October 2020 Market Commentary

## *Helter Skelter*

***"When I get to the bottom***
***I go back to the top of the hill***
***Where I stop and turn and I give you a thrill***
***'Till I get to the bottom and I see you again***
***Yeah, yeah"***

**The Beatles.** John Pratt/Keystone/Getty

https://www.youtube.com/watch?v=qEzBQL87ywY

"Helter Skelter" may just be the perfect market anthem for 2020; up, down, sideways, round & round, woo-ooh, the S&P 500 is **up 5.58%** through three quarters! What will the fourth quarter bring… helter skelter.

Humans and markets love predictability; a certain rhythm to life, unfortunately 2020 has shattered our rhythm. Nature continues to dance to that rhythm: in the way that the sun rises and sets, in the way that rainy Aprils give way to steamy Julys, giving way to crisp Octobers, and cold January's.

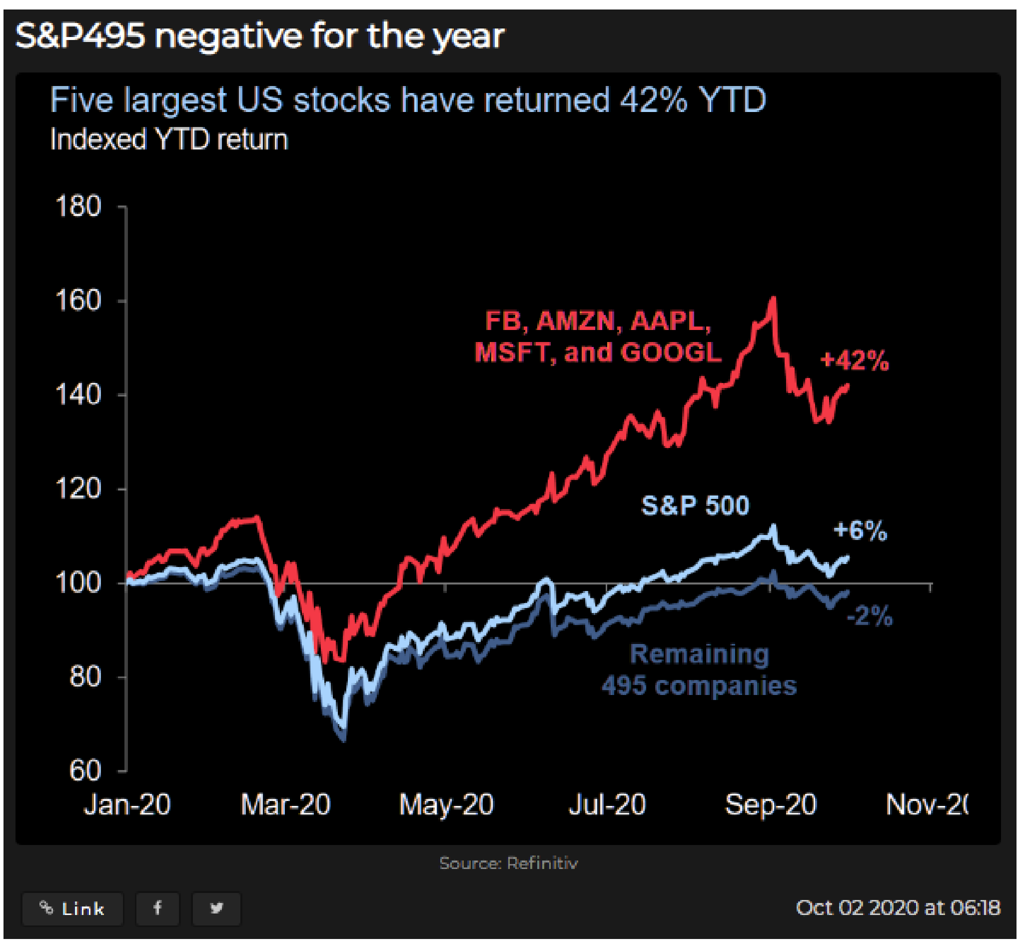
For us though our rhythms are broken. Our daily commutes, the radio DJ's morning reports, the pleasantries exchanged with the barista, the water cooler talks with coworkers are missing. Packing lunches, getting children off to school, attending football games, casually hanging out with friends on the weekends, all gone.

