COVID-19 and the Election

October 29, 2020

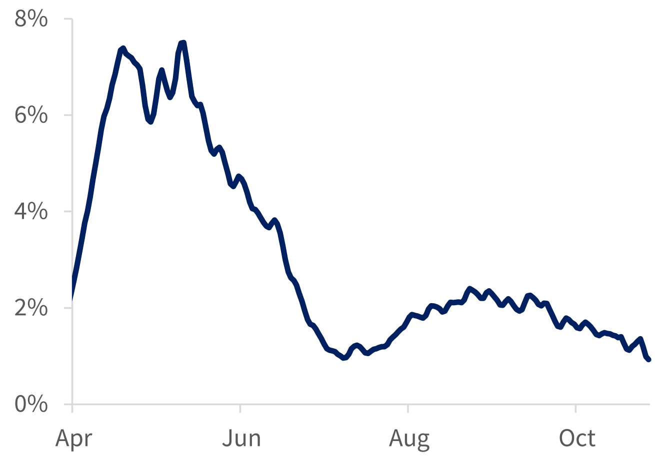
Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

US equities are off to a weak start this week, as the S&P 500 posted its worst three day decline (-5.6%) since early June and is now down almost 9% from recent highs. While pullbacks such as this are uncomfortable and never easy for investors to digest, it is always important to put the decline into perspective. Even after accounting for this recent decline, the S&P 500 is still up over 46% off of the lows in March and remains in positive territory year-to-date (+1.2% on a price return basis). In addition, pullbacks are not uncommon as the S&P 500 typically experiences three to four 5% or more pullbacks, on average, in a given year. Two factors are driving the recent market decline – the recent surge in COVID-19 cases and the uncertainty surrounding the 2020 election. The psychological impacts of these dynamics and the potential uncertainty that lies ahead is overshadowing some of the relatively healthy fundamental factors we have been seeing.

COVID-19 Resurgence

After plateauing in the late summer months, the COVID-19 outbreak is experiencing its third surge in the US. While a rise in cases was expected given the return to school, businesses reopenings, and colder temperatures, the speed of the increase has become concerning. The US posted its largest daily increase in COVID cases on record (83k) over the weekend and the seven-day moving average continues to move higher. This recent surge is not confined solely to the US, as Europe is grappling with record levels of new cases and has since re-instated social distancing measures in select countries (e.g., curfews, closure of bars). However, while the surge in cases is concerning, it is important to note that both deaths and hospitalizations have lagged the rising cases as the medical community has better learned how to cope with and treat the virus. From an equity market perspective, week-to-date, the spike in cases led to a decline in the 're-opening trade' or the bottom portion of the K-shaped economic recovery path that we have been articulating for the last several months. Some of the hardest hit industries during this pullback are those most closely tied to deteriorating COVID trends (e.g., airlines, cruises, hotels, and energy). While widespread lockdowns in the US remain unlikely, a continued resurgence could potentially reduce our economic and earnings forecasts.

COVID-19 Deaths to New Cases Trending Lower



Source: FactSet, as of 10/28/2020

Election Uncertainty

Prospects of a 'Blue Wave' led the market to anticipate a substantially larger fiscal stimulus package post-election, with estimates for the size of the potential package in the $3-5 trillion range. However, as expected, polls in swing states have narrowed over the past two weeks (Biden's average lead in the battleground states has fallen from 5% to 3.5%) bringing uncertainty to the market's base case of a Democratic Sweep. Subsequently, the odds of the Democratic party gaining control of the Senate have declined ~14% (from 70% to 56%) over the past three weeks.

