Fourth-Quarter 2020
American Portfolios Quarterly Market Commentary

by Chief Investment Officer Clifford T. Walsh, CFA

AFTER AN UNPRECEDENTED 2020, the upcoming year appears to offer a relatively tame outcome, but only because of how much last year deviated from the norm. In our view, 2021 will experience significantly more impact-producing events than most. Not only will the economy fully reopen following the rollout of the COVID-19 vaccines, spurring significant changes in behavior and economic activity, but new presidential and Senate leadership will drive a shift in agendas with far-reaching effect.

THE WASHINGTON FALLOUT

Without a doubt, the area with the greatest potential to impact corporate America and the financial markets in 2021 and 2022 are the changes in White House Administration and the loss of the simple majority in the U.S. Senate by Republicans. President-elect Joe Biden has an aggressive agenda for his term. We expect mixed success in implementation and will attempt to handicap the more relevant issues and likelihood of success.

While many are calling the election results a “Blue Wave,” we don’t think the term is appropriate. The Democratic wins will certainly pave the way for more left-leaning legislation, but almost all legislation requires 60 votes in the Senate. This means that Republican cooperation will be necessary, and it is not very likely. Some fiscal-related measures can pass with a simple majority using the budget process and, as President, Biden will have two chances this year to use the reconciliation process for his economic stimulus plan, which he most certainly will do should Republicans fail to support such plans.

With respect to other areas, the 60-vote requirement to cut off debate and proceed to a vote necessitates getting GOP support, which will temper the more ambitious elements of Biden’s agenda. Overall, the political changes open up some gridlock, but the Republicans still have some power to restrain more aggressive pieces of the Democratic agenda. We do not think this parallels the 2008 sweep that brought filibuster-proof, 60-plus Democratic seats in the first two years of President Obama’s first term. Biden is inheriting the weakest majority dating back to 1900, which will impact his effectiveness.

In fact, the Democrat lead in the House is only 10 seats, down from 36 before the 2020 election. History indicates that the party of the president loses seats in the House in the midterms; it seems doubtful that the Democrats will offer a lot of risky policies unless they want to lose House control, which, of course, they do not. We believe the odds now favor the GOP to reclaim the House in 2022. The Democrats will have to move fast, but tread carefully. Therefore, it is unlikely that Biden will achieve anywhere close to all of his agenda. Perhaps that is why the markets reacted positively to the runoff elections in Georgia with the two Senate wins indicating further economic stimulus, but with reduced risk of out-of-control spending.

STIMULATION CONVERSATION

We believe there is a good chance of sufficient bipartisan support for an economic stimulus package that addresses four key areas: state and local aid; expanded unemployment benefits; funding for testing and vaccine distribution; and another round of payments to individual citizens. Small business support could be included, as well.

We think this package could pass in the first quarter and be a solid short-term boost for the economy. Democrats will need Republican support in the Senate, so the risk is that it could take longer. Furthermore, if the reconciliation process is needed instead (because of Republican opposition), it could take longer to pass, as it requires more steps and would take place after a possibly lengthy standoff.

WILL THE TAX MAN COMETH?

Unlike COVID-relief legislation, which some Republicans might support, there will be little Republican support for tax increases, which makes it very likely that Democrats use the reconciliation process to raise taxes. Social Security is protected during the reconciliation process, but there are no procedural obstacles to raising other taxes via reconciliation.

Congress will likely reverse some of the individual income tax changes that passed in 2017 after President Trump was elected. A net increase in personal taxes is possible; however, it will certainly be more progressive with rates in the top income bracket increasing the most. A restoration of the state and local income and property tax deductions is possible, but not necessarily probable. The 2017 tax law limited this deduction to $10,000. Restoring this deduction is expensive and regressive, which is likely to lead some progressive Democrats to oppose the change. A few Democratic senators whose states have low- or no-income taxes might also push back at raising personal taxes to restore that deduction.

Capital gains taxes are unlikely to rise as much as Biden has proposed, which threatens to raise these taxes to equate to personal income rates. We think this is aggressive and likely to receive significant pushback. That being said, returning to capital gains and dividend tax rates in the high 20 percent range—similar to the 28 percent rate that President Reagan and a divided Congress agreed to in the Tax Reform Act of 1986—appears possible.

From a corporate tax perspective, Biden has proposed to raise the corporate tax rate from 21 percent to 28 percent; increase the effective tax rate on international intangible income; and to impose a global minimum tax on corporations, among other changes. There will likely not be sufficient support to implement all of these proposals, but there will likely be enough support to raise the corporate tax rate potentially to the mid 20 percent range and to incrementally increase taxation of international corporate income earned by U.S. companies.

THE RISK OF RE-REGULATION

We expect corporate regulations to increase under Biden's presidency, putting pressure on the broader economy. While regulatory changes cannot pass via the reconciliation process, Democratic control of the Senate will allow Biden to nominate officials who favor more stringent regulation than were previously in

place. Under the Congressional Review Act (CRA), Democrats could also overturn regulations that the Trump Administration implemented since August 2020 with a simple majority in the Senate. While there will most certainly be winners in the financial markets (i.e., clean energy) as a result of increased regulation, we expect it will be a deterrent to growth as it was under the Obama Administration.

