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Market Commentary

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Abstract

Vaccine development appears on track so inoculations may begin this fall but could last years. Policy in China remains a geopolitical concern. In domestic politics, Democrats' 300 pending legislations so far appear unlikely to forge a new policy direction.

Major Developments

The pandemic continues unabated in the United States. In the rest of the developed world the epidemic is under control, but occasional outbreaks warn that there is considerable latent danger. The experience of the less developed world is highly variable. In South America the experience has been disastrous while in Indochina it appears fairly mild.

Vaccine development appears on track. The Oxford vaccine appears the closest to approval in multiple nations. One of the manufacturing licensees is the Serum Institute of India. This firm is the world's largest vaccine manufacturer and their recent status report provides considerable definition as to where vaccine development currently stands. Their vaccine is currently in final (stage 3) testing with the data required for regulatory approval expected to be available in mid-October. Approval should follow by month end. Meanwhile, the company is manufacturing the vaccine and stockpiling it pending approval. Their manufacturing line currently runs at the rate of 60 million doses per month. However, this vaccine requires a two-dose series of injections, so a month's production only amounts to a half percent of world demand. With commercial licenses in 92 countries, the Serum Institute is working to increase its production capacity and hopes to have doubled it by next April. The Bill and Melinda Gates Foundation is supplying $150 million in capital towards this capacity expansion. The vaccine is expected to cost about $3.30 per dose before distribution costs. The Indian government intends to provide free inoculations to its population. To this end, it has contracted for 11 months production from the Serum Institute. It expects to contract with 3 other manufacturers as well if their vaccines also prove efficacious. As this data indicates, the project of manufacturing the necessary doses and then jabbing 14 billion arms is a massive one. While a vaccine may represent an ultimate solution of the pandemic, public health measures to control it remain highly relevant. Intelligent prioritization of vaccine application will also be quite important for the first six months to ensure that the maximum benefit is derived from the limited supply rolling off production lines. There appears to be a substantial fraction of the population which is suspicious of the emergency vaccine development effort and intends
not to get the vaccine, or at least to wait some time before doing so. Given the mismatch of manufacturing capacity to global demand, we think vaccine shortage rather than public resistance will be the dominant theme of the initial roll out.

Internationally, China recently announced a treaty for cooperation with Iran. This announcement is a reversal of alliances - China having previously supported economic sanctions against Iran. The agreement could develop in a very unfavorable direction. China at one time followed a policy of

spreading nuclear weapons to third countries. Strategic cooperation between the two countries, if it develops, would allow China to meddle in the Middle East and thus apply pressure on the US likely to deflect attention away from West Asia where China is seeking dominance. Although the US State Department likes to blame the Chinese Communist Party for China's unfriendly moves, that rhetoric does not lead to clarity of thought. Modern China's combination of state capitalism, heavy domestic surveillance, repression of minority cultural identities and personal autocracy is much more in the mold of the strongly nationalistic dictatorships of the 1930s. Like them, its foreign policy is driven by a quest to secure raw materials for its industrial economy, rather than by promotion of ideology. A second important driver of foreign policy is the redressing of perceived historical injustices - again a theme of the 1930s. This nationalist agenda appears to enjoy reasonable support by the populace. Also, like other highly disciplined states before it, there is considerable risk that the leadership will be confused by the working disorder of liberal democracies into underestimating the latent power of the United States and its allies. Many US firms are dependent on supply chains that start in China. The United States' largest company, Apple Computer, is particularly exposed in this regard. These firms are at least temporary hostages of the international situation and are likely to be voices urging the United States to be circumspect in responding to China's aggressive moves. Tactical circumspection, however, runs the risk of being misread as strategic weakness. The international situation is on an unfavorable trend. Former Secretary of State George Schultz has recently advised diplomacy aimed at forestalling escalation of minor incidents into major crises and extensions to the national strategic stockpile to insulate the United States from economic blockades imposed by China.

Domestically, the polls continue favorable for the Democrats and there is a good possibility that they will capture both Houses of Congress and the Presidency in the November elections. At this point there are 300 pieces of Democrat inspired legislation which have passed the House but are currently shelved in the Senate. Much of this legislation could be rapidly enacted in 2021 if the Democrats gain control of the government. As a possible leading indicator, it is therefore worthwhile to examine this stock of legislation. It can be divided into three groups. The first group is matters of significance to only specific locales, such as renaming post offices and locating new Federal facilities. The second group consists of pieces of tactical legislation, for instances measures intended to protect the Affordable Care Act or the DACA program from Trump's hostile intents. This legislation loses much of its raison d'etre in the event of a Democratic victory at the polls. It is likely to be replaced by new, more sweeping measures rather than being enacted as it currently stands. Redrafting and passing such legislation necessarily takes time, and so such bills are unlikely to be passed in the first round of legislation. The third group of legislation includes measures which are nationally consequential and ready for quick enactment. It is this group we focus on.

