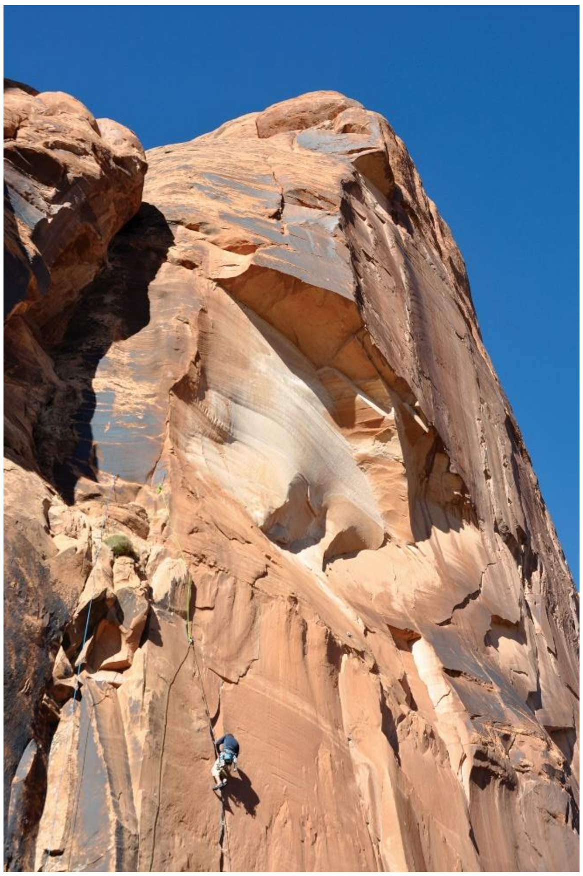
Sunday Night Insight
July 19, 2020

Climbing the Wall of Worry



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Since the trough of the S&P 500 on March 23rd, US equities have climbed the "wall of worry." Reported daily COVID-19 infections have skyrocketed, fatalities have increased, hospitals in states such as Florida and Arizona have faced an onslaught of COVID-19 patients stretching their ICU capacities, Google and Apple Mobility data have recently stalled, budget deficits are set to approach WWII levels, President Trump's approval ratings have declined, and prospects for a democratic sweep of the Presidency, Senate, and House of Representatives have increased, bringing with it fears of higher taxes.

While climbing this wall of worry, US equities have returned 45.0% from the trough, offsetting all prior losses for a cumulative year-to-date return of 0.9%. Non-US developed equities have returned 29.7% in local currency terms and 38.6% for dollar-based investors given US dollar depreciation over this period. On a year-to-date basis, non-US developed equities returns have lagged US equities, with returns of -7.7% in local currency terms and -7.4% for dollar-based investors. The US dollar is nearly unchanged year-to-date relative to a basket of developed market currencies.

Emerging market equities have rallied 37.7% from the trough for a year-to-date return of 0.4% in local currency terms and -3.8% in dollar terms, as emerging market currencies have depreciated in 2020.

The steady climb of the S&P 500 and non-US equities in the face of rising COVID-19 infections, slowing economic growth, and election concerns has prompted many investors to question the sustainability of this rally. To address this concern and map out the rationale for our investment recommendation to stay invested in spite of this 45% rally, we hosted four conference calls over the last two weeks.

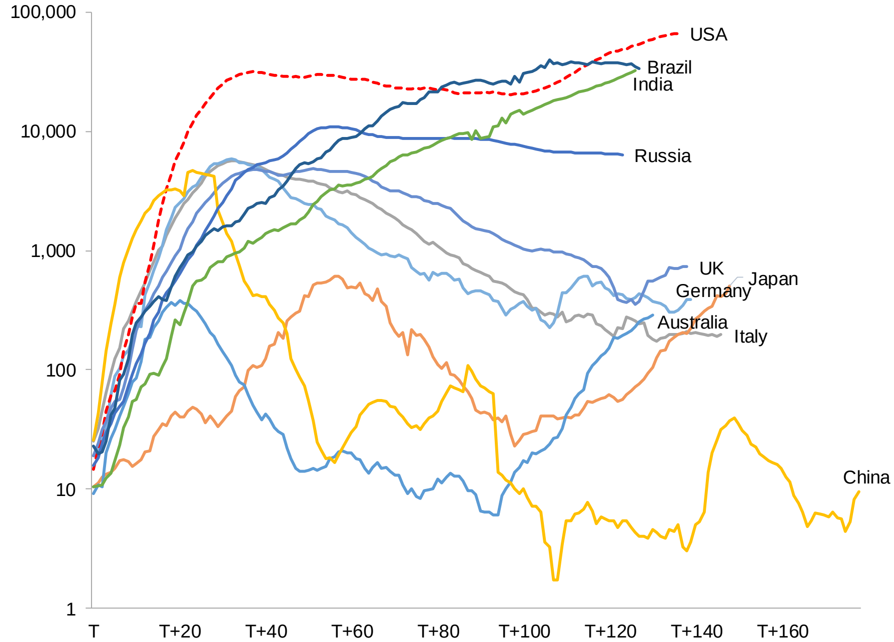
The purpose of this *Sunday Night Insight* is to review the key takeaways from each client call and conclude with our latest investment recommendation.

Before reviewing the takeaways, we begin, as we have done in prior *Sunday Night Insights*, with a brief update on COVID-19 and share some insights from Dr. Luciana Borio—Vice President at In-Q-Tel and former Director for Medical and Biodefense Preparedness Policy at the White House National Security Council between 2017 and 2019—who joined us on two of our client calls.

COVID-19 Update

Infections worldwide stand at over 14 million, with an average of 221,000 daily infections over the last 7 days. To date, about 600,000 people have died. The key drivers of the increasing infections are the US, India, and Brazil, as shown in Exhibit 1.

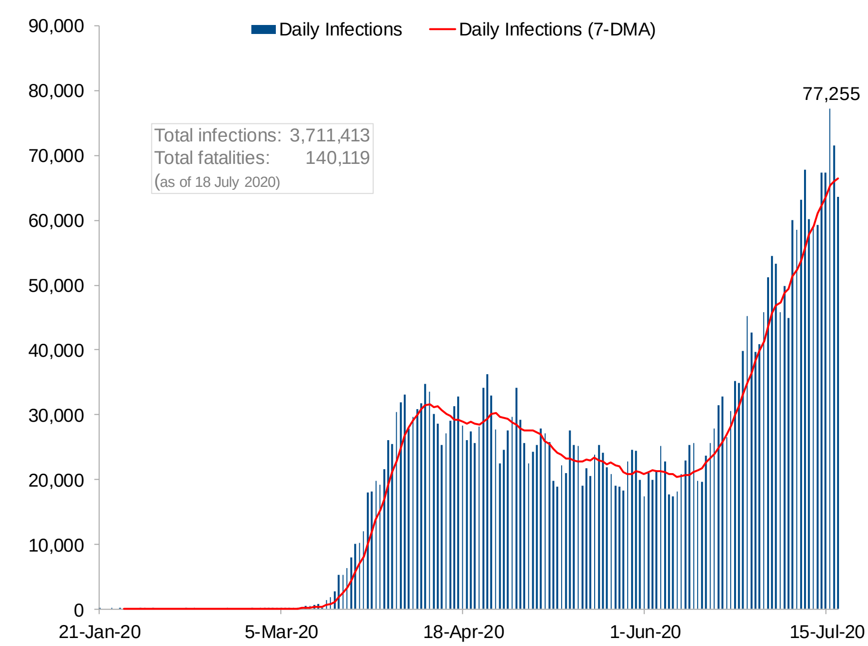
1. Global Daily COVID-19 Infections (7-Day Moving Average, Log Scale) – Through July 18, 2020



Source: Investment Strategy Group, Johns Hopkins University.

