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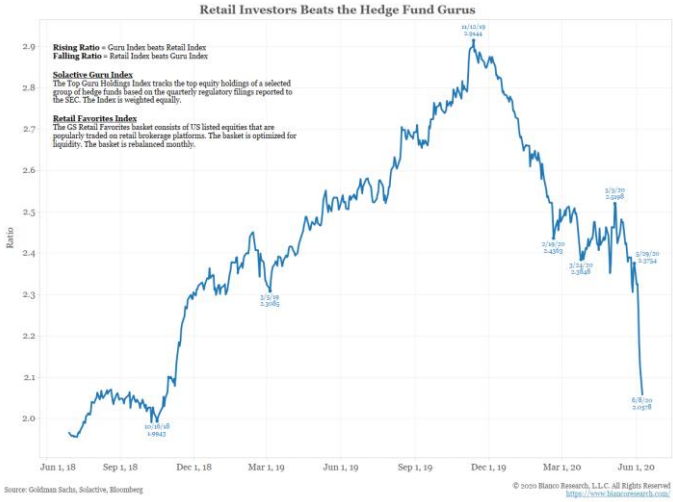
One of the traditional characteristics of equity markets is that they rarely spend much time priced at what most investors would consider to be "fair value", and instead tend to trade back and forth between being undervalued and overvalued, relative to the economic fundamentals of the underlying companies. These swings tend to take place over extended periods of time, and often continue until they reach extremes in one direction or the other.

Of course, the lesson of this year, which has included the shortest bear market in history (presuming that the bear market is over), is that a swing from overvalued to deeply undervalued to very highly valued again can sometimes take place with remarkable speed.

This anomalous action is almost certainly attributable to the circumstances surrounding, and the catalyst for, 2020's bear market and historic economic contraction. Normally, recessions and bear markets are preceded by a prolonged and gradual deterioration in economic fundamentals. However, this cycle is different, because this is the first purposeful and self-inflicted economic contraction in U.S. history. Indeed, because the current set of circumstances is so unique, it does call into question so many of the lessons of history on which so much of modern portfolio management is based.

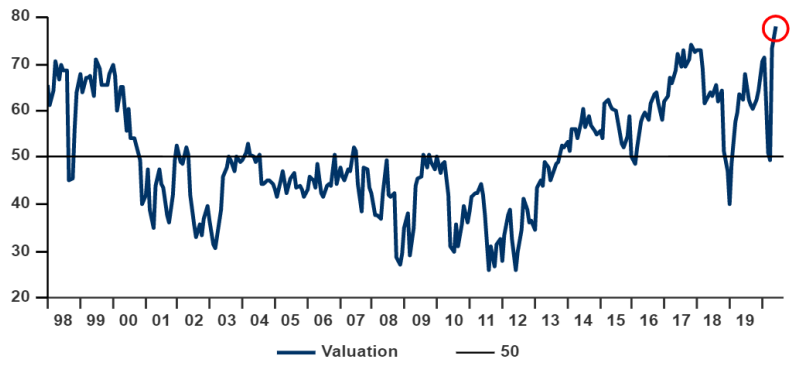


Indeed, since its March 23rd lows, the S&P 500 Index has enjoyed its strongest month of gains since 1987 and its strongest fifty-day rally (+39.6%) ever. Moreover, it took place in an environment in which almost every rule of prudent investing dictated that one stay on the sideline and wait for the stock market to retest its March lows, which probably explains why the majority of institutional, along with a great many traditional individual/smaller investors, missed out on the rally, while a new breed of inexperienced, and even reckless, micro-investors have dramatically outperformed many of the country's top tactical managers.

Importantly, while most of the current economic contraction was self-inflicted, it is noteworthy that the National Bureau of Economic Research, which is responsible for dating economic cycles, determined that the current recession actually started in February of this year, weeks before the Trump administration ordered the shuttering of the economy, in response to the COVID-19 pandemic.

