up with fundamentals still matters. Sorting out economic fundamentals brings focus on growth in jobs, incomes and business investment. Sorting out government fundamentals brings focus on policies for taxes, regulation, incentives and interest rates. Sorting out investment fundamentals brings focus on objectives, time horizons and risk tolerance. This focus enhances the outcome of investments keeping up with needs.

CHART I

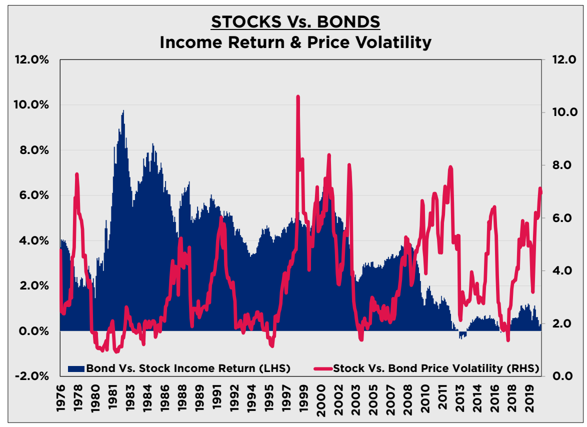

CHART II

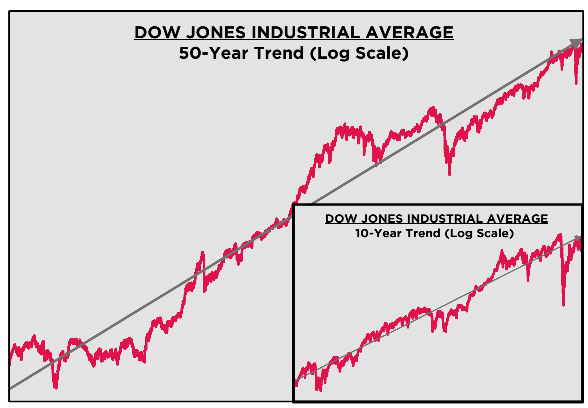

CHART III