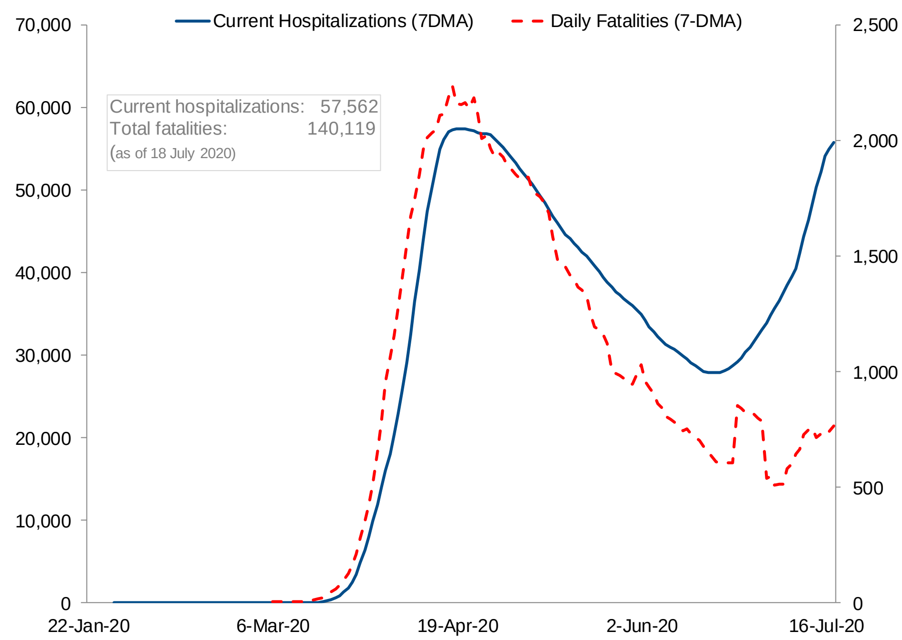
In the US, daily infections reached a peak of 77,255 on July 17th, raising the 7-day moving average to a high of 65,997. This level is more than triple the low of 20,363 infections reached on June 9th, as shown in Exhibit 2. This significant shift in the trajectory of daily new infections is driven by increases in Florida, Arizona, Texas, and California. As a result, daily hospitalizations and fatalities have also increased, as shown in Exhibit 3.

2. US Daily New COVID-19 Infections – Through July 18, 2020



Source: Investment Strategy Group, Johns Hopkins University.

3. US Hospitalizations and Daily COVID-19 Fatalities – Through July 18, 2020



Source: Investment Strategy Group, Johns Hopkins University, The COVID Tracking Project.

While nationwide testing has increased significantly over the last several months to an average of 750,000 tests per day, there are still shortages in some of the states where infections are surging and demand is exceeding supply.

In some states, the positivity rate—the percentage of those tested who test positive for Covid-19—is substantially above the World Health Organization's recommendation of 5%. Such high rates of new infections also make contact tracing virtually impossible—contact tracing for 10,000 people is much easier than for 77,000 people in the absence of a fully automated technological solution.

As we look towards the fall and winter seasons and consider the risks of further increases in the rate of new infections, we continue to seek the guidance of many infectious-disease and public-health experts. Dr. Luciana Borio, has been one such resource. The key takeaways from her comments on two of our recent client calls were:

- Until the emergence of vaccines—which she considered to be more likely in 2021 than 2020—therapies are an important tool to deal with COVID-19. She highlighted the more widely known benefits of Remdesivir and Dexamethasone in reducing hospital stay and mortality rates, but also touched upon some other promising therapies including Galidesivir, an antiviral drug that has entered into clinical trial in Brazil, and Baricitinib, an anti-inflammatory drug.

- She also shared her optimism about monoclonal antibody therapies. While there is no certainty that they would be effective, she believes that they are "the most promising therapeutic class for COVID-19." She highlighted the development of such drugs by Regeneron, Vir, and Eli Lilly in a July 5th *Wall Street Journal* article.[1]

- In terms of whether the current surge in the US is a second wave or the continuation of the first wave and what that means for the fall and winter, she said that the "issue of waves is really a question of nomenclature." Importantly, she added that the "focus on the resurgence in the fall is misplaced." It is far more important to recognize that "individual action does matter" and wearing masks and physical distancing were most effective in reducing transmission.

- Importantly, she believes that lockdowns are a blunt instrument so a more strategic approach with masks, social distancing, and avoiding concentrated closed environments or poorly ventilated spaces like bars and movie theaters will be more effective in preventing further resurgence in the fall and winter.

Economic Outlook

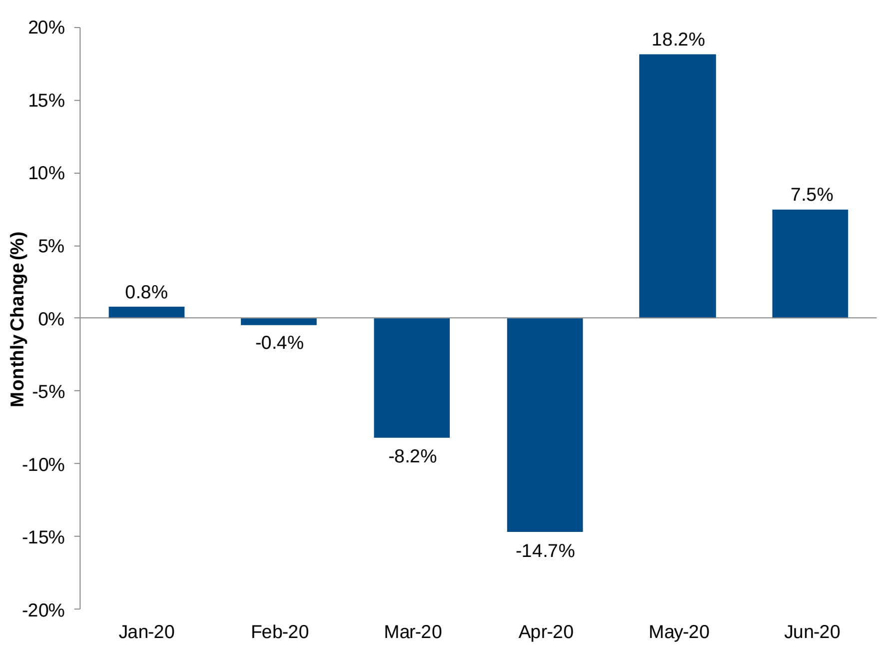
Avoiding a lockdown in the fall or winter and flattening the curve of rising daily infections is critical to the outlook for the economy and financial markets.

Our two guest speakers focusing on the economic outlook were Jason Furman, former Chairman of the Council of Economic Advisers (2013-17) and Professor of the Practice of Economic Policy at Harvard Kennedy School and the Department of Economics at Harvard University, and David Mericle, Chief US Economist in Global Investment Research at Goldman Sachs.

The key takeaways from the call were:

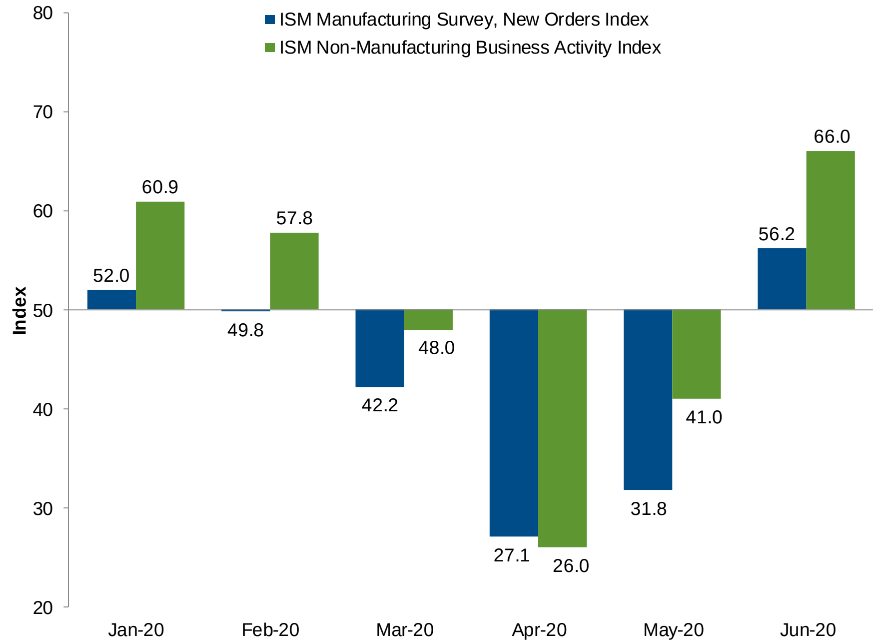
- The US economy bottomed in April and economic data has surprised to the upside. The shift is probably best seen in the swing in retail and food services sales, select components of ISM manufacturing and non-manufacturing indexes, and the dramatic change in non-farm payroll employment, as shown in Exhibits 4, 5, and 6.