Probability of Democratic Senate Majority Decreasing

Source: FactSet, as of 10/28/2020

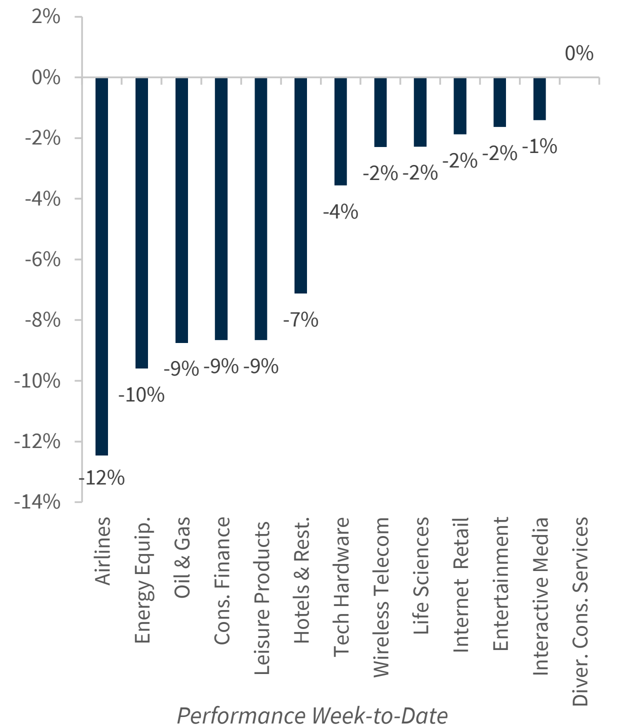
Since further fiscal stimulus is likely a post-election issue, gridlock in Congress may either reduce the anticipated size of the bill or delay its passage until next year. While the economic recovery has remained on solid footing, the record amount of fiscal stimulus was the driving force to 'bridge' this economy to a more normal, post-COVID time period. As the benefit of the initial stimulus wanes, the more challenging the recovery becomes. The postponement of stimulus will likely hamper the near-term strength of the economy and may slow the pace of the recovery for both employment and small business re-openings. Small businesses highlight the need for further action by Congress, as the number of open small businesses is still down ~25% with well over 100k small businesses permanently closed.

Percentage of Small Businesses Closed

Source: FactSet, as of 10/28/2020

This week, the market is set to receive economic data points that will likely show that the third quarter (ended September 30) was the strongest quarter of economic growth in history (Raymond James Estimate: 30-35%). Similarly, the third quarter 2020 earnings season has come in much better than expected (82% of companies have beaten their earnings expectations and by an average of 15%) and has illustrated the resiliency of corporate America. However, we acknowledge that both of these figures are backward looking and may be overshadowed by concerns about the future path of COVID and the election outcome. But given that we've experienced COVID fears throughout the year and that we've dealt with contested, polarized politics before, we caution long-term investors from making short-term investment decisions based on these events.

Re-Opening Industries Underperforming Week-to-Date



Source: FactSet, as of 10/28/2020

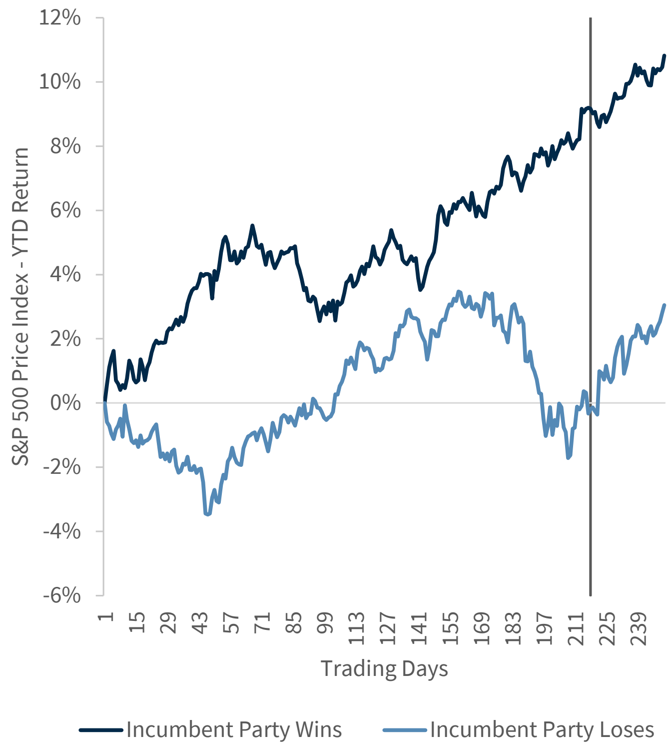
Conquering COVID-19

While we do expect the new case count to remain elevated into the winter, we do not expect a full scale shutdown like we saw in April and May. Local and regional restrictions (i.e., Chicago) may be put into place, but those are likely to be isolated, worst case situations. The upward path of the virus is likely to fuel uncertainty until a vaccine is developed, but what could change psychology in a positive direction is favorable results from Phase III trials (i.e., Pfizer, Moderna, Astrazeneca, Johnson & Johnson) that could be released within the next few weeks. However, as a widely available vaccine is not expected until next year, we forecast both the economy and the equity market recovery to remain bifurcated until then, with industries in the top portion of the 'K' driving positive performance while industries in the bottom portion of the 'K' lag. As a result, selectivity will remain critical. We reiterate our bias to the Info Tech, Communication Services, Health Care, and Consumer Discretionary sectors as favorable earning and sales growth given their location within the top portion of the 'K' should boost these sectors.

