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Midland

Wealth Management

Market Outlook

Uncertainty May Lead to Greater Volatility

Fall has arrived with shorter days, cooler nights and leaves showing the true beauty of the season. With the change of season also comes the highly anticipated election with political posturing at the forefront. Uncertainty surrounding the outcome and constant conversation about what each candidate will mean for the market and economy is ever-present and difficult to ignore. In reality, over the long term it hasn't mattered who was president or which party was in control. The equity market has moved higher during each presidency back to 1930, except for George W. Bush's terms. Under Bush, the market experienced two recessions and two bear markets (2001-02, 2007-08). The economic environment has a greater impact on market returns than who is in control in Washington.

What does happen during election cycles is increased volatility due to the uncertainty of future policy. This year is no different. What do the candidates' platforms mean for the market? What is the market impact if Democrats take control of both the House and Senate, as well as the Oval Office? What is the impact if Republicans maintain the Oval Office and Senate or just maintain the Senate? While the ultimate outcome from these respective scenarios is unknown, a brief commentary on each follows:

Trump wins with Republican-controlled Senate, Democrat-controlled House

- Very little change from the current status. A tougher stance on China will be one of his primary areas of focus. In addition, he may introduce further tax cuts for the middle class but odds of it passing Congress are limited.
- Not covered here is a sweep of the House and Senate by Republicans but if that were to occur, policies pursued by President Trump would have a greater probability of enactment.

Biden wins with Republican-controlled Senate, Democrat-controlled House

- A primary focus of this scenario is tax increases. This includes reversal of tax cuts implemented under Trump for corporations and individuals. In addition, capital gains tax would increase, especially for higher income individuals. This may be difficult to implement with a split congress.
- Another topic on Biden's platform is increased government oversight in many industries including energy, financial services and healthcare to name a few. Once again, a divided congress will make this somewhat difficult to enact.

Biden wins with Democrat-controlled House and Senate

- There is a higher probability of increased taxes passing, which would result in lower earnings for corporations. If implemented early in Biden's presidency, reduction in 2021 earnings per share (EPS) for the S&P 500 is estimated to be 10% to 12%. Capital gains tax increase may result in selling before year end to take advantage of the lower tax rate.
- Regulations will increase, which typically result in higher costs for corporations.

Although long-term market returns are not dependent on the president or the party in control, congressional checks on the Oval Office have historically been a positive influence on the stock market. When there has been a Democratic president and a split Congress, the Dow Jones Industrial Average has returned 7.99% per year on average. Markets perform well when there is more

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certainty and minimal change. With a split government, no candidate's platform will be embraced wholeheartedly, and dramatic changes to policy will not happen.

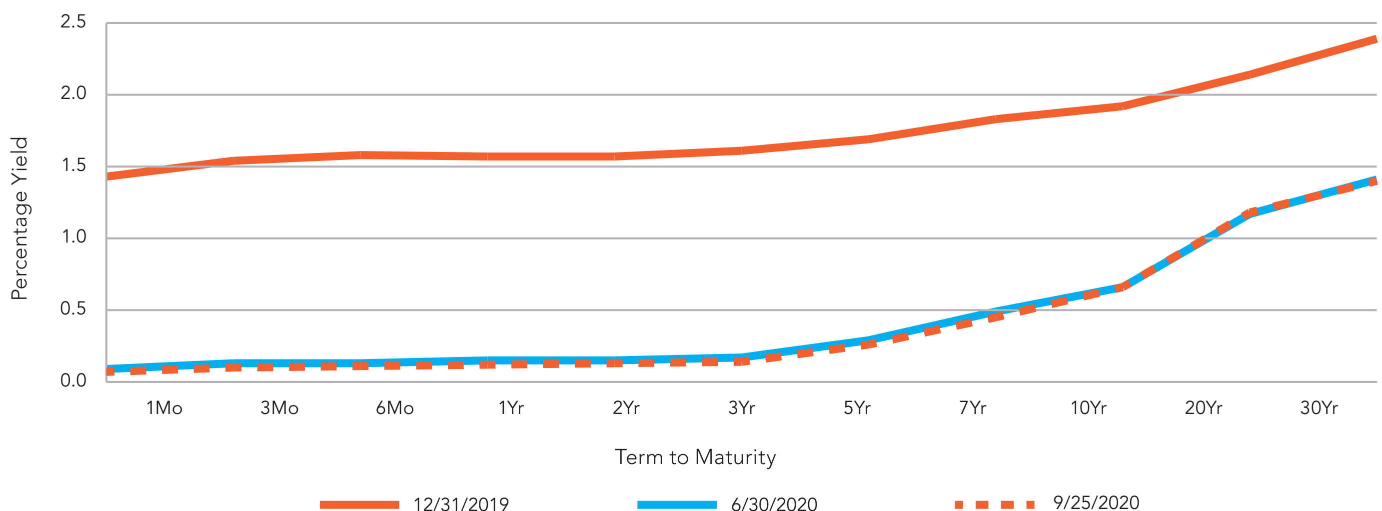
During the third quarter, equity markets provided positive returns for investors with strong performance in July and August. The S&P 500 experienced one of the fastest recoveries following a bear market, from a record high to a new record. From the February high to a new high in August with a bear market in between, it encompassed only 126 trading days. When analyzing past elections, incumbents are 0-6 when in a recession or if there has been a 20% drop in the market during the election year. Will this market rebound and economic recovery be enough for President Trump to break this trend? This election year is different than the past because the recession and bear market were a result of an exogenous event (COVID-19) rather than the normal business cycle (strong demand, tight monetary policy).