4. US Total Retail and Food Service Sales



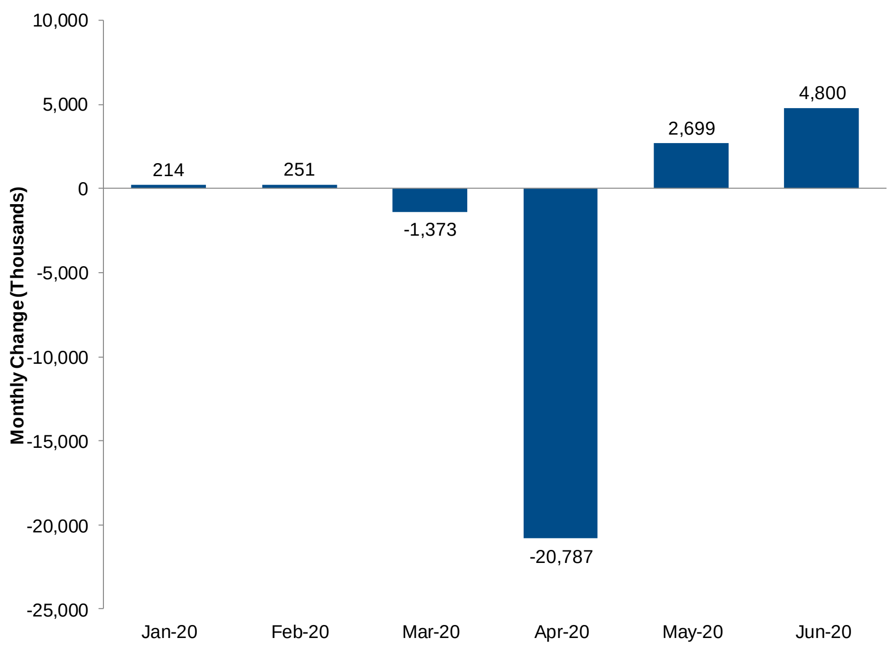
Source: Investment Strategy Group, Bloomberg.

5. Selection of ISM Survey Components



Source: Investment Strategy Group, Bloomberg.

6. Change in Non-Farm Payroll Employment (Thousands)

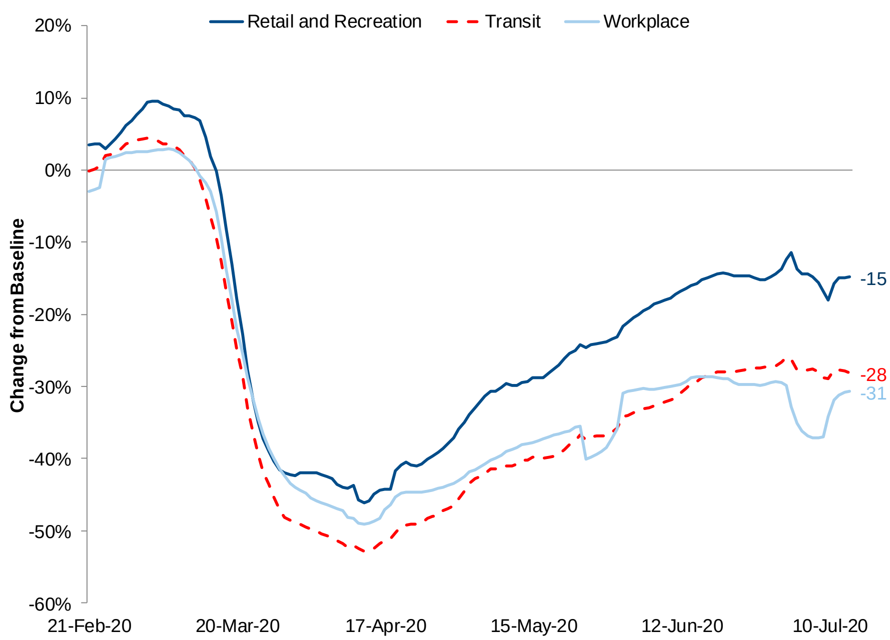


Source: Investment Strategy Group, Bloomberg.

- While higher-frequency data such as Apple and Google mobility data and OpenTable seated diners confirm the bottom in April, they also show that the upward trend has stalled, probably as a result of the surge in new infections. As shown in Exhibits 7 and 8, Google mobility trends are lower than their recent highs, as is the OpenTable data.

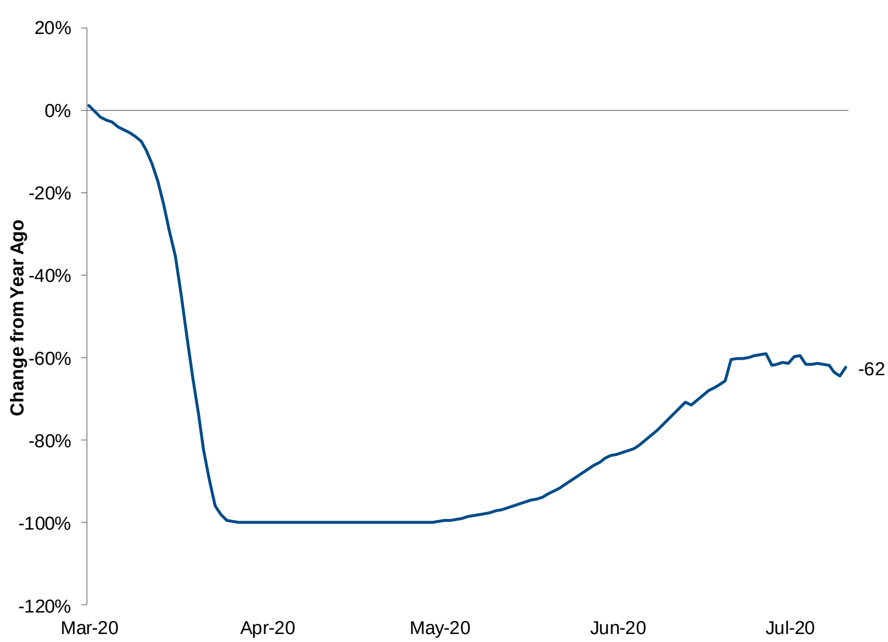
Airport traffic, as measured by the Transportation Security Administration (TSA), and hotel occupancy have also decreased from recent peaks.

7. Google Mobility Data (7dma) – Through July 14, 2020



Source: Investment Strategy Group, Google.

8. OpenTable Seated Diners Data (7dma) – Through July 18, 2020

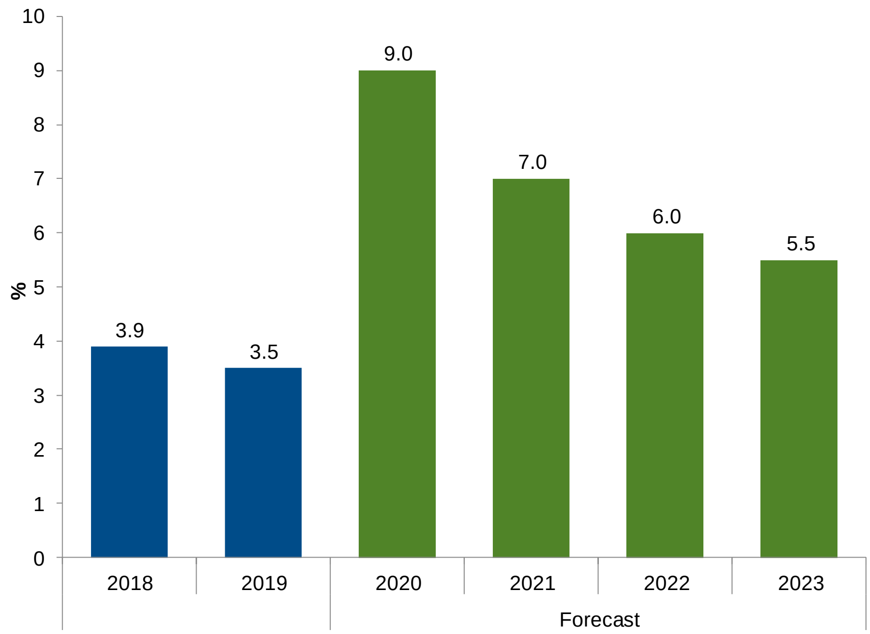


Source: Investment Strategy Group, OpenTable.

- Goldman Sachs' economics team has revised their economic projections for the third quarter downward as result of the COVID-19 resurgence. Their current GDP forecast stands at -4.6% for 2020 and 5.8% for 2021. On a cumulative basis, they expect year-end 2021 GDP to be about 1% above year-end 2019 levels.

- While the unemployment rate has dropped significantly from its recent peak, further gains will be harder to achieve. Both Furman and Mericle agreed that it will take several years before we approach the pre-pandemic levels of unemployment, as shown in Exhibit 9.