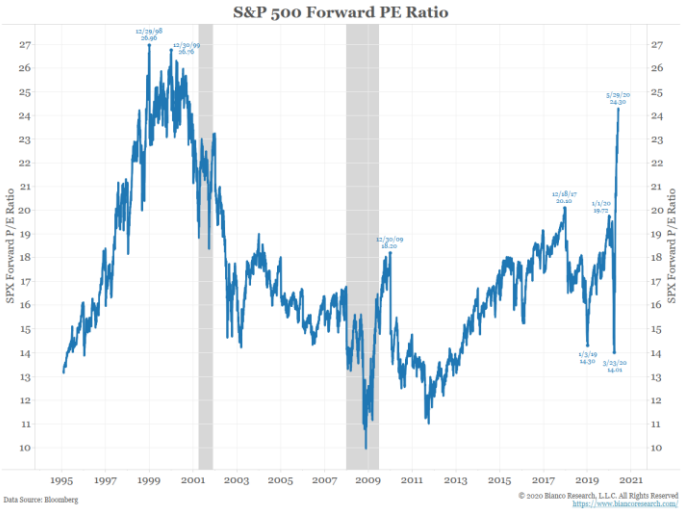
It is further noteworthy that, despite the enormity of this year's rally in the domestic equity markets, the level of skepticism amongst many professional portfolio managers has not lessened one iota. To the contrary, the most recent Bank of America Global Fund Manager Survey reveals that a record 78% of the survey group, which consists of 212 institutional portfolio managers who are responsible for $598 billion in assets under management, believes that the domestic stock market is "over-valued" and/or "over-priced".

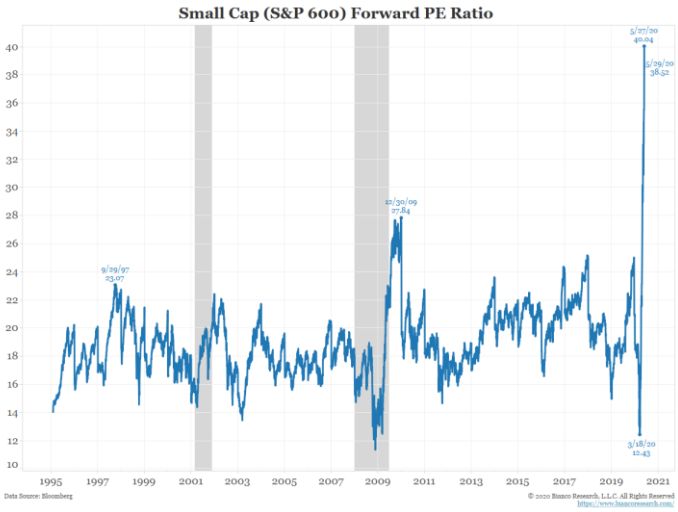
Exhibit 2: Equity over-valuation composite indicator



Source: BofA Global Fund Manager Survey, Bloomberg

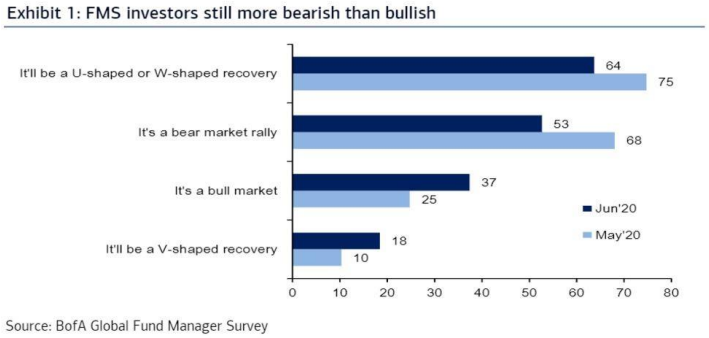
This is the highest "over-valued" reading since the survey began back in 1998, even surpassing the levels of concern recorded during the bursting of the "dot-com bubble" back in late 1999 and early 2000. These valuation-related concerns seem particularly relevant at the current time, when the popular equity indexes are either testing or threatening to retest their all-time highs, which were notably set earlier this year, during a time of economic optimism and signs of investor euphoria, while the anticipated retest is taking place during a time of Great Depression levels of economic contraction and unemployment, a global pandemic that has killed more than 120,000 Americans, and protests taking place in many American cities.

