Economic & Market Commentary

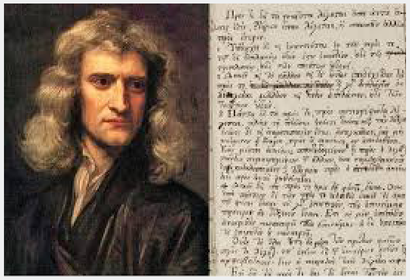
Fall 2020

The Federal Reserve Changes Its Approach

Jackson Hole is not the normal venue for announcements of significant changes in monetary policy. This year, like everything else about 2020, offered a surprise. Meeting at its annual retreat in Wyoming, the Federal Reserve Open Market Committee stated its intent to allow inflation to run above its long term target for an extended period following a period of below-target price readings. It will now emphasize average inflation in its decision process. The days of adopting tighter monetary policies when inflation approaches a target are over, for now.

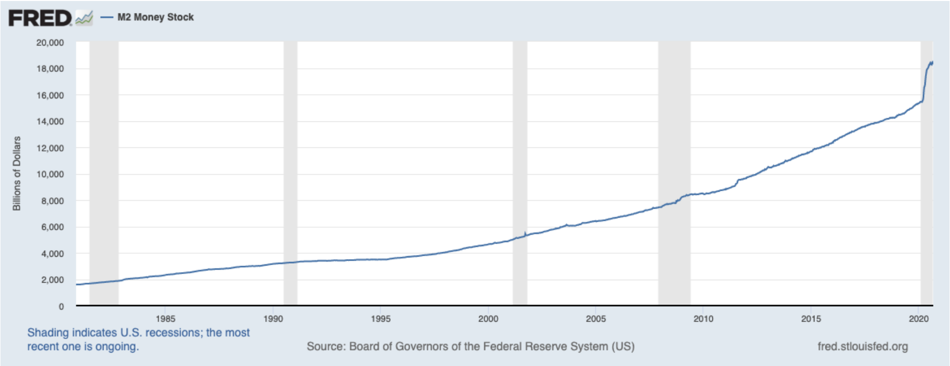
Some Laws Are Far-Reaching

Sir Isaac Newton was a 17th century physicist and mathematician. Principia, his primary work, set forth laws of motion and gravitation proven correct centuries later. He, alongside Albert Einstein, is considered the greatest scientific mind in history. His three laws of motion -- usually referred to as Newton's laws -- define the science of movement. The second of these laws states that when force acts on an object, the object will accelerate; in short, Mass X Velocity = Momentum. Physics also applies to the financial world, as we will see.



This action, at least in part, is recognition by the Fed that longstanding models were flawed. Following the end of the 2008-2009 credit crisis, and until the onset of the Covid-related economic downturn, a mantra of Open Market Committee announcements was that 'low inflation is transitory'. It wasn't. The predictive value of the Phillips Curve – the relationship between employment levels and inflation rates – failed. Similarly, concerns of higher inflation from massive monetary and fiscal stimulus have been unfounded – at least thus far.

What happened? Let's revisit Newton's second law. The mass – the broad money supply – rose steadily in the last several years, particularly in recent months. Higher secular inflation from rising money creation is not automatic – it must be accompanied by steady or rising velocity throughout the financial system. This second variable – the velocity of money moving in the economy – declined in the post-crisis era and collapsed with Covid-19 shutdowns. Thus no inflation momentum, then or now. See the charts below, courtesy of the Federal Reserve Bank of St. Louis, for the evidence.

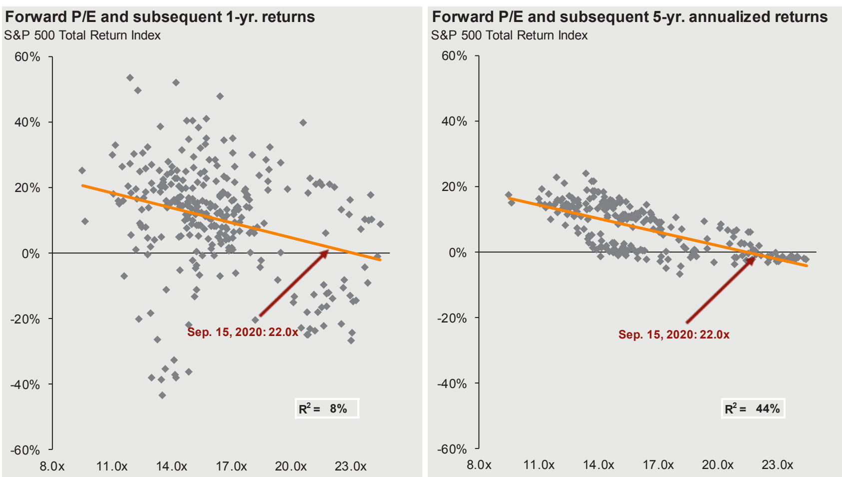


Let's return to Jackson Hole. The Fed's announcement is a clear signal to markets that interest rates will remain 'lower for longer'. The implications for investors are far-reaching. The first issue is the valuation conundrum. The chart on the next page – from J.P. Morgan's Guide to the Markets – shows the S&P 500 approaching its late 1990s peak valuation based on forward earnings projections. Other measures (price-to-book value, dividend yield, etc.) tell a similar story – stocks are expensive by all standard metrics – *except when compared to interest rates.*