9. GIR Forecast: US Unemployment Rate at Year-End

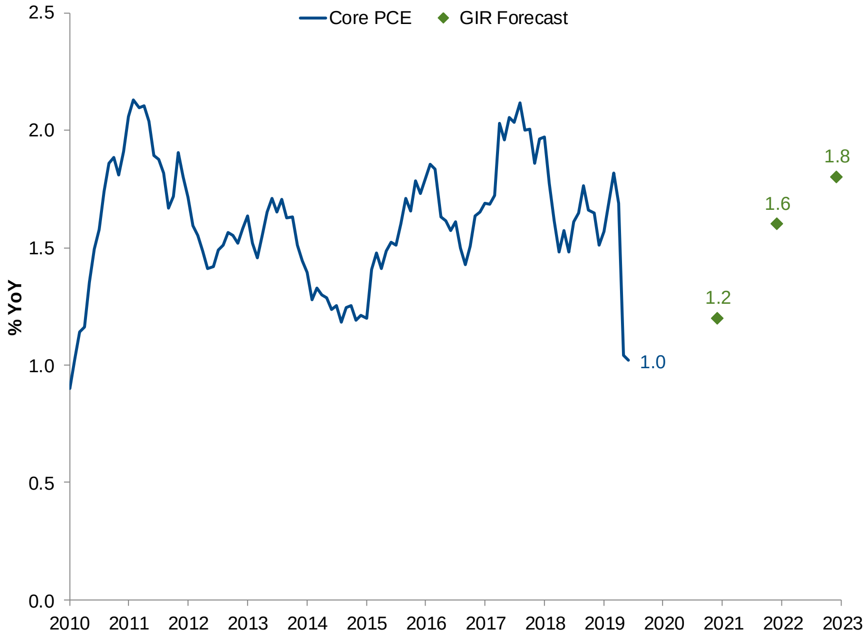


Source: Goldman Sachs Global Investment Research.

- Fiscal stimulus to date has been critical to the recovery, but further stimulus is needed to continue supporting the unemployed, small businesses, and state and local governments. GIR expects Congress will enact another $1.5 trillion (7% of GDP) in fiscal measures, most of which would be implemented in 2020.

- Neither guest speaker is concerned about inflation over the next several years. GIR's inflation forecasts are shown in Exhibit 10.

10. Core PCE + GIR Forecasts Through 2023 (% YoY)



Source: Goldman Sachs Global Investment Research.

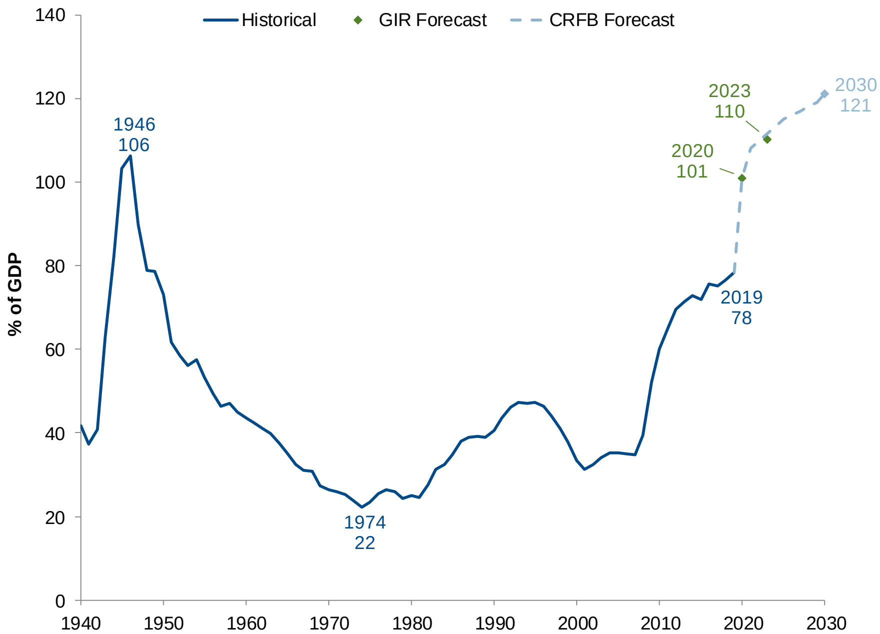
- The downside risks to the growth forecast are a further deterioration in the spread of COVID-19 or a delay in fiscal stimulus. The upside risk is further progress on therapies or vaccines.

- Furman strongly believes that fiscal sustainability has to be viewed in the context of today's low interest rate environment and the resulting low interest burden. A debt-to-GDP ratio of 150% is about the same in terms of the interest burden as to "what we used to have with a debt-to-GDP ratio more like 40%."

Risks of the Rising Debt Trajectory

If GIR's forecast for another $1.5 trillion in fiscal stimulus is realized, total fiscal stimulus in the US will amount to about 20% of GDP. Such an increase in US debt is expected to push the debt-to-GDP ratio from 78% in 2019 to 101% in 2020 and to 121% by 2030, far exceeding the peak levels seen after WWII, as shown in Exhibit 11.

11. US Debt-to-GDP Ratio: Realized + GIR/CRFB Forecasts Through 2030



Source: Goldman Sachs Global Investment Research, Committee for a Responsible Federal Budget.

The key question affecting our investment outlook is whether such high debt levels will lead to a fiscal crisis in the US.

To address this question, we turned to William Gale, the Arjay and Francis Miller chair in Federal Economic Policy at the Brookings Institute and author of *Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future*, and to Maya MacGuineas, President of the bipartisan Committee for a Responsible Federal Budget for our second client call.

The key takeaways from the call were:

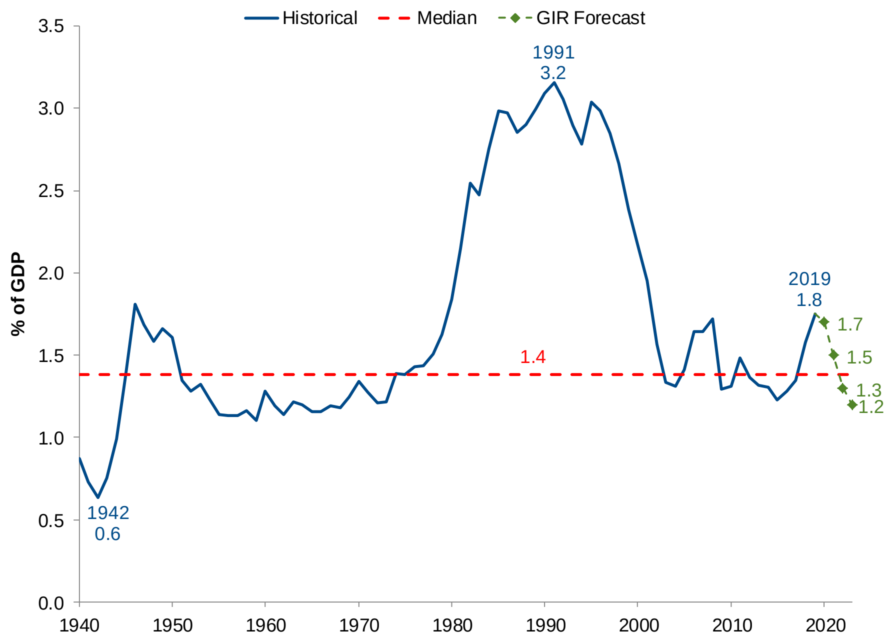
- Both guest speakers concurred that fiscal stimulus was necessary to offset the shutdown of the economy as a result of COVID-19. According to Gale, "the economy is ailing right now" and "the economy is more important than the budget." Gale actually referred to the fiscal stimulus as fiscal relief, where there is a need to provide continued relief.

- Healthcare, support for state and local governments, payments to the unemployed and some form of rent support to avoid evictions were mentioned as important components of the next stimulus package.

- Inflation was not a near-term concern but it could become an issue in the more distant future. The probability of high inflation further out in the future was estimated at 10–20%.

- The very low level of interest rates will keep the cost of servicing the debt low and is forecasted to represent 1.2% of GDP by 2023, the lowest level since the 1960s, as shown in Exhibit 12. While both speakers agreed that this was not a financing burden, they also thought it will be important to think of fiscal discipline once the US overcomes the pandemic and economic activity reverts to trend growth.

12. GIR: US Interest Expense (% GDP) - Realized + Forecasts Through 2023



Source: Goldman Sachs Global Investment Research.

- While the US continues to be a magnet for portfolio and foreign direct investment flows, both speakers expressed some concerns. MacGuineas believes that the US will be more vulnerable with such high levels of foreign indebtedness and Gale highlighted the importance of building a more resilient economy, and less dependence on foreign investors is a component of that resilience.

- MacGuineas shared that she often gets asked if the US could reduce its debt burden by selling assets. While that could provide temporary relief to bring debt down on a one-time basis, it will not solve the long-term shortcomings of the current budget process.