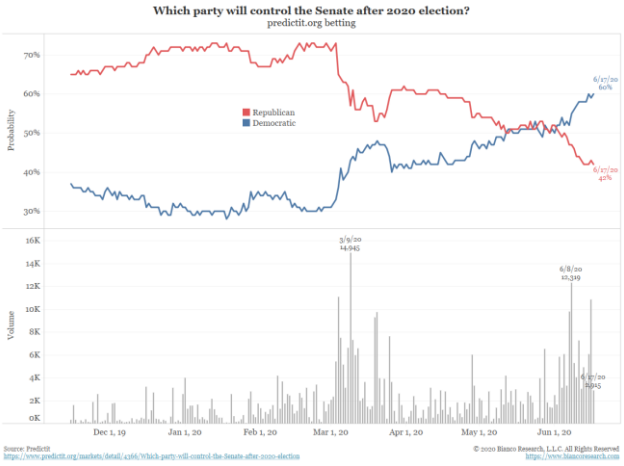




That's not even to mention the fact that the equity markets are trading at the highest valuations (as a multiple of expected corporate earnings) for the S&P 500 Index since the aforementioned "dot-com bubble" of 1999 and early 2000, and the highest valuations ever in the history of domestic small and mid-cap stocks. Indeed, based upon this very popular measure, there is no question that the equity markets have reached levels of extreme overvaluation.

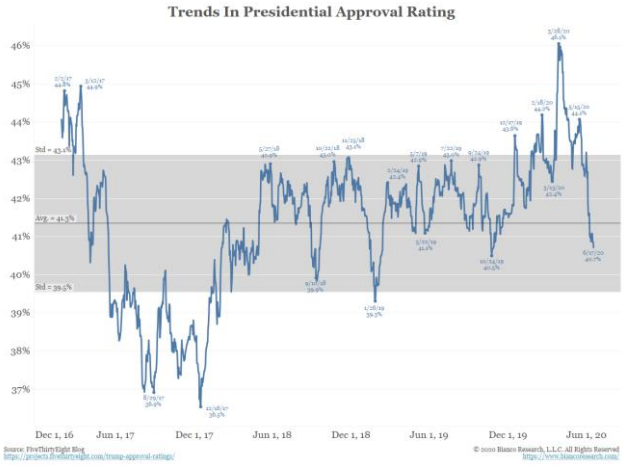
However, the caution and bearishness noted in this well-respected survey does not stop there, as only 18% of managers expect the type of rapid, "V-shaped" economic rebound that equity markets appear to be anticipating, and only 37% of respondents even believe that the equity markets are currently in a new bull market. In contrast, 53% of these professional managers believe that the current historic rally in equity prices is nothing more than a counter-trend rally within an ongoing bear market.





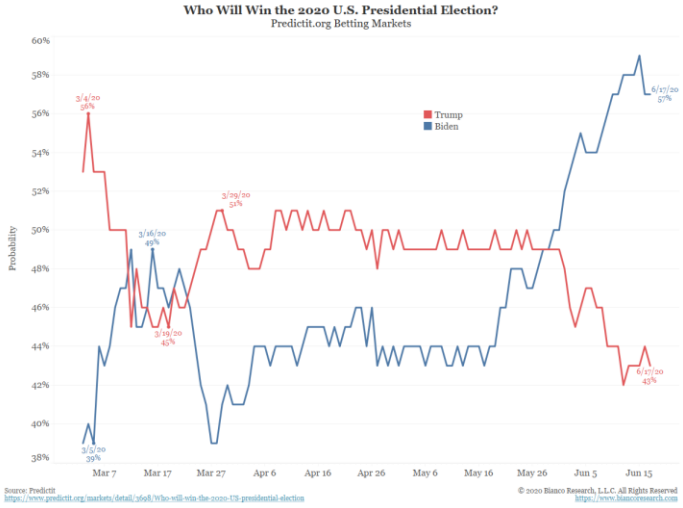
The most significant concerns noted by managers in the survey were, in order, a second wave of COVID-19 infections (an increasingly justified concern), a permanently high level of unemployment (due to the shut-down-related bankruptcy of so many small businesses), and the growing potential for a so-called "blue wave", with the November election returning all three branches of government to Democratic control. While recent history has taught us that both the polls and the prediction markets can be far less than perfect in their predictive utility (think Brexit, Trump, etc.), this third "tail risk" has gone from potentiality to probability over recent weeks, as the prediction markets have shifted from the presumed outcome of the Republicans maintaining control of the Senate, to now a 60% (and growing) likelihood that the Democrats will take control of that branch of government.