While volatility may increase during this period, ignoring the market headlines and remaining a long-term investor have proven time and time again to be the best decision. Proper assessment of risk tolerance and long-term goals will result in an appropriate asset allocation. No one can control the day-to-day volatility. As history has shown, no matter which party is in control, the market has provided positive returns over the long term.

Federal Reserve Policy and the Fixed Income Market

Fixed income investors could have slept through the third quarter and not missed a beat when it comes to Treasury yields. The fundamental outlook for Treasury yields and Federal Reserve Bank (Fed) policy remains highly dependent on coronavirus-related outcomes. If the economic reopening and recovery proceeds as anticipated, the front end of the yield curve (short-term interest rates) should remain anchored by a patient and accommodating Fed. Longer yields would likely rise as the market reprices the growth and inflation outlook. However, if the rise in new COVID-19 cases inhibits the economy's reopening and recovery, yields could retest their low levels of last March. Any economic setback should contain upward pressure on the longer end of the yield curve.

Fed monetary policy continues to add liquidity and stability to fixed income markets. If needed, qualified borrowers can raise funds at cheap relative rate levels. However, smaller businesses, which utilize banks for funding, are most affected by the pandemic and are having a hard time opening or staying open. Credit markets are working well for both buyers and sellers of bonds. This easier credit flow environment was the result of the Fed's aggressive moves during the volatile first and second quarters. During that period, the Fed took emergency actions that slammed short-term interest rates to nearly zero while expanding its security purchasing program. Even now, the Fed is expected to buy about $120 billion of fixed income securities monthly. Recent statements from the Fed suggest it will maintain its low interest rate policy until possibly 2023. The Fed reinforced its strategy to increase the level of consumer inflation to a 2% target. However, in change to previous statements and actions, the Fed is willing to have consumer inflation exceed 2% for a period of time before tightening policy. The new policy enhancement suggests the Fed is worried about the risks to the current path of the economic recovery in light of the COVID-19 related condition holding back growth.



With the Fed relentlessly pursuing maximum employment (assuming inflation doesn't get out of hand), economic data won't really matter anymore for Fed policy until much later in this recovery cycle. The Fed is pursuing more of a social agenda where backsliding from full employment could result in additional easing, while growth has no impact. For now, the Fed's reaction function to tighten monetary policy has a high hurdle.