Most importantly, neither speaker—both of whom would be considered strong proponents of fiscal discipline—believe that fiscal stimulus at the current pace will lead to a fiscal crisis anytime in the foreseeable future. The debt trajectory should not be a worry at this time.

Election Outlook

We next turn to the outlook for the elections: what is the risk of a democratic sweep that could imply significantly higher taxes, including corporate taxes, that would lower corporate profitability and create a generally less favorable environment for financial markets. As shown in Exhibit 13, both the equity market and the bond market outperform during divided government relative to single-party government. The data is statistically significant since 1928 and in the post-WWII period. Clearly, the financial markets understand that a system of checks and balances on government policies is a structural advantage of the United States.

13.A) S&P 500 Average One-Year Price Returns Following Elections

	Since 1928			Since 1945	
	All				
	1931 Divided	1931 Single Party	Excl. Recessions	All	Excl. Recessions
Divided	6.0%	6.9%	13.6%	7.8%	13.6%
Single Party	8.1%	7.1%	7.6%	9.0%	7.5%
Divided minus Single Party	-2.1%	-0.2%	6.0%	-1.2%	6.0%
Statistical Confidence Level of Different Return Averages	45%	5%	94%	29%	95%

13.B) US Bonds Average Calendar-Year Total Returns

	Since 1928			Since 1945	
	All				
	1931 Divided	1931 Single Party	Excl. Recessions	All	Excl. Recessions
Divided	7.4%	7.6%	7.1%	7.5%	7.1%
Single Party	3.8%	3.6%	3.3%	2.8%	2.4%
Divided minus Single Party	3.6%	3.9%	3.8%	4.7%	4.7%
Statistical Confidence Level of Different Return Averages	> 99%	>99%	99%	> 99%	> 99%

Note: The first column assumes that 1931 was a year of divided government because a number of special elections held that year to replace members of both parties who passed away resulted in shifting the House majority from Republican to Democratic. The second column assumes that 1931 remained a single-party government.

Source: Investment Strategy Group, Bloomberg.

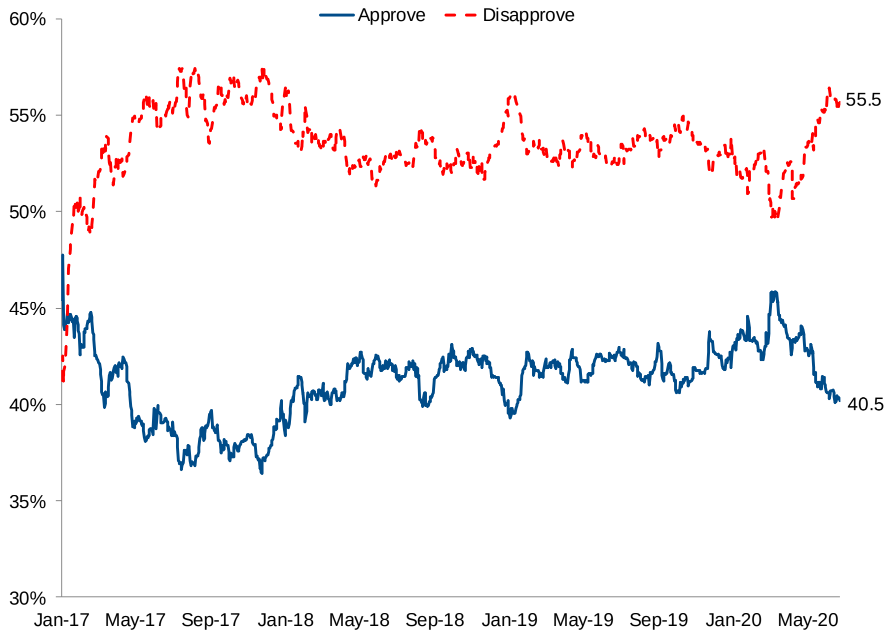
Our guest speakers to help inform our election outlook were Charlie Cook, Editor and Publisher of The Cook Political Report, and Jon Lieber, Managing Director for the US at Eurasia Group and formerly an associate director at the National Economic Council at the White House.

The political landscape has changed considerably since January, when the base case according to PredictIt—a New Zealand-based prediction market that offers prediction exchanges on political and financial events—was divided government. According to the latest data, Democrats are favored to win the majority in the Senate with a 64% probability, retain the majority in the House with an 87% probability, and win the Presidency with a 62% probability.

Cook assigned a 70% probability to a Biden win and 60% chance to a Democratic Senate. Lieber assigned a 60% probability to a Biden win and 55% to a Democratic Senate.

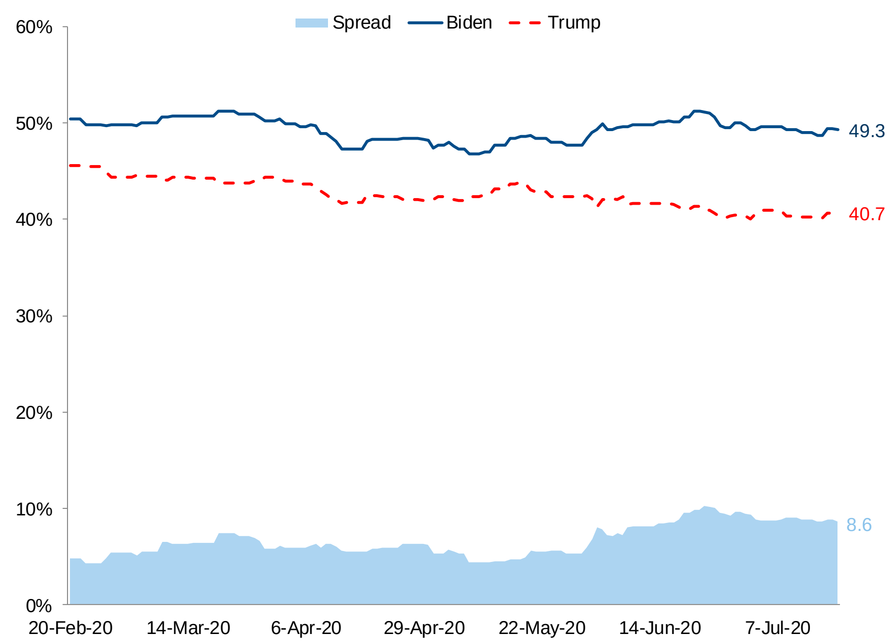
The significant shift in sentiment regarding President Trump is seen in his declining approval ratings, which are the lowest since January 2019 and well below their recent peak in March 2020 (see Exhibit 14), as well as the widening of the polling spread between him and former Vice President Joe Biden (see Exhibit 15). According to the guest speakers, the key driver for the decline in the President's approval ratings was his handling of the pandemic and voters' decreasing confidence in his competence, especially given that a growing economy was no longer a factor.

14. President Trump's Overall Approval Ratings



Source: Investment Strategy Group, FiveThirtyEight.

15. Polling Average – Through July 19, 2020



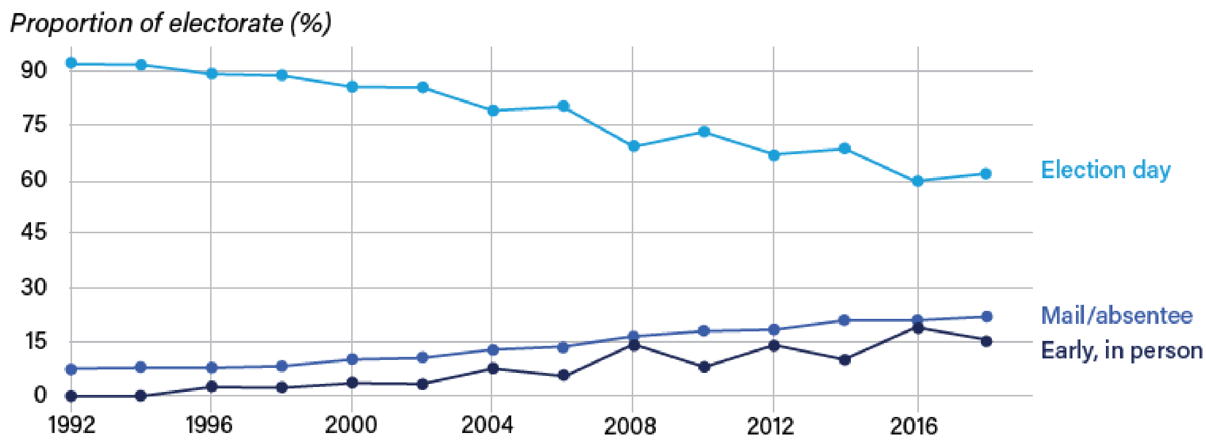
Source: Investment Strategy Group, RealClearPolitics.