As of the date of this report, the prediction markets are assigning an 83% likelihood that the Democrats maintain control of the House and a 57% likelihood that Joe Biden will be the next president. The Real Clear Politics analysis of all of the major presidential polls assigns Biden a 50.1% chance of victory versus a 41.3% chance for Trump (allowing for third-party candidates).



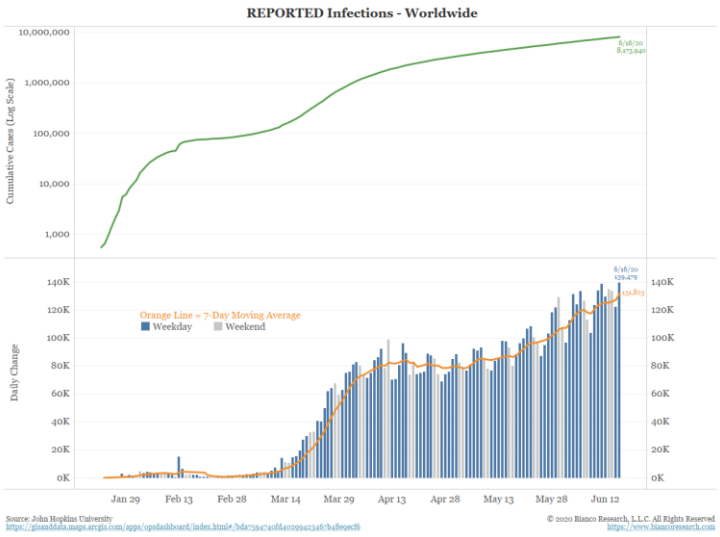
One of the really interesting anomalies is the fact that President Trump's approval ratings started collapsing just as the stock market bottomed, which is certainly ironic, as President Trump has always considered the stock market to be a "report card" on his administration. However, upon closer inspection, this may not be as counterintuitive as it might at first appear.

Importantly, that is not to suggest that Biden's policies are more favorable for the capital markets than are Trump's, as former Vice-President Biden has already stated his plans to, among other things, tax capital gains as ordinary income, increase corporate taxes from 21% to 28%, introduce a minimum tax of 15% on all corporations that generate at least $100 million in annual revenue, tax all unrealized capital gains at death, and significantly increase taxes on anyone making over $400,000 per year.



However, there is a historical tendency for the first half of election years to be highly volatile due to all of the election-related uncertainly, but for the stock market to rally in the second half of the year, once investors start to gain confidence that they know what the election outcome is ultimately likely to be.

As we have discussed on many occasions, at any point in time, investors can be faced with good news, bad news or uncertainty. While investors will virtually always prefer good news, they will generally prefer bad news to uncertainty, because they at least know how to price the "bad news" into their market outlook, which is something that they can not do with uncertainly. In other words, it is very possible that part of this powerful stock market rally is due to the fact that investors are celebrating the additional clarity provided by the suddenly widening gap between the election odds for Trump and Biden respectively.



That said, we believe that the markets still view the election as a secondary influence that will become more impactful later in the year. In the meantime, we agree with the majority of portfolio managers in the Bank of America survey that the single most important factor for the stock market is the outlook for a second and potential third wave of the coronavirus pandemic.

We believe that this is particularly true, as we attribute much of the stock market rebound to a general belief amongst investors that 1) the world economy can successfully reopen without a resulting resurgence of COVID-19 cases, and 2) that the U.S. economy is rebounding both sooner and more strongly than was expected. Current evidence is that investors have been overly optimistic in regard to the first premise, as evidenced by the significant new COVID-19 surges across the southern and southwestern states, particularly in Texas, Arizona, Florida, Arkansas, and North and South Carolina, but may prove quite correct regarding the second premise.

Topping off the reasons for caution is the fact that this dramatic rebound from the lows has been virtually straight up, with no retest of the lows. To explain how rare that is, there has only been one bear market since 1950 that did not, at some point, go back and retest the previous lows, and that was in 1982, when Fed Chairman Paul Volker finally declared victory in his war on inflation and dropped short-term interest rates from 22% to single digits in a few short years. It is noteworthy that the current recovery was similarly catalyzed by a monetary policy decision, as March 23rd was not just the date of the equity market lows, but also the date when the Federal Reserve announced the return of their quantitative easing programs, and at a size and pace far in excess of their QE1, QE2 and QE3 programs that helped to pull the domestic economy out of the Global Financial Crisis.