This lack of rhythm is disconcerting. There is peace in rhythm. There is a sense of security and predictability. Not a stagnant sort of predictability, just enough to make us feel like everything is going to be okay. Today we have chaos, helter skelter, we don't know what to expect from one minute to the next. Have you even thought about making plans for your Christmas holiday?

Markets generally abhor unpredictability; they like to follow the rise and fall of the business cycle, the ebbs and flows of supply and demand, cause and effect. 2020 has no natural predictability, we've had a government mandated great recession, and now an attempted government orchestrated recovery. We have no way of forecasting, because there is nothing natural, it is all artificial.

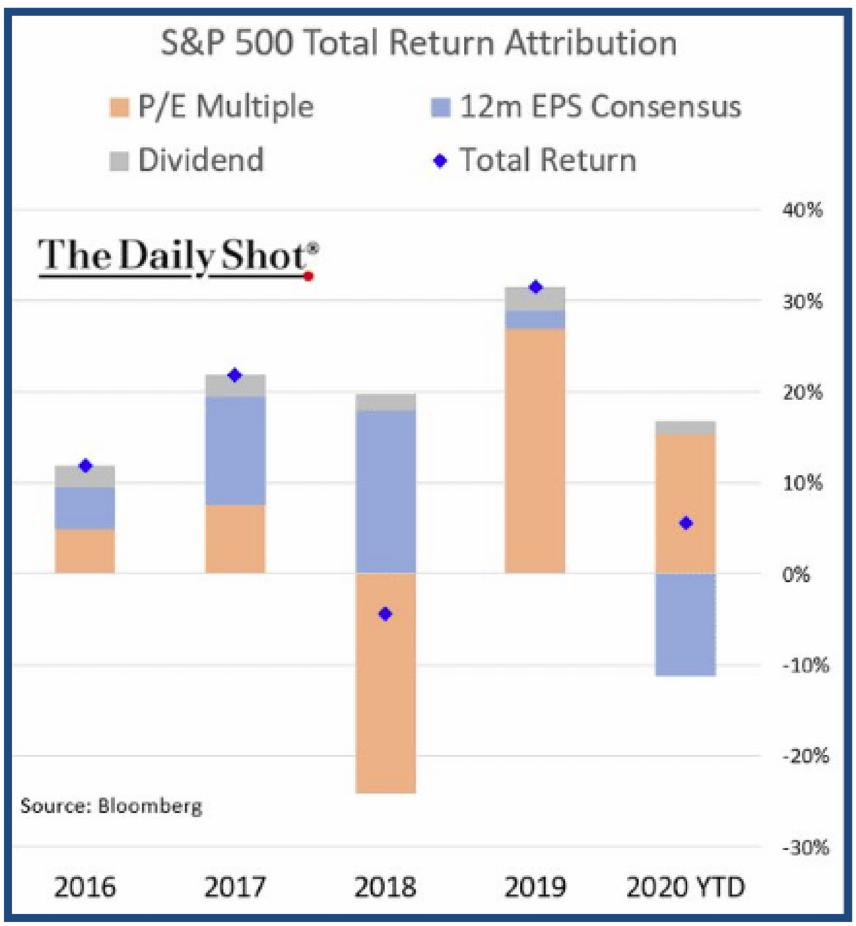
Why are stocks even up in 2020? Because they've been orchestrated to rise. The Fed forcing rates to zero along with the massive amounts of fiscal stimulus have forced investors to take on risk. It doesn't feel right because it's not natural.

And not all stocks are up; in fact if you take out the five largest stocks in the S&P 500 the index would actually be down 2% year-to-date.

