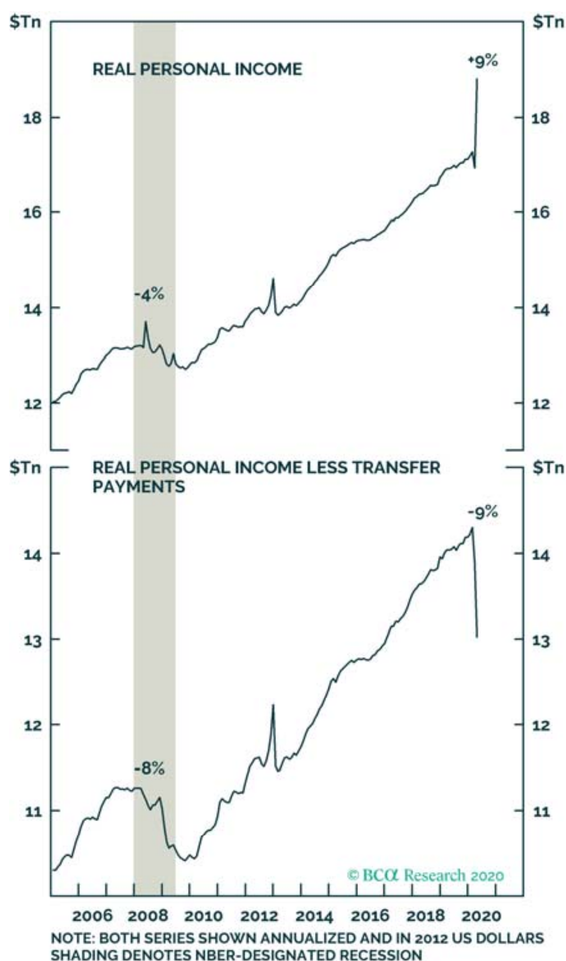
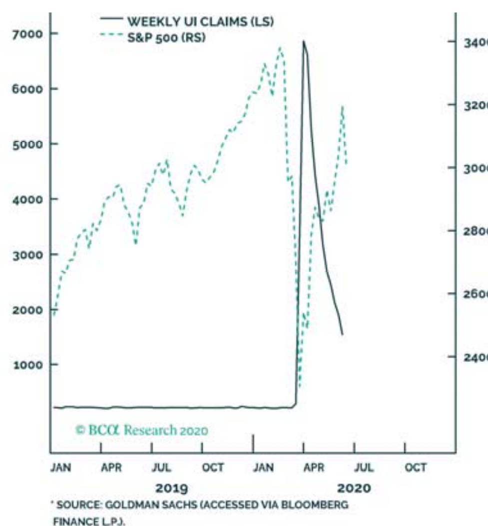
Notes From the North: Market Outlook

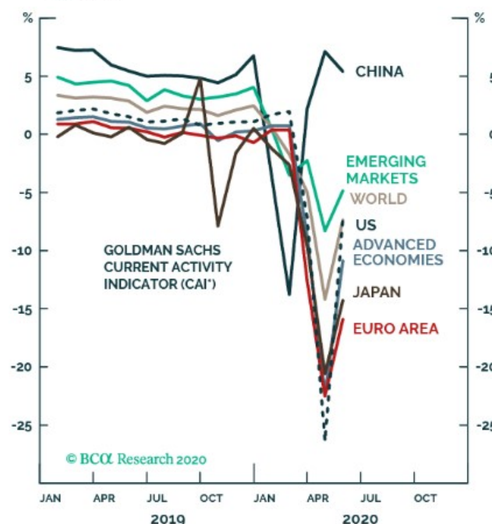
June, 2020

How can stock prices have diverged so dramatically from the economic trends, especially when the trends are so visible in the world right in front of our eyes? The best explanation is that stocks are focusing on the future and responding to powerful monetary and fiscal policy stimulus measures taken in recent months. The Federal Reserve moved first with monetary policy (which we discussed last month), and Congress followed up with a powerful dose of fiscal stimulus shortly thereafter, the *Coronavirus Aid, Relief, and Economic Security*, or "CARES" Act.

State unemployment insurance typically provides a small footbridge to help workers get over an employment lapse without getting swept downstream. The chart below, left, illustrates how the stimulus checks and the federal unemployment benefits of the $2 trillion CARES Act turned a 9% overall personal income decline into a 9% increase in personal income. The CARES Act constructed a veritable Golden Gate bridge! (The bridge is so sound and the view so spectacular, in fact, that quite a few employers have had trouble enticing their workers to leave their federal benefits behind and return to work.) The recently announced spike in May retail sales should not have surprised anyone. Note, however, that the federal unemployment benefits are set to expire at the end of next month, and Democrats and Republicans are having more trouble agreeing on the nature of what will replace those.







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BCA notes that the rebound in stocks tracked the peak in initial unemployment claims (previous page, top right) and the trough in current activity indicators (previous page, bottom right). While BCA is cautious on the nearer term outlook, they still expect stocks to out-perform fixed income over the next 12 months. Their longer term expectations for various categories and their proposed asset allocation for a typical balanced account are shown in the table below:

10-Year Asset Return Projections

COMPOUND % RETURNS P.A.			
	THE PAST 1982-2019	THE FUTURE 2020-2030	PORTFOLIO WEIGHT
US EQUITIES	11.5	4.0	40
OTHER DEVELOPED EQUITIES	9.1	5.5	20
EM EQUITIES	12.5	7.0	5
10-YEAR TREASURIES	7.3	0.7	25
CORPORATE BONDS	8.2	3.0	10
TOTAL PORTFOLIO*	9.7	3.5	100
U.S. INFLATION	2.7	2.0	
TOTAL PORTFOLIO REAL RETURN	6.8	1.5	

* BASED ON WEIGHTS IN FINAL COLUMN.

Keep in mind that these figures do not reflect the possible benefits of rebalancing amongst the asset classes. The tried and true process of maintaining asset class targets, trimming back the ones that outgrow their targets and adding more to the ones that seem to need fertilizer may sound tame, but it can add to the expected return of a balanced account. It also has the great advantage of helping to corral the emotional and return-reducing reactions that tempt investors to buy high and sell low.

We generally don't recommend dramatic moves such as the one recently announced by strategists for the Grantham Mayo Otterloo ("GMO") "Benchmark-Free Allocation Strategy." GMO thinks the market has priced in the best possible scenario for economic recovery, while ignoring the many uncertainties that could depress stock prices. In mid-May, the team made a bold decision to reduce their product's net equity exposure from 55% to 25%. Interestingly, however, they did not increase their bond or cash exposure. Rather, they used the proceeds to buy the most undervalued stock sectors while shorting the most overvalued sectors. Given the rather meteoric recovery in the market, we tend to agree with the thought process underlying the strategic change even if we don't agree with the tactical shift they took. We are not finding a vast assortment of new positions that offer the right combination of quality and value we seek. For the most part, we continue to stay the course and stick with the high quality stocks that have given us good long term returns. Many of these companies are weathering the storm relatively well and they should gain market share during this period of stress when weaker rivals may struggle to invest in new factories, equipment or acquisitions.

Martha Cottrill, CFA	Carl Erickson	Edmund R. Taylor, CFA
Principal	*Principal*	*Chief Investment Officer*

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