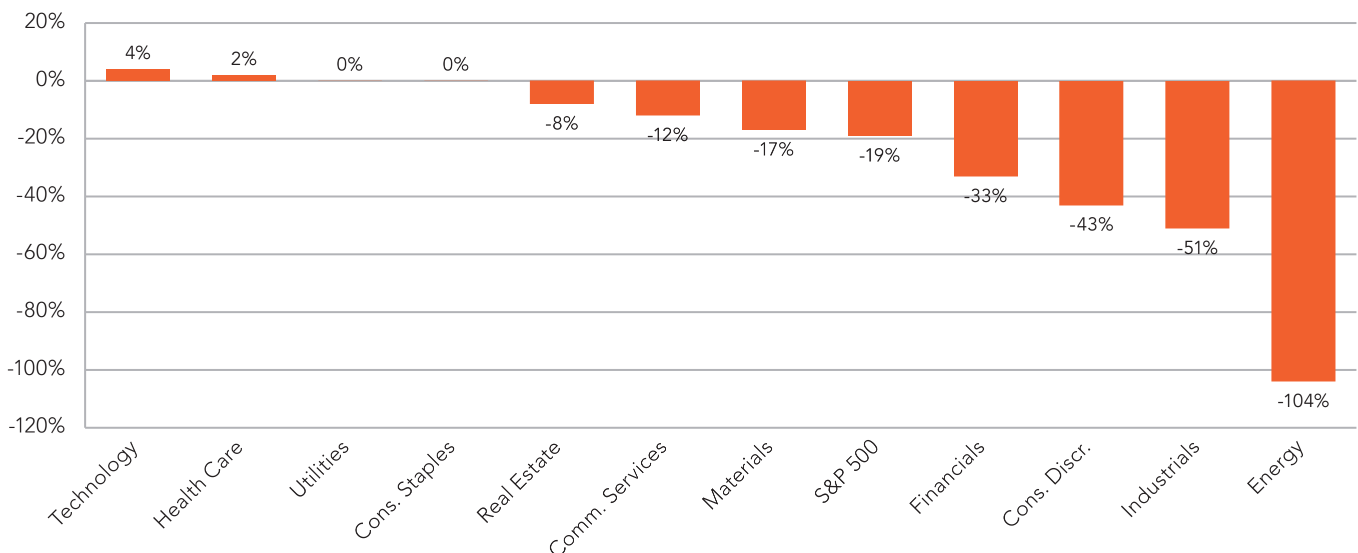
With the Fed's actions, U.S. Treasury yields setting record lows and razor thin credit spreads, some investors are questioning whether traditional core fixed income can still serve as effectively as a ballast or insurance in portfolios. Historically, the interest rate sensitivity of a core bond allocation served as a diversifier to equities, providing price appreciation potential and resiliency in the face of stock market declines. Core bonds generally have been used to help decrease overall investment portfolio volatility while pursuing attractive returns that can outpace inflation. Even with interest rates somewhat range-bound at lower levels, we believe this correlation benefit should persist – that is, rates could still go lower in a negative growth scenario when equities and risk assets underperform.

We have taken the position that interest rates will remain under control of the Fed for the next few years. We are managing our fixed income portfolios slightly above the 4.12 year duration of the Bloomberg Barclays' Intermediate U.S. Government/Credit Bond Index. We find this level of duration prudent in light of the current pace of economic recovery, the level of assets purchased by the Fed and high level of market liquidity.

We favor the short- and intermediate- term as opposed to longer-term maturities. With the Fed maintaining its easy monetary policy and providing a backstop for market liquidity, investors may look to or need to take on risk for added income and yield. With the potential valuation asymmetry in upside versus downside to rates, we find it hard to be positive on longer-term fixed income securities at present yield levels. Investors can take advantage by allocating dollars into credit-based fixed income securities and/or funds. We are emphasizing higher quality investment grade credit in this environment in recognition of an evolving credit cycle that could lead to downgrades and defaults next year against a backdrop of what is likely to be a long and uneven economic recovery. While a fixed income portfolio may not repeat the good returns of previous quarters, it offers value in a diversified portfolio. Rates are low, but we believe the defining features of a core bond position – diversification and return potential – continue to make it a critical component of a well-balanced portfolio.

Technology Stocks to the Rescue

At the end of August, equities certainly seemed priced for perfection as they continued to climb towards all-time highs. The S&P 500 returned 5.51% in July and also had the best August since 1986 with stocks up 7.01%. Investors skeptical of the market rally did find some vindication in September, when many of the indexes had a sharp and rapid 10% correction in three days. Volatility in September is likely here to stay as investors begin to shift their focus to the upcoming election.



Beneath the surface, we have seen an incredibly uneven equity market recovery, with major differences by both sector and style. As of September 22, large-cap growth stocks are up 16.51% YTD versus large-cap value, which are down 14.22%, a difference of 30%. The current bull market has been highly concentrated in a relatively small number of stocks. In particular, eight stocks have led the way with remarkable gains while the average stock has lagged behind. The NASDAQ index has been the standout leader this year, increasing by 50% in 100 days and pushing some stocks to an overvalued level. Recently, these eight stocks had a price to earnings ratio of 47x compared to the overall market of around 21x next year's earnings.

Technology and Health Care sectors have outshined all other sectors in the S&P 500 for many good reasons as they have benefited from consumers and businesses that can still spend money and invest for the future. Corporate earnings expectations for these two sectors are still estimated to be positive year-over-year, with Technology expected to grow by 4% and Health Care by 2%. Many of the other sectors remain in bear market territory, including Airlines, Energy and Banks. These sectors are expected to have either flat earnings growth or a significant detraction from earnings growth. For example, Energy's corporate earnings are expected to decline by 104%, followed by Industrials down 51%.

Both COVID-19 and the upcoming elections continue to have investors on edge. Typically, about five or six weeks away from an election, the market has historically traded sideways to lower. Currently, it seems the market is focusing on the election and trying to figure out what the outcome may be. Unfortunately, it is highly likely that we won't know the result until after Election Day given mail-in ballots and potential for contested outcomes. A Democratic sweep would almost certainly mean a rollback of Trump's massive corporate tax cut, which would be a negative for corporate earnings. However, additional economic stimulus and stability on the China trade front could be a positive.