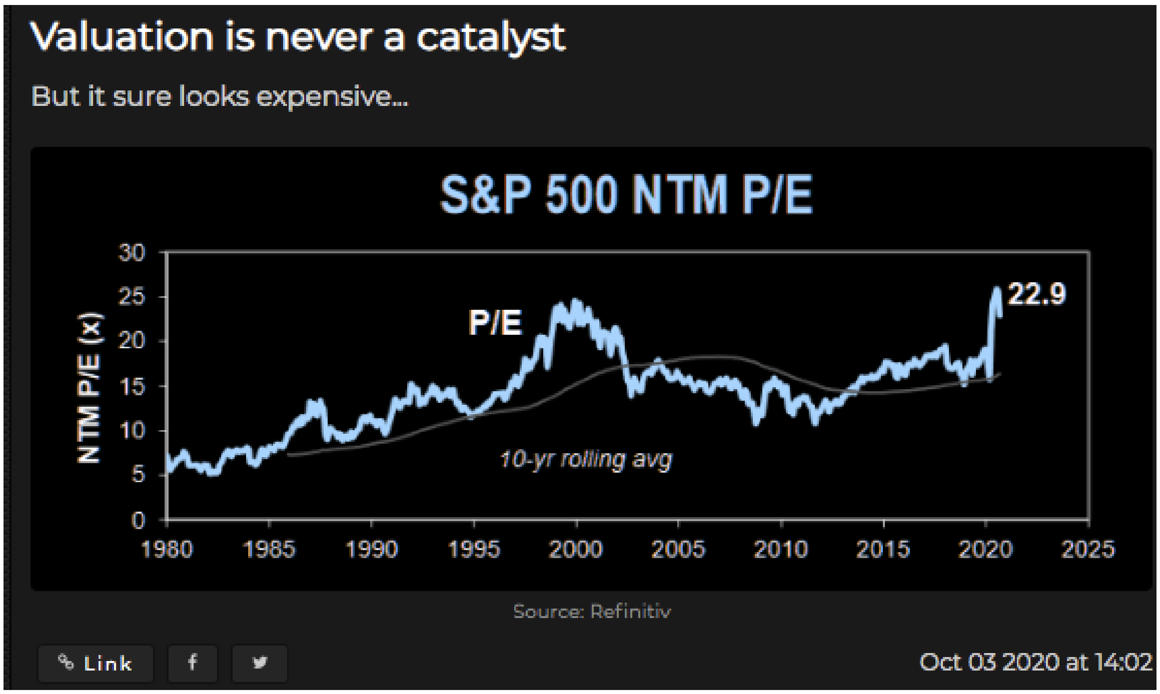


In times of great uncertainty I often find myself getting back to basics, some tried and true fundamentals. Lets look at the total returns of stocks. Returns on stocks are made up of three factors: Earnings Growth + Dividend Yield + the Change in P/E Multiples. Historically earnings growth has nearly equaled long-term nominal GDP growth of about 5%. Long-term dividend yields have been about 3%, and the change in P/E multiples have averaged a positive 1%. Hence the long-term total return on stocks is about 9% (5% + 3% + 1%).

This is the long-term, and the long-term is made up of many short-terms that are significantly more volatile. Dividend yield is the most stable of the three factors and the current yield on the S&P 500 is 1.66%. Earnings changes can be a bit more volatile, especially when you have tax changes or recessions, and the change in P/E multiple is the most volatile. I often call this Psychology/Earnings instead of Price/Earnings, because we are dealing with what individuals are willing to pay for future earnings streams. What is surprising about 2020 is that nearly all of the markets positive return has come from multiple expansion in the biggest growth stocks. Zero interest rates and massive amounts of uncertainty have forced investors into those few large growth companies.



This P/E expansion has caused stocks (especially those big growth stocks) to trade at historically high levels. The chart below shows the P/E ratio of the S&P 500 based on NTM (Next Twelve Month earnings estimates). While these numbers rival the peak numbers in 1999, valuation indicators are not good market timing indicators since stocks can trade at lofty levels much longer than expected (especially when we have so much fiscal stimulation from the Fed and Washington).