While many question the reliability of poll results, Cook believes that the polls are much more reliable now because they have addressed the shortcomings of 2016 by polling President Trump supporters more carefully and thoroughly.

Two key concerns were highlighted by the speakers:

1. The logistics of voting are more complicated given COVID-19. As shown in Exhibit 16, the percentage of ballots cast by mail has increased to 25% in recent years. Eurasia Group believes that the percentage could exceed 50% given their view of likely shortages of polling places and volunteer polling workers.

16. Proportion of Electorate by Type of Voting



Source: Eurasia Group, MIT Election Lab, US Census.

2. Another major concern is getting the results post-election in a timely fashion. Lieber suggested that counting the votes and certifying the results could delay the final result by about a week.

Lieber also believes that suggestions that the election may be postponed or that President Trump would refuse to leave the White House are "red herrings" and not realistic scenarios. Nevertheless, he believes that accusations of vote fraud, foreign influence, and other factors such as voter suppression will undermine confidence in the legitimacy of the next President.

Finally, with respect to the Biden tax plan, Lieber suggested that it serves two functions: demonstrating credibility on fiscal issues and addressing income inequality in the US. However, he also pointed out that higher taxes would be phased in over time and corporate taxes would be increased by one percentage point a year until 2025 or 2026. Jason Furman had suggested that only half of the $4 trillion Biden tax plan would actually be implemented and made into law.

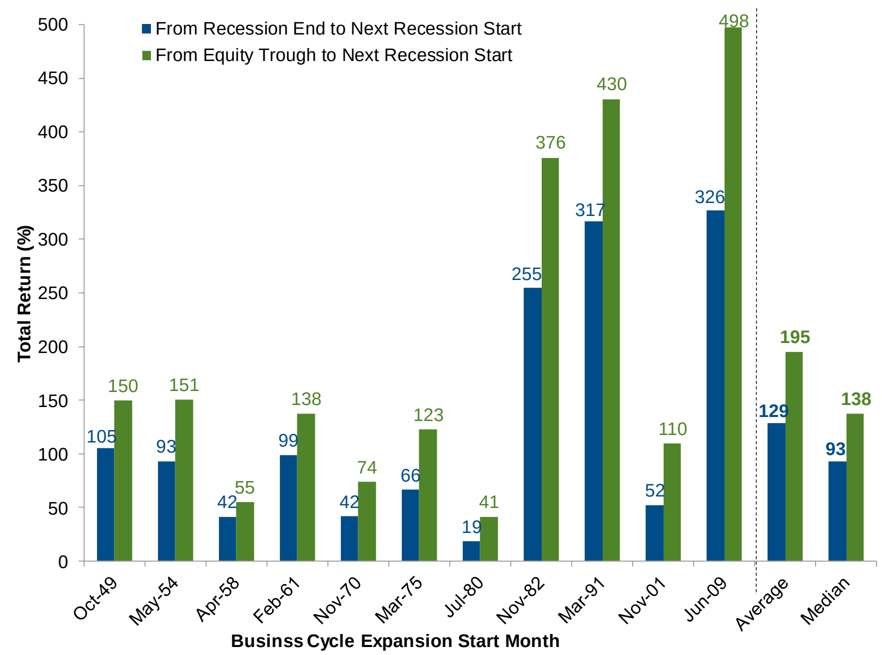
Outlook for US Equity Returns

Having mapped out the economic outlook, the minimal risks to any type of fiscal crisis, and the risks from the election related to a single-party government and the prospects of higher taxes, we now turn to the outlook for equity returns both for the rest of 2020 and over the next several years.

Our two guest speakers for the fourth call were Howard Marks, Director, Co-Chairman, and Co-Founder of Oaktree Capital Management and author of *The Most Important Thing* and *Mastering the Market Cycle*, and David Kostin, Chief US Equity Strategist at Goldman Sachs Global Investment Research.

One of the key questions for investors is whether equities will deliver the type of returns seen in past economic expansions, as shown in Exhibit 17, if April marked trough of the recession and the beginning of a new economic cycle. Marks, whose book discusses the importance of being aware of where we are in a market cycle, shed some light on how we should view the current environment:

17. S&P 500 Total Return During Post-WWII US Expansions



Note: The start date and end date of business cycle expansions are the first date of the NBER business cycle trough month and peak month.

Source: Investment Strategy Group, Bloomberg, NBER.

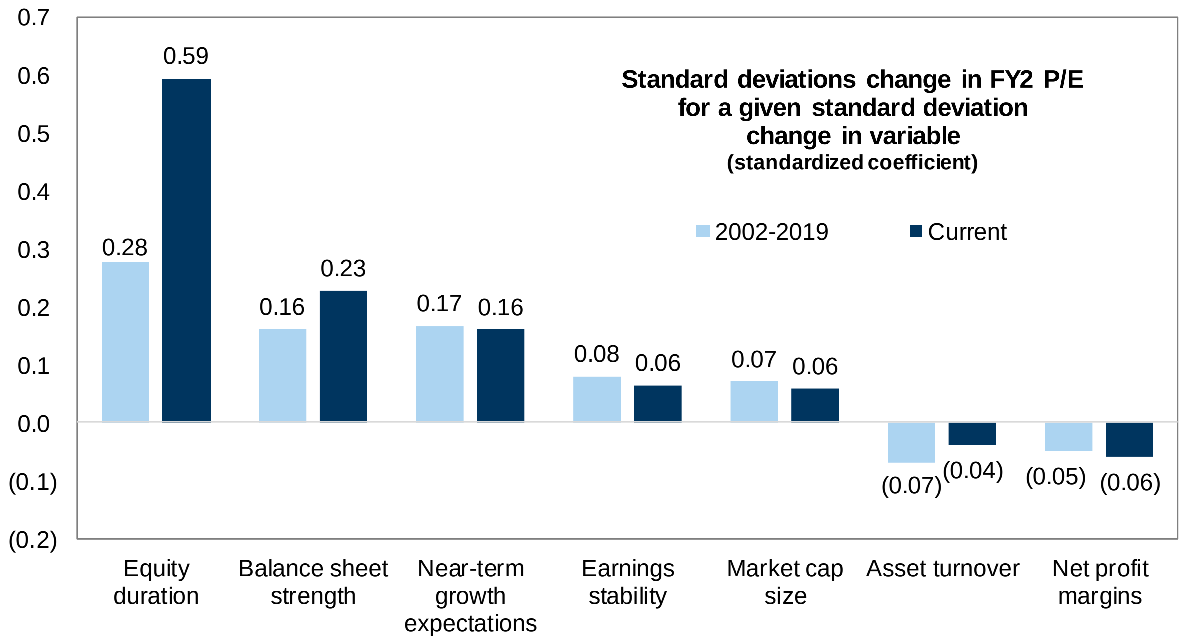
1. The current experience does not represent a normal cycle so one cannot rely on normal cyclical behavior.

2. While the economy will improve and profits will rise, equity prices are starting this period of economic improvement at valuation multiples that are already above-average based on 2021 earnings, so we cannot expect the same type of returns as experienced in past expansions which began at lower valuations.

3. Importantly, it is the very low level of interest rates that justifies current valuations. The S&P 500 is within 4% of the all-time high it reached on February 19th, yet since that time the level of S&P 500 earnings expected in 2021 has been pushed forward to 2022. “The decline in interest rates bridges that gap.”

Kostin shares the view that interest rates have been a key driver of the current rally in equities. Another contributing factor is the premium that investors are paying for “long-term growth when interest rates are low and earnings growth is scarce.” Stocks that have the strongest growth prospects over the next 10 years have long implied equity duration and, as shown in Exhibit 18, investors are paying a record premium for such long-duration assets relative to history. The sector with the longest implied duration is information technology, which has been a key contributor to currently high valuations.