The For The Peoples Act of 2019 (HR1) is a grab bag of measures the Democrats feel strongly about with regard to the conduct of elections. It provides a modicum of public matching funds for campaigns, reforms administration of election finance law, attempts to limit gerrymandering, takes aim at specific voter suppression moves and seeks to reverse a Supreme Court decision expanding the political participation of entities. Direct economic impact of the bill is minimal, and the political impact probably less than the Democrats hope.

The Strengthening Health Care and Lowering Prescription Drug Costs Act (HR 987) is another grab bag bill, much of which enjoys bipartisan support. The basic intent of the bill is to support the medical insurance regime established by the Affordable Care Act and to curtail certain

anti-competitive practices of prescription drug companies. There will be marginal impact on both of those industries, but the bill does not set new policy directions. Two other Bills, the Purple Book Continuity Act (HR1520) and the Orange Book Transparency Act (HR1503) are also aimed at the prescription drug industry. These bills concern administration of the patent system for drugs. They are highly technical measures regarding the timing of various disclosures and updates.

The Equality Act (HR 5) extends the civil rights protections of the various alternate sexual orientations (broadly the LGBTQ community.) Path breaking when drafted, this bill has since been superseded by a Supreme Court ruling that the Civil Rights Act of 1968 already protects this community.

The Paycheck Fairness Act (HR 7) builds on the Equal Pay Act of 1963 in the attempt to eliminate gender bias in pay. A gender-based pay gap clearly exists, but part of it occurs for legitimate reasons - some women may prefer emotionally rewarding but lower paying careers and others preference childbearing over building corporate seniority. It is thought that gender bias only accounts for about a third of the pay gap. HR7 attempts to address this issue by enforcing greater employer transparency about pay. The likely corporate response will be to make pay grades more granular, criteria for promotion more explicit, and to address specific cases of inequity. Employers are unlikely, however, to expand their total payroll, so any gains by currently underpaid woman will likely be offset by economies in other areas such as enhanced early retirements. This is the sort of stir-the-ant-hill measure which feeds skepticism about regulatory interventions.

The Bipartisan Background Checks Act (HR 8) is intended to thwart sale of guns to criminals and mentally unstable people. Gun dealers have long been required to conduct background checks of prospective purchasers. But sales between private individuals, as occurs at gun meets, have not required such checks. HR8 would extend background checks to gun sales between unrelated private parties. The bill is opposed by the fraction of the gun owning public which opposes any form of gun regulation but is supported by everyone else.

The Save the Internet Act (HR 1644) would restore the Obama era regulations in favor of "net neutrality." These rules limited the ability of telecommunication providers to extract revenues from businesses providing services over the internet. The Obama regulations lacked the force of law and so were easily changed by the Trump administration. This act would restore them and, as enacted law, they would enjoy greater policy stability.

The SECURE Act (HR1994) is a grab bag of measures to promote retirement savings. The bill **Reauthorizing the Violence Against Women (VAWA) Act (HR 1585)** is a routine reauthorization of a prior act with additions extending the policy to same sex couples and imposing certain gun ownership restrictions in situations deemed of potential risk to protected persons. **The Climate Action Now Act (HR 9)** re-enrolls the United States in the Paris Climate Change Accord. Separately Biden has committed to take this action if elected. There are approximately two dozen laws dealing with technical issues in particular domains (e.g. multi-employer pension plans, chemical facilities, Indian land, government employee pay, and formation of shell corporations.)

To summarize, this mass of legislation is intended to keep the existing administrative/regulatory regime running and up to date. It is not intended to set substantial new policy directions. Republican opposition has derived more from a disinclination to engage in the regulatory process at all rather than from opposition to specific measures.

Market Developments
Risk assets generally had a good month. US large cap stocks (as represented by the S&P 500) rallied +7.2% in an atypically busy August, raising the year-to-date performance to +9.7%. Technology, healthcare, quality growth, momentum, and the usual suspects (Apple, Amazon, Google, Facebook, Tesla, Nvidia, Zoom) blazed new heights.

There are several proximate causes of this euphoria: first, an evident economic upswing with indicators of inflation (including headline, core, and wage measures), and activity (capacity utilization, business purchasing) all having ticked up since their Q2 lows. While many indicators remain weak (e. g. unemployment at 8.4%%; GDP down -8%) what matters is that the US has perceptibly shifted beyond its Q2 recession phase into an early cycle recovery phase that many argue can be sustained. Second, while many shops and restaurants remain closed, and airline and energy companies flounder, a far larger proportion of our stock market lies in those bellwether tech firms which have enjoyed rising sales and earnings as the trends they bet on (like remote work, online shopping and cloud computing) have continued to pay off faster than previously expected. No wonder renowned investor Warren Buffett now holds a significant position in Apple. And third, the Federal Reserve's widely watched signal from its annual Jackson Hole meeting was a dovish one: the Fed is shifting to target average inflation, we were told, and hence may tolerate short lived inflation spikes as long as the broader trend appears controlled. So even though 10-year treasuries now yield less than inflation (0.72% vs 1.0%) no rate hike lies on the immediate horizon.

