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ECONOMIC & MARKET UPDATE

The third quarter was another positive one for the financial markets. Stocks continued their dramatic recovery from the March lows, reaching all-time highs in August before undergoing a correction. They ended the quarter on a strong note. Bond yields were steady during the quarter, remaining at very low levels and providing positive returns. We believe the portfolios have performed well given the overall environment.

> “In three words I can sum up everything I’ve learned about life: It goes on.”
>
> – Robert Frost

Even though the time, date, and circumstances under which these words were spoken cannot be identified, they are widely attributed to Robert Frost, one of the most famous American poets of the 20th century. We choose to use them even if he did not speak them, for they are a useful way of expressing optimism in the midst of the pandemic that we continue to find ourselves suffering through. It is important in times such as these to remember that, indeed, life does go on. The general sentiment holds, and we specifically direct it to the world of economics and investment. In this letter we will put forth a cautiously optimistic view of the U.S. economy and financial markets. It is too early to be fervently optimistic, but we are far enough along to begin viewing the future more constructively, we believe.

A NEW CYCLE OF RECOVERY/EXPANSION Economies consistently expand for only so long. They are always subject to periods of contraction, called recessions, after which they begin a recovery phase until economic activity surpasses previous peaks. Then, expansion begins. This sequence gives rise to the term “recovery/expansion,” which describes the full upward cycle. For our purposes, we are assuming that this recovery actually began at the nadir of economic activity in March/April of this year.

It was not long ago that our economy was enjoying the longest recovery/expansion in U.S. history, lasting into its 11th year. That benign state of affairs was rudely interrupted by the sudden arrival of COVID-19, the resulting near shutdown of the economy, and the largest economic contraction of the last 90 years. This is a perfect example of an exogenous event, for COVID-19 arrived out of nowhere, was not expected, and wrought tremendous damage to the economy. The recession of 2020 was different from others, for it had little to do with underlying economic conditions prior to the recession. This is not to imply that all was perfect, but the economy was reasonably well balanced and enjoying near-full employment. Things were pretty good.

The fact that the economy was functioning well going into the recession is at the core of our view that recovery has begun and can be sustained. And, we are encouraged that the recovery is proceeding at a rate that exceeds early estimates. Both Gross Domestic Product (GDP) and employment, the two broadest measures of economic activity, are recovering faster than expected. These measures are still deeply depressed but moving in the right direction. Their depressed state is a reminder of just how far we have to go, but the important thing is that the recovery has begun.

While the circumstances under which the Great Recession occurred are different from those of the current one, there are lessons to be learned from the aftermath of that recession. Recall that the recovery was aided by both monetary and fiscal stimulus. The Federal Reserve (Fed) maintained federal funds at 0% for seven years, and the Obama stimulus package created large federal deficits. Fear ran high that these aggressive measures would lead to high inflation, but that never materialized. Instead, the economy recovered at a brisk pace initially and then settled into an economically sustainable growth rate of around 2% per year. It was able to be sustained for its 11-year duration because inflation remained dormant and monetary policy was very accommodative.

It would be naive to assume that the current economic recovery/expansion cycle will be a duplicate of the previous one. But, its path can be similar if inflation remains low, enabling low interest rates and supportive monetary and fiscal policy. It is generally accepted that the sustainable growth rate for our economy is around 2%. This takes into account low growth in the labor force and low productivity increases, the two major factors that produce economic growth. We conclude that we are in the early stages of a new recovery/expansion cycle, which, like the previous one, has the potential to endure for a number of years. We caution that there is nothing straight-line about economic recoveries. They tend to move forward in fits and starts but result in overall progress, and we expect the same for this one.

A NEW BULL MARKET IN STOCKS Economists like to point out that the stock market is not the economy, and the economy is not the stock market. True, and the last few months provide ample proof since the stock market has rallied to new, all-time highs in the midst of tremendous economic turmoil. In fact, the economy and the stock market do not move in unison, at least over the short term, but over the long term, companies need an economy that provides an environment that is sufficiently constructive in which to operate successfully. In the long run, the economy is essential to the stock market.

The stock market is always looking ahead and discounting the future, and currently it is expressing its belief that things are improving, and the economy will be getting back on its feet in a reasonable amount of time. There are other factors as well that are supporting stocks. Long-term interest rates are very low and are expected to stay low. Investors apply a discount rate to future earnings and dividends. When the discount rate is low, the present value of those discounted future flows is worth more, hence higher values for stocks. Finally, the other major asset class, bonds, is providing such low yields that many investors are choosing stocks instead. This is popularly expressed as TINA: There Is No Alternative.

As noted above, some of the popular stock indices reached all-time-high levels in August. What is the significance of this? Importantly, from a technical standpoint this signaled the beginning of a new bull market in stocks. The sharp decline in February and March took stocks down into bear market territory, and now the sharp recovery has put them in bull market territory. For sure, all stocks have not reached new highs, and one disturbing aspect of the stock market today is the heavy weight that a few companies occupy in the indices. It is always healthier for the upward movement in the market to be broad and inclusive. Nevertheless, this milestone of new highs is important, for it opens up the possibility of thinking differently about the coming years and how stocks might perform.

Our view on stocks does not preclude stock market corrections. In fact, we are in one now, a development that should come as no surprise considering the strong run that stocks have enjoyed. Also, there is some hesitation about how sustainable the recovery can be without further fiscal support. Corrections can be good things as they

help to wash out excesses in investor behavior and restore balance. As such, they can represent an opportunity for longer-term investors.

BONDS HAVE DONE THEIR PART Bond yields have declined sharply, reflecting the depressed state of economic activity as well as Fed policy. We expect yields to remain low for a considerable time, although relatively small increases in yields could be possible as the economic recovery gains strength. Low yields are important as they provide economic stimulus by encouraging borrowing. And, as noted above, low yields support higher stock prices. Until inflation and inflation expectations rise, we expect bond yields to remain low.

CONCLUSION In this letter we express optimism that the economy has endured the worst of the current recession and is now in recovery, one that has the potential to last a long time. We also note that a new bull market is underway for stocks. Low interest rates support both the economy and the stock market; we expect that support to be maintained. But what we have not expressed is the pace at which the recovery may proceed and when it will enter an expansion phase. A lot depends, of course, on the COVID-19 pandemic and how it is controlled, managed, and eventually ended. Nor have we speculated as to the rate of return that investors might expect from stocks in the new bull market. On both scores we are cautious. The economy still has many issues, and stocks are not cheap. On one thing we are clear: we will continue to invest for the long term in the highest-quality securities we can find.

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