18. GIR: Relative Importance of Fundamental Variables in Explaining P/E Multiple

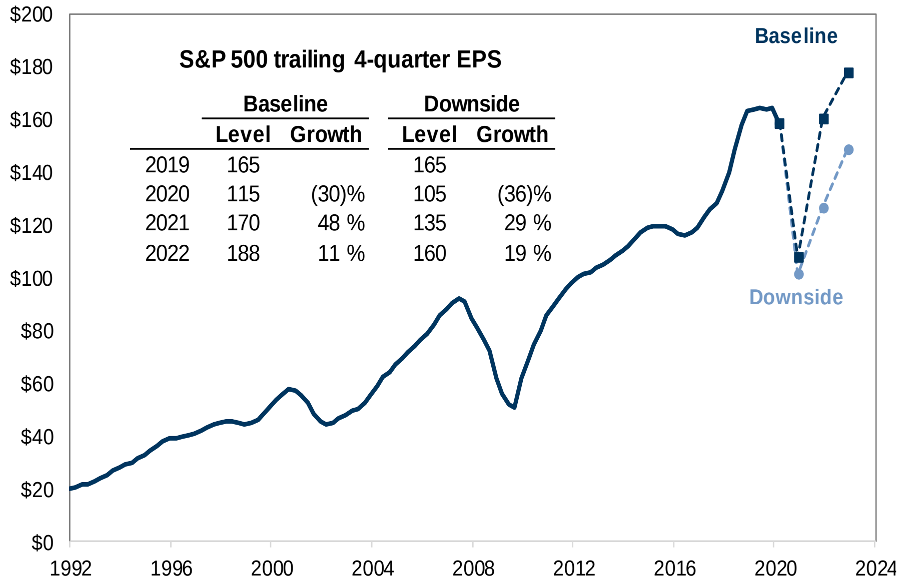


Note: Quarterly data since 2002. Excludes Financials and Real Estate. Includes time fixed effects.

Source: Goldman Sachs Global Investment Research.

Near term, Kostin believes that there are some risks to the downside, ranging from the surge in COVID-19 infections to the stalling in the economy in some regions due to a slowdown—or in some cases reversal—of the reopening of the economy, and “a significant and consequential election” in November. However, more and more investors are asking him about 2022 earnings, which he expects to stand at $188 per share, an increase of 11% from his 2021 forecast of $170 per share, as shown in Exhibit 19.

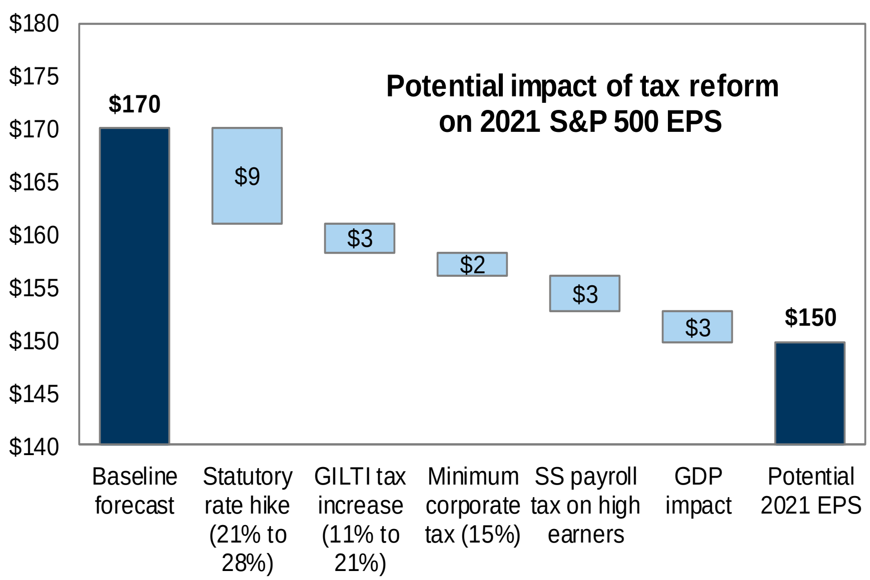
19. GIR: Top-Down S&P 500 EPS Forecast



Source: Goldman Sachs Global Investment Research.

The biggest risk to Kostin's earnings forecast is Biden's tax reform, which could lower 2021 earnings from $170 per share to $150 per share, as shown in Exhibit 20. His year-end target for the S&P 500 in 2020 is 3000, and 3100 by mid-year 2021.

20. GIR: Potential Impact of Tax Reform on 2021 S&P 500 EPS



Source: Goldman Sachs Global Investment Research.

For more long-term investors, Kostin estimates that the S&P 500 will generate a 6% annualized return through 2030, with a possible low of 2% or a high of 11%. The 6% expected return is the average of five different approaches, as shown in Exhibit 21.

21. GIR: Five Approaches to Estimating 10-Year Forward Total Returns

		10-Year Annualized Return		
	Approach	Low	Average	High
I.	Starting absolute valuation	(1)%	2.7 %	6 %
II.	Starting relative valuation	(0)	8.7	18
III.	Equity allocations	5	6.5	8
IV.	Dividend yield and growth	1	4.7	12
V.	Economic modeling	6	7.2	9
	Average	**2 %**	**6.0 %**	**11 %**
	Historical returns (1880-2020)	*4 %*	*9.2 %*	*14 %*

Past performance is not indicative of future results.

Source: Goldman Sachs Global Investment Research.

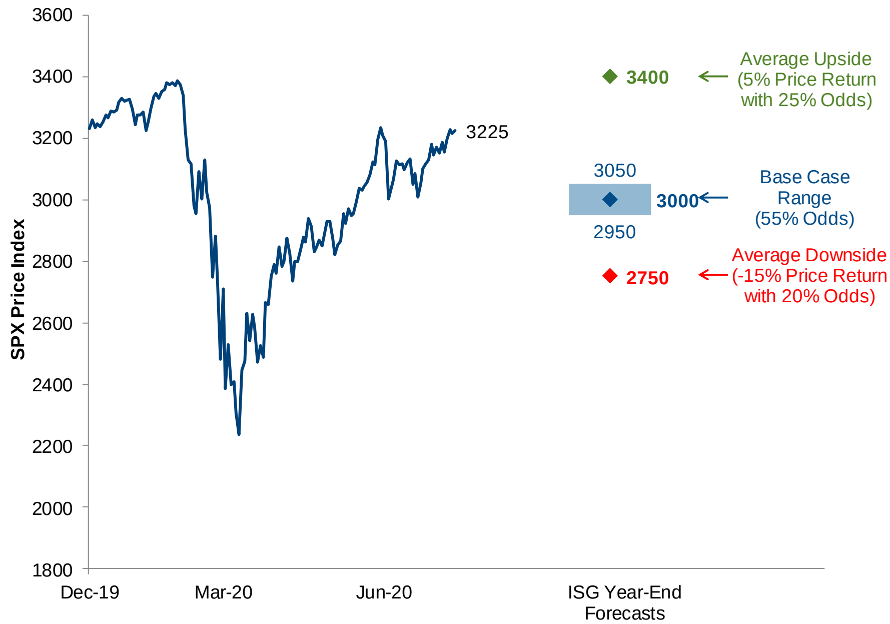
Marks concurred with David's view of equity returns of about 6% for the long term and the outperformance of equities relative to bonds.

Our Investment Recommendation

The image of a climber scaling a wall may be familiar to some of our clients. It is an image we previously used in our 2013 *Outlook: Over the Horizon*, where we wrote that the 17% return of 2012 despite the European sovereign debt crisis, US fiscal cliff, and risks of a Chinese hard landing was "a poignant reminder of the old Wall Street adage that markets climb a wall of worry." At the time, we recommended an underweight to fixed income and some tactical tilts towards a range of equities.

In the current environment, after a 45% rally, we recommend clients stay invested in equities. This recommendation is based on a base case of 3000 for the S&P 500 by year-end, with a 25% probability of reaching 3400, as shown in Exhibit 22. While we expect earnings to be lower by 20–25% relative to 2019, we expect earnings in 2021 to range between $167 per share to $172 per share. As equities are forward looking, we believe that 2020 earnings are no longer the focus of investors at this time.

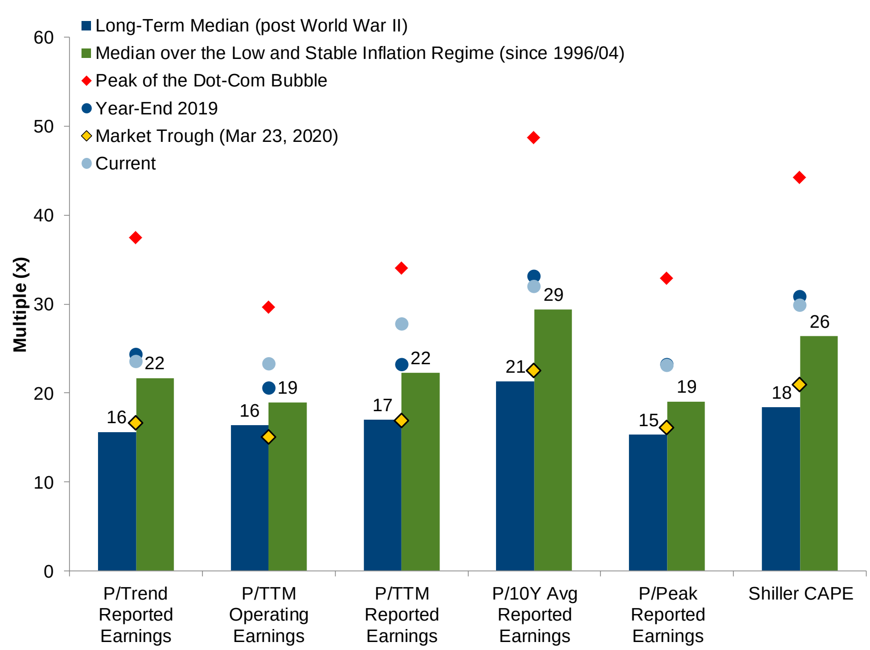
22. ISG S&P 500 Forecasts: Base Case and Potential Downside and Upside Scenarios – As of July 17, 2020



Source: Investment Strategy Group, Bloomberg.