Election Clarity

History has taught us that there has not been a meaningful party-driven difference in long-term portfolio performance, and that maintaining a consistent strategy under volatile times is typically the best path to success for investors. Using the equity market (S&P 500) as a predictor of the presidency suggests the election remains a toss-up. The three-month performance (since August 3) prior to the election favors the incumbent (Trump) if it is up and the challenger (Biden) if is down. Since August 3, the S&P 500 has been essentially flat (demarcation line is 3,294). More importantly, the equity market tends to move higher post-election (regardless of the winner) as the market tends to benefit from more clarity around the winner and the potential policy impact moving forward. We believe that more fiscal stimulus is a question of when, not if, and its eventual implementation should serve as a boost to the economy. Our base case is that a Trump victory will get the stimulus sooner but that a Democratic Sweep will result in a larger stimulus package.

Market Performance Given Which Party Wins

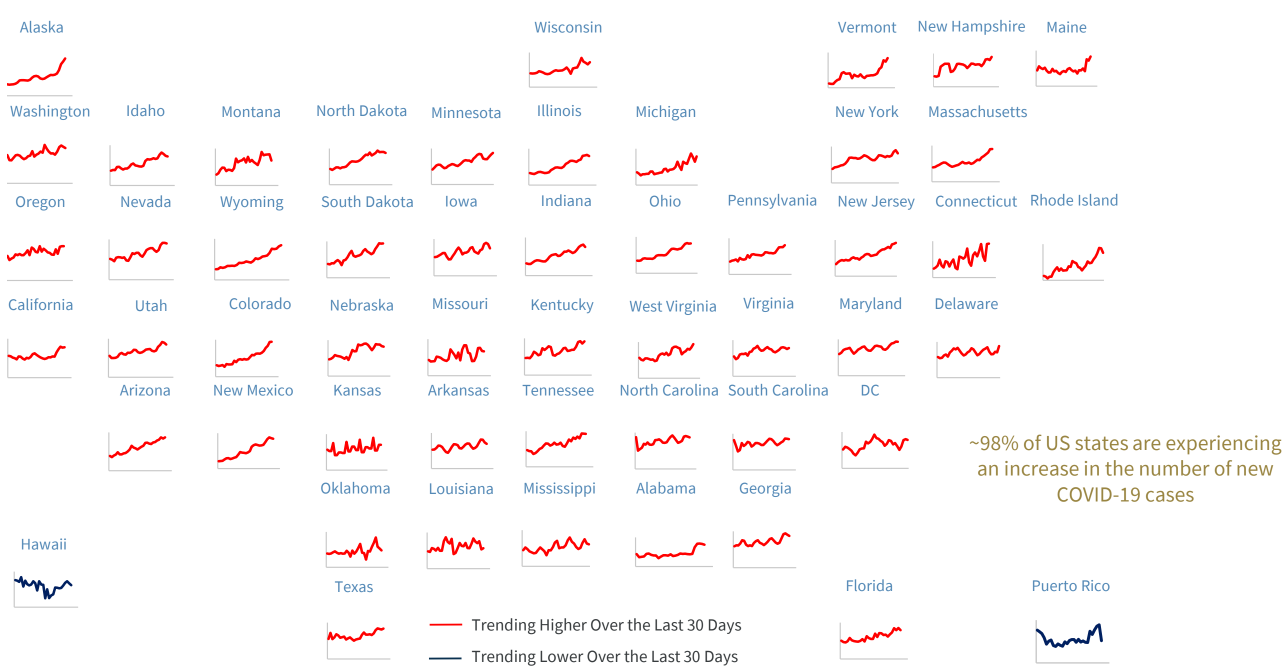


Source: FactSet, data since 1947

Bottom Line

In the weeks ahead, the market may continue to face elevated volatility until Election Day passes and/or the recent COVID surge is mitigated. But as we get over 'election fatigue' and 'COVID fatigue,' psychology is likely to improve and we can once again focus more squarely on fundamentals, which we believe should improve as we move into next year. As a result, we remain optimistic on equities longer term, and we reiterate our 12-month S&P 500 price target of 3,530.

Daily New Cases Trends in the US



All expressions of opinion are those of Investment Strategy and not those of Raymond James & Associates, Inc. and are subject to change. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Past performance is not indicative of future results. No investment strategy can guarantee success. There is no assurance any of the trends mentioned will continue or that any of the forecasts mentioned will occur. Economic and market conditions are subject to change. Investing involves risks including the possible loss of capital. The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion. It is not possible to invest directly in an index. Technical Analysis is a method of evaluating securities by analyzing statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity. Further information regarding these investments is available from your financial advisor. Material is provided for informational purposes only and does not constitute a recommendation.

RAYMOND JAMES®

INTERNATIONAL HEADQUARTERS: THE RAYMOND JAMES FINANCIAL CENTER

880 CARILLON PARKWAY // ST. PETERSBURG, FL 33716 // TOLL-FREE: 800.248.8863 // RAYMONDJAMES.COM