The Half Empty Glass Is Also Half Full

There are two takeaways to this. We know that the best predictor of future returns is valuation at the starting point. Given that fact, the likelihood of outsized market gains over the next several years is low. While anything can happen near term (2020 is Exhibit A for this!), long term tends to be more predictable. Market data over the last quarter-century suggest little net progress for the S&P 500 over the next half-decade.

P/E ratios and equity returns



Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

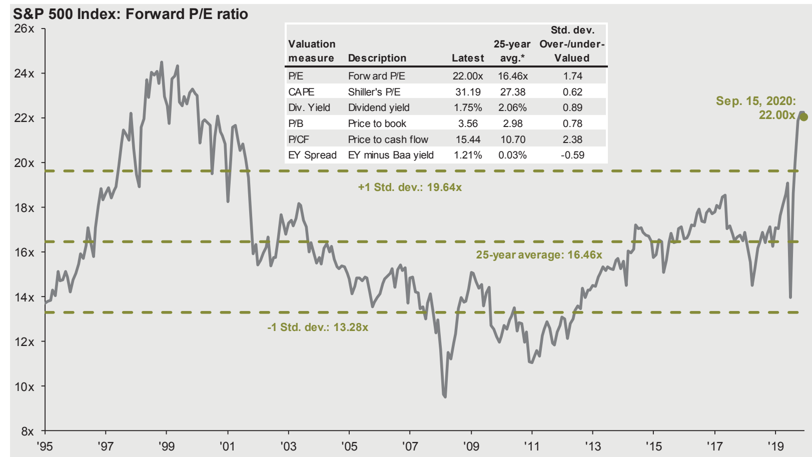
J.P.Morgan Asset Management

But consider the relationship between interest rates and equity prices. The two primary asset classes compete for investor dollars and, as discussed in last quarter's commentary, the level and direction of interest rates is a key determinant of the pricing of the stock market. If the Federal Reserve stays true to its word, low interest rates should place a reasonable floor under equity markets. A risk-free rate close to zero will continue to encourage a shift to risk-oriented assets. Even so, as noted above and below, the intermediate term prospects for U.S. financial markets are not equal to those of the past.

Vanguard's Capital Markets Model return outlooks, published in the firm's September 2020 Market Perspectives, show nominal annualized U.S. equity returns of 3.9% to 5.9% over the next ten years. Comparable projections for U.S. aggregate bonds are 0.7% to 1.7%. By inference, a portfolio balanced between U.S. stocks and bonds might have a midpoint target return of about 3.1% over the next decade (© The Vanguard Group, Inc., used with permission). While hypothetical and subject to change, this outlook (and it's consistent with others we see) suggests investors look beyond traditional asset classes for potentially higher returns.

Economic & Market Commentary is written by the Investment Services Department at Security National Wealth Management.

S&P 500 valuation measures



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	22.00x	16.46x	1.74
CAPE	Shiller's P/E	31.19	27.38	0.62
Div. Yield	Dividend yield	1.75%	2.06%	0.89
P/B	Price to book	3.56	2.98	0.78
P/CF	Price to cash flow	15.44	10.70	2.38
EY Spread	EY minus Baa yield	1.21%	0.03%	-0.59

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

J.P.Morgan Asset Management

The Re-Emergence of TANSTAAFL

After a decade of the investment winds at our backs, we will be re-acquainted with one of the oldest concepts of investing – There Ain't No Such Thing As A Free Lunch. Higher prospective returns may be available, generally from today's underrepresented asset classes – emerging markets, private equity and debt, and the like. At the same time, the risk components of these non-traditional sectors – lower credit quality and limited liquidity are just two – are greater than for major market stocks and bonds. This may lead to elevated volatility; those in search of enhanced returns will need to be prepared.

Our Position

Neither of the two major asset classes are poised for outsized gains over the intermediate future. Cash will not provide a noticeable positive return. Our strategy will be in two parts. U.S. stocks and bonds will remain core positions in portfolios under our management. We will expand representation in non-traditional asset classes where appropriate. Attention to valuation and overall risk control will remain paramount. Equally important, we will work with clients to help insure portfolio structures are consistent with the goals they want to achieve. Mutual understanding of goals and expectations is always important, and is particularly so today.