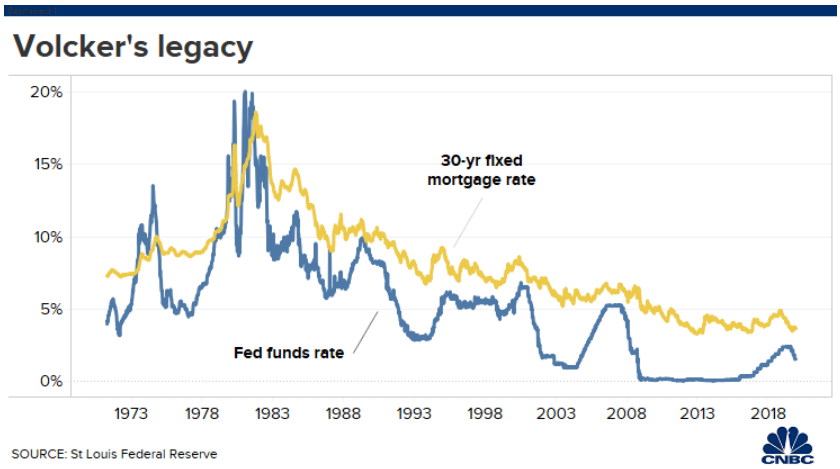
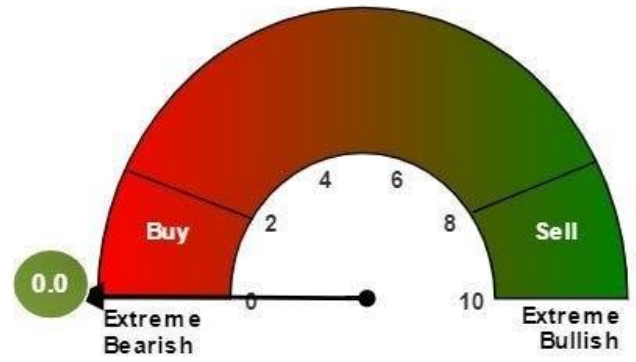
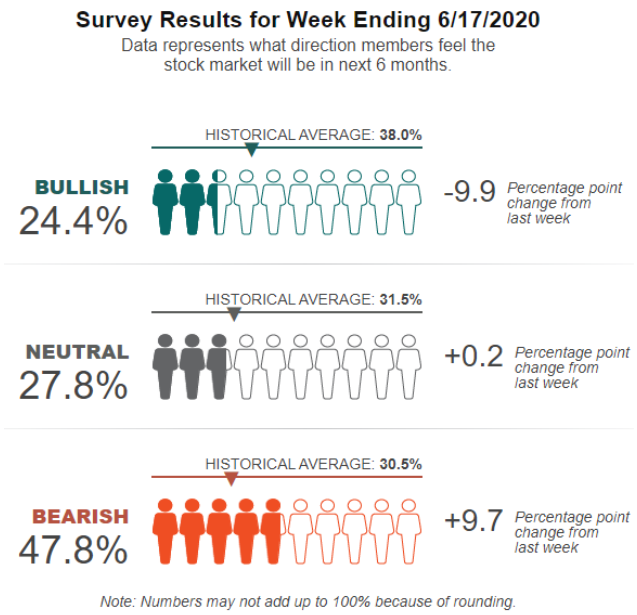


Chart 9: BofA Bull & Bear Indicator



Source: BofA Global Investment Strategy

To be clear, there are a great many justifications for the level of caution that we are seeing reflected in the current near-record levels of sideline cash and generally very bearish sentiment readings on the part of both most individual investors and institutional portfolio managers, which raises the all-important question, particularly in light of the historically very high market valuations, of whether the market's potential returns still justify the risks.



In the near term, we suspect that this new surge in coronavirus cases is likely to stall the equity market's impressive advance, and there is no doubt that there is growing evidence of significant speculation in the markets, which has historically provided a prescient warning sign, but may be less concerning this time, in light of the high level of caution among both professionals and the more traditional members of the investing public.