Market Index	August 2020	Jan-Aug 2020
S&P 500	7.2%	9.7%
Russell 2000	5.1%	-4.6%
MSCI EAFE	2.2%	-0.7%
MSCI Emerging Markets	-1.1%	-8.8%
Bloomberg Barclays US Government	-0.8%	6.3%
Bloomberg Barclays US Aggregate	1.0%	0.7%
Bloomberg Barclays US High Yield	1.4%	-2.1%
Bloomberg Commodity	0.3%	2.1%

Outlook
Many investors are again wondering: are we in the midst of another market bubble? Quite possibly. The S&P 500 index ended August at a nosebleed 29 times trailing earnings, roughly double its long-term average. Worse, August's buoyant stock market headlines mask a worrying lack of breadth: not only is the recent market rise driven by just a handful of names, but their trajectories recently appear to have gone vertical (like Salesforce up 15% in a week, or Zoom up 40% in a day on little news). Professional investors as a group appear confused and market-shy, while individual investors are still gleefully piling in (thanks to Robinhood's free trades having become the norm across Schwab, Fidelity and others). It seems reasonable to imagine that - with a second wave of COVID-19 induced human and economic damage, plus more corporate bankruptcies and a likely contentious election, all lying ahead - the Fed's posture will remain accommodative into 2021. Still, many of today's investors remember past crashes (including 2020's own narrowly averted ruin) so while bulls love to point out those ballooning money market balances, they aren't enough reason

not to dash for market exits upon the first signs of trouble. Bubbles are famously hard to call, and even harder to time; suffice to say current markets indicate ample cause for caution.

Where might safety lie? An area of obvious neglect is suggested by Exxon's imminent drop from both Dow Industrials 30 and S&P 500 indexes. Exxon was the longest serving component of the former, having joined in 1928. As recently as 2013 it was the largest US company with a market capitalization of $415 billion. Currently it is closer to $180 billion. Only Chevron now represents oil in the Dow, and speaking of industries represented in the Dow, oil is currently the S&P 500's smallest at 2.5%. Our June Commentary noted the changing investment character of integrated oils and urged that they be considered only as bond alternatives and only with proper attention to dividend coverage. That guidance is reaffirmed.

Other possible equity allocations are US Value and International Equity. Both appear significantly cheaper than the S&P 500 index, but also lack its evident earning power. We will examine International stocks in a future note. For many US Value names meanwhile, the best-case scenario is a future infrastructure bill - potentially massive and hopefully bipartisan, in 2021. Besides the perennial highways and bridges, we would note the evident need to upgrade the electrical grid as a candidate for infrastructure investment. Bear in mind that value sectors (like banks, industrials, and basic materials) tend to rally during early phases of a business cycle recovery, which is where (as we saw earlier) the data places the US at present. We are growing sympathetic to this cyclical timing argument as well as to dividend yields that currently approach 3% with low duration (i.e. low interest sensitivity) to boot.

Finally, we turn to treasury bonds. Respected market commentators (like Ray Dalio, Jeff Gundlach and Ben Inker - all colleagues we respect and whose views we track carefully) appear to have reached consensus that US treasuries yields (currently a measly 0.72% for a 10-year term, or approximately their lowest ever) cannot possibly fall below 0%. Therefore, the argument goes, the likely next move of significance is toward much higher yields, which would then cause these bonds to fall in price. Hence our respected colleagues are out hunting for substitutes, which range from gold, to inflation-linked bonds, to exotic tactical strategies. We see ample mathematical, empirical and economic evidence to not capitulate to this consensus view, weighty though it is. First, there is simply nothing verboten about negative yields. Japan, Switzerland and Germany are all living with negative government bond yields, which the bond math (professionals: think "divide by 1 + r") supports effortlessly. Second, even if the bond bull market is over, it does not follow that things will immediately turn bearish. Yields could range trade at their current levels for an extended period. Elevated US unemployment is reason enough, for now, to suppose that yield fluctuations will remain more symmetric than widely supposed. And always bear in mind that when it comes to investing, the only safety guaranteed by consensus is that of failing conventionally.

Guidance

We've called for a prudent disjointing (or "barbell") allocation since May. While that remains our headline guidance, at current valuations, it makes sense to dial up caution. Conditions favorable to continued upward momentum in quality growth technology names remain in place - so another few points of upside in those names (shaking off current market turbulence) should surprise no one. But as we enter fall, now is an apt moment for dynamic allocators to review and reengage their sell discipline. Building upon this theme, while income is scarce, bonds still merit a place as risk mitigators in portfolios seeking balanced growth.

That said, it's time to look beyond the obvious categories that have served investors well for so long. Value stocks appear compelling. Superior long-term investment opportunity is however likeliest to lie in relatively inaccessible niches: entrepreneurial businesses that capitalize upon the newly normalized modes of work, school, healthcare and socializing; distressed private debtors who lack access to government or bank facilities; owners of neglected or beaten down assets who successfully repurpose them. Stepping further back, for the majority of investors, what matters now and always is timeless: peace of mind through securing one's longer-term financial goals, plus the confidence to re-engage during periods of market uncertainty.