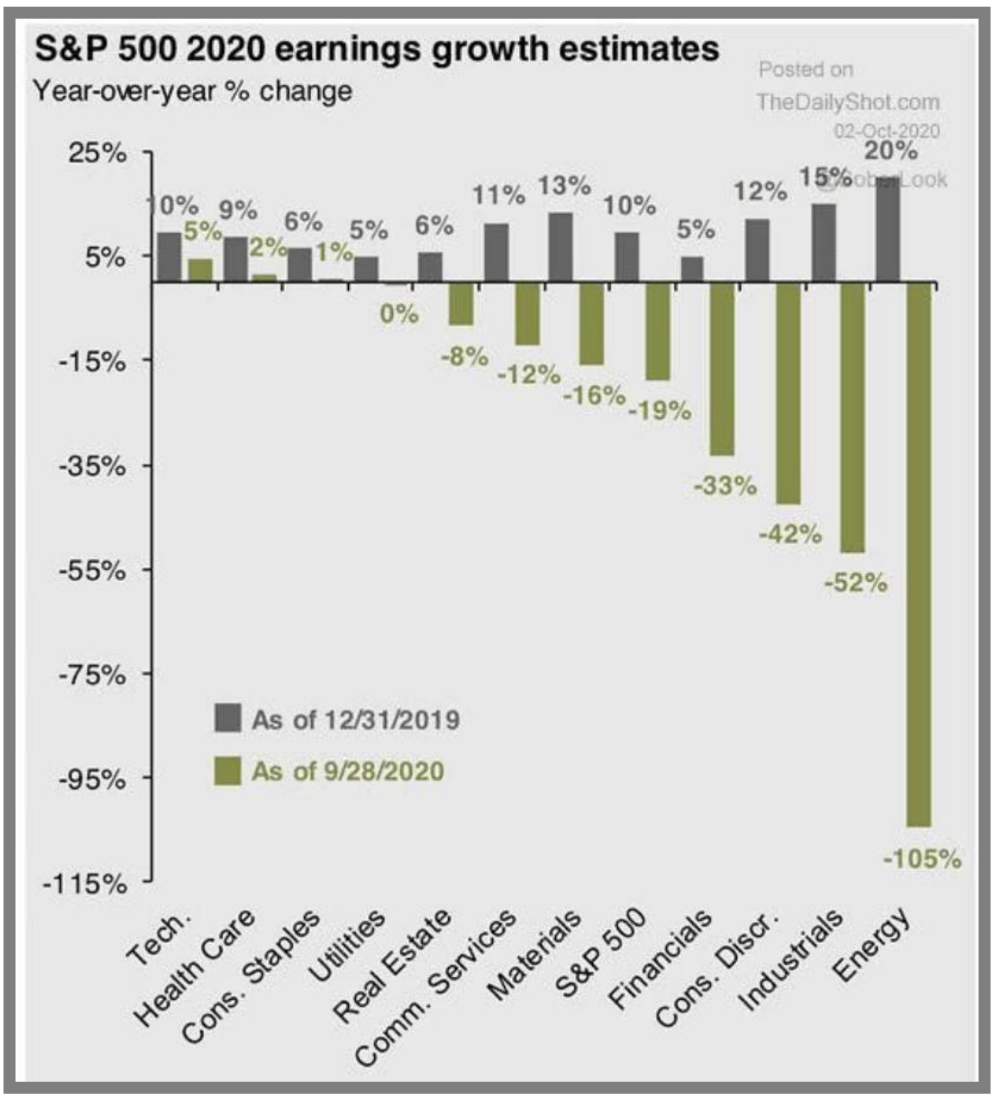

Okay, lets get back to our total return model (TR = Div. Yld + Earnings Growth + P/E Change). At the beginning of 2020 this is what the model looked like:
Dividend Yield = 1.74%
Projected Earnings Growth = 10%
P/E multiple expansion or contraction = -3%
Equals a projected Total Return of about 8-9%

Obviously things have changed a bit since January. Now we are expecting S&P 500 earnings to be down 19% instead of up 10%. But amazingly P/E multiples have expanded by about 15% instead of contracting 3%.

Do you want to try and look forward into 2021? Helter Skelter. Okay, we know the dividend yield is 1.66%, so we've got that number. How about earnings estimates? Most analysts expect earnings to rebound by about 24% in 2021 from 2020's depressed levels, this is still about 5% below 2019's level. Now what will investors be willing to pay for these earnings? Will record high P/E multiples expand, contract, or stay the same? Your call.

For me I'll try and focus on the long-term, a dividend yield of 2%, earnings growth following nominal GDP growth of about 4%, and nothing from P/E change, for a Total Return of 5-6%. Please don't hold me to this!

***"Tell me, tell me, tell me the answer***
***You may be a lover, but you ain't no dancer***
***Helter Skelter***"



As 2020 enters it's final quarter and 2021 approaches I hope we can find our rhythm again. Just like the change of seasons, the rising sun, and the shifting tides, we need to find some predictability in our lives and our economies. It may not be like our old routines, but we need to strive for the new normal, something that brings order out of the chaos, no more helter skelter.

As always, be careful out there.

Chris Wiles, CFA

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