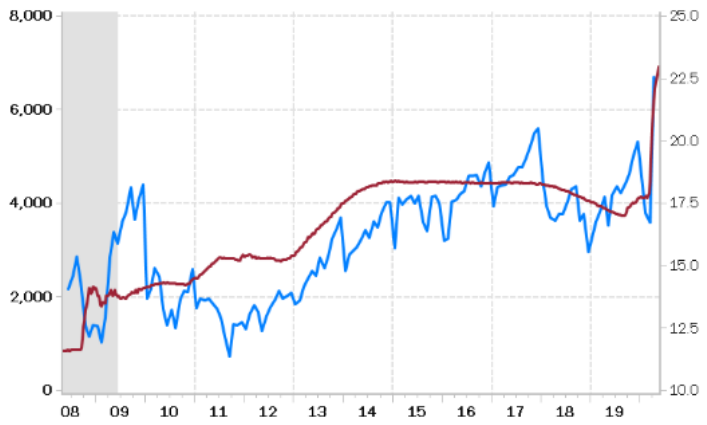
If there is one primary reason to remain invested in equities in the current market, it may be found in the truism that the Fed always gets what it wants and, in this instance, the Fed wants a stronger economy and higher prices for financial assets.

Sometimes the Fed is so clear in their messaging that investors ignore it at their own risk, as was the case during the Global Financial Crisis, when then-Chairman Bernanke announced at the Jackson Hole Symposium in November of 2008 that the Fed was going to use quantitative easing to increase the value of financial assets, thereby creating a wealth effect and stimulating consumer spending, which represents 70% of the domestic economy. Those that listened benefitted from one of the strongest bull markets in history. Those that did not found themselves much like many investors and portfolio managers find themselves today, on the sidelines, and badly underperforming the markets.

Obviously, the past is not necessarily prologue. However, Chairman Powell has been equally clear in his messaging in the current environment, first during his May 17th *60 Minutes* interview, when he responded to a question about whether or not the Fed had already done all that it can do. His response was that "we're not out of ammunition by a long shot. No, there's really no limit to what we can do with these lending programs that we have. So, there's a lot more we can do to support the economy, and we're committed to doing everything we can as long as we need to".

Just in case anyone was not paying attention, he reiterated on June 10th his commitment to use the Fed's literally unlimited ability to create credit when he said in a press conference that "We just — we want to be there if things — if things turn bad in the economy or, you know, if things go in a negative direction, we want to make sure that — that we, you know, that we're there".

CHART 2: Fed Balance Sheet Moves In Lockstep With The Expanded P/E Multiple
United States
(red line; left axis; reserve bank credit outstanding; $ billions)
(blue line; right axis; S&P 500 forward P/E estimate; ratio)

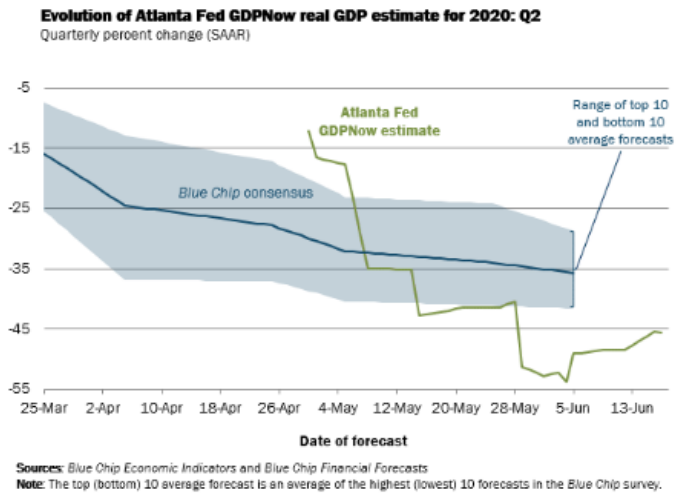


Shaded region represents period of U.S. recession
Source: Haver Analytics, Rosenberg Research

However, the Fed's market influence does not stop with Powell's reassurances, or the aforementioned March 23rd announcement that the Fed was renewing its quantitative easing programs. It is also no coincidence that, since the end of March, the Fed's balance sheet has expanded by $3 trillion, while the market capitalization of the S&P 500 has increased an eerily similar $2.8 trillion, and that the correlation between the forward-looking price-to-earnings multiple of the S&P 500 Index and the size of the Fed's balance sheet is now above 90%.

