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"Learn from yesterday, live for today, hope for tomorrow. The important thing is not stop questioning."
Albert Einstein

As we pass the half-way point for the year, we take stock of the economic and financial reality and, as Albert Einstein urges in his quote, we will not stop questioning.

The self-induced economic coma of the lockdown strategy has, unsurprisingly, left major scars in our economic system with unemployment in double digits and a current collapse in earnings projected for the second quarter at approximately 44%.

The act of reviving the economy is also proceeding by fits and starts as COVID-19 persists in our lives and a lack of coordinated national strategy make the recovery more uneven than it should be. And yet, financial markets have strongly rebounded and somewhat stabilized. Such disconnect is in everyone's mind and different explanations are being researched.

One such interpretation has to do with the recognized inability of the market to price "radical uncertainty," as bond powerhouse PIMCO puts it. The inability to model such uncertainty leads investment professionals toward more quantifiable elements such as policy and monetary responses.

In our view, whether the spark came from radical uncertainty or logical modeling, putting greater weight on the monetary policy responses and fiscal action seemed the correct approach. As we indicated in previous missives, the size of the Federal Reserve's action, along with the fiscal package, was too large to ignore.

Fed's action resulted not only in a sudden stabilization of the credit markets and in a constant bid for different assets, but it also completely reassessed the discount rate used in valuation models. The quite telegraphed intention of the Fed to continue to implement very dovish monetary policy, increases significantly the present value of further out earnings and dividends and therefore allows for multiples such as Price/Earnings ratios to expand. Assuming steady normalization and improvements in medical research, it is reasonable to expect 2022 as the year of full catch-up, hence the trajectory of valuation models toward that target.

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Going forward, markets will need Main Street confirmation that things in general are progressing, but they will also continue to ask for oversize institutional intervention. Continued large monetary and fiscal action, however, will increase some entrenched and some new trends. Probably, asset price inflation will continue but in a later stage, we might also start witnessing general price inflation. This combination will eventually have repercussions on long term asset allocations, where more attention should be dedicated to inflation resistant assets and international assets as well.

On the subject of asset allocation management, we also want to shed some light. Strategic changes as the economy responds to structural modifications are inherent part of the process. However, often one feels the need to be more actively tactical, especially when uncertainty rises. And uncertainty clearly has been rising since February.

Conversely, we cautioned against such an overly reactive approach. During the first quarter crash, we wrote that long term portfolios should do very little even in the face of what looked like complete mayhem ("The Market and the Corona Virus Effect," February 28).

As scary as the action was in the last few months, acting wisely and resisting the urge to be very tactical would have paid off. While some sectors and many stocks are still quite below their recent highs, the S&P500 benchmark is only negative by a few percentage points and tech is actually strongly positive year to date. Being radically tactical can lead to mistakes that can be tremendously magnified by the turbulence that usually marks periods of uncertainty.

As Bloomberg reports, if one had sat out the best five days, 2020 would look disastrous compared to mildly disappointing. For example, in March the index dropped more than 5% in five occasions. However, in the same month, it also experienced four of the five biggest yearly gains which totaled over 900 points in the S&P500. To give some historical reference, as per Bloomberg, the index suffered 13 bear markets before 2020 in the last 100 years and all of the them were eventually recovered and surpassed by an average 68%. In investing, time is *the essence*.

As if a pandemic, a recession and social riots were not enough, 2020 is also an election year. Elections can induce volatility in financial markets as investors try to position portfolios for possible new agendas and power plays.

The deteriorating chances for Trump to be re-elected, along with the improving probabilities of a Democratic sweep also in the Senate, have raised worries that a full grip on power by the Democrats might spell gloom and doom for financial markets. Besides the historical evidence against the theory of underperforming markets when a Democratic President sits in Pennsylvania Avenue, a Biden's win might be generally neutral.

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JP Morgan broke down the Biden's likely agenda in four segments and tried to quantify the hit on earnings. The most obvious and most damaging policy would be a partial reversal of the Tax Cut and Jobs Act. Assuming the tax rate gets reversed back to at least 28% from the current 21%, the estimated hit on the earnings for the S&P500 should be around $9. Such number should be almost entirely recovered by a softening on tariffs. JP Morgan estimates that a reduction in friction costs and lower import prices should add $8.5 in earnings. A third policy on the agenda is higher infrastructure spending which will make sector winners and losers but in aggregate should be neutral. The fourth item is an increase in the Federal minimum wage, which should be neutral to positive as it should improve aggregate demand while putting pressure on margins.

One thing is for sure, the second half of 2020 will be as surprising as the first one.

As always, we would like to thank you for the renewed confidence in our work,

Youri Bujko

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