International equities have seen a nice recovery from their March lows, however European equities have not been able to keep up with U.S. equities in part because of their sectoral weighting, with less Technology and more Financials. As of September 18, the MSCI EAFE was down 4.46%, but the emerging market index was slightly positive, up 1.19%. Helping emerging markets has been the weaker U.S. dollar, record low interest rates, and rising commodity prices.

Given the rapid runup in large-cap growth equities, our investment team made a tactical decision in August to reduce some of our overweight to the large-cap growth sector and increase our allocation to large-cap value. We will eventually emerge from a COVID-19 society and once a vaccine is distributed, the value style companies, which are trading at very attractive valuations, should stand to benefit the most. Our strategy continues to have an overweight to growth, albeit to a lesser extent given high valuations.

With the upcoming election, concerns of COVID-19 resurging, and current stretched valuations, we continue to remain cautious in our equity strategy as we head into the fourth quarter. We will be keeping a close eye on the market breadth and would like to see additional companies outside of large-cap Technology begin to participate in the market recovery.

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What to Review and Revise Amidst Divorce

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Have you heard the old joke, "What is the number one cause of divorce? Marriage!" Bad humor aside, the current divorce rate in the United States is 42% for first marriages. It increases to 67% for second marriages, and 73% for third marriages. In May, it was reported that the divorce rate doubled after the coronavirus quarantine was lifted in Wuhan, China. With these statistics in mind, it may be appropriate to review what actions should be taken by either party if there is a divorce.

This article will briefly touch on three areas that should be reviewed and revised accordingly. The areas cover your estate planning documents, the titling of your assets, and your beneficiary designations.

The core four of estate planning documents consists of a Durable Power of Attorney, Health Care Proxy, your Disposition of Remains Appointment, and your Last Will and Testament.

It is important to review the Power of Attorney and Health Care Proxy that allow a designated person to make financial and important health care decisions on your behalf respectively. You do not want a disgruntled ex-spouse to have this authority if anything happens to you before the divorce is final. A much-overlooked document is the Disposition of Remains Appointment. This appoints a person to carry out your wishes as to how your earthly body is taken care of after you are gone. This issue is one that arises in many extended and untraditional families.

If there is a pending divorce, you should immediately review any trust documents and your will. Wills can and should be changed during pending divorce proceedings. In some jurisdictions, a divorce will revoke any provisions to an ex-spouse under state law. For instance, if a person is divorced, dies, and failed to update his/her estate planning documents taking into account the divorce, some states may revoke the bequest to former spouses in their wills or other estate planning documents. However, many states do not have such a statute. The revocation of a divorce statute is only effective if the divorce is final (i.e. a decree) and does not apply during the pendency of the divorce proceeding. The lesson is, do not rely on state laws to remove the ex-spouse from your estate plan. Review your will to see if any dispositive provisions go to your former spouse, do not forget to check if they are named in any fiduciary capacity, and check any trust agreements that are in existence.

It is recommended that you should assemble a comprehensive and detailed inventory of assets owned, which should include how each is registered or titled. Usually this will be required at some time during the course of the divorce. Assets to retitle include real estate, bank accounts, and other registered assets. Jointly held real estate and financial accounts documents need your immediate attention with a pending divorce.

Do not overlook authorizations to access digital accounts, including financial accounts, email accounts, social media accounts, etc., that you may have given to your soon to be ex-spouse.

Beneficiary designations should be reviewed on life insurance policies, employee benefit plans, and your individual retirement accounts. You should contact each insurance company that issued a life insurance policy and ask them for a new beneficiary designation form to fill out and sign.

With employee benefit plans, the administrator should be contacted to request how the beneficiary can be changed. While most of the property interests are governed by state law, it is possible that Federal law may have an effect in certain cases. This is especially true if the company's retirement plan must comply with ERISA regulations. The Employee Retirement Income Security Act of 1974 (ERISA) governs spousal rights in retirement plans.

Contact the custodian of your individual retirement accounts and inquire what steps need to be taken for the change of beneficiary to become effective. It is important not to rely on telephone instructions for the beneficiary change. Make sure to obtain it in writing and confirm it is sent and received by the appropriate recordkeeper.

Remember to review financial arrangements that include joint lines of credit, joint loan guarantees, and direct deposits into accounts that may have been titled or held with the soon to be former spouse.

Lastly, keep in mind that there are a number of assets that should be considered and reviewed because of their specific nature, including: closely held business interests, partnership interests, real estate held for investment purposes, artwork and collectables, private market interests with liquidity restraints, and aircraft or watercraft.

Hopefully you will not need this advice, but it may prove useful for someone you know going through a divorce.

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