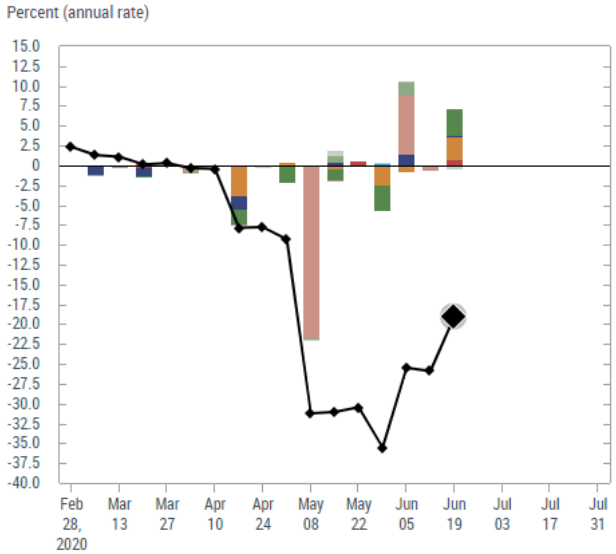
We cannot imagine that we will see a continuation of the low-volatility, one-way-trading environment that has defined the environment for domestic large-capitalization stocks since late March, and are acutely aware of the fact that, between a deep recession, a potentially worsening pandemic, and an apparent misalignment between stock market valuations and the real world, the Fed and the government certainly have their work cut out for them.

To put the economic backdrop into some perspective, we will turn to research from two of the Regional Federal Reserve Banks, in this case the Atlanta and New York Feds, which produce "nowcasts", which attempt to provide a real-time snapshot of the condition of the domestic economy.

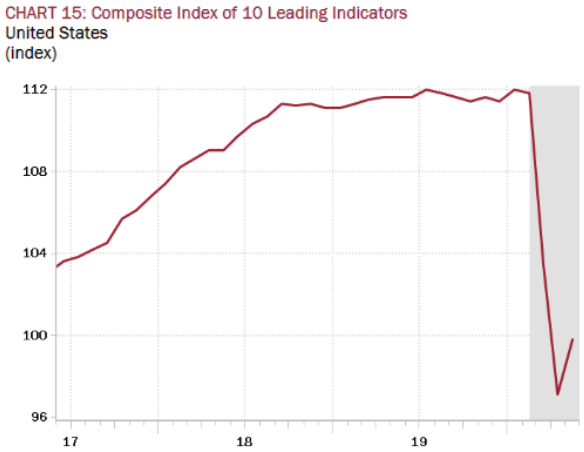


The more bearish has been the Atlanta Fed model, which estimated that, at its trough, the U.S. economy was contracting at a -54% rate on an annualized basis, but that the rate of contraction has now improved to a still horrendous -45%, albeit at least moving in the right direction.

The New York Fed model (right), has been less bearish, with the peak contraction calculated at a still very depressed -35%, but with estimates that the economy has rebounded fairly impressively to a -19% rate of contraction, which is still historic.



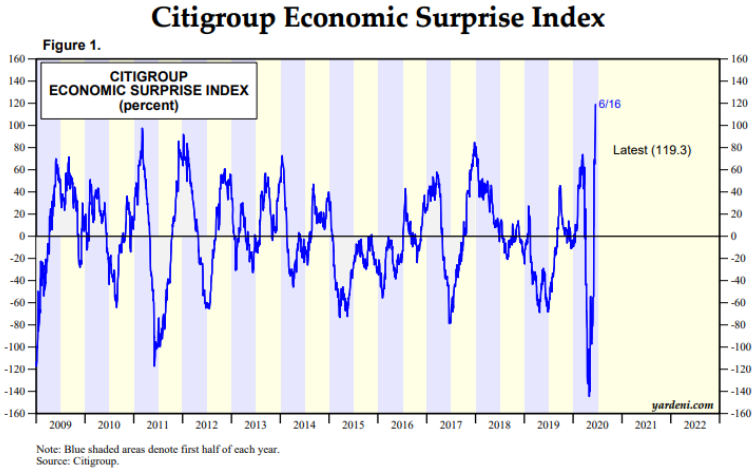
The strength of the rebound and how long the economy stays at these depressed levels will be all important, as that will determine the magnitude of the overall damage to the economy. Of particular importance will be the magnitude of the damage relative to the magnitude of the fiscal and monetary stimulus offsets. If the economy can rebound sooner and/or more strongly than expected, the stimulus may actually turn out to be outsized relative to the actual economic damage, an outcome that would very likely produce stronger than expected economic growth, better than expected corporate profits, and higher than expected levels of future inflation. At least thus far, there is a growing body of evidence that supports that potential outcome.