THE FED AND INTEREST RATES

With all of the geopolitical changes occurring, the Federal Reserve (the Fed) has taken a back seat for the first time in a while. In the first half of 2020, the Fed took strong action to support the economy and financial markets, cutting the federal funds rate to a range of 0 to .25 percent, opening or expanding a very wide range of facilities designed to support different parts of the bond market, and doubling the size of its balance sheet. This was welcomed by the financial markets, likely fueling a notable increase in asset prices.

The Fed has stated that it expects interest rates to remain at emergency levels through 2023 and will allow inflation to “run hot.” At the current time, we do not see any reason to doubt this forecast. While supply disruptions and capacity contraction may put upward pressure on prices in some industries or geographic areas, we point to demographics and secular forces at play to balance this: the graying of America, excessive debt loads and technological innovation—all deflationary in nature.

We think the Fed will remain overshadowed by geopolitics during the next two years. While monetary policy will likely remain accommodative in the short to medium term, we expect its ability to support growth and stimulate the financial markets to wane, as it is unlikely to expand from here. This current phase is likely to be a challenging period for central banks with few remaining tools to provide additional stimulus or manage unexpected challenges, which is why we believe Fed Chairman Jerome Powell has increasingly discussed the need for fiscal stimulus, seemingly hoping to pass the baton to the government.

Should inflation pop up and “run hot” before we expect, the Fed could emerge from the shadows earlier than expected, but we view this as a low probability event at this point.

BELABORING THE LABOR MARKET

From an economic perspective, our biggest concern is personal income, or lack thereof, which is being suppressed by contracting labor and small business markets. We think this is the largest economic risk currently being overlooked by the financial markets. While the S&P 500 has long outperformed the broader economy, we are growing concerned that share repurchases will not be able to significantly offset declines in consumer spending to meet consensus earnings forecasts for 2021 and 2022.

There is still significant labor-market impairment. Currently, the U.S. economy is still 10 million jobs shy of February levels. Not to mention, nearly 20 million Americans are receiving some sort of government benefit. Recent jobs data shows that the recovery not only stalled in December, but actually contracted. Further deterioration is likely in the coming months, as indicated by the Conference Board’s Employment Trends Index, which declined modestly for the first time since May and is down more than 9 percent compared to a year ago.

Even if the government backstops the consumer once again, it will be on borrowed money, exacerbating an already-significant debt concern. Consumer spending is 70 percent of the economy during normal times, so this is a significant issue on which we will continue to stay focused.

PUTTING IT ALL TOGETHER

Combining all the moving parts and possible outcomes of the COVID-19 pandemic and changes in the White House and Congress is certainly no easy task. Despite solid price momentum as of late and general optimism in the financial markets, which could carry higher, we think the outlook for financial market returns in 2021 is muted and likely to be below long-term averages. Given current market valuation multiples, we believe a significant economic recovery has already been priced in.

It has become apparent to us that investment focus should become increasingly thematic and more selective than in the past because the equity markets, and financial assets in general, have become extended, with the risk toward the downside, in our view. Broader asset prices don't reflect the mid- to long-term economic outlook because the financial markets have been boosted by unprecedented fiscal and monetary policy stimulus, requiring nimbler and more focused asset allocation down to the industry and stock levels.

We think it is possible to see a significant shift from value to growth within the equity markets, but view it more as rebalancing of valuation or reversion to the mean than a rising tide that will lift all boats. Certainly, a more open and vibrant economy—our hope should the so-far inefficient vaccine rollout succeed in 2021—will experience the release of pent-up demand in many areas, but potentially be offset by a drawdown in the overheated goods sector and those businesses benefitting from the stay-at-home trend. Cyclical value sectors and industries, small cap stock, and international equities, as well as developed and emerging markets, have begun to close the performance gap with the previously high-flying U.S. large-cap technology and growth stocks. We think this is likely to continue in a post-COVID-19 market.

As far as the fixed-income markets are concerned, we have been advising against owning long-duration Treasuries for quite some time. Despite the recent selloff, which may be near a short-term bottom, we think it is too early to view this asset class as attractive. Democrats taking the Senate majority is a game-changer with respect to spending and borrowing, and likely to lead to lower lows from here. We believe this is only the beginning of a lower trading range in long-duration Treasuries, albeit those who have taken outsized bets against duration might want to consider reducing such bets closer to neutral.

As always, there are attractive investment opportunities to be had. In 2021, we think they may prove to be fewer and perhaps more difficult to find. We recommend balance with a small bias toward areas that underperformed during the economic pressure of 2020 as they are likely to offer the most upside in a recovery scenario.

In our next update, we will assess the first 100 days of Biden's presidency, which are certainly set to be interesting and impactful to the economy and financial markets.

QUESTIONS AND COMMENTS

Clifford T. Walsh, CFA
Chief Investment Officer
American Portfolios Financial Services, Inc.
631.439.4600, ext. 277
ctwalsh@americanportfolios.com

Samuel J. Rozzi, CFA
Manager of Due Diligence
American Portfolios Financial Services, Inc.
631.439.4600, ext. 136
sjrozzi@americanportfolios.com

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