CONWAY • JARVIS LLC
Investment Outlook

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Perspective On a Post-Recession Stock Market

As the close of Q3 approaches, investor focus is turning away from a grim and gritty 2020 toward a better 2021, or so we hope. However, the path dead ahead to that better next year is beset with uncertainty surrounding the next stage of the pandemic, the policy response and its effect on the economy, and the upcoming election. All of which will have an effect on the stock market. Recent forecasts predict the economy returning to pre-pandemic levels of production and growth by the end of this year. If true, we will have endured a deep, but short, recession that left Wall Street enjoying a new bull market while a substantial portion of Main Street languishes. Our worry is how the market will react to the reality of a smaller, slower economy emerging in the wake of the recession.

Recession or Just An Intentional Pause?

Initially, news of the pandemic prompted us to voice concerns about its effect on human behavior, the economy, and its markets. We worried that the institutional and governmental response might prove to be more damaging than the virus itself. Many, we among them, thought that the economy would contract for a number of quarters and perhaps years due to the virus and the lockdown that followed. We feared we were looking at the mother of all modern-era recessions. Well, here we are, barely two quarters later, having witnessed the shortest bear market in history, the quickest bull market recovery, and what looks like to some as an impending end to a deep, but brief, recession. Could this have been the best recession ever?

We'll answer that with a resounding "Maybe." Investors generally focus on GDP growth as a measure of the economy expressed in percentage terms. In Q1 2020 we saw the economy *contract* by *5%* as the recession officially started in February. With the economy intentionally *paused* in response to the pandemic, the second quarter followed with a decline of *31.7*%. Thankfully, the Fed was on its game early in Q1 and used all its tools to preempt any thoughts of the "D" word (Depression) occurring. Current forecasts for the third quarter now have GDP growth *expanding* roughly 32%. That would officially mark the end of the recession. Looking beyond year-end, it's estimated that US GDP may *expand* by 3.2% in 2021. By any measure, that's a full recovery.

In search of a simpler view of the recession and recovery, we measured nominal dollar amounts for GDP and Retail Sales, using 2019 (a pretty good year!) as the baseline and high watermark. 2019 ended with GDP and Retail Sales totaling $21.7 trillion and $529 billion respectively. We saw those numbers drop to $19.5 trillion and $413 billion with the economy at its lowest ebb. Current forecasts have GDP returning to its peak level sometime in Q1 of next year. Retail sales have been on a tear, aided by record e-commerce numbers, and are expected to hit their peak level by the end of the year. When combined with data flowing from the Manufacturing/Industrials sectors, it appears we are on the cusp of what only can be defined as a remarkably robust recovery. Perhaps, the stock market had it right as it "V'd" up to a new record high.

Where Do Stocks Go From Here?

As governing bodies hit the "*Pause*" button on the economy, the stock market responded accordingly with a contraction of its own to the tune of -35% between February 19 and March 23rd. The Fed then stepped in with no tool spared in adding historic levels of liquidity to the economy. The NASDAQ, propelled by its mega and large-cap Tech components vaulted beyond its previous record high to achieve its own bull market in June. The S&P 500 followed to a new record in mid-August, officially making it the quickest bull market recovery in history. So, assuming the virus cooperates and a vaccine becomes available, how will the market react if and when the "Play" button is pushed and the economy is reopened?

First and foremost, it's likely the stay-at-home tech stocks that have been driving much of NASDAQ performance will recede from their nosebleed valuation levels. Much of that capital will likely be directed to more rationally priced value/income stocks rather than the sidelines. We're seeing indications of this beginning in these first few weeks of September. Secondly, because human behavior is slow to change, the sectors hardest hit by the pandemic are likely to lag the broader market. Those would include travel, leisure, hospitality, brick and mortar retail, and secondarily the banks that finance so many of those businesses and their landlords. This view is consistent with our belief that a smaller and slower-growing economy will emerge from the recession and persist for the next couple of years as people continue to give thought to the potential consequences of gathering in public.

For that reason, we'll borrow the oft-used phrase, "Abundance of Caution", in describing our approach to the market. We expect to see the broad market trade erratically with a modest upward bias as the recovery unfolds. The internals of the market should reflect a reallocation of capital from some investor-loved companies to some attractive laggards and a few stocks with a bit of hair on them. For us, that means beginning to slightly reduce our exposure to some over-weighted winners and move capital into what we believe to be stocks playing "catch-up" in a post-pandemic economy.

For us, the end of recession is not a signal to *increase* exposure to stocks but to optimize *where* we get that exposure within the market. This is especially true with the election approaching and holding the potential to impart a significant change in fiscal policy. As we reallocate capital within the market, we caution clients to avoid falling in love with the *amount* of certain stocks that they own since breaking up (profit-taking) is hard to do. We're not intent on *abandoning* those companies that have served us well these past few years. We'll still own them. We *are* intent on remaining disciplined in our approach and that means maintaining an optimal level of diversification by periodically rebalancing portfolios. That's Investing 101.

Here's an Update on Our Identified Risks to Recovery and Economic Expansion:

COVID-19: As we approach the flu season, concerns persist. The focus is turning toward a reduced number of hospitalizations even though cases increase in some regions. There are indications that some level of herd immunity is being acquired. **Moderate, reduced from Significant**

The Fed: Indications are that a zero interest rate environment will continue into 2023. **Remains Benign**

Trade War: Phase Two of trade agreement stalled until next year as China awaits outcome of election. **Remains Moderate**

Global Economy: Global recession persists as uneven recovery lags that of the US. Hard Brexit prospect remains probable due to Irish border. **Significant for now.**

The Election: Debates on the near horizon. Civil and uncivil unrest now politicized. Polls point to the probability of a shift away from current fiscal policy in 2021. Investors are concerned. **Remains Significant**

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