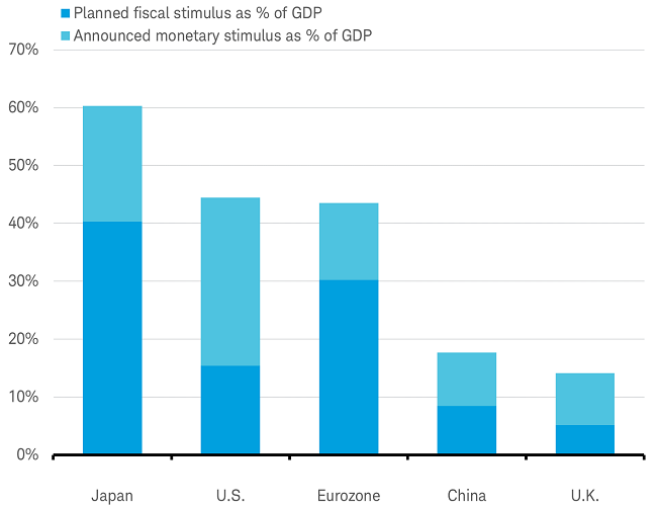
Shaded region represents period of U.S. recession
Source: Haver Analytics, Rosenberg Research

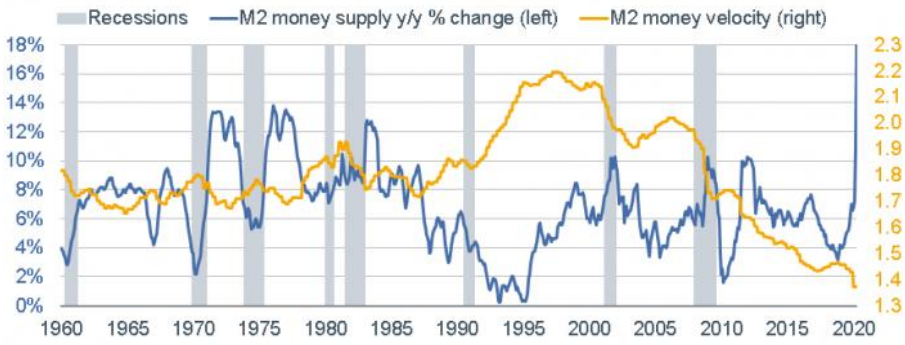
This more optimistic intermediate-term outlook is being further supported by the various composites of leading economic indicators (i.e., economic data that historically tends to presage future general economic trends).

Equally important from the perspective of the markets is how actual economic data is coming out relative to expectations. The importance comes from the fact that market prices are based upon future expectations, and when data comes out much differently than expected, prices need to adjust up or down to price in the new reality. This is exactly what is measured by the Citi Economic Surprise Index, which is indicating that economic data is coming in much stronger than was expected, and that the rebound, particularly in employment, seems to be about a month ahead of consensus expectations.



As noted, also important to consider is the size of the stimulus versus that of the economic damage. Even if you use the very pessimistic reading of -54% at the depths of the Atlanta Fed "nowcast", that is an annualized number, so it is really only -13.5% per quarter. If that lasted for two full quarters before recovering, which we think is a dramatically overly-pessimistic scenario, that would be an economic contraction of 27%. By contrast, combined domestic monetary and fiscal stimulus now totals 44% of U.S. GDP, which means that there is every possibility that the economy could end up growing much faster overall than it would have if not for the coronavirus shutdown. Indeed, according to Rosenberg Research, the level of GDP (economic output) "could end up being $3 trillion greater than would have been the case without the crisis".





On top of that, we still have an explosion in monetary liquidity, where money supply (blue line) has increased by 20% over the past two months, while the willingness to spend money (velocity: gold line) has collapsed. If it is not being spent, it is being saved and invested and, in such circumstances, "money tends to flow where it is treated best". Over the intermediate and longer term, we believe that will most likely continue to be in the stock market.

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