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Key questions as equity volatility picks up

After a strong surge in the summer, equity prices have cooled in recent weeks. The technology sector entered a full-blown correction, and weakness has spread to the broader market. Key drivers for the decline include diminishing prospects for a new fiscal stimulus package, rising coronavirus cases, growing uncertainty over U.S. election prospects that accelerated with last week's news about President Trump's health and concerns over full valuations. As we enter the last quarter of the year, investors face a number of key questions and rising uncertainty.

HIGHLIGHTS

- **Over the summer, investors appeared to be positioned for a better economic environment than we expected. And as that acceleration appears to be fading, stock prices have been coming under pressure.**
- **Stocks look relatively expensive, but appear more attractive when compared with cash and government bonds.**
- **We think stocks are likely to remain choppy for the rest of this year, but also believe prices will be higher one year from now.**



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Why is economic momentum fading?

When the world entered the throes of the sharp recession in the spring, we expected a sharp rebound followed by a gradual and choppy economic recovery. The initial recovery resembled a “V” pattern, but the path has since cooled and looks more irregularly higher. Two key factors have driven economic momentum: 1) massive monetary and fiscal stimulus from interest rate cuts, new Federal Reserve programs, unemployment assistance and benefits to individuals and businesses; and 2) a reopening of areas of the economy. At this point, both of these tailwinds are fading.

Absent a proven and widely available coronavirus vaccine, many individuals and businesses are reluctant to return to “normal,” even if lockdown restrictions are eased further. This will slow the economic recovery and could cause disappointments for those expecting a quicker return to pre-pandemic activity levels. As far as monetary policy, the Fed and other central banks are committed to retaining near-zero interest rates for years to come, but monetary policy cannot do much more absent a new emergency. Finally, the odds of a near-term deal on a new fiscal stimulus package are fading. Counter to earlier expectations, a deal before the November elections seems unlikely. We will almost certainly see some sort of additional stimulus after the election and/or in 2021, but the delay is causing real pain to individuals and businesses who desperately need assistance.

To be clear, we have not turned more negative on prospects for economic growth. We always expected momentum to fade. But it appears that many investors expected a stronger recovery and priced in prospects of additional economic reopening as they banked on more fiscal stimulus. As such, many areas of the stock market started to look frothy over the summer and stocks were poised for a setback.

Are U.S. stocks overvalued?

This is a key question and is more complicated than it might seem. On an absolute basis, valuation measures based on corporate earnings prospects (trailing, forward and cyclically adjusted) all suggest equities are expensive relative to their own history. Additionally, stocks also look expensive based on measures such as price-to-book, price-to-sales and total market capitalization relative to GDP. All of this implies that long-term returns for the broad market may be limited over the coming decade.

On a relative basis, however, stocks look more attractive when compared with cash and many areas of the bond market. With short-term rates pegged at zero, investors are essentially getting almost no returns on cash investments. And government bond yields remain at or close to historical lows (and remain below zero in some countries), making them even more expensive than stocks. This is the so-called TINA (there is no alternative) argument for stocks: It’s hard to make the case that stocks aren’t the better option when the dividend yield of the S&P 500 is higher than long-term government bond yields.

Where are stock prices heading?

Although stocks prices have declined since August, short-term risks still look somewhat elevated. Equities have not regained their footing since the market high on September 2, as economic reopening and hopes for fiscal stimulus have been fading. Additionally, uncertainty over the U.S. election has been rising even before we learned that the president tested positive for coronavirus. Many investors are worrying about (or indeed expecting) a protracted post-election battle over who actually won. Technical measures have also turned more mixed, as the selloff that started in the high-flying technology sector has spread to the broader market.

At this point, we counsel patience for investors. We think stocks are likely to remain in a sideways, choppy trading pattern through the end of the year. And it is very possible that stocks hit their high for the year when the S&P 500 Index reached 3,588 on September 2).¹ We're not expecting significant downside risks, but we think stocks need time to digest the gains earned since March and fundamentals need time to catch up.

While we think near-term risks for stocks remain elevated, we also believe global equity prices will be higher one year from now. At least one vaccine candidate currently in Phase 3 trials is likely to prove viable and be widely available at some point by the first half of next year. And policymakers should eventually be able to enact additional fiscal stimulus. These factors should allow the economy to reaccelerate, and stocks typically do well when economic growth is climbing. Looking ahead, we think it is likely that corporate earnings will exceed their previous peak by the end of 2021 and the U.S. economy should reach a new GDP high in early 2022.

This leads to questions of investment positioning. Stock selectivity looks to be more critical than ever, given near-term pressures, the likelihood of diminished long-term returns and ongoing volatility. We have long been waiting for a rotation from U.S. to non-U.S. stocks, but that leadership transition remains elusive. That shift would require the sort of synchronized, robust acceleration in global growth similar to what occurred after the global financial crisis. Chinese growth has been improving, but we need a broader global economic reopening, which probably requires a coronavirus vaccine. For now, we think investors should continue to focus on companies that have proven abilities to generate (and put to work) free cash flow and those that have sustainable earnings prospects. Additionally, we think investors should continue to own a mix of growth and value stocks with a tilt toward cyclical, as performance leadership shifts can happen quickly.

2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	1.5%	5.1%
Dow Jones Industrial Avg	1.9%	-1.3%
NASDAQ Composite	1.5%	24.3%
Russell 2000 Index	4.4%	-6.8%
MSCI EAFE	1.6%	-6.7%
MSCI EM	2.2%	-0.9%
Bloomberg Barclays US Agg Bond Index	-0.1%	6.7%
BofA Merrill Lynch 3-mo T-bill	0.0%	0.6%

Source: Morningstar Direct, Bloomberg and FactSet as of 2 Oct 2020. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indexes are unmanaged and unavailable for direct investment.

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1 Source: Bloomberg, Morningstar and FactSet

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the *Nasdaq*. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **Russell 2000 Index** measures the performance approximately 2,000 small cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **Euro Stoxx 50** is an index of 50 of the largest and most liquid stocks of companies in the eurozone. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index (DAX Index)** is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. **MSCI EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. The **BofA Merrill Lynch 3-Month U.S. Treasury Bill Index** is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

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