We also believe that while equities are expensive, they are not excessively valued given the low and stable inflation environment. As shown in our often-used exhibit on valuations (see Exhibit 23), equities are about 17% overvalued and nowhere near the levels witnessed in the dot-com bubble.

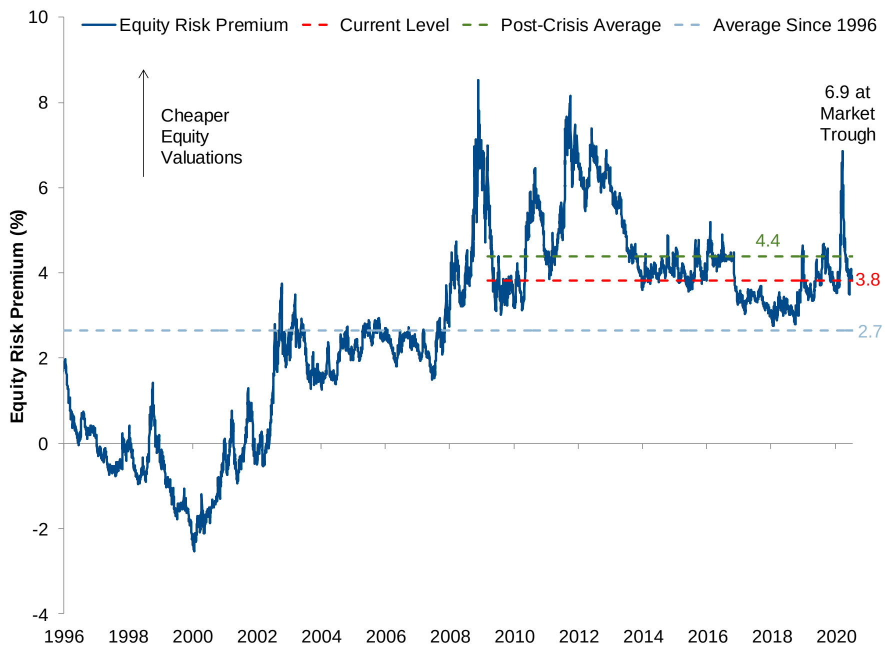
23. S&P 500 Valuation Multiples – As of July 17, 2020



Source: Investment Strategy Group, Bloomberg, Robert Shiller.

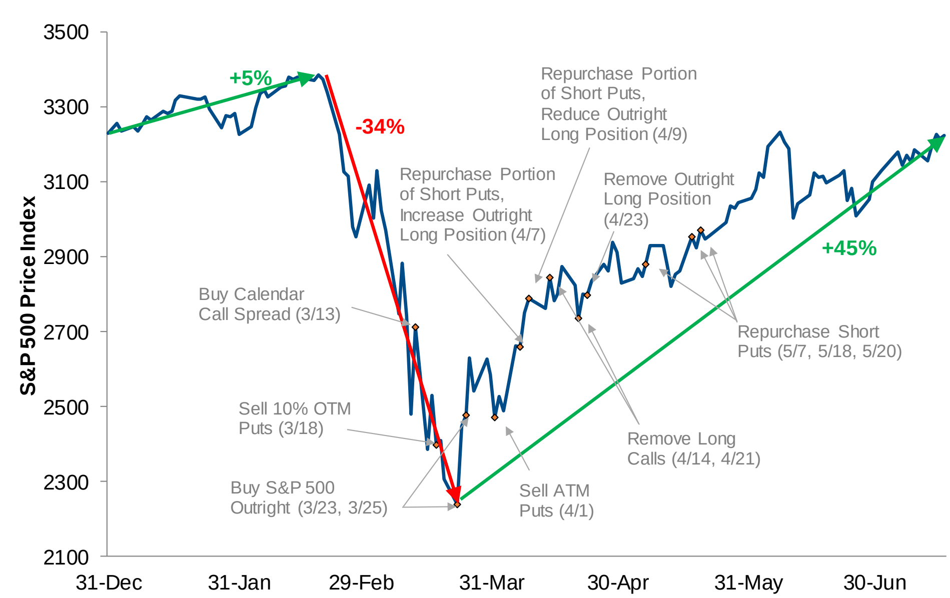
We also concur with Howard Marks and David Kostin that equities should be viewed in the context of the current environment of low interest rates. As shown in Exhibit 24, equities offer an attractive risk premium relative to the 10-year Treasury rate of 0.62%. We expect equities to have mid-single-digit annualized returns for the foreseeable future, exceeding the low-single-digit returns of high-quality bonds and the near-zero returns of cash and cash-like instruments. We note that our recommendation to stay invested comes after a two-month window when we were tactically overweight equities, as shown in Exhibit 25.

24. S&P 500 Implied Equity Risk Premium: Forward 12-Month Earnings Yield Less US Treasury 10Y Yield – Through July 17, 2020



Source: Investment Strategy Group, FactSet.

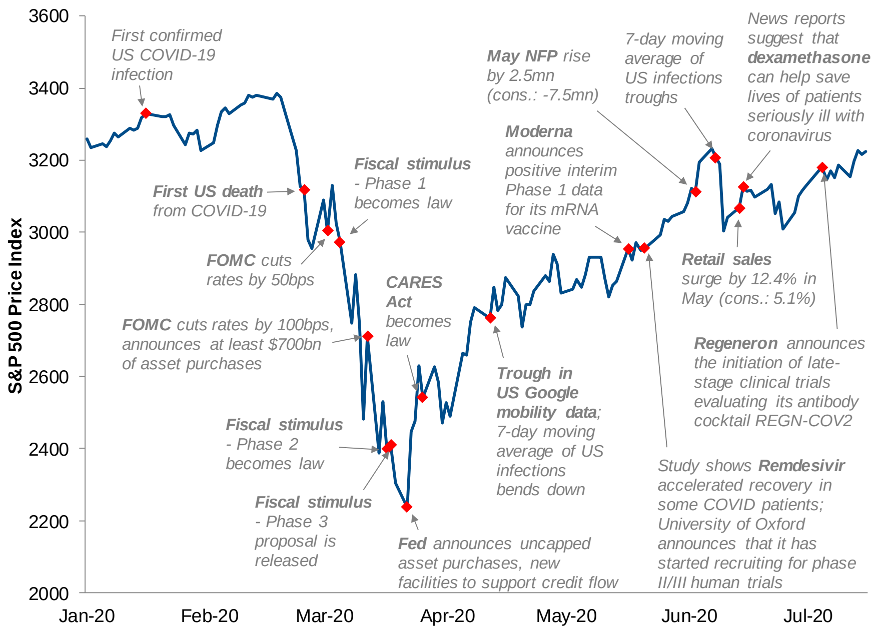
25. Tactical Asset Allocation to the S&P 500 – Through July 17, 2020



Source: Investment Strategy Group, Bloomberg.

Finally, while it may appear that the equity market has only climbed the wall of worry, we think it is helpful to see that the S&P 500 has also responded to important fiscal and monetary policy measures and to announcements regarding progress in COVID-19 therapies and vaccines, as shown in Exhibit 26. Given the enormity of policy measures on a global basis and the enormity of resources devoted to the development of therapies and vaccines, we believe that this rally has been driven by fundamental shifts in policy, in the economic outlook, and in healthcare.

26. S&P 500 YTD Performance and Key Events – Through July 17, 2020



Source: Investment Strategy Group, Bloomberg.

Endnotes:

(1) Luciana Borio and Scott Gottlieb, "Antibodies Can Be the Bridge to a Vaccine," *Wall Street Journal*, July 5, 2020.

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The statements in this report are current only as of their date, July 19, 2020. For a discussion of some of the risks and important factors that could affect the Firms' future results and financial condition, please refer to their quarterly reports filed on Form 10-Q and their Annual Reports filed on Form 10-K along with their other public reporting, including in particular the "Risk Factors" included therein.

We have expressed views from various sources including experts in the medical and pharmaceutical community. These views may be different than other views in the medical and/or